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INTERVIEW | MONDAY, FEBRUARY 15, 2010

Up!

James Paulsen, Chief Strategist, Wells Capital Management

By JONATHAN R. LAING

AN INTERVIEW WITH JIM PAULSEN: Wells Capital Management's chief strategist is unique in his optimism for the economy and stocks -- and he makes a persuasive argument. Back to all-time highs for the S&P 500?

WELLS CAPITAL MANAGEMENT'S CHIEF strategist, Jim Paulsen, has become an outlier -- a single hand clapping -- on Wall Street. Amid near-universal pessimism about the economy and its avatar, the stock market, he maintains that the U.S. is on the cusp of a robust economic recovery that stands a better-than-even chance of yielding a new secular bull market in stocks. A product of rural Iowa, Paulsen works in Minneapolis -- far from the jaded climes of Wall Street. His upbeat prognostications haven't always worked out. He admits to "blowing it" by failing to sense the ferocity of the 2008-09 economic and stock-market meltdown. Yet he nailed the rebounds after the tech bust and Sept. 11 attacks. Furthermore, he hung tough after the stock-market meltdown last March, with widely ridiculed predictions that both the economy and markets would come thundering back.



Jonathan Chapman for *Barron's*

Barron's: *Why is there such fear and loathing among investors and economic players generally, even as the economy appears to be recovering and stocks, until recently, have soared?*

Paulsen: You can't go through a period like the past two years and expect people to feel good about things -- not after they were conditioned to believe that we were on the verge of repeating the Great Depression.

Why are you confident that you're right and the conventional wisdom wrong?

Policy responses in terms of fiscal and monetary stimulus have been unprecedented because officials, too, became panicked. Ever since Lehman went down [in October 2008], we've seen 10% annualized monetary growth. The federal budget deficit has gone from a \$350 billion annual rate to over \$1.5 trillion. Short-term interest rates have been taken to effectively zero. Long-term rates are near postwar lows. The dollar has fallen significantly and the price of oil cut in half. These changes, collectively, while they may spur inflation a couple of years out, have had a more-than-favorable impact, short term. Corporations these days are sized as if depression could ensue any day. They've purged payrolls, lopped off underperforming operations, cut costs, slashed inventories, held back on capital spending and boosted productivity.

So you expect that the snapback in economic activity will spring-load corporate profits and propel stocks higher?

I think so. You're going to see big jumps in the coming months in all the items they have purged, including hiring. Companies have the greatest profit leverage that they've had in decades. Right now, the level of cash flow relative to capital spending on corporate balance sheets is at a 50-year high. As sales increase, profits figure to soar.

How can we have a decent economic recovery if the U.S. consumer, who accounts for roughly 70% of GDP, remains in an economic hurt locker?

Household-debt levels remain a problem. But I think the issue has been overdramatized. During the bust, the biggest problem wasn't so much the people who lost their jobs as [that] unemployment surged from 5% to 10%; it was the other 90% of the folks who had a job but were scared out of their wits. They just quit spending. Now, however, their paralysis is abating.

Are we seeing any signs of improved consumer psychology?

Absolutely. We had a much stronger holiday shopping season than anyone expected. Real personal consumption in the last 12 months has risen almost 2% year-over-year. Take a look at the fixed-costs portion of household ledgers, which include not just debt service but also energy costs. The two items combined topped out at about 25% of disposable income in the first quarter of 2008. But they've come down since to around 22% of income, as energy costs have dropped and financing costs have eased some. The combined total, in fact, is lower than at any time during the 1980s. So many consumers are now in a position to return to the mall. By spring they will have had four consecutive quarters of rising net worth and fatter 401 (k) accounts. It's likely that households will have seen a couple of months of positive job creation. The S&P/Case Shiller index of housing prices will likely have generally continued its multimonth string of rising prices. Bank credit will likely be more plentiful and core inflation and interest rates will remain low. All these factors will combine to boost sagging consumer spirits.

The conventional wisdom holds that we're experiencing a sub-par economic recovery that by the second half of this year is destined to lose steam. You obviously don't agree.

To date, the first two quarters of the recovery -- the third and fourth quarter of 2009 -- have been on a par with the two of the strongest recoveries in the last 50 years: 1975 and 1982. So out of the gate, we'd have to say that real gross-domestic-product growth this time around seems to have a lot of promise.

I think that some commentators are ignoring some extremely positive factors in the current recovery. Take inventories, for example. I expect that we're going to have a prolonged positive impact from inventory rebuilding that will be comparable to 1982, when inventories boosted GDP for some five straight quarters of that recovery. This time around we've only stopped liquidating inventories at such a rapid rate as in early 2009, so the rebuild lies ahead.

When will the rebuild occur?

I think it will occur throughout the rest of the year. This wild-card factor alone could help push GDP growth up to 5% from, say, 3% to 4%.

What else bodes well for real GDP growth?

Look at the beleaguered housing and auto industries. Today, they account for about 3% of GDP, but their woes have subtracted anywhere from one to two percentage points off of GDP growth for much of the past three years. If the two industries merely stop sliding and level off that would add one percentage point to real GDP growth every quarter. Likewise, the improvement in the U.S. trade balance. Even if the trade balance remains negative,

the fact that exports continue to rise relative to imports figures to have an outsized impact on GDP growth. Net exports have been a chronic negative for real GDP growth for the better part of two decades.

Surely you don't think that with our huge oil-import needs, our trade balance could turn positive?

Trade will remain a negative but less of a negative, which, of course, boosts GDP. But it's conceivable that our trade balance could turn positive one day. Look at the revival we're already seeing in manufacturing. The most recent monthly ISM [Institute for Supply Management] purchasing-managers' report showed strong manufacturing activity. Industrial production has been strong in the last six months. Exports have had a lot to do with this.

Trade used to take away about half a percentage point of annual GDP growth over the last decade. Going forward, net exports are likely to add half to one percentage point to growth. So, say the consumer craps out, as many experts assume, and adds only two percentage points to GDP growth rather than the three percentage points we've become accustomed to. Well, I've just found for you an offsetting factor in net exports to compensate for that one-percentage-point contribution decline to GDP growth from consumer spending.

What does this all mean for the stock market? Many think that a vicious correction -- or worse -- lies ahead for investors.

We're in the early stages of what I think will be a robust economic recovery. That bodes well for stocks, even though the market performed so strongly last year from the March-panic lows. We won't see a moonshot like last year. But I think there are plenty of good fundamental underpinnings.

Such as?

The investor psychology is bad, which is, of course, good for stocks. The latest correction, which came close to hitting 10%, revived all the investor fear and loathing. We've also got plenty of dry powder -- money on the sidelines -- that investors may some day deploy into stocks. Liquid-asset holdings of households and businesses now stand at around \$10 trillion. That's a record, relative to GDP. This money is likely to act as a slow-release Tylenol tablet over the next several years, leeching into the market and driving stock prices higher. Stock prices should also be bolstered by low core inflation. Finally, you've got accelerating global growth, particularly in the developing world. Thus, we're likely early and not late in the stock bull market.

But aren't stocks fairly valued at current levels?

On a trailing 12-month basis, the Standard & Poor's 500 is selling for around 18 times reported earnings. But price/earnings ratios are much lower looking forward -- 13.5 times this year's estimated earnings and 11 times next year's consensus forecasts. What makes these readings so low is the fact that, in past periods, when P/E ratios got this low, there was either rampant inflation and/or high interest rates. That's not the case today, and that's what makes current valuations so compelling.

How high could stocks go?

This year, 1350 for the S&P is a reasonable possibility some time during the year. We'll let the stocks figure out exactly when the market will do it. Longer term, the recovery cycle is likely to follow one of two scenarios. The first would see a strong recovery and a surge in corporate earnings. Stocks would certainly make a lunge toward their all-time highs of, say, 1565 in the S&P and likely reach those levels. But the problem could come from the fact that strong economic growth would also unleash inflation in a major way. Then the Fed would be compelled to raise interest rates, and that, in turn, would choke off the recovery. The result would be a trading-range market with the new highs setting the upper band for stock prices.

And the second path?

This is the one that I think we stand a better than even chance of achieving. If inflation remains in check or rises only slightly, then I think that we have a real shot at a prolonged secular bull market. The key will be keeping inflation under control a couple of years out, when the recovery is in full swing.

Do the huge budget deficits as far as the eye can see concern you?

I don't think we're in an Armageddon situation. We've run large deficits as a percentage of GDP in the past, such as in 1975, when the deficit blew out to 6.5% of GDP and people thought the world had come to an end. If you look back in U.S. economic history, the five years after the deficit peaks invariably have torrid growth. Same for the peak in unemployment, which we recently hit. Remember: President Clinton left us in the late 1990s with budget surpluses and low unemployment, yet the succeeding decade was nothing to write home about in terms of either growth or stock-market performance.

We hope you turn out to be right. Thanks, Jim.

E-mail comments to editors@barrons.com

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