September 07, 2017

Economics Group

MONTHLY OUTLOOK

U.S. Overview

Continued Growth in a Changing Policy Context

Although the outlook for solid real economic growth and continued below-target inflation in the second half of the year remains intact, the policy outlook is quite fluid. The fundamentals of employment, manufacturing and construction picking up provide the backdrop for a positive economic outlook. Our outlook is for GDP and real final sales growth in the second half at 2.5 percent plus, with solid contributions from the consumer, business and government sectors.

As for inflation, we anticipate that the PCE deflator, the Fed's benchmark, will remain near 1.4 percent for the rest of the year, comfortably below the Fed's 2 percent target. However, labor costs will drift upward. Given the growth and inflation outlook, we expect the FOMC to move ahead with policy normalization by announcing the start of its balance sheet reduction program in September and raising the fed funds rate in December. For the dollar, we anticipate relative weakness. Meanwhile, corporate profit gains remain modest given a cap on top line nominal GDP growth and rising unit labor costs.

However, the outlook on policy going forward is very uncertain. We expect only two rate increases by the FOMC in 2018—not the three the FOMC has currently penciled in, simply because our inflation outlook remains modest compared to the 2 percent target. As for fiscal policy, Congress will begin to tackle a long to-do list of legislative deadlines this month. We assume a tax cut for 2018, but on a far more modest scale than campaign proposals would suggest.

International Overview

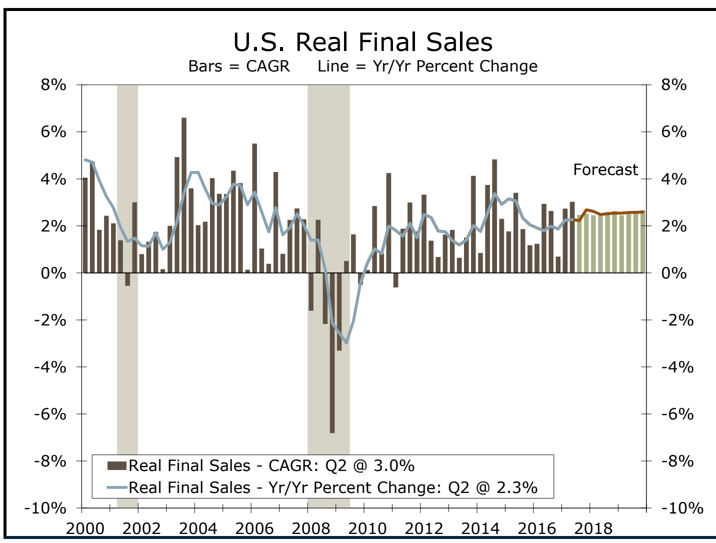
Steady Firming Global Growth Still Intact

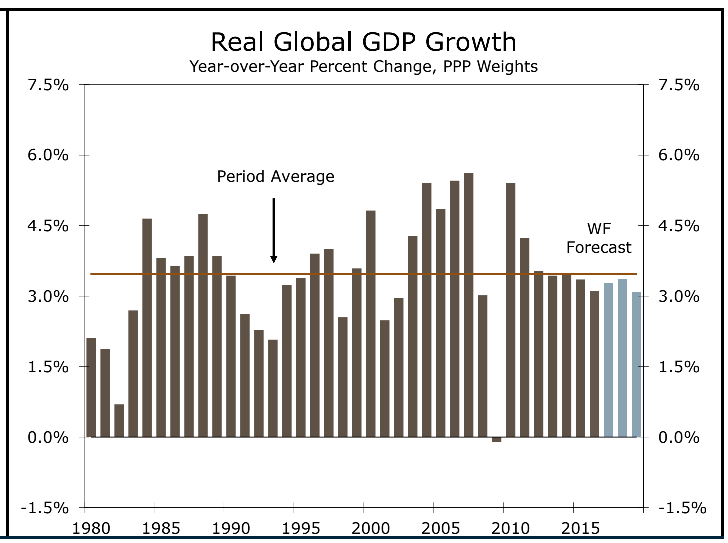
Around the world, the economic indicators have been mixed but if there has been a pattern emerging it is one in which numbers are coming in a bit better than expected. That is certainly true for Japan and Canada, both of which have reported significantly stronger GDP growth in the second quarter than the consensus had expected.

Economic numbers in Europe have been stronger as well. The Bloomberg economic surprise index for the Euro-area has been moving higher on trend since March.

Top-line global GDP is expected to grow at 3.4 percent in both 2017 and 2018 before gradually tapering off a bit in our newly added column for 2019. As the picture gradually brightens, the central banks of the developed world are in various stages of policy normalization.

The Federal Reserve and the Bank of Canada represent one end of the spectrum with both of these North American banks underway with rate increases. The European Central Bank is arguably next in line as it readies the Eurozone for a dialing back of its asset purchase program later this year. Rate increases from the Bank of England are not expected this calendar year but should come into focus in 2018. The Bank of Japan (BoJ) is perhaps the only exception as it maintains a public profile of pedal-to-the-metal accommodation for the foreseeable future. As we discuss on page four however, even the BoJ will perhaps have less urgency around its yield targeting objective as global rates rise.





Source: U.S. Department of Commerce, IHS Global Insight, International Monetary Fund and Wells Fargo Securities

Positive Growth and Low Inflation

Our outlook is for real final sales growth in the second half of roughly 2.5 percent, with solid contributions from the consumer, business and government sectors. For the consumer, continued gains in jobs and modest inflation have supported an improvement in real disposable income over 2016, with gains of 2.1 percent expected in the second half of 2017. Meanwhile, household wealth has improved with equity and real estate values continuing their ascent.

Business investment in equipment is expected at 6-8 percent growth in the second half of 2017, boosted by continued gains in real final sales and low interest rates. Government spending, both federal and state, will add to growth in the second half of 2017 and 2018 as well. However, the future is now, as retiree entitlement benefits are limiting other government spending.

Inflation: Still Below Target

As for inflation, we anticipate that the PCE deflator, the Fed's benchmark, will remain between 1.4 to 1.7 percent through next year, stubbornly below the FOMC's 2 percent target. The consumer price index should also remain in the 1.5 to 2.0 percent range. Contrary to popular commentary, we view the modest fall in inflation as more than just transitory. Since the start of 2017, auto, housing and healthcare inflation have slowed. These price movements suggest caution going forward. Labor costs, as measured by the ECI, should continue to drift upward, but this will create issues for corporate profits in industries unable to pass along rising input costs due to competitive pressures.

Profits and the Dollar

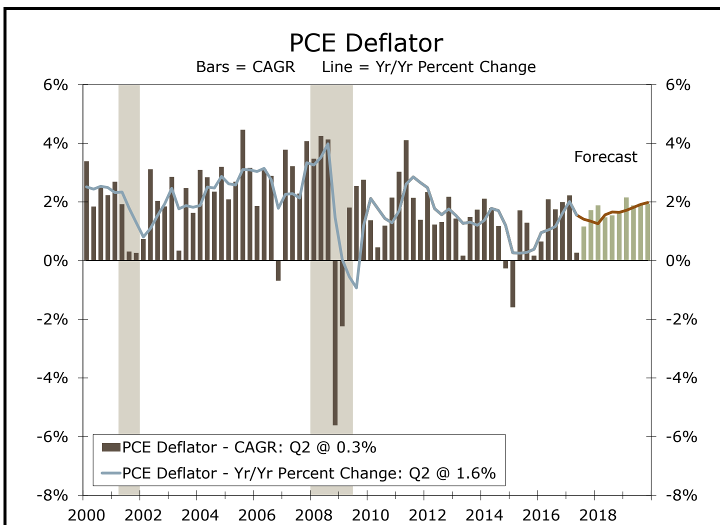
Limited top line growth in nominal GDP combined with rising unit labor costs will continue to put pressure on corporate profits. The economy is late in the cycle, as optimism about the future state of the economy is fading. With our projected slowdown in productivity, coupled with our projected pick-up in labor costs, we are forecasting before tax profits at 3.0 percent and after tax profits at 2.3 percent in Q3. We assume such a decline coming off of Q2 figures due to the bottoming out of year-over-year profits in Q2-2016, which drove the strong Q2-2017 profits figures.

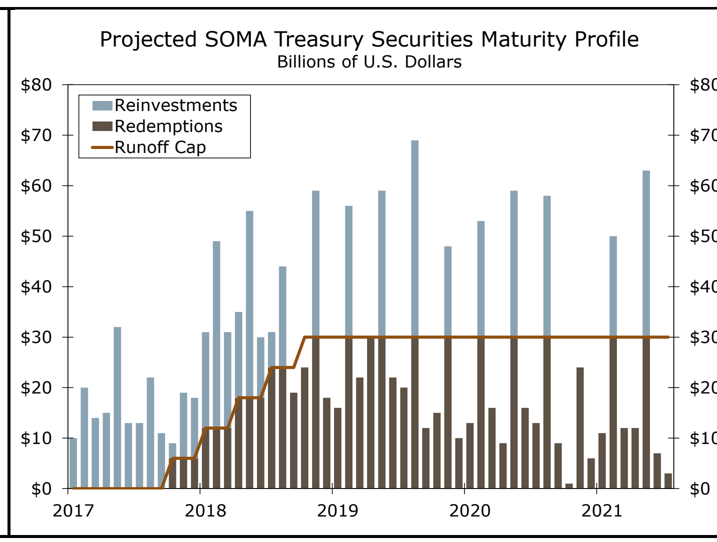
A more cautious inflation outlook/FOMC policy path will allow the trade weighted dollar to continue to decline as foreign central banks begin the process of pulling back on their accommodation. The Bank of Canada has already raised its benchmark rate and the ECB is continuing to taper.

Economic Policy Uncertainty

Monetary policy is unlikely to follow the dot-plot path laid out by the FOMC. Given the growth and inflation outlook, we expect the FOMC to announce the start of balance sheet reductions in September and raise the federal funds rate in December. Our expected path for inflation will limit the extent of FOMC moves in 2018. Our outlook for the benchmark 10-year Treasury rate is 2.49 percent to end Q4. Rising yields abroad should further push up U.S. long-term rates in 2018.

As for fiscal policy, now that Congress has returned from its August recess, it has begun to tackle a long to-do list of legislative deadlines, including lifting the debt ceiling, funding the government beyond the end of September, reauthorizing a number of federal programs, providing additional emergency aid in the wake of Hurricane Harvey and passing a budget resolution to serve as the vehicle for changes to tax law. It appears that a solution to the debt ceiling, funding bill and Harvey funding will likely pass well in advance of the end-of-the-month deadline. The focus will now shift to the remaining agenda items, the December fiscal policy debates and tax reform. For 2018, we do expect a corporate tax cut to be put in place and to boost after-tax profits in the second half of 2018.





Source: U.S. Department of Commerce, Federal Reserve Bank of New York and Wells Fargo Securities

Wells Fargo U.S. Economic Forecast

	Actual						Forecast										Actual		Forecast		
	2016				2017				2018				2019				2015	2016	2017	2018	2019
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product (a)	0.6	2.2	2.8	1.8	1.2	3.0	2.7	3.0	2.5	2.5	2.5	2.6	2.4	2.6	2.6	2.7	2.9	1.5	2.2	2.6	2.5
Personal Consumption	1.8	3.8	2.8	2.9	1.9	3.3	3.0	2.5	2.5	2.6	2.6	2.6	2.3	2.5	2.4	2.4	3.6	2.7	2.8	2.6	2.5
Business Fixed Investment	-4.0	3.3	3.4	0.2	7.1	6.9	5.3	6.2	4.8	4.1	4.0	3.7	3.6	3.5	3.5	3.6	2.3	-0.6	4.8	4.9	3.7
Equipment	-13.1	-0.6	-2.1	1.8	4.4	8.8	6.9	8.7	5.4	4.3	4.2	3.7	3.7	3.3	3.5	3.7	3.5	-3.4	4.1	5.9	3.7
Intellectual Property Products	6.3	11.1	4.2	-0.4	5.8	4.9	4.4	5.0	5.2	4.8	4.7	4.5	4.6	4.6	4.6	4.6	3.8	6.3	4.3	4.9	4.6
Structures	2.3	0.5	14.3	-2.2	14.8	6.2	3.0	2.5	3.0	2.4	2.4	2.2	2.0	1.9	1.9	1.9	-1.8	-4.1	6.6	2.9	2.1
Residential Construction	13.4	-4.8	-4.5	7.1	11.1	-6.5	-3.0	6.5	6.5	6.5	6.5	6.5	4.5	4.5	4.5	4.0	10.2	5.5	1.8	4.4	5.2
Government Purchases	1.8	-0.9	0.5	0.2	-0.6	-0.3	-0.5	0.4	0.7	0.8	0.8	0.8	0.7	0.7	0.7	0.7	1.4	0.8	-0.2	0.5	0.7
Net Exports	-584.2	-572.4	-557.3	-631.1	-622.2	-613.4	-614.6	-628.1	-638.8	-648.1	-653.3	-655.3	-651.9	-646.9	-638.3	-627.6	-545.3	-586.3	-619.6	-648.8	-641.2
Pct. Point Contribution to GDP	-0.3	0.3	0.4	-1.6	0.2	0.2	0.0	-0.3	-0.2	-0.2	-0.1	0.0	0.1	0.1	0.2	0.2	-0.7	-0.2	-0.2	-0.2	0.0
Inventory Change	40.6	12.2	17.6	63.1	1.2	1.8	30.0	50.0	50.0	50.0	48.0	45.0	44.0	43.0	40.0	40.0	100.6	33.4	20.8	48.3	41.8
Pct. Point Contribution to GDP	-0.6	-0.7	0.2	1.1	-1.5	0.0	0.7	0.5	0.0	0.0	0.0	-0.1	0.0	0.0	-0.1	0.0	0.2	-0.4	-0.1	0.2	0.0
Nominal GDP (a)	0.8	4.7	4.2	3.8	3.3	4.0	3.9	4.8	4.4	4.0	4.1	4.3	4.6	4.5	4.5	4.7	4.0	2.8	3.9	4.3	4.4
Real Final Sales	1.2	2.9	2.6	0.7	2.7	3.0	2.5	2.5	2.5	2.5	2.6	2.6	2.5	2.6	2.6	2.7	2.6	1.9	2.4	2.5	2.6
Retail Sales (b)	2.9	2.7	2.5	3.9	5.1	4.0	4.1	3.3	3.5	4.5	5.0	5.7	5.7	5.4	5.0	4.7	2.6	3.0	4.1	4.7	5.2
Inflation Indicators (b)																					
PCE Deflator	1.0	1.0	1.2	1.6	2.0	1.6	1.4	1.3	1.3	1.6	1.7	1.6	1.7	1.8	1.9	2.0	0.3	1.2	1.6	1.5	1.9
"Core" PCE Deflator	1.6	1.7	1.8	1.9	1.8	1.5	1.4	1.4	1.5	1.7	1.7	1.8	1.8	1.8	1.8	1.9	1.3	1.8	1.5	1.7	1.8
Consumer Price Index	1.1	1.1	1.1	1.8	2.6	1.9	1.7	1.5	1.3	1.8	2.0	2.0	2.0	2.1	2.2	2.3	0.1	1.3	1.9	1.7	2.2
"Core" Consumer Price Index	2.2	2.2	2.2	2.2	2.2	1.8	1.6	1.6	1.6	2.0	2.1	2.1	2.1	2.0	2.1	2.1	1.8	2.2	1.8	1.9	2.1
Producer Price Index (Final Demand)	0.0	0.1	0.2	1.4	2.0	2.3	2.2	2.2	1.9	1.8	2.2	2.2	2.3	2.3	2.4	2.4	-0.9	0.4	2.2	2.0	2.3
Employment Cost Index	1.9	2.3	2.3	2.2	2.4	2.4	2.5	2.6	2.6	2.8	2.9	3.0	3.0	3.1	3.1	3.2	2.1	2.2	2.5	2.8	3.1
Real Disposable Income (a)	0.2	1.9	0.7	-1.8	2.9	3.2	2.2	2.1	3.5	2.7	2.6	2.6	2.5	2.5	2.5	2.5	4.2	1.4	1.6	2.7	2.5
Nominal Personal Income (b)	2.9	2.5	2.6	1.6	3.1	2.9	2.9	3.7	3.6	4.0	4.4	4.7	4.7	4.8	4.6	4.4	5.0	2.4	3.2	4.2	4.6
Industrial Production (a)	-1.3	-0.7	0.8	0.7	1.6	5.2	2.4	2.3	2.4	2.2	2.3	2.1	2.5	2.3	2.3	2.3	-0.7	-1.2	2.0	2.5	2.3
Capacity Utilization	75.8	75.7	75.8	75.8	75.8	76.6	76.7	76.8	77.0	77.2	77.4	77.5	77.7	77.8	78.0	78.0	76.8	75.7	76.5	77.3	77.9
Corporate Profits Before Taxes (b)	-6.2	-8.2	-1.6	8.7	3.3	7.0	3.0	3.2	3.1	3.0	3.0	2.9	2.9	2.8	2.7	2.7	-1.1	-2.1	4.1	3.0	2.8
Corporate Profits After Taxes	-4.2	-8.0	-2.2	14.1	3.7	8.6	2.3	3.0	3.0	4.4	4.4	4.4	4.4	4.4	4.4	4.4	-1.5	-0.5	4.3	4.0	4.4
Federal Budget Balance (c)	-245	60	-186	-210	-317	4	-177	-366	-246	52	-190	-365	-300	-35	-200	-375	-439	-586	-700	-750	-900
Current Account Balance (d)	-119.2	-108.2	-110.3	-114.0	-116.8	-118.0	-120.0	-125.0	-130.0	-135.0	-140.0	-145.0	-145.0	-145.0	-140.0	-140.0	-434.6	-451.7	-479.8	-550.0	-570.0
Trade Weighted Dollar Index (e)	89.8	90.6	90.0	95.8	94.0	90.5	88.0	88.0	87.5	85.8	84.0	83.0	82.0	81.0	80.0	79.0	91.1	91.6	90.1	85.1	80.5
Nonfarm Payroll Change (f)	196	164	239	148	166	187	148	153	170	160	160	155	150	150	145	145	226	187	164	161	148
Unemployment Rate	4.9	4.9	4.9	4.7	4.7	4.4	4.4	4.3	4.2	4.1	4.0	4.0	3.9	3.8	3.9	3.8	5.3	4.9	4.4	4.1	3.9
Housing Starts (g)	1.15	1.16	1.15	1.25	1.24	1.17	1.23	1.27	1.27	1.29	1.29	1.30	1.35	1.37	1.37	1.38	1.11	1.17	1.22	1.29	1.29
Light Vehicle Sales (h)	17.3	17.2	17.5	17.8	17.1	16.8	16.5	16.8	16.8	16.8	16.7	16.7	16.6	16.6	16.5	16.5	17.4	17.5	16.8	16.8	16.5
Crude Oil - Brent - Front Contract (i)	35.2	47.0	47.0	51.0	54.6	50.8	49.0	48.0	48.0	50.0	51.0	53.0	53.0	53.0	53.0	53.0	54.0	45.1	50.6	50.5	53.0
Quarter-End Interest Rates (j)																					
Federal Funds Target Rate	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.25	2.25	2.50	0.27	0.52	1.25	1.75	2.25
3 Month LIBOR	0.63	0.65	0.85	1.00	1.15	1.30	1.35	1.65	1.65	1.90	1.90	2.15	2.15	2.40	2.40	2.65	0.32	0.74	1.36	1.90	2.40
Prime Rate	3.50	3.50	3.50	3.75	4.00	4.25	4.25	4.50	4.50	4.75	4.75	5.00	5.00	5.25	5.25	5.50	3.27	3.52	4.25	4.75	5.25
Conventional Mortgage Rate	3.69	3.57	3.46	4.20	4.20	3.90	4.03	4.20	4.28	4.36	4.40	4.46	4.49	4.55	4.57	4.65	3.85	3.65	4.08	4.38	4.56
3 Month Bill	0.21	0.26	0.29	0.51	0.76	1.03	1.08	1.30	1.45	1.60	1.67	1.85	1.95	2.10	2.15	2.30	0.05	0.32	1.04	1.64	2.13
6 Month Bill	0.39	0.36	0.45	0.62	0.91	1.14	1.15	1.40	1.55	1.70	1.77	1.95	2.05	2.20	2.25	2.40	0.17	0.46	1.15	1.74	2.23
1 Year Bill	0.59	0.45	0.59	0.85	1.03	1.24	1.27	1.55	1.68	1.80	1.87	2.05	2.15	2.25	2.30	2.45	0.32	0.61	1.27	1.85	2.29
2 Year Note	0.73	0.58	0.77	1.20	1.27	1.38	1.46	1.72	1.83	1.93	2.00	2.15	2.23	2.33	2.38	2.50	0.69	0.83	1.46	1.98	2.36
5 Year Note	1.21	1.01	1.14	1.93	1.93	1.89	1.95	2.20	2.29	2.39	2.45	2.58	2.65	2.75	2.80	2.90	1.53	1.33	1.99	2.43	2.78
10 Year Note	1.78	1.49	1.60	2.45	2.40	2.31	2.30	2.49	2.57	2.66	2.71	2.78	2.82	2.88	2.91	3.00	2.14	1.84	2.38	2.68	2.90
30 Year Bond	2.61	2.30	2.32	3.06	3.02	2.84	2.95	3.19	3.29	3.41	3.49	3.58	3.62	3.68	3.71	3.80	2.84	2.59	3.00	3.44	3.70

Forecast as of: September 7, 2017

Notes: (a) Compound Annual Growth Rate Quarter-over-Quarter
(b) Year-over-Year Percentage Change
(c) Quarterly Sum - Billions USD; Annual Data Represents Fiscal Yr.
(d) Quarterly Sum - Billions USD
(e) Federal Reserve Major Currency Index, 1973=100 - Quarter End
(f) Average Monthly Change
(g) Millions of Units - Annual Data - Not Seasonally Adjusted
(h) Quarterly Data - Average Monthly SAAR; Annual Data - Actual Total Vehicles Sold
(i) Quarterly Average of Daily Close
(j) Annual Numbers Represent Averages

Source: U.S. Department of Commerce, U.S. Department of Labor, Federal Reserve Board, IHS Global Insight and Wells Fargo Securities

Steady Expansion in Global Activity

Our forecast for topline global GDP growth of 3.4 percent for both 2017 and 2018 remains unchanged relative to the forecast from last month. That said, the forecast for advanced economies moved up by a tenth of a percent to 2.3 percent for the current year. That reflects some adjustments to the individual country-level forecasts. As discussed in the domestic outlook, the prospects for full year GDP growth are now a bit brighter for the United States

We revised higher our forecast for Japan as well after a second quarter outturn for Japanese GDP growth that was nearly double consensus expectations. It was the sixth consecutive positive quarter for economic growth (a long stretch given Japan's propensity for volatility in GDP reports – see graph below left) and the 4.0 percent annualized growth rate marked the fastest pace of growth in that year-and-a-half long period.

Interestingly, even as other banks are normalizing or at least talking about normalizing monetary policy, the Bank of Japan (BoJ) has resolutely resisted signaling anything to financial markets in the way of policy tightening. As other central banks gradually raise rates, we think there will be a diminished need for the BoJ to engage in government bond purchases to target a yield of "about zero" on its 10-year government bonds.

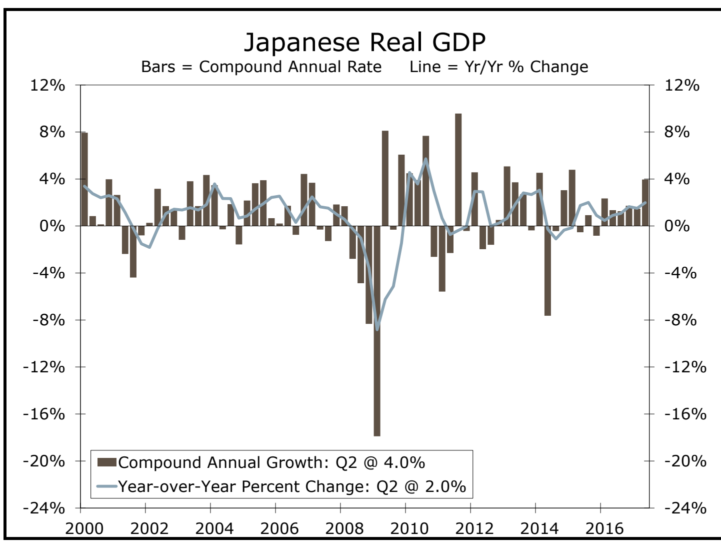
For a few weeks Japan held the title of the fastest second-quarter growth rate among the advanced economies we forecast, but Canada took it away when it published a 4.5 percent annualized growth rate. The torrid pace of growth in Canada was cited as a rationale for a rate increase from the Bank of Canada at its September 6 meeting. We are not convinced that the pace of growth in either Japan or Canada is sustainable. That said, the growth in the first half of the year justifies some tweaking in our full-year forecast for both economies. The statement that accompanied the rate hike from the Bank of Canada noted that the move reflects a removal of excessive policy accommodation previously and noted some key vulnerabilities of the Canadian economy: an indebted household sector, still low wage pressure on inflation and a shaky housing market.

In Europe our expectation for growth of a little below 2.0 percent in the United Kingdom and a little above 2.0 in the Eurozone remains unchanged. Based on the higher frequency economic indicators, that does not sound unreasonable. Recent reports on June employment in the United Kingdom showed the unemployment rate there dipping to 4.5 percent amid faster-than-expected job growth while retail sales figures for July were broadly better-than-expected.

Still, until some of the uncertainty regarding the Brexit process is cleared up, many businesses may adopt a wait-and-see attitude regarding investment spending. Between that apprehension and the subdued growth profile in the United Kingdom, we expect the Bank of England to refrain from raising rates at least through the end of the year.

In the Eurozone, the various PMIs remain in the mid-to-high 50s range which is consistent with the 2.0 percent or better GDP growth we have forecast for this year and next. The steady improvement in economic fundamentals should eventually lead to higher inflation which may lead the ECB to announce another reduction in its monthly bond purchases which could take effect as soon as December. We look for the ECB to cease buying bonds altogether by mid-2008.

The topline forecast for developing economies GDP growth is unchanged at 4.5 percent for both 2017 and 2018. The big driver in this part of the forecast is our expectation that moderation in the pace of Chinese economic growth will continue taking the headline growth rate down ever closer to 6.0 percent. The pace of growth in India forecast to slightly outpace the headline growth rate in China throughout the forecast period.



Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2017	2018	2019	2017	2018	2019
Global (PPP Weights)	3.4%	3.4%	3.1%	3.2%	3.3%	3.1%
Global (Market Exchange Rates)	3.2%	3.3%	2.8%	3.2%	3.3%	3.1%
Advanced Economies[1]	2.3%	2.3%	1.8%	1.7%	1.9%	1.4%
United States	2.2%	2.6%	2.5%	1.9%	1.7%	2.2%
Eurozone	2.1%	2.0%	1.7%	1.5%	1.7%	1.9%
United Kingdom	1.6%	1.7%	1.6%	2.6%	2.1%	2.0%
Japan	1.9%	1.1%	0.7%	0.3%	0.7%	0.3%
Korea	2.9%	2.8%	3.0%	2.1%	2.0%	2.4%
Canada	3.0%	2.0%	1.9%	1.6%	1.9%	2.0%
Developing Economies[1]	4.5%	4.5%	4.3%	4.8%	4.8%	4.8%
China	6.6%	6.3%	5.9%	1.5%	2.0%	1.9%
India[2]	7.1%	6.4%	7.2%	3.1%	4.1%	4.3%
Mexico	2.1%	2.3%	2.4%	6.0%	5.0%	5.2%
Brazil	0.6%	2.0%	2.2%	3.5%	3.5%	3.8%
Russia	1.7%	2.0%	2.2%	4.2%	4.3%	4.5%

Forecast as of: September 7, 2017

[1]Aggregated Using PPP Weights

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2017		2018				2017		2018			
	Q3	Q4	Q1	Q2	Q3	Q4	Q3	Q4	Q1	Q2	Q3	Q4
U.S.	1.35%	1.65%	1.65%	1.90%	1.90%	2.15%	2.30%	2.49%	2.57%	2.66%	2.71%	2.78%
Japan	0.00%	0.00%	0.02%	0.02%	0.03%	0.03%	0.00%	0.03%	0.05%	0.07%	0.09%	0.12%
Euroland[1]	-0.37%	-0.35%	-0.30%	-0.15%	0.05%	0.20%	0.40%	0.45%	0.60%	0.75%	0.85%	1.00%
U.K.	0.27%	0.30%	0.40%	0.60%	0.65%	0.85%	1.10%	1.20%	1.40%	1.50%	1.60%	1.75%
Canada[2]	1.40%	1.50%	1.65%	1.75%	1.90%	2.00%	1.90%	2.00%	2.20%	2.30%	2.40%	2.45%

Forecast as of: September 7, 2017

[1] 10-year German Government Bond Yield [2] 3-Month Canada Bankers' Acceptances

Source: International Monetary Fund and Wells Fargo Securities

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