December 16, 2016

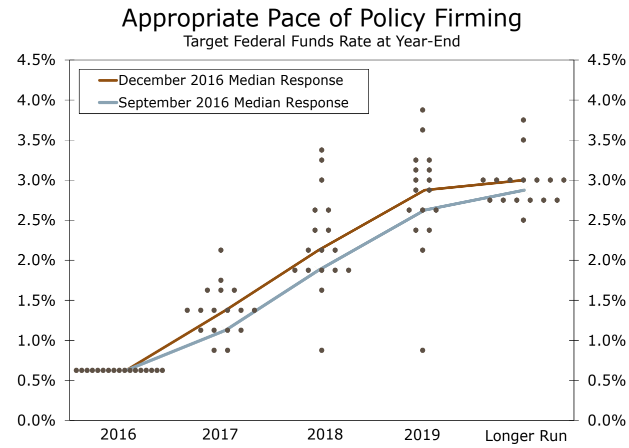
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Rates Are Moving on Up

- This week the Federal Open Market Committee (FOMC) hiked rates for the second time in the current tightening cycle and signaled that more rate hikes may be needed in 2017.
- November's retail sales report disappointed, posting only a slight rise for the month and showing downward revisions to October's data.
- Industrial production contracted in November largely due to a drop in utilities output.
- Measures of producer and consumer prices continued to indicate that inflation is beginning to firm.



Global Review

An Inflection Point for European Production?

- We learned this week that industrial production in the Eurozone fell in October despite expectations for a slight increase. Brighter days may be ahead. For the first time in years, manufacturing PMI in the Eurozone is running hotter than services PMI.
- Industrial production remains under pressure in Asia as well, as is evident by the stall-speed in Japan and the still-modest rate of growth in China.
- The Bank of Korea (BoK) kept rates unchanged this week despite a maelstrom of conflicting pressures confronting the Bank.

Wells Fargo U.S. Economic Forecast

	Actual			Forecast					Actual		Forecast		
	2016				2017				2014	2015	2016	2017	2018
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	0.8	1.4	3.2	1.7	2.1	2.3	2.3	2.2	2.4	2.6	1.5	2.2	2.2
Personal Consumption	1.6	4.3	2.8	2.5	2.3	2.5	2.4	2.0	2.9	3.2	2.7	2.6	2.3
Inflation Indicators [2]													
PCE Deflator	0.9	1.0	1.0	1.5	2.1	2.1	2.2	2.2	1.5	0.3	1.1	2.1	2.2
Consumer Price Index	1.1	1.1	1.1	1.8	2.4	2.4	2.6	2.5	1.6	0.1	1.3	2.5	2.6
Industrial Production [1]	-1.7	-0.8	2.0	0.5	2.6	2.2	2.3	2.1	2.9	0.3	-0.9	1.8	1.8
Corporate Profits Before Taxes [2]	-6.6	-4.3	2.8	3.0	2.9	2.8	2.6	2.5	5.9	-3.0	-1.4	2.7	2.5
Trade Weighted Dollar Index [3]	89.8	90.6	90.0	94.5	94.5	95.8	97.3	98.3	78.4	91.1	91.2	96.4	98.9
Unemployment Rate	4.9	4.9	4.9	4.8	4.8	4.7	4.7	4.6	6.2	5.3	4.9	4.7	4.5
Housing Starts [4]	1.15	1.16	1.15	1.22	1.18	1.20	1.22	1.23	1.00	1.11	1.17	1.22	1.25
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	0.25	0.27	0.56	1.00	1.50
Conventional Mortgage Rate	3.69	3.57	3.46	4.12	4.13	4.15	4.17	4.19	4.17	3.85	3.71	4.16	4.28
10 Year Note	1.78	1.49	1.60	2.42	2.45	2.48	2.51	2.54	2.54	2.14	1.82	2.50	2.66

Forecast as of: December 8, 2016

[1] Compound Annual Growth Rate Quarter-over-Quarter

[2] Year-over-Year Percentage Change

[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End

[4] Millions of Units

[5] 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

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U.S. Review

Rates Are Moving on Up

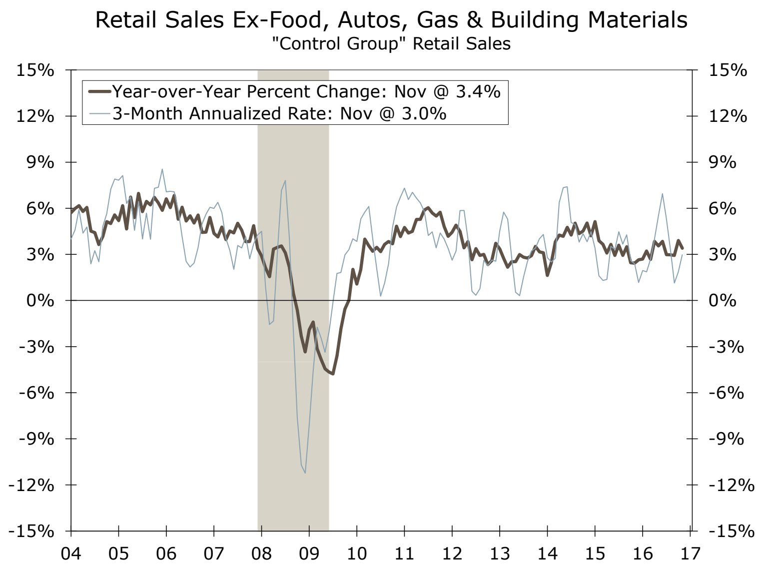
This week was exceptionally busy between the FOMC announcement and a plethora of economic data releases. Though, the big news was the second rate hike out of the FOMC since 2006. Inflation measures continued to reflect a firming price environment for consumers and producers, while retail sales data showed a disappointing start to the holiday shopping season. On the industrial side of the economy, output contracted in November with only a slight upward revision to October's output figures. Businesses also remained cautious in their pace of inventory building in the first month of the fourth quarter. New home construction activity contracted sharply in November and the more forward-looking permit activity showed that building activity may downshift once again in December. This week's economic data reinforced our outlook for more modest GDP growth in the fourth quarter, at 1.7 percent on an annualized basis.

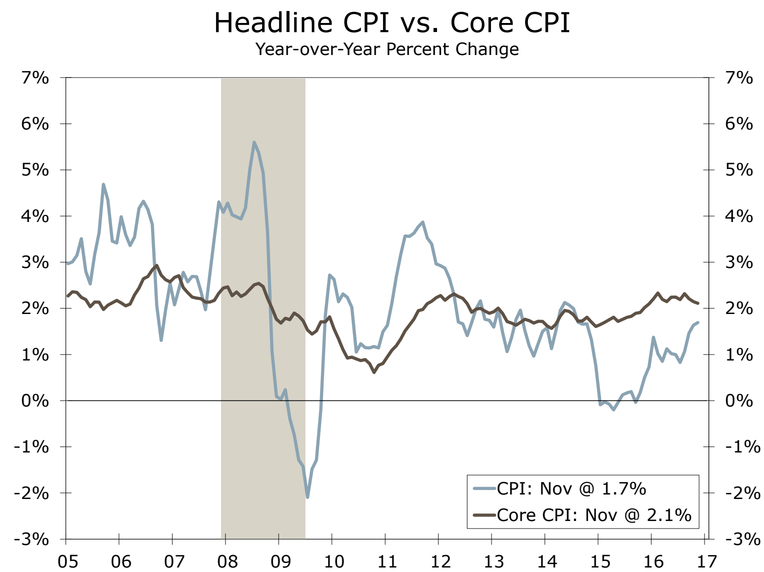
In addition to this week's rate hike, FOMC committee members signaled that more rate hikes may be needed in 2017, which sent interest rates higher across the yield curve. A closer look at the "dot plot" showed six FOMC members look for three rate hikes next year, but six members think the Fed will hike less than three times (five members look for more than three hikes). For the time being, we are maintaining our call for two rate hikes in 2017. That said, we will continue to monitor the employment data and more importantly the inflation measures for signs that the Fed may need to tighten faster than our current forecast.

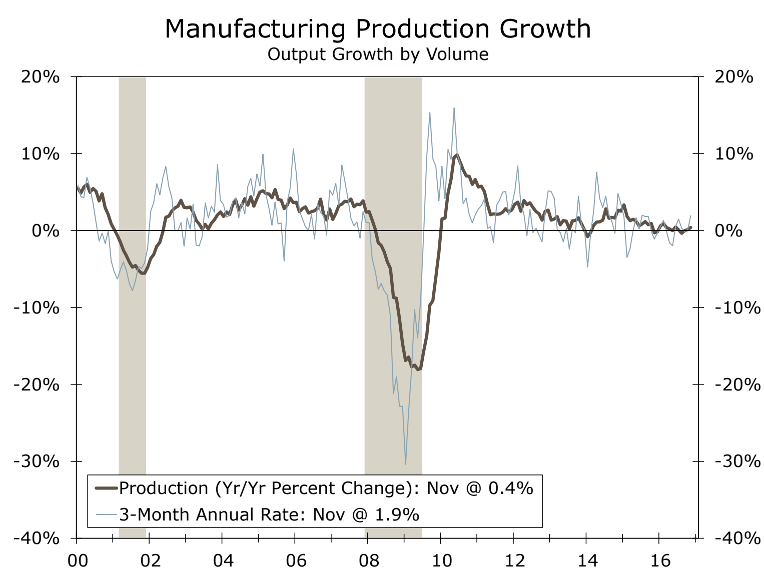
Retail sales climbed a very slight 0.1 percent in November to start the holiday shopping season. More concerning was the subdued 0.1 percent growth in control group sales and a downward revision to the October control group sales data. Consumer and producer price data for November released this week continued to support the case for firming price pressures going into 2017. The headline Consumer Price Index is now up 1.7 percent on a year-over-year basis with core inflation up 2.1 percent. The higher consumer price environment means the disappointing nominally reported retail sales report will likely translate into more modest real consumer spending growth in Q4.

Housing starts fell 18.7 percent to a 1.09 million-unit pace in November, which only partially reverses October's 27.4 percent surge in new home construction. More forward-looking housing permit data showed that the downshift may persist in December.

Industrial production fell in November, as utilities output and manufacturing both contracted for the month. The pullback in manufacturing activity continues to reflect a challenging environment for manufacturers with the stronger U.S. dollar and sluggish global growth environment. Both of these factors also appear to be holding back the pace of inventory building, which fell 0.2 percent in October. More forward-looking measures in the manufacturing sector such as the Empire and Philadelphia Fed surveys both pointed toward more optimism among manufacturers, which supports our argument for slightly stronger business investment in the new year.







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

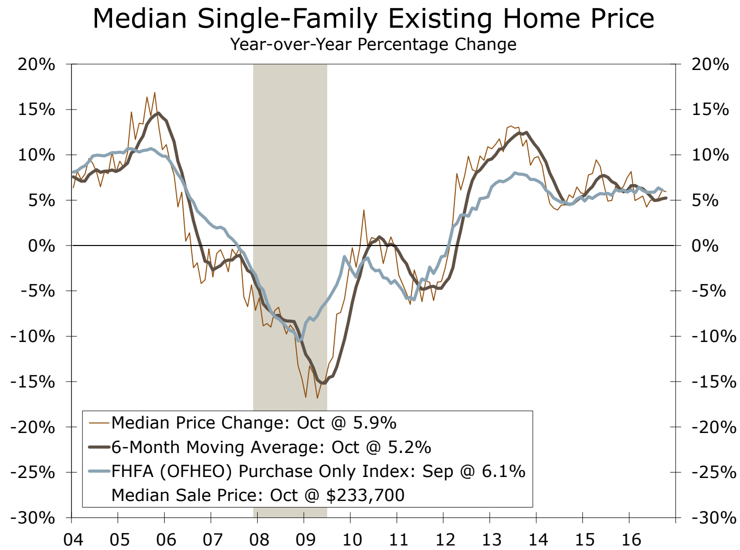
Existing Home Sales • Wednesday

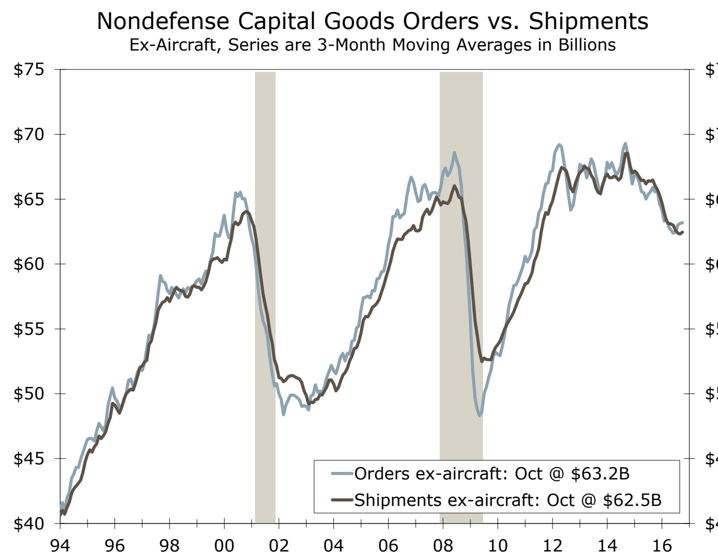
Existing home sales rose 2 percent in October after a solid 3.6 percent gain in September, marking the fastest pace of home sales since Feb. 2007. Housing inventory continued to edge lower, falling to 2.02 million homes. Inventories are now 4.3 percent below their year-ago level. Low inventories have kept prices firm, with the median price rising nearly 6 percent year to year.

We look for a slight rise in existing home sales in November to a 5.61 million-unit annual pace. In the year ahead, steady price gains, coupled with higher mortgage rates, will present affordability challenges and likely exert a drag on sales activity. That said, we look for just a modest slowdown in 2017 to a 2.4 percent increase from the expected 3 percent pace registered in 2016. In a separate release next week, new home sales for November are reported on Friday. We anticipate sales to rise to a 582,000 unit pace, up from October's 563,000.

Previous: 5.60M **Wells Fargo: 5.61M**

Consensus:5.52M





Durable Goods • Thursday

Durable goods orders rose 4.6 percent in October, aided by a boost in aircraft orders. Nondefense capital goods orders ex-aircraft, a proxy for business spending plans, rose 0.2 percent in October and are up a solid 3.8 percent on a three-month annualized basis. Core capital goods orders have increased in four of the past five months, a feat that has not occurred since late 2010.

There are some signs that the headwinds the manufacturing sector has faced over the past two years have begun to abate. Oil prices have steadily risen from their 2016 lows. Our forecast for global real GDP growth, while still below its long-run average, marks a slight increase from this year's pace. The dollar, however, remains near a multi-year high, and we expect some modest appreciation over the next year. Although a break-out in the factory sector remains elusive, improving fundaments should help build some momentum in this space heading into the new year.

Previous: 4.6% **Wells Fargo: -5.0%**

Consensus: -4.1% (Month-over-Month)

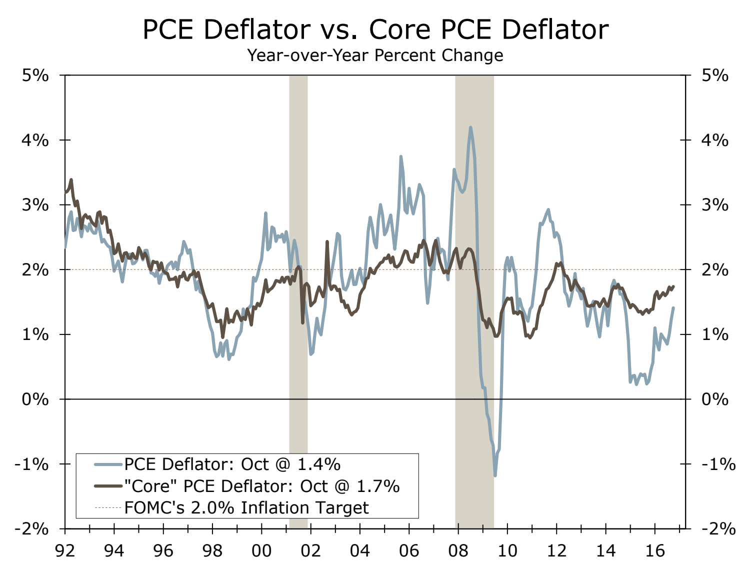
Personal Income & Spending • Thursday

Personal spending disappointed in October despite a surprise to the upside for income growth. Preliminary data on the consumer from the November retail sales report suggest that, through the first two months of Q4, real consumer spending is on track to meet our expectations of about 2.5 percent growth in Q4. We will look to the November personal income & spending report to confirm our outlook for consumer expenditures.

The PCE deflator, the Fed's preferred measure of inflation, continues to trek higher toward the 2 percent target. Neither the headline nor the core indices have been above 2 percent since 2012, a streak we expect to end next year. We anticipate the PCE deflator will rise to 2 percent on a year-ago basis in early 2017, with the core PCE deflator reaching the 2 percent mark toward the end of next year. This upward trend for inflation puts the Fed's dual mandate squarely in sight and should support multiple rate hikes in 2017.

Previous: 0.6% **Wells Fargo: 0.3%**

Consensus: 0.3% (Month-over-Month, Personal Income)



Source: National Association of Realtors, FHFA, U.S. Department of Commerce and Wells Fargo Securities

Global Review

More Mixed Signals on the Eurozone

At its meeting last week, the European Central Bank (ECB) announced plans to eventually dial back the amount of its monthly asset purchase program to €60 billion per month from the current pace of €80 billion per month. The change will not take effect until April 2017, and the ECB assured investors that the program would remain in place at least through the end of 2017 "or beyond, if necessary."

The nature of this announcement was not surprising; many market watchers had been expecting some form of tapering eventually. The timing, however, was earlier than expected. Broad measures of inflation in the Eurozone remain well below the ECB's target, there is a degree of political uncertainty in the air in Europe at present and there are mixed signals for the prospect for economic growth.

This week, we learned that industrial production (IP) in the Eurozone fell 0.1 percent in October, which cut the year-over-year rate of IP growth to just 0.6 percent from 1.3 percent in September. The consensus had been looking for a modest increase in the month. The weakness in the factory sector may be short-lived according to new activity measures. Preliminary readings of the various purchasing manager surveys for December also became available this week and the manufacturing PMI climbed to a multi-year high of 54.9. The services PMI slipped a little but remains firmly in expansion territory at 53.1. The composite of both PMIs was unchanged at 53.9.

Asian Manufacturing

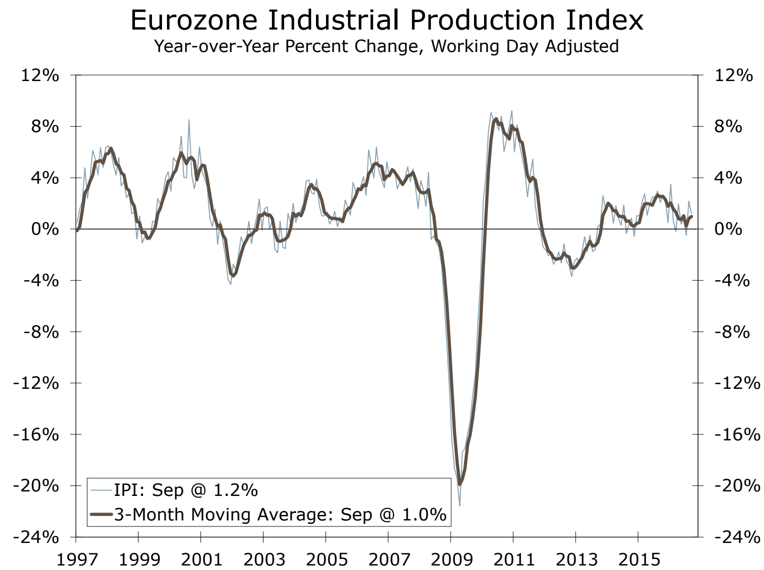
Speaking of manufacturing, Asia's two largest economies also reported industrial production figures this week. China reported a 6.2 percent year-over-year growth rate in its industrial production for November, up slightly from 6.1 percent the prior month.

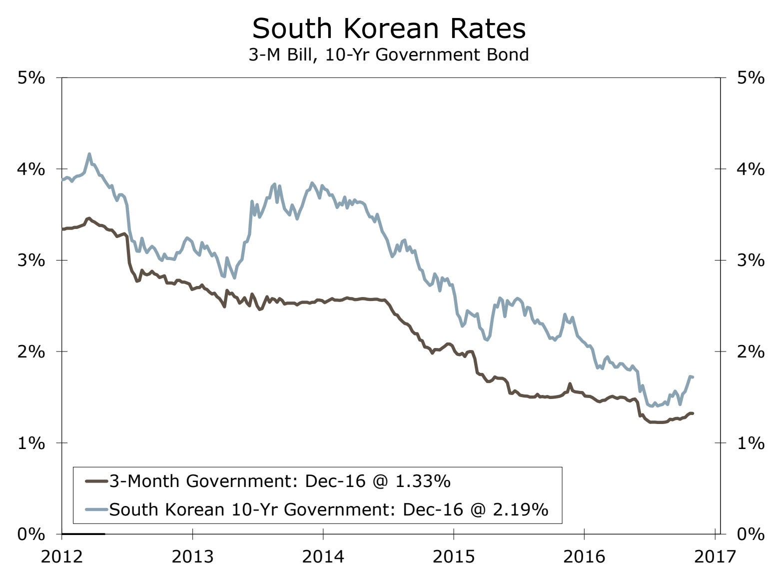
In Japan, industrial production was flat during the month, which is emblematic of many other measures of activity in Japan lately. The year-over-year growth rate is off 1.4 percent, but capacity utilization did pick up during the month. Another modest bright spot was the fact that the Tankan survey of manufacturing in Japan climbed to 10 in the fourth quarter from 6 previously.

Bank of Korea Meets Amid Combination of Challenges

Elsewhere in Asia, the Bank of Korea faced a confluence of difficult factors. For starters, the Korean economy has been under pressure in recent quarters as the export-intensive economy fights the headwinds of soft global growth. Additionally, the Korean president was impeached earlier this month on charges of influence peddling. Finally, recent trends of rising interest rates and a falling currency were exacerbated by the Fed's decision to hike rates and adopt a more hawkish policy stance.

The BoK could offset some of the selling pressure on Korean sovereign debt and the Korean won by raising rates, but that would put pressure on an already struggling domestic economy. The BoK kept its target rate unchanged at 1.25 percent.





Source: IHS Global Insight and Wells Fargo Securities

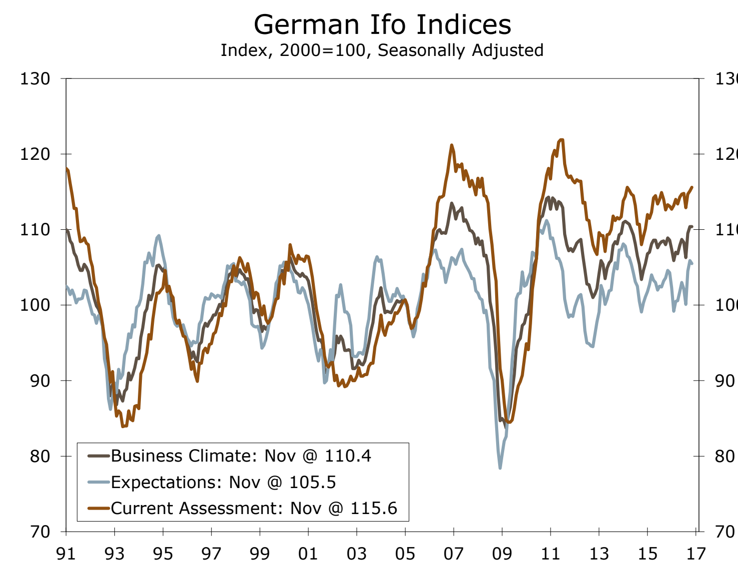
Germany IFO • Monday

There were mixed results from the PMI indices with the manufacturing index increasing to 55.5 in December from a 54.3 reading in November and a weaker-than-expected services PMI, which fell to 53.8 compared to 55.1 the previous month. Germany is scheduled to release the IFO business climate, current assessment and expectations index on Monday. The climate index was flat at 110.4 in November, while the current assessment index was slightly higher at 115.6 from 115.1. The expectations index, on the other hand, was a tad lower at 105.5 compared to 105.9 in October. Thus, it will be interesting to see if the improvement in the manufacturing PMI had a positive effect on the IFO reading in December.

Meanwhile, we will get the release of the GfK consumer confidence index for January on Friday. The index has been very close to 10 during the past several years. The GfK was 9.8 in December.

Previous: 110.4

Consensus: 110.6



Argentina Q3 GDP • Thursday

A year after Mauricio Macri took power as president, the administration has very little to show. After the first successes managing the transition to a freely floating exchange rate and an opening of the country's capital market, the economy has deteriorated considerably due to higher inflation, as the Macri administration decided to eliminate public utility subsidies. However, even as the subsidies were eliminated the fiscal deficit has not improved and the administration has had to go to the international capital market to finance the deficit, which has increased borrowing at a time when interest rates are increasing.

On Thursday, the statistical agency is scheduled to release the preliminary result for Q3 GDP and the picture is not going to be good, as markets estimate that the economy remained in a recession during the quarter.

Previous: -2.1% (Quarter-over-Quarter)

Mexico Economic Activity Index • Thursday

On Wednesday, the Mexican statistical institute is scheduled to release the demand side results for GDP in the third quarter of the year, which will give us an idea of the performance of every demand sector of the economy during the quarter. Perhaps the most interesting segment from Q3, on the demand side, will be the impact of the large depreciation of the Mexican peso on real exports of goods and services.

On Thursday, the institute will release the economic activity index, which is a monthly proxy for GDP, for October, and we will be able to take a peek at the performance of the Mexican economy during the first month of the current quarter. Although markets are expecting the economy to weaken further in the last quarter of the year, good export performance could mitigate the other forces pulling the economy down.

Previous: 1.62%

Consensus: 1.20% (Year-over-Year)

Source: IHS Global Insight and Wells Fargo Securities

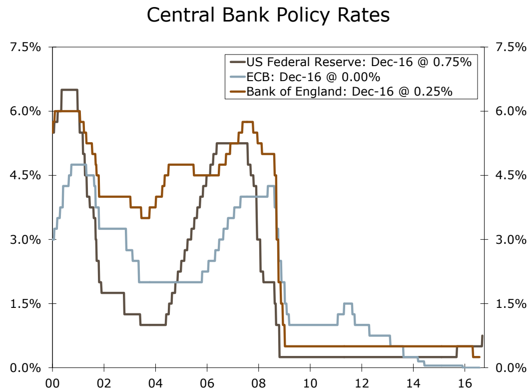
Interest Rate Watch

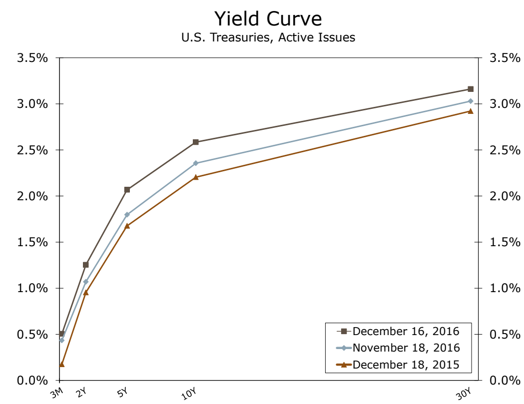
The Fed Finally Makes Its Move

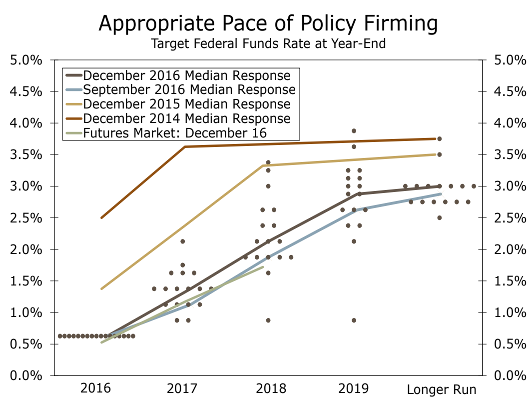
As expected, the Federal Open Market Committee hiked the federal funds rate by one-quarter percentage point at its December 13-14 meeting. The commentary, summary of economic projections and Janet Yellen's press conference all signaled a slightly more hawkish tone from the Fed. The dot plot now calls for three quarter-point increases in 2017, up from two earlier, followed by three more in 2018 and three more in 2019. The long-term federal funds rate has also firmed up to between 2.75 percent and 3 percent. Estimates for growth and inflation were raised slightly and the outlook for the unemployment rate was reduced.

Taken together, the latest developments would mark a victory for the Fed. Economic activity has firmed to the point that the unemployment rate is within range of full employment and inflation is moving back toward the Fed's preferred 2 percent target. Talk of deflation and negative interest rates seems like nothing more than a bad dream today and Janet Yellen even took the opportunity to walk back her earlier comments about perhaps letting the economy run a little hot for a while in order to draw job seekers back into the labor market. Yellen noted that her earlier comments were merely an academic exercise and not part of the Fed's policy analysis. The question takes on new importance in the wake of the presidential election, which saw President-elect Trump argue for a more active fiscal policy.

Long-term interest rates rose in the wake of the Fed's decision. The yield on the Treasury's 10-year note is now just shy of 2.60 percent and the yield on the 2-year note has risen to 1.26 percent. Part of that increase reflects the Fed's more hawkish view. It also likely reflects the first significant reversal in the dot plot since it was introduced five years ago. Expectations for the federal funds rate were consistently lowered prior to the December meeting. At this time last year, for example, the dot plot implied that the federal funds rate would be 1.25 percent today. Rather than focus on past misses, we believe the message is that the risks are now to the upside.







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

Credit Market Insights

Long-Term Inflation Outlook Higher

The New York Fed's Survey of Consumer Expectations provided a comprehensive look into consumers' near-term expectations for inflation, the labor market and household finances, before and post-presidential election in November. During the month, inflation expectations declined one-year ahead but rose modestly for three-years ahead. For price inflation, the outlook remained mixed, with expectations for education price increases ticking up but subsiding for rent, gas and medical care.

Household Finance Outlook Mixed

The outlook for household income growth over the coming year fell to 2.4 percent. Despite the modest decline, consumers surveyed still plan to spend more next year as they believe they will have lower taxes and will be financially better off a year from now, which bodes well for our expectation of continued strengthening in consumer spending.

Labor Market Future Cloudy

Consumers, overall, are uncertain about the future of the labor market. The likelihood of losing their current job in the next 12 months increased in November across all demographics, the largest being for individuals earning $50,000 to $100,000. Those surveyed are also less optimistic in finding a new job in three months and few plan to quit their jobs in the next year. That said, employment growth remains solid and less workers are applying for unemployment benefits. A tighter labor market should prompt wage growth and lift expectations.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.16%	4.13%	4.03%	3.97%
15-Yr Fixed	3.37%	3.36%	3.25%	3.22%
5/1 ARM	3.19%	3.17%	3.12%	3.03%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$2,098.3	-3.90%	-2.81%	7.64%
Revolving Home Equity	$408.2	-3.78%	-6.89%	-6.31%
Residential Mortgages	$1,751.2	2.98%	4.80%	6.18%
Commerical Real Estate	$1,950.5	-3.07%	0.58%	10.49%
Consumer	$1,366.7	31.37%	10.74%	8.36%

Source: Freddie Mac, Federal Reserve Board and Wells Fargo Securities

Topic of the Week

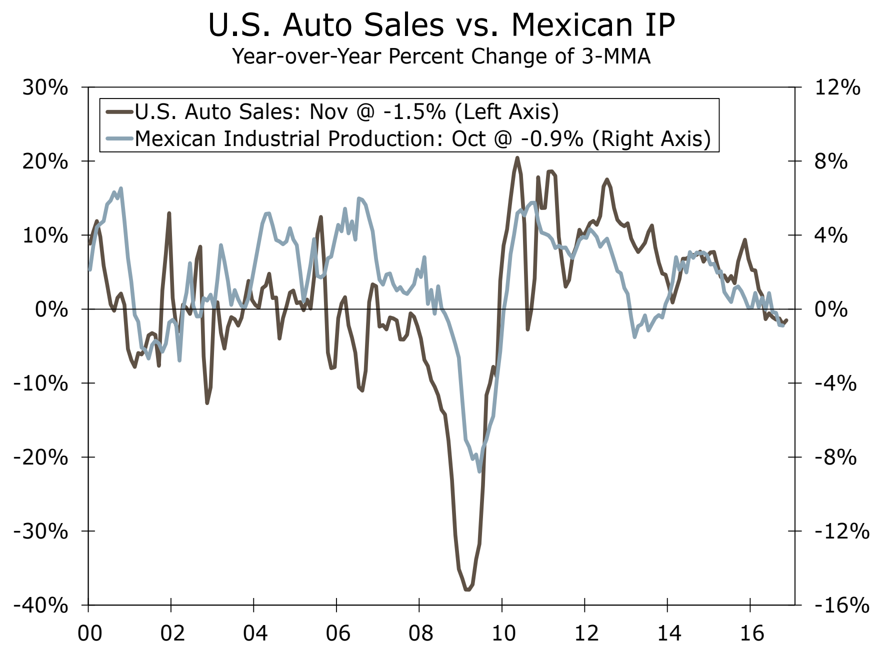
Why Is Mexico Different?

Perhaps no other country in the world has as much at stake as Mexico, due to the new U.S. President-elect Donald Trump, who has threatened to take measures against countries that have taken “advantage” of the United States in the past—unfavorable trade deals, currency manipulation or immigration inflows. Mexico shares a large border with the United States, which is also a major destination for Mexican exports (i.e., automobiles). We expect the Mexican economy to suffer a mild recession in 2017, dropping 1.1 percent in real terms.

Mexico’s auto industry has benefited considerably from its closeness to the United States. Turmoil in the U.S. automobile sector during the Great Recession was an opportunity for the North American automobile industry to adjust its production strategy—which was a boon to Mexican automobile production as many automobile producers increased investment in Mexico. However, Mexican manufacturing production is highly linked to U.S. manufacturing production so whatever the Trump administration does against the Mexican manufacturing sector could negatively impact the U.S. manufacturing sector.

Although a change in policy could take some time, the first economic variable to take notice of Mr. Trump’s triumph was the Mexican peso. The large depreciation of the Mexican exchange rate could be a short-term incentive for Mexican exports to the United States, as the depreciation makes Mexican goods more competitive in the global economy. On the other hand, Mexican import-competing sectors will also benefit from the large depreciation of the peso.

President-elect Trump’s policies toward Mexico are still highly uncertain. However, some sectors of the Mexican economy, such as trade to the United States, foreign investment, remittances and interest rates, etc., could be severely impacted. Our expectation is that the Mexican economy will be negatively affected by the new policies. For a more information please see our full report, “*Why Is Mexico Different?”* which is available on our website.



Source: IHS Global Insight and Wells Fargo Securities

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 12/16/2016	1 Week Ago	1 Year Ago
3-Month T-Bill	0.50	0.53	0.25
3-Month LIBOR	0.99	0.95	0.53
1-Year Treasury	0.98	0.95	0.80
2-Year Treasury	1.25	1.13	1.00
5-Year Treasury	2.07	1.89	1.75
10-Year Treasury	2.59	2.47	2.30
30-Year Treasury	3.16	3.15	3.00
Bond Buyer Index	3.88	3.78	3.57

Foreign Exchange Rates

	Friday 12/16/2016	1 Week Ago	1 Year Ago
Euro ($/€)	1.042	1.056	1.091
British Pound ($/£)	1.241	1.257	1.500
British Pound (£/€)	0.840	0.839	0.727
Japanese Yen (¥/$)	118.180	115.320	122.210
Canadian Dollar (C$/$)	1.337	1.318	1.378
Swiss Franc (CHF/$)	1.030	1.017	0.990
Australian Dollar (US$/A$)	0.732	0.745	0.723
Mexican Peso (MXN/$)	20.430	20.389	16.983
Chinese Yuan (CNY/$)	6.961	6.908	6.473
Indian Rupee (INR/$)	67.771	67.418	66.726
Brazilian Real (BRL/$)	3.394	3.380	3.884
U.S. Dollar Index	103.110	101.590	97.871

Foreign Interest Rates

	Friday 12/16/2016	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.33	-0.33	-0.12
3-Month Sterling LIBOR	0.37	0.38	0.58
3-Month Canada Banker's Acceptance	0.92	0.90	0.85
3-Month Yen LIBOR	-0.03	-0.06	0.08
2-Year German	-0.79	-0.75	-0.33
2-Year U.K.	0.15	0.14	0.63
2-Year Canadian	0.83	0.74	0.55
2-Year Japanese	-0.18	-0.18	-0.03
10-Year German	0.31	0.37	0.68
10-Year U.K.	1.46	1.45	1.95
10-Year Canadian	1.84	1.73	1.51
10-Year Japanese	0.08	0.06	0.30

Commodity Prices

	Friday 12/16/2016	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	51.50	51.50	35.52
Gold ($/Ounce)	1131.57	1160.01	1072.31
Hot-Rolled Steel ($/S.Ton)	585.00	570.00	364.00
Copper (¢/Pound)	257.50	264.20	206.10
Soybeans ($/Bushel)	10.17	10.12	8.65
Natural Gas ($/MMBTU)	3.37	3.75	1.79
Nickel ($/Metric Ton)	11,250	11,058	8,506
CRB Spot Inds.	498.63	492.48	401.11

Source: Bloomberg LP and Wells Fargo Securities

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	19	20	21	22	23
U.S. Data			**Existing Home Sales** October 5.60M November 5.61M (W)	**Durable Goods Orders (MoM)** October 4.3% November -5.0% (W) **Leading Economic Index** October 0.1% November 0.0% (W)	**New Home Sales** October 563K November 582K (W) **U. Mich. Consumer Sentiment** November 93.8 December 98.0 (C)
Global Data	**Eurozone** **Construction Output (YoY)** Previous (September) 1.8%		**Sweden** **Riksbank Interst Rate** Previous -0.50%	**Sweden** **Retail Sales (MoM)** Previous (October) 2.4%	**Singapore** **CPI (YoY)** Previous (October) -0.1%

Note: (W) = Wells Fargo Estimate (C) = Consensus Estimate

Source: Bloomberg LP and Wells Fargo Securities

Wells Fargo Securities Economics Group

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