April 14, 2017

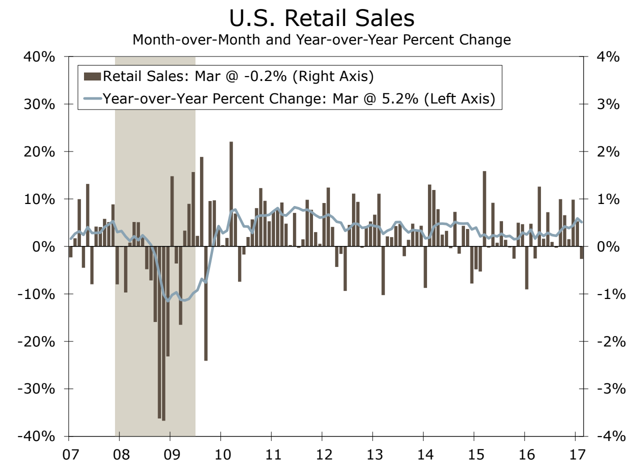
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

The Hard Data Looks a Bit Soft

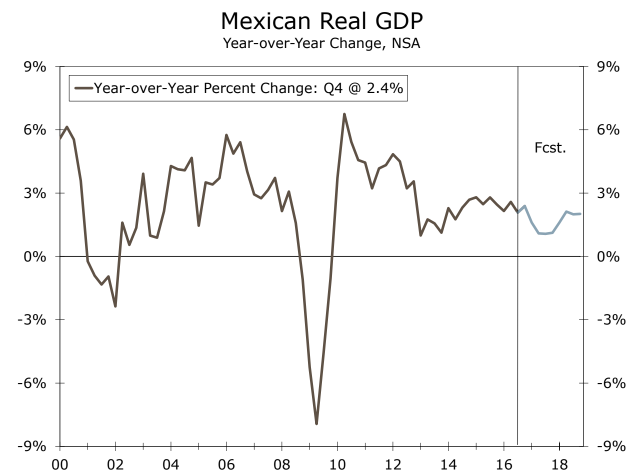
- Headline retail sales fell in line with expectations in March, while February's already soft print was revised lower. Looking past the headline, however, control group sales are up 4.1 percent on a three-month annualized basis.
- Energy prices weighed on headline inflation data in March, with consumer prices declining for the first time in more than a year. The core index also slipped, with the year-over-year rate falling to 2.0 percent. Import prices and the PPI also edged lower on the month.
- Survey data released this week point to continued tightening in the labor market and suggest that the March slowdown in nonfarm payrolls is likely to be short-lived.



Global Review

Global Growth Continues to Solidify

- Information on the global economy continues to show growth solidifying. This week's strong import and export numbers from China, up 20.3 percent and 16.4 percent, respectively, year over year, are a clear indication that trade has started to improve. Concerns on further economic weakness in Chinese and global economic growth are giving way to slowly improving and stabilizing economic conditions.
- We are now forecasting a 1.2 percent growth rate for the economy this year rather than the mild recession. Still, we believe that the Mexican economy will be negatively affected by the new policies from the Trump administration but that the effects will be spread over several years.



Wells Fargo U.S. Economic Forecast

	Actual 2016				Forecast 2017				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2014	2015	2016	2017	2018
Real Gross Domestic Product [1]	0.8	1.4	3.5	2.1	0.8	2.9	2.6	2.3	2.4	2.6	1.6	2.1	2.5
Personal Consumption	1.6	4.3	3.0	3.5	1.1	2.7	2.5	2.4	2.9	3.2	2.7	2.5	2.7
Inflation Indicators [2]													
PCE Deflator	0.9	1.0	1.0	1.4	2.0	1.9	2.0	2.0	1.5	0.3	1.1	2.0	2.2
Consumer Price Index	1.1	1.1	1.1	1.8	2.7	2.4	2.5	2.4	1.6	0.1	1.3	2.5	2.4
Industrial Production [1]	-1.3	-0.7	0.8	0.8	2.2	3.2	2.4	2.4	3.1	-0.7	-1.2	1.8	2.4
Corporate Profits Before Taxes [2]	-6.6	-4.3	2.1	9.3	3.8	3.6	3.2	3.1	5.9	-3.0	-0.1	3.4	2.9
Trade Weighted Dollar Index [3]	89.8	90.6	90.0	95.8	94.0	96.3	97.0	99.3	78.4	91.1	91.6	96.6	97.4
Unemployment Rate	4.9	4.9	4.9	4.7	4.7	4.6	4.6	4.5	6.2	5.3	4.9	4.6	4.5
Housing Starts [4]	1.15	1.16	1.14	1.25	1.26	1.24	1.26	1.27	1.00	1.11	1.17	1.26	1.35
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.50	0.25	0.27	0.52	1.31	1.88
Conventional Mortgage Rate	3.69	3.57	3.46	4.20	4.20	4.29	4.45	4.46	4.17	3.85	3.65	4.35	4.53
10 Year Note	1.78	1.49	1.60	2.45	2.40	2.55	2.72	2.75	2.54	2.14	1.84	2.61	2.84

Forecast as of: April 12, 2017
[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

Inside

U.S. Review

The Hard Data Looks a Bit Soft

Headline retail sales fell in line with expectations in March, declining 0.2 percent. February's already soft print was revised lower, however. Weakness in auto sales continued to weigh on the headline, with auto sales falling in four of the past five months. Control group retail sales, which filter directly into GDP, rose a better-than-expected 0.5 percent on the month. On a three-month annualized basis, control group sales are up 4.1 percent (top chart). While solid, given the pickup in inflation and softer trend in auto sales, we look for real personal consumption to slow to a 1.1 percent annualized rate in the first quarter.

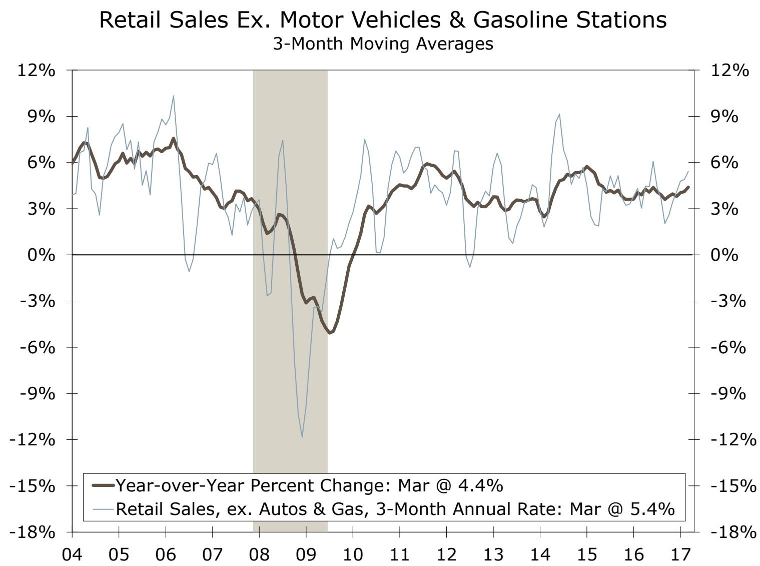
Survey data released this week point to continued tightening in the labor market and suggest that the March slowdown in nonfarm payrolls is likely to be short-lived. Job openings reportedly remained on course in February, rising to 5.74 million, which marks a seven-month high. Moreover, nearly one-third of small business owners indicated job openings were hard to fill in March (middle chart), according to data from the NFIB small business survey. As a result, more owners reported increasing compensation to attract and retain workers. A net 28 percent of owners stated raising workers' compensation, which marks the second-highest reading since mid-2007. These measures suggest that demand for labor remains solid and support our outlook for a continued decline in the unemployment rate and a gradual pickup in wage growth over the course of the year.

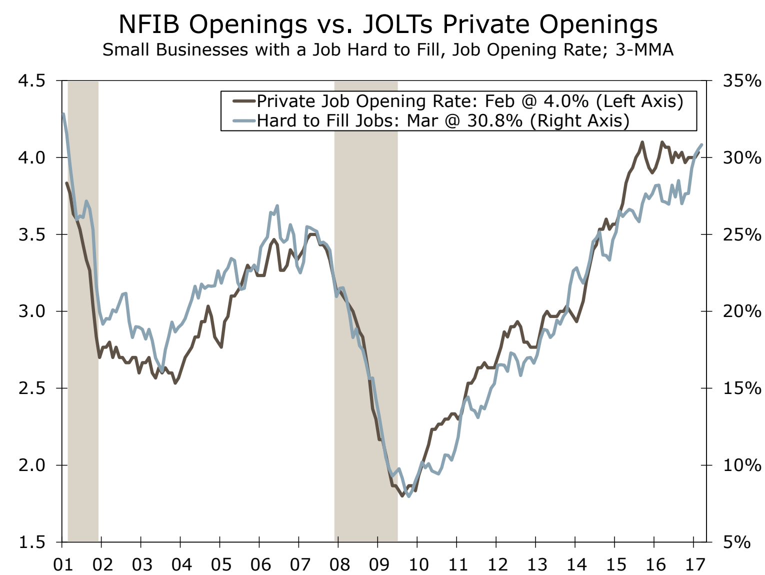
Energy Weighs on Headline Inflation Data

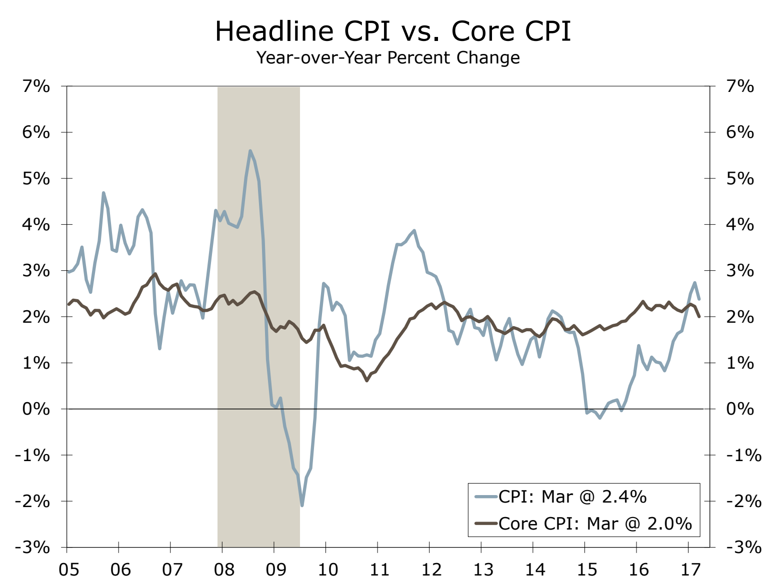
Import prices fell 0.2 percent in March, marking the first drop in four months as the recovery in oil prices took a pause. Ex-petroleum, however, prices rose 0.2 percent and are up 1.2 percent on a year-over-year basis. The upward momentum in nonfuel prices has largely been driven by strengthening in the business sector as nonfuel industrial supplies and capital goods prices are rebounding. Export prices edged higher in March and are up 3.6 percent over the past year.

The Producer Price Index (PPI) ticked down 0.1 percent in March, ending a six month string of gains. As expected, energy was a drag on the headline, down 2.9 percent. Ex-food, energy and trade services, the PPI rose 0.1 percent, marking the tenth consecutive increase.

Consumer prices fell in March for the first time in more than a year, declining 0.3 percent versus expectations that price levels would remain unchanged. A 6.2 percent decline in gasoline prices was the largest contributor to the headline's drop. Excluding energy, prices also slipped 0.1 percent despite a rebound in food prices. The core index also fell a modest 0.1 percent, the first decline in more than six years. Weakness was reported in both core goods and services. The core index slipped to 2.0 percent year-over-year; however, we do not see this weakness as start of a new trend. Despite this week's mixed readings on price pressures, we believe the Fed will continue to focus on their preferred inflation measure, the core PCE, which continues to drift higher.







Source: U.S. Department of Labor, U.S. Department of Commerce NFIB and Wells Fargo Securities

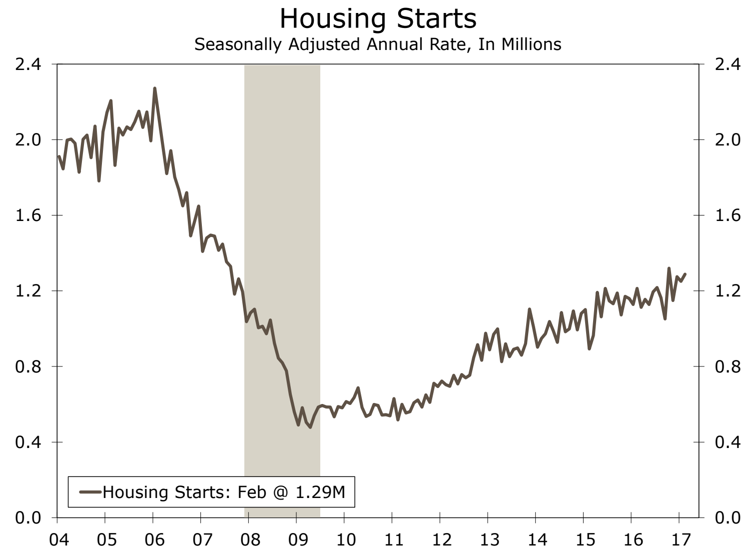
Housing Starts • Tuesday

Mild weather in January and February allowed the homebuilding season an earlier start in 2017. Housing starts were up 3.0 percent in February to a 1.29 million unit pace, with all of the increase in single-family starts. Momentum is increasingly shifting toward single-family homes in suburban markets as multifamily continues to cool in urban markets. Steady job and income growth, combined with tight inventory of homes available for sale in many markets, should continue to support homebuilding going forward.

The early start to the spring homebuilding season may bring some volatility to the seasonally adjusted data in coming months. Spring months are unlikely to see the large gains they normally do because they did not fall off as much as they normally do this winter. We expect housing starts to come in at a 1.21 million unit annual pace in March.

Previous: 1.29M **Wells Fargo: 1.21M**

Consensus: 1.25M



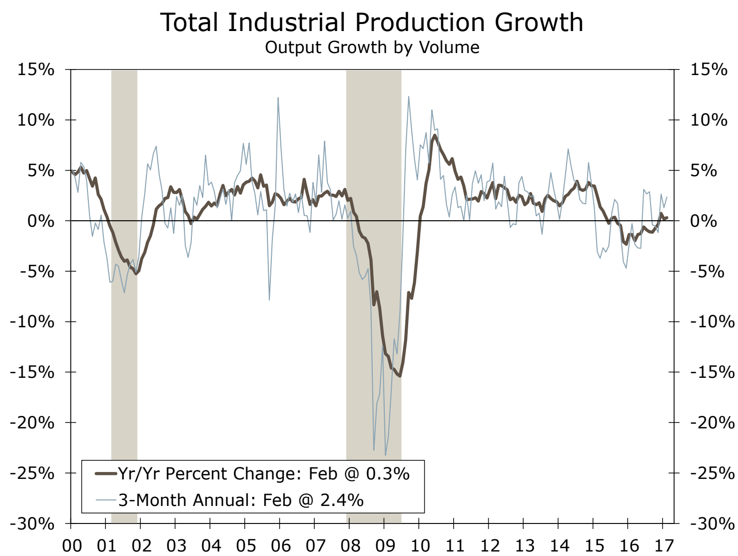
Industrial Production • Tuesday

February's flat reading of industrial production was largely the result of warmer weather weighing utilities output for the second straight month. Manufacturing and mining output continued to climb. Factory output rose 0.5 percent in February, continuing its six-month winning streak as manufacturing activity ramps up after two years under the weight of slow global growth, decreased energy exploration and high inventories. Factory data continue to steadily improve as these headwinds fade into the rearview mirror.

Looking to March, we expect continued improvement in manufacturing output. The ISM slipped slightly in March but still pointed to a ramp up in production while factories added more workers in March. Utilities output should reverse course in March, as colder temperatures returned to most of the country. Taken together, we expect the headline to be up 0.9 percent on the month.

Previous: 0.0% **Wells Fargo: 0.9%**

Consensus: 0.5%



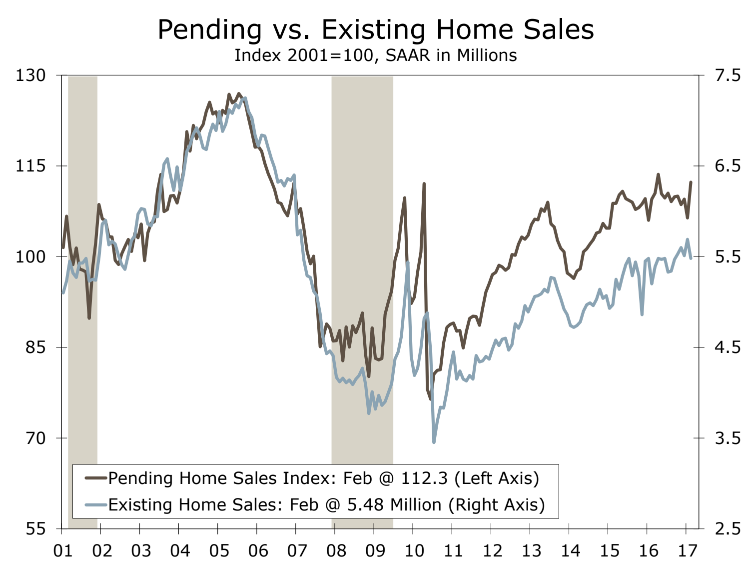
Existing Home Sales • Friday

Home sales declined 3.7 percent in February following a 3.3 percent jump in January. February's slowdown was to be expected, given the January decline in pending home sales, which are measured when the contract is signed and tends to lead existing home sales, which are counted at closing. February's pullback in existing home sales did alleviate some pressure on exceptionally tight inventories of homes available for sale, though at a 3.8-month supply, the market remains competitive for homebuyers.

Pending home sales picked back up in February, which bodes well for a faster pace of existing home sales in March. We expect a healthy spring selling season, as stronger job and income growth encourages home purchases. However, the supply of homes available for sale remains exceptionally low, making this a sellers' market.

Previous: 5.48M **Wells Fargo: 5.64M**

Consensus: 5.55M



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

Global Review

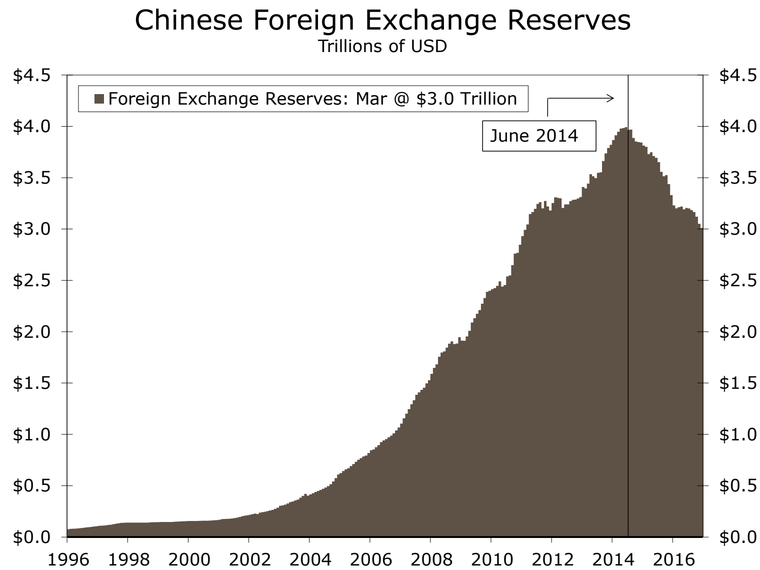
Global Growth Continues to Solidify

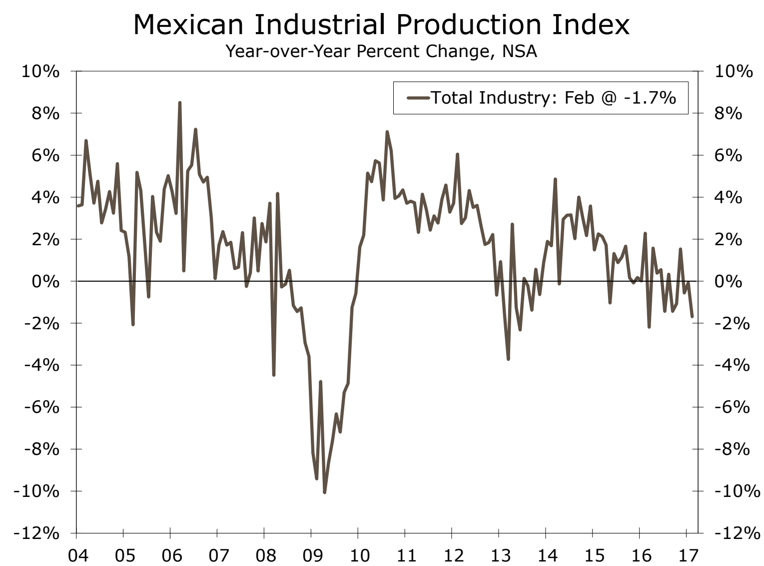
Information on the global economy continues to show growth solidifying. This week's strong import and export numbers from China, up 20.3 percent and 16.4 percent, respectively, year over year, are a clear indication that trade has started to improve and concerns on further economic weakness in Chinese and global economic growth are giving way to slowly improving and stabilizing economic conditions. Last week's third consecutive increase in monthly foreign reserves was a further sign that expectations on the future of the economy have improved somewhat after several years of dwindling reserves.

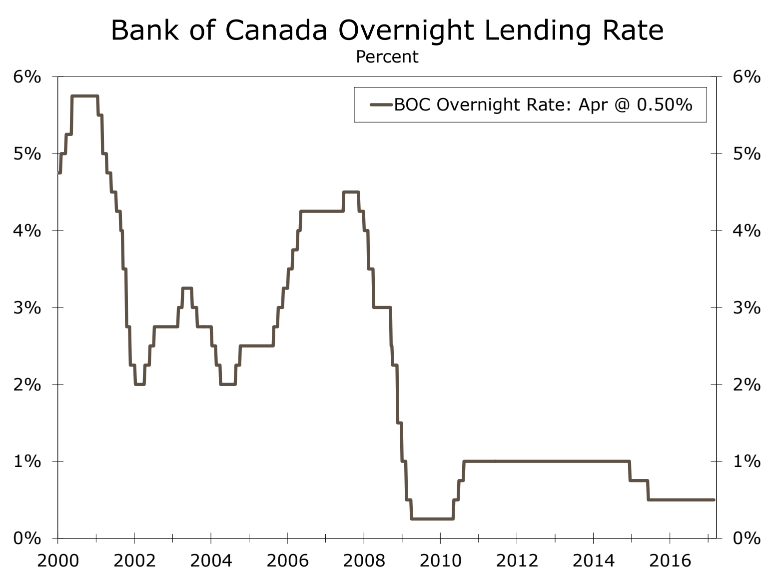
Meanwhile, in this Hemisphere, we have become a bit more optimistic on the future of the Mexican economy. There has been an important shift in the conversation from the new U.S. administration regarding all-things-Mexico lately. Thus, we are now forecasting a 1.2 percent growth rate for the economy this year rather than the mild recession. Still, we believe that the Mexican economy will be negatively affected by the new policies from the Trump administration but that the effects will be spread over several years. Furthermore, industrial production numbers for February were mixed, with the construction sector leading growth in the month but public utilities and mining output weakening further. Meanwhile, the manufacturing industry remained relatively stable but almost unchanged from the previous month. However, we saw a strong increase in automobile production and automobile exports in March so manufacturing output is probably going to improve in the short run. Also in North America, the Bank of Canada, as expected, decided to keep its benchmark overnight interest rate unchanged at 0.50 percent as the economy has continued to improve and inflation remains contained.

In South America, the Brazilian central bank cut interest rates by 100 bps as inflation continues to decline amid still very weak economic activity. Meanwhile, our expectation for this year's economic performance remained unchanged even as the central bank has become more dovish in terms of inflation and inflationary expectations. We still expect the economy to grow 0.7 percent in 2017. However, we are still concerned with the ongoing investigation into the Car Wash fraud scandal, which has continued to expand and now has even touched Fernando Henrique Cardozo, ex-president of Brazil during the Plan Real in the mid-1990s. But, accusations have also spilled across the border as Peruvian and Mexican officials have also been accused of taking bribe money from Brazilian construction conglomerate Odebrecht.

In Europe, even as the economy continues to improve, markets have started to concentrate on France's approaching elections (April 23), with analysts envisioning a second-round vote (if needed, on May 7) as no candidate is expected to win them during the first round. However, the presidential elections are probably the least of the problems as potential alliances between diverging political parties and movements make compromise even more difficult and policies more difficult to implement.







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

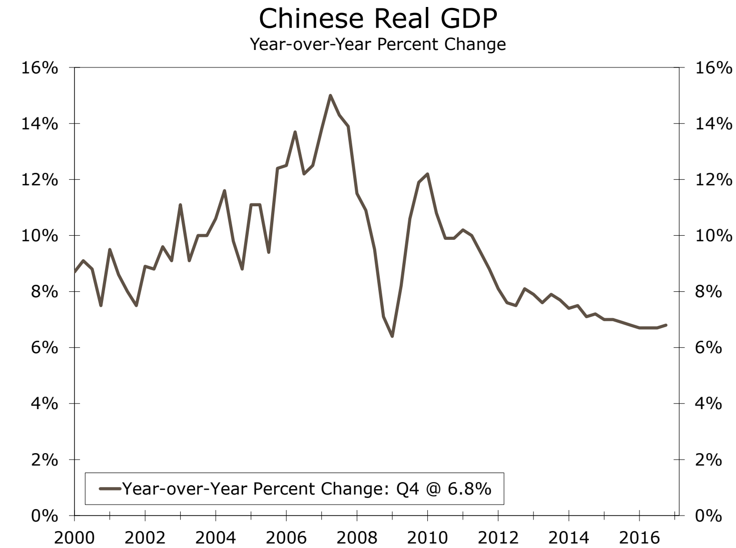
China GDP Growth • Monday

The Chinese economy has been decelerating for the past few years. That said, real GDP growth in China has stabilized just below 7 percent in the past few quarters, and most analysts suspect a similar rate of growth was registered in the first quarter. The Chinese government has been able to engineer a "soft landing" via expansionary economic policies.

Chinese authorities do not release timely data on the demand-side components of real GDP, but monthly indicators provide some useful insights into the economy. Data released this week showed that export growth has picked up recently, which is helping to support real GDP growth in China. Next week's data releases on retail spending and industrial production in March will give analysts further insights into the current state of the economy. Looking forward, we expect that GDP growth will slowly downshift as investment spending decelerates further.

Previous: 6.8% (Year-over-Year) Wells Fargo: 6.7%

Consensus: 6.8%



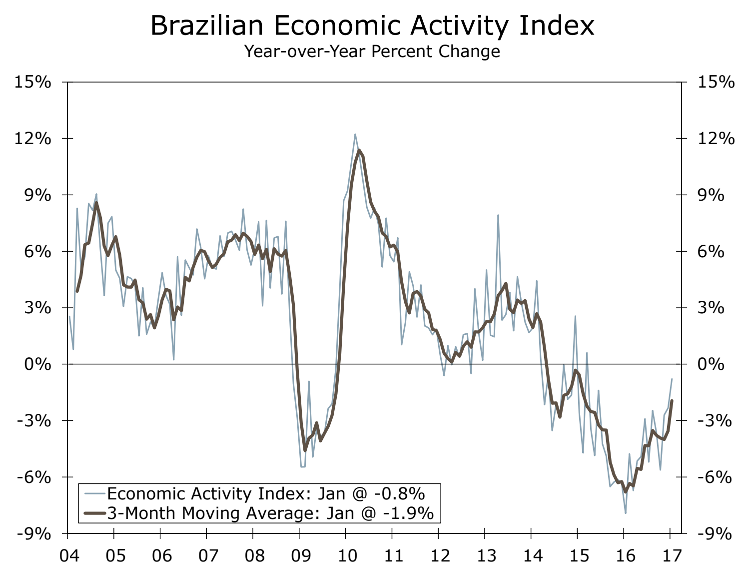
Brazil Economic Activity Index • Monday

Real GDP in Brazil has contracted 9 percent since peaking in Q1-2014. The monthly economic activity index, which will print next week, will offer some insights into the state of the Brazilian economy in the first quarter. Although the year-over-year rate of descent of the index is flattening out, there are few signs yet to suggest that economic growth in Latin America's largest economy is turning positive again.

Inflation data for April will also print next week. CPI inflation, which shot up as high as 11 percent in early 2016, has been dropping like a stone in recent months due to economic weakness and exchange rate appreciation. The nosedive in inflation has allowed the central bank to reduce its main policy rate by 300 bps since October (it cut the rate by 100 bps this week). Further disinflation would give the central bank scope to ease policy further in coming months.

Previous: -0.8% (Year-over-Year)

Consensus: -2.4%



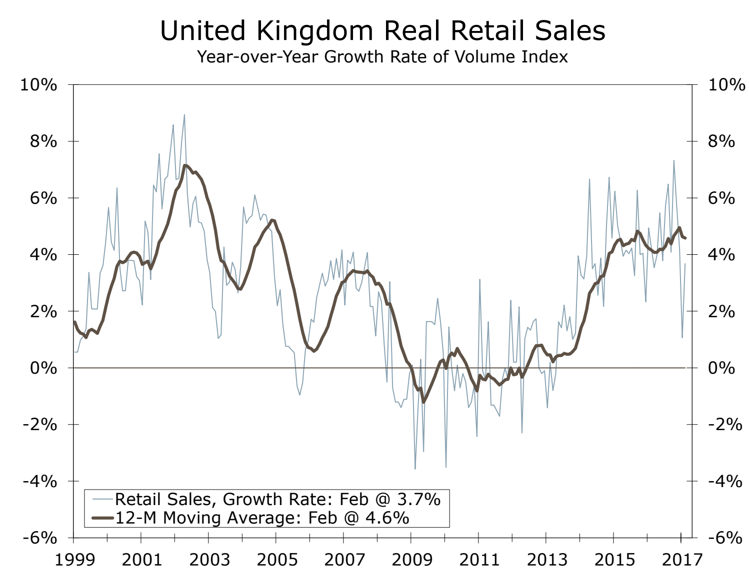
U.K. Retail Sales • Friday

Following the Brexit referendum last June, there was concern that the uncertainty associated with the negotiation process could cause the British economy to slip into a mild recession. However, economic growth in the United Kingdom has remained positive due, at least in part, to resiliency in consumer spending.

That said, growth in retail spending has slowed recently. If the volume of retail sales edges down 0.2 percent in March relative to February, as the consensus forecast anticipates, then real retail spending will have contracted more than 1 percent on a sequential basis in the first quarter. Although real spending on services likely remained positive in Q1, the modest downturn in real retail sales suggests that overall consumer spending has decelerated. Rising inflation, which reflects the effects of sterling depreciation in the wake of the Brexit referendum, has eroded growth in real disposable income.

Previous: 1.4% (Month-over-Month)

Consensus: -0.2%



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

Interest Rate Watch

Perfect Policy Storm?

Three policy initiatives are on a path to challenge investors and policy makers going forward. Each of these initiatives is on a path that has not been explored before and thereby adds to the risk of the implications of the confluence of economic storms.

FOMC: Uncertain Search for Neutral

For the FOMC, the direction of policy intentions, as illustrated by the top graph, is for a rise in the funds rate for the next two years. Yet, while the intended direction for rates is clear, the magnitude of the move remains uncertain, given both the pace of inflation and the debates surrounding the neutral interest rate target. Debate on the real neutral rate (zero, one or two percent) also faces the feedback effects between interest rates, growth and inflation. These feedback effects are highly uncertain, given that policymakers have not gone down this policy path before.

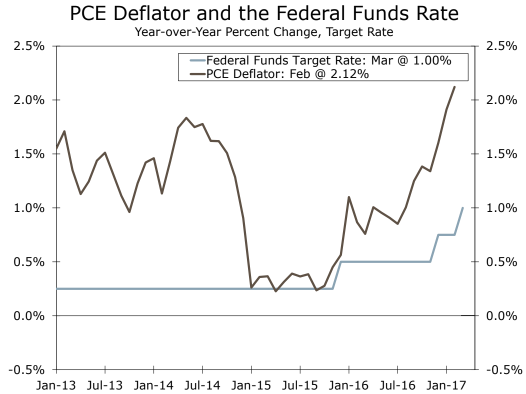
Rising Treasury Debt Issuance

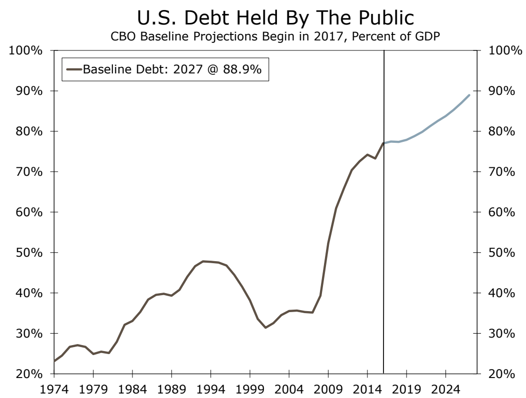
For U.S Treasury and fixed income investors, the expected path of debt finance and the amount of debt held by the public projected by the CBO (middle graph) signal that Treasury finance is moving into unexplored territory.

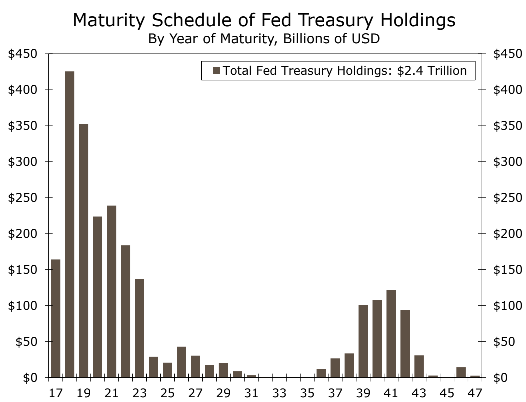
Again, there is an interaction of a rising path for Treasury finance in an environment of tighter monetary policy (above) as well as changes in sentiment of foreign investors to Treasury debt. There is no linear path here for rates but rather the interaction of forces beyond the bounds of our experience in the amount of debt and the willingness of investors to buy debt in a rising inflation environment.

More Treasury Issuance in the Face of a Less Willing Buyer

Recent commentary by FOMC speakers has highlighted that the FOMC is considering starting the process of shrinking its balance sheet. Again, we are entering unexplored territory. As illustrated in the bottom graph, the maturity schedule of Treasury debt is very front loaded. A triumvirate of influences will take market rates and volatility into a world we have seen before.







Source: Federal Reserve Board, IHS Global Insight, CBO and Wells Fargo Securities

Credit Market Insights

Consumers Remain Optimistic

Earlier this week, the New York Fed released its monthly *Survey of Consumer Expectations*, which provides an outlook of consumers' near- and medium-term expectations for inflation, the labor market and household finances. In March, the decline in inflation expectations over the short- and medium-term was broad-based across different demographics, while household finances and the labor market expectations improved.

Consumers' outlook on the labor market strengthened over the month. The job-finding-expectations component increased to its highest level since the series' start in mid-2013. Even the disappointing March employment print was not enough to dampen job seekers' outlook on future employment, which is at nearly 60 percent. Moreover, those surveyed believe that wages are going to pick up in the near term.

In addition, more households believe they are moving in the right direction and will be better off next year. Consumers expect their household income to grow and are more confident in their ability to maintain their debt and are satisfied with the level of credit afforded to them. Also, expectations for higher interest rates on saving accounts as well as higher U.S. stock prices rose to series highs.

That said, we think the momentum of the economy and the strength of the consumer will be able to withstand two additional Fed rate hikes that we have forecasted for this year.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.08%	4.10%	4.23%	3.58%
15-Yr Fixed	3.34%	3.36%	3.44%	2.86%
5/1 ARM	3.18%	3.19%	3.24%	2.84%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$2,085.1	12.97%	-7.00%	2.77%
Revolving Home Equity	$396.5	-10.35%	-7.38%	-7.43%
Residential Mortgages	$1,748.6	-12.39%	1.43%	3.98%
Commerical Real Estate	$2,003.6	5.60%	7.50%	8.97%
Consumer	$1,364.3	-3.31%	-2.81%	5.82%

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

Topic of the Week

Balancing Act: Normalizing the Balance Sheet

As the Fed considers what to do with its $4.5 trillion balance sheet and the implications these decisions might have on financial markets, we are reminded of Donald Rumsfeld's observation that "it is easier to get into something than to get out of it."

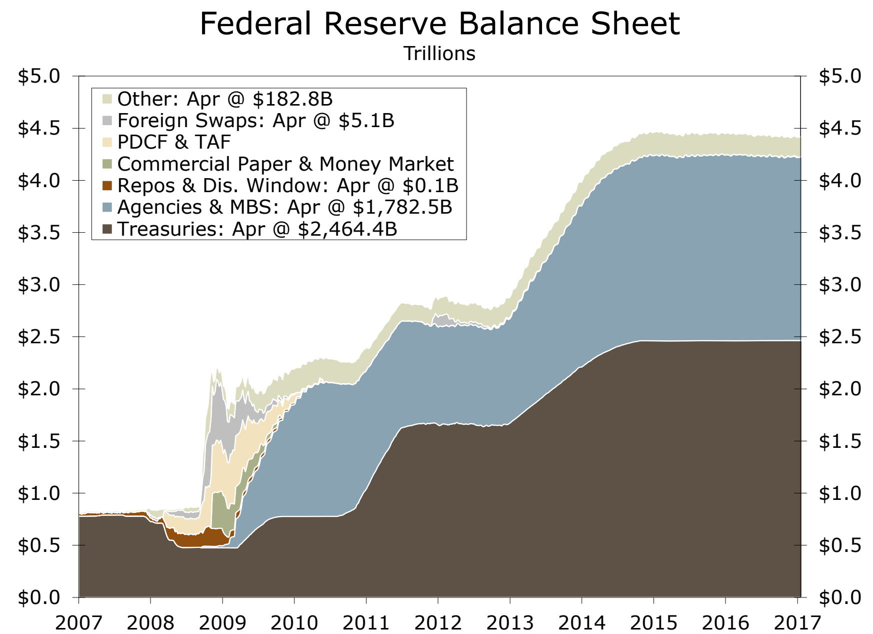
Prior to the 2008 financial crisis, the Fed's asset holdings were about $900 billion, consisting primarily of Treasuries (top chart). Today, the balance sheet is roughly $4.5 trillion, comprised mostly of Treasuries and mortgage-backed securities (MBS).

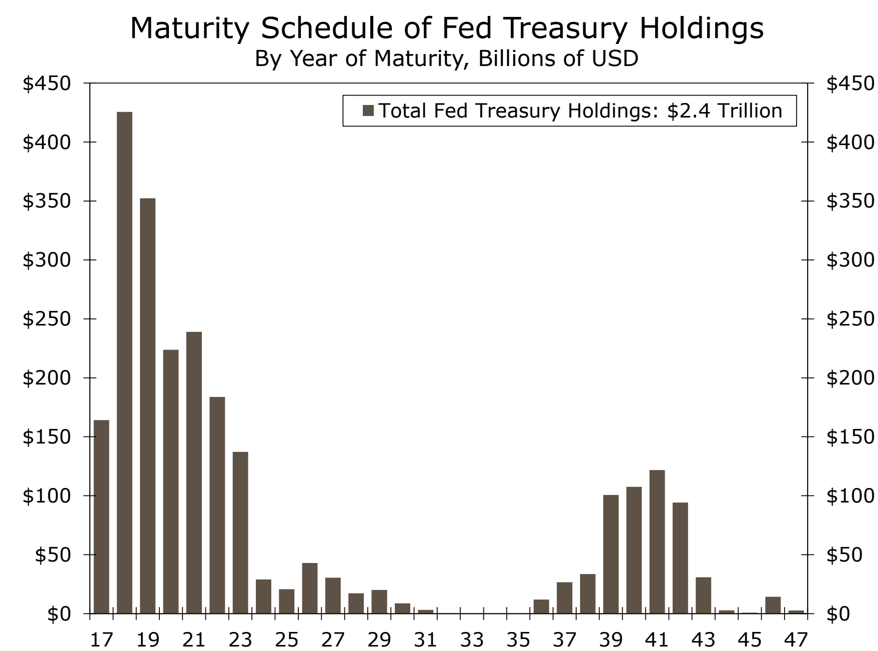
Fed guidance on the timing and structure of balance sheet reductions has been fairly tight-lipped until recently. However, based off of the Fed's "Policy Normalization Principles and Plans," the Fed appears set to 1) allow maturing assets to roll off rather than outright sell securities and 2) gradually return its holdings to primarily Treasuries over the long run.

The front-loaded nature of the Fed's Treasury holdings is conducive to a policy that ends reinvestments. As illustrated in the bottom chart, more Treasury securities come due in 2018 than any other year. For MBS, however, there is a less clear path ahead: Prepayment on MBS, due to refinancing, downsizing/upsizing, mobility and other factors, all influence the pace at which these securities will mature.

In our view, the Fed most likely will propose starting the process by allowing maturing securities to roll off by year's end, through a combination of MBS and Treasury reductions. In order to prevent a taper tantrum repeat, the Fed will likely try to signal this well in advance and choose to reinvest a sizable percentage of the maturing assets, smoothing the transition. If all proceeds according to plan and the economy continue to improve, the Fed would then gradually reduce the share of its reinvestments to normalize further.

For further reading, see our special report *Balancing Act: Normalizing the Fed's Balance Sheet* available on our website.





Source: Federal Reserve System and Wells Fargo Securities

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 4/14/2017	1 Week Ago	1 Year Ago
3-Month T-Bill	0.80	0.81	0.22
3-Month LIBOR	1.16	1.15	0.63
1-Year Treasury	1.13	0.95	0.57
2-Year Treasury	1.21	1.29	0.77
5-Year Treasury	1.77	1.92	1.25
10-Year Treasury	2.24	2.38	1.79
30-Year Treasury	2.89	3.01	2.60
Bond Buyer Index	3.77	3.83	3.30

Foreign Exchange Rates

	Friday 4/14/2017	1 Week Ago	1 Year Ago
Euro ($/€)	1.062	1.059	1.127
British Pound ($/£)	1.253	1.237	1.416
British Pound (£/€)	0.848	0.856	0.796
Japanese Yen (¥/$)	108.640	111.090	109.400
Canadian Dollar (C$/$)	1.332	1.340	1.284
Swiss Franc (CHF/$)	1.004	1.009	0.967
Australian Dollar (US$/A$)	0.757	0.750	0.770
Mexican Peso (MXN/$)	18.504	18.666	17.445
Chinese Yuan (CNY/$)	6.886	6.901	6.483
Indian Rupee (INR/$)	64.411	64.534	66.645
Brazilian Real (BRL/$)	3.147	3.144	3.498
U.S. Dollar Index	100.430	101.180	94.902

Foreign Interest Rates

	Friday 4/14/2017	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.36	-0.36	-0.26
3-Month Sterling LIBOR	0.34	0.34	0.59
3-Month Canada Banker's Acceptance	0.94	0.94	0.91
3-Month Yen LIBOR	0.02	0.04	-0.01
2-Year German	-0.86	-0.78	-0.52
2-Year U.K.	0.11	0.13	0.43
2-Year Canadian	0.73	0.73	0.57
2-Year Japanese	-0.23	-0.21	-0.26
10-Year German	0.19	0.26	0.13
10-Year U.K.	1.04	1.10	1.42
10-Year Canadian	1.49	1.55	1.25
10-Year Japanese	0.01	0.06	-0.09

Commodity Prices

	Friday 4/14/2017	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	53.18	51.70	41.76
Gold ($/Ounce)	1285.73	1254.45	1227.93
Hot-Rolled Steel ($/S.Ton)	655.00	655.00	476.00
Copper (¢/Pound)	257.05	265.80	216.80
Soybeans ($/Bushel)	9.30	9.16	9.52
Natural Gas ($/MMBTU)	3.23	3.33	2.04
Nickel ($/Metric Ton)	9,695	10,019	8,953
CRB Spot Inds.	503.31	513.26	451.27

Source: Bloomberg LP and Wells Fargo Securities

Next Week's Economic Calendar

	Monday 17	Tuesday 18	Wednesday 19	Thursday 20	Friday 21
U.S. Data	**NAHB Housing Market Index** March 71 April 70 (C) **TIC** January $110.4B February	**Housing Starts** February 1288K March 1209K (W) **Industrial Production (MoM)** February 0.0% March 0.9% (W)		**LEI** February 0.6% March 0.2% (W)	**Existing Home Sales** February 5.48M March 5.64M (W) **Manufacturing & Services PMI** February 53.3 & 52.8 March 53.8 & 53.6 (C)
Global Data	**Brazil** **Economic Activity (YoY)** January -0.8%	**South Korea** **Producer Price Index (YoY)** Previous (February) 4.2%	**Eurozone** **CPI (MoM)** Previous (February) 0.4% **Russia** **Retail Sales (MoM)** Previous (February) -2.3%	**Eurozone** **Construction Output (MoM)** Previous (January) -2.3%	**Eurozone** **Manufacturing & Services PMI** Previous (March) 56.2 & 56.0 **United Kingdom** **Retail Sales (MoM)** Previous (February) 1.4%

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

Source: Bloomberg LP and Wells Fargo Securities

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