May 24, 2019

WELLS FARGO SECURITIES

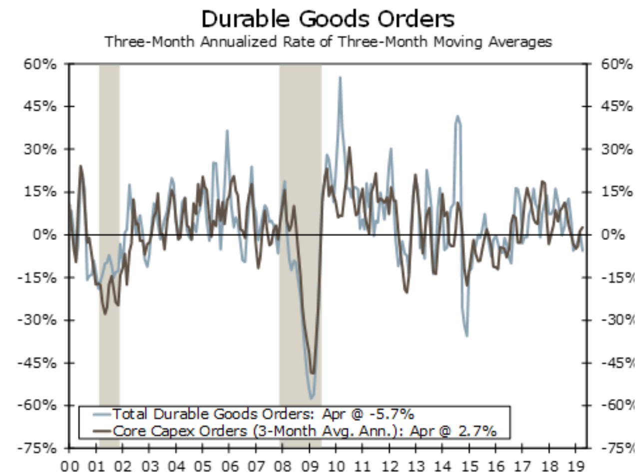
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Housing Looking Up as Dark Trade Clouds Gather

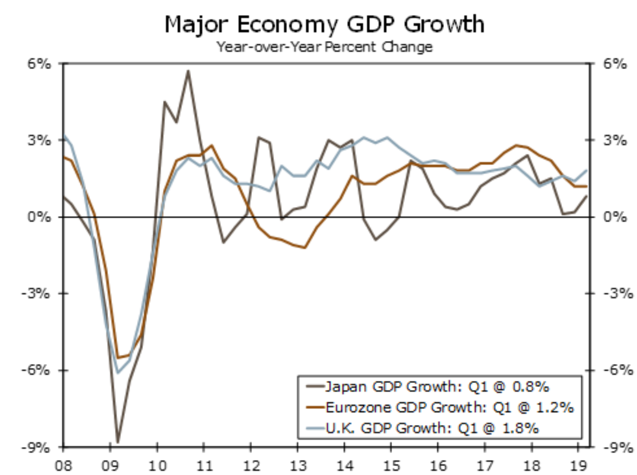
- Durable goods orders slipped 2.1% during April. The grounding of the 737 MAX led to a 25.1% drop in commercial aircraft orders. However, core capex orders also fell 0.9%, a signal that business investment should continue to be subdued.
- Home sales stumbled during April. Existing sales fell 0.4% and new sales dropped 6.9%, though the monthly weakness masks a more positive trend driven by lower mortgage rates.
- Minutes for the early May FOMC meeting appear to confirm our view that the Fed is not likely to raise interest rates this year.



Global Review

Global Economy Pauses, But Will It Refresh?

- Data out of foreign economies during the past week have been mixed, with no clear evidence that international growth was either speeding up or slowing down in early 2019.
- Japan's Q1 GDP was firmer than expected, though mainly due to soft imports rather than strong domestic demand. March machinery orders were firmer than forecast, while exports were softer than forecast.
- After the U.K economy showed resilience in Q1, confidence surveys suggest a possible slowing in Q2. Meanwhile Eurozone PMIs eased in May, and it seems likely that Eurozone Q2 GDP growth might fall short of its Q1 pace.



Wells Fargo U.S. Economic Forecast

	Actual				Forecast				Actual			Forecast	
	2018				2019								
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2016	2017	2018	2019	2020
Real Gross Domestic Product [1]	2.2	4.2	3.4	2.2	3.2	2.5	2.2	2.5	1.6	2.2	2.9	2.8	2.1
Personal Consumption	0.5	3.8	3.5	2.5	1.2	2.9	2.4	2.4	2.7	2.5	2.6	2.4	2.1
Inflation Indicators [2]													
PCE Deflator	1.9	2.2	2.2	1.9	1.4	1.6	1.7	1.8	1.1	1.8	2.0	1.6	2.1
Consumer Price Index	2.2	2.7	2.6	2.2	1.6	2.0	2.0	2.2	1.3	2.1	2.4	2.0	2.3
Industrial Production [1]	2.3	4.6	5.2	4.0	-0.3	0.3	1.6	2.2	-2.0	2.3	4.0	2.0	1.0
Corporate Profits Before Taxes [2]	5.9	7.3	10.4	7.4	7.4	6.2	3.7	5.7	-1.1	3.2	7.8	5.7	0.6
Trade Weighted Dollar Index [3]	103.1	107.3	107.6	110.1	109.8	109.0	108.8	107.8	109.4	108.9	106.4	108.8	105.0
Unemployment Rate	4.1	3.9	3.8	3.8	3.9	3.7	3.7	3.6	4.9	4.4	3.9	3.7	3.6
Housing Starts [4]	1.32	1.26	1.23	1.19	1.19	1.26	1.27	1.28	1.17	1.20	1.25	1.27	1.29
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	1.75	2.00	2.25	2.50	2.50	2.50	2.50	2.50	0.52	1.13	1.96	2.50	2.44
Conventional Mortgage Rate	4.44	4.57	4.63	4.64	4.28	4.20	4.25	4.30	3.65	3.99	4.54	4.26	4.26
10 Year Note	2.74	2.85	3.05	2.69	2.41	2.60	2.65	2.70	1.84	2.33	2.91	2.59	2.66

Forecast as of: May 8, 2019

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

[2] Year-over-Year Percentage Change

[3] Federal Reserve Advanced Foreign Economies Index, 2006=100 - Quarter End

[4] Millions of Units

[5] Annual Numbers Represent Averages

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

Inside

Together we'll go far

U.S. Review

Housing Looking Up as Dark Trade Clouds Gather

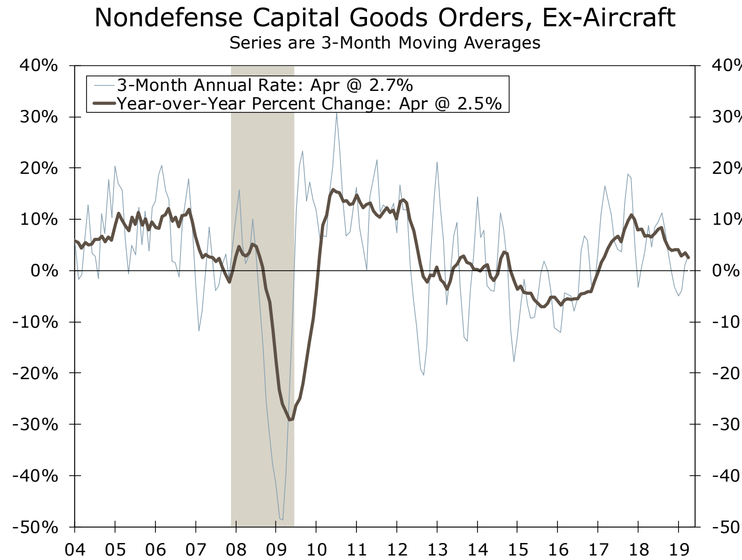
Dark clouds continued to gather over the once-promising trade discussions between the United States and China. Increasingly stark dialogue sent financial markets into a tizzy this week, an indication that there is a wider gap between the two parties than many observers had initially thought. On a more auspicious note, tariffs imposed last year on steel and aluminum imported from Mexico and Canada were lifted this week, which will likely bring the USMCA trade agreement a step closer to ratification.

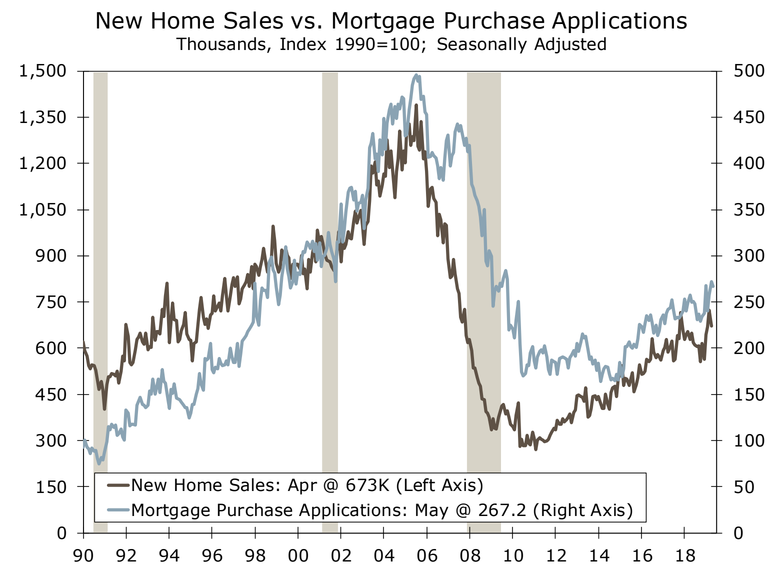
Trade headwinds are likely playing a role in weakness out of the factory sector. Durable goods orders fell 2.1% during April. Orders have been influenced by volatile aircraft orders in recent months, and this was again the case. The grounding of the Boeing 737 MAX and subsequent negative headlines have led to net cancellations, which weighed heavily on April's outcome. The civilian aircraft component of orders fell 25.1% while shipments declined 16.0%. That said, the weakness in orders extends beyond commercial aircraft. Core capex orders also slipped 0.9%, and have slowed to 2.5% year-over-year. Overall, manufacturing activity should continue to be subdued in coming months amid heightened trade frictions and sluggish global growth.

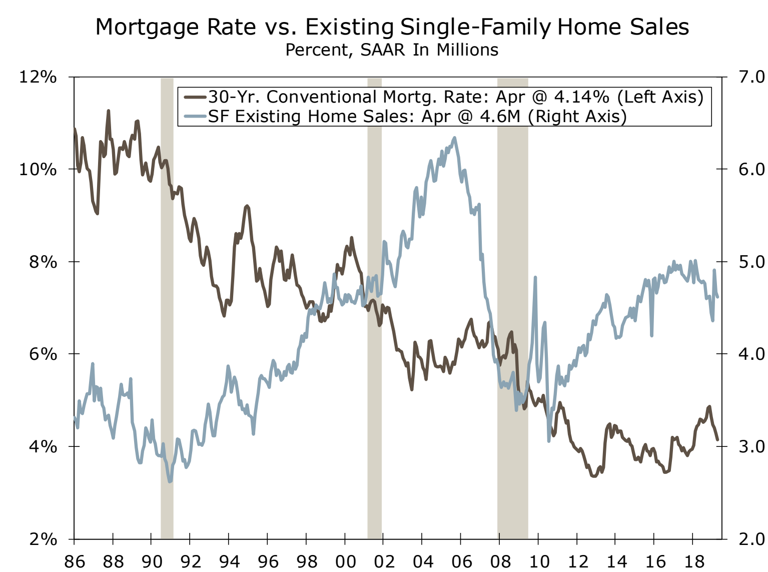
On a brighter note, lower mortgage rates have helped stymie the sharp pullback in home sales seen last year but have not reversed it. Declines in both new and existing home sales during April mask an overall improving trend in the housing market. New home sales came in below expectations, falling 6.9% in April. However, the report contained significant revisions to prior months' data, which showed sales reached a cycle-high 723,000-unit pace during March. Furthermore, the 673,000-unit sales pace hit in April was the fourth strongest since 2007. New home sales have likely been helped by builders offering discounts to clear rapidly rising inventories, however the trend is clearly improving and sales are now running 7.0% ahead of their year-ago pace.

Existing home sales also posted a drop and fell 0.4% during the month. While underwhelming, existing sales remain fairly solid and are running just slightly below their year-ago pace. A significant breakout is unlikely this year, but sales should be stronger than they have been the past few months. The rate on the 30-year fixed-rate mortgage fell to 4.14% in April, the lowest point since early last year. A pickup in purchase applications has followed. Through May 10, the purchase application index is 4.0% above the level averaged last year during that same period.

Meanwhile, the minutes for the early-May FOMC meeting revealed that the strong GDP report in Q1 assuaged many officials' fears of the mounting downside risks which had accumulated towards the end of 2018. While many Fed officials believe most of the weakness in core inflation is transitory, some members argued the downside risks to inflation have increased. Bear in mind that the recent escalation in trade tensions occurred after the meeting and the imposition of additional tariffs on goods imported from China may cause many Fed members to reassess risks to the outlook. However, the minutes reaffirm our stance that the Fed will likely keep further interest rate hikes on hold for the rest of the year.







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

Consumer Confidence Index • Tuesday

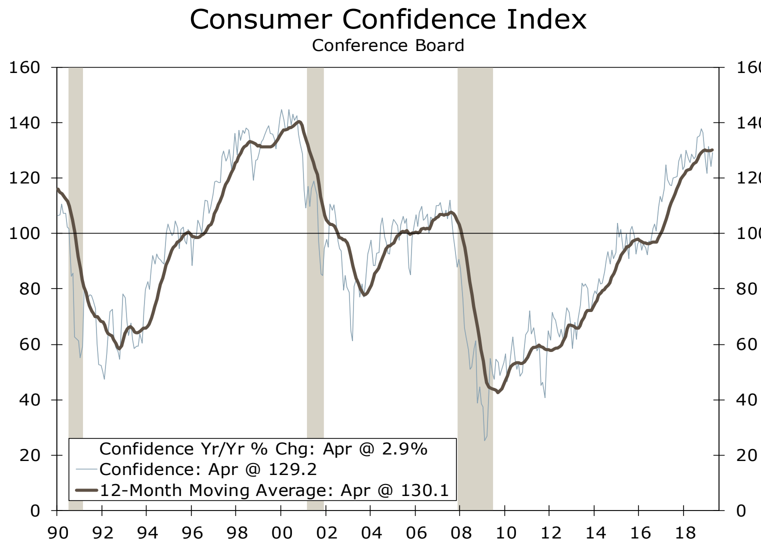
Consumer confidence came to a halt in recent months. Mounting trade tensions between the United States and China, an uncertain path forward for monetary policy and financial market volatility have imparted some instability in monthly optimism measures.

As recently as October, the consumer confidence index trended to its cycle high of 137.9, just before the market sell-off to end last year weighed on optimism. But, even as the S&P 500 regained its lost ground this year, lingering trade tensions and policy uncertainty prevented a renewed gain in ebullience. The preliminary print for the University of Michigan consumer sentiment index—final print to be released Friday—suggests that sentiment remained limited in May.

But, the Conference Board's survey was completed before the more recent weakness in financial markets and prior to the escalation of the trade war, so we may see a bit of a bounce in May.

Previous: 129.2 **Wells Fargo: 137.2**

Consensus: 130.0

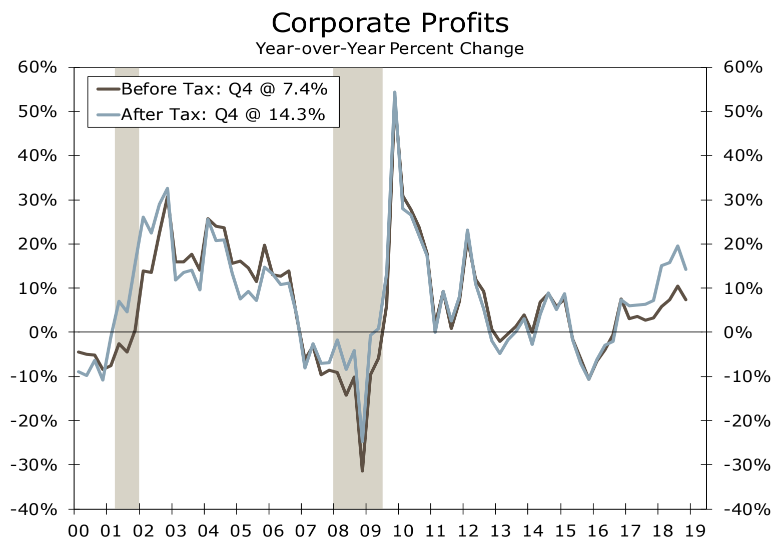


Q1 Corporate Profits • Thursday

U.S. corporations saw profits surge in 2018, due in part to a boost from favorable corporate tax reform enacted in late 2017, but also to the strong rate of economic growth. As the tax cuts dropped out of the year-over-year calculations, it was only natural for after-tax profits to decelerate this year. The pace of growth in before-tax profits has held up slightly better, but is expected to slow. With the second release of Q1 GDP next week, we receive the first look at corporate profit growth. We have written previously that S&P 500 earnings metrics and the economy-wide measure of profit growth that feeds into GDP differ in coverage and methodology. While expectations of corporate earnings-per-share have been volatile in recent months, we expect pre-tax profit growth to slow based on our forecast that real GDP growth will downshift this year. We will be paying particular attention to increased cost pressures stemming from tariffs, which are a wild card for profit margins.

Previous: 7.4% (Before-tax, Year-over-Year)

Wells Fargo: 6.2% (Before-tax, Year-over-Year)

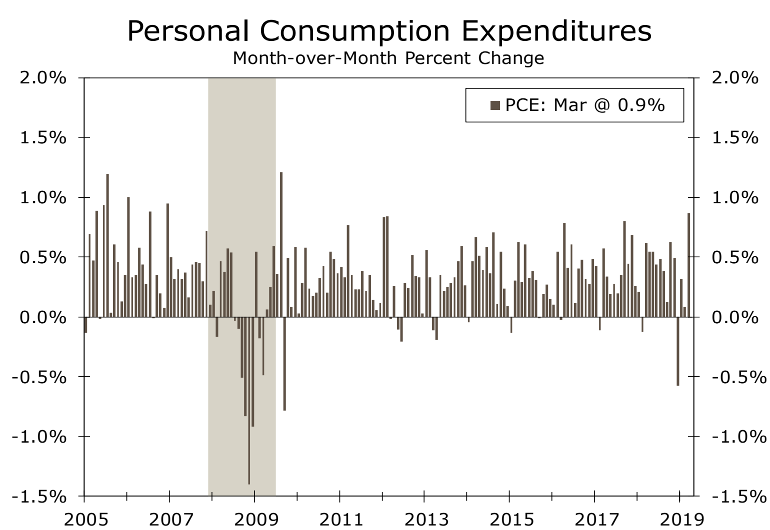


Personal Income & Spending • Friday

The all-but-static economic environment of late has not only weighed on consumer confidence but purchasing habits as well. In recent months, consumer data have lagged and in some ways been misleading, like the still-curious drop in December spending, sparking fear of a broad retrenchment. Spending ended the first quarter with a solid 0.9% increase, suggesting some momentum headed into Q2. But, with April retail sales falling 0.2%, another surge in April spending is unlikely. Baring a huge retrenchment in May and June, spending should still be on track for a decent quarter. Of additional focus on Friday will be the core PCE deflator. The recent Fed minutes disclosed that officials viewed the recent downshift in inflation as 'transitory', but others saw the anchoring of inflation expectations as a headwind to reaching its 2% target. We look for some pick-up in this measure, but we expect it to remain below 2% this year.

Previous: 0.1%, 0.9% **Wells Fargo: 0.4%, 0.2%**

Consensus: 0.3%, 0.2% (Month-over-Month)



Source: The Conference Board, U.S. Department of Commerce and Wells Fargo Securities

Global Review

Good News, Bad News

It was a mixed week for foreign economic data, starting with the release of Japan's Q1 GDP data on Monday. The figures looked impressive at first glance, with Japan's economy growing 2.1% quarter-over-quarter annualized. However, the underlying details were underwhelming. Household consumer spending fell at a 0.4% pace and business investment contracted at a 1.2% pace. Domestically the main sources of strength were residential investment and public investment. In fact the key driver behind the favorable headline growth figures was the large 17.2% quarter-over-quarter annualized fall in imports, an indicator of still subdued domestic demand. With consumer spending growing only moderately, and the government still on track at this stage to raise the consumption tax in October, the Bank of Japan's accommodative monetary policy stance looks likely to persist for an extended period of time.

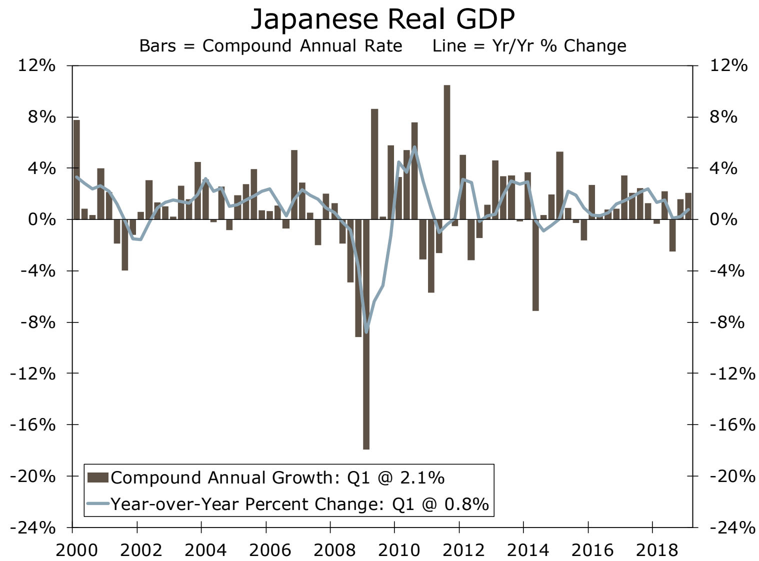
The news got slightly better as the week progressed as the April core CPI firmed to 0.9% year-over-year, and March core private machinery orders rose 3.8% month-over-month. That said, CPI inflation remains well short of the central bank's 2% inflation goal, while machinery orders are still down 0.7% compared to the same month a year ago.

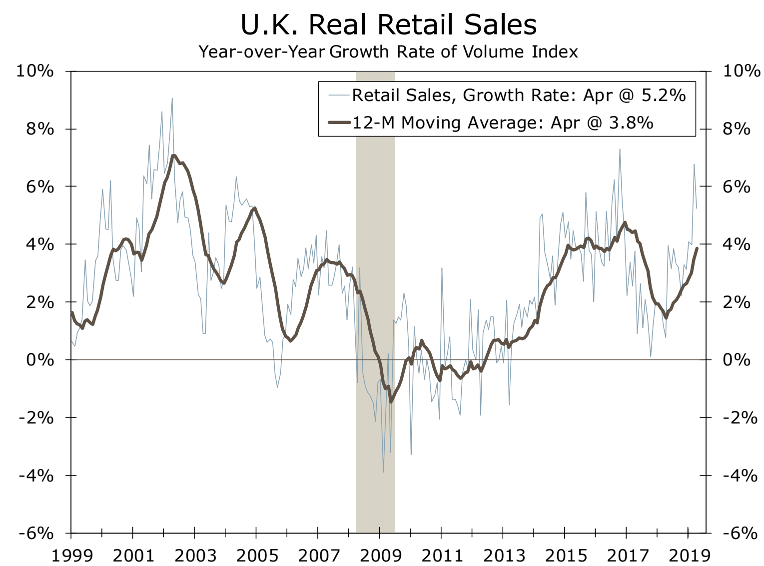
U.K. Resilience Shows Some Signs of Cracking

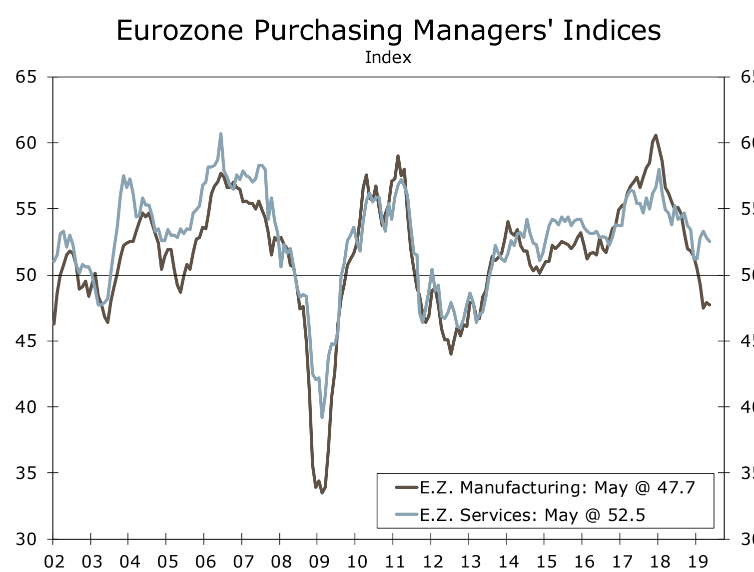
U.K. economic data have generally been resilient in early 2019, but showed some mild softening in the latest figures. After three months of strong gains, April retail sales fell 0.2% month-over-month, with sales growth slowing to 4.9% year-over-year from 6.3% in March. A May manufacturers' survey also showed a drop in the orders balance to -10, the weakest reading since late 2016. CPI inflation remained close to the central bank's target in April as the headline CPI rose 2.1% year-over-year and the core CPI rose 1.8%. However, while Brexit uncertainty hangs over the economy, we think a Bank of England rate hike is unlikely this year. On the Brexit front, U.K. PM May outlined her latest Brexit proposal, which included a referendum on her deal contingent on it being passed by parliament, and giving parliament a choice over the post-Brexit customs model. Those measures received little support, however, and the U.K. looks no closer to leaving the EU in the near future following May's subsequent announcement that she would step down as Prime Minister on June 7.

Eurozone Economy Struggling to Gain Traction

Finally, this week also saw the latest reading on the health of the Eurozone economy in the form of several confidence surveys from across the region. The Eurozone May manufacturing PMI eased to 47.7, remaining below the breakeven 50 level. The services PMI also dipped to 52.5. For Germany—the largest economy within the Eurozone—the May IFO business confidence index fell to 97.9, reaching its lowest level since late 2014. So far in Q2, the Eurozone composite PMI is tracking in line with its Q1 average, although it still appears likely that Q2 GDP growth could slow from the relatively solid 0.4% quarter-over-quarter gain seen in Q1.







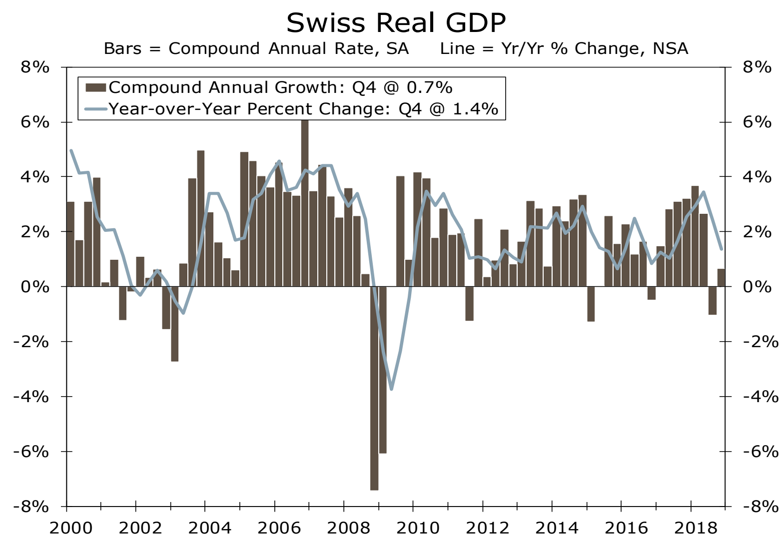
Source: Bloomberg LP, Datastream and Wells Fargo Securities

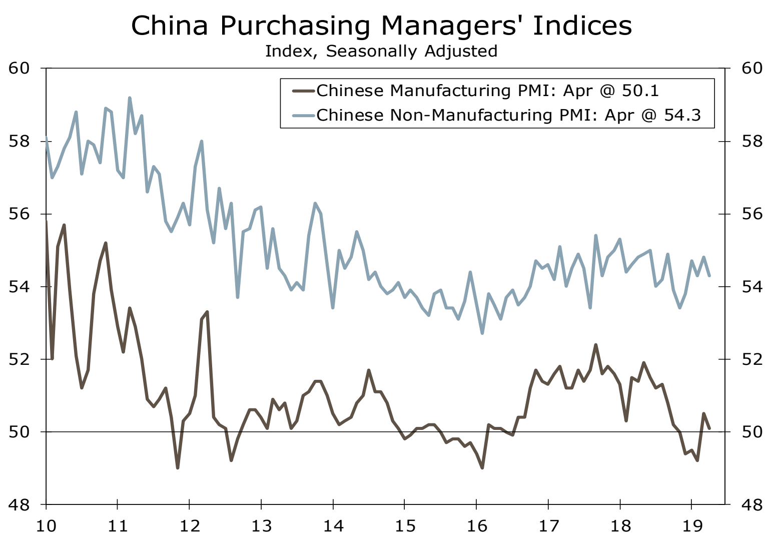
Switzerland GDP • Tuesday

Switzerland's Q1 GDP is released next week and will likely show the economy began 2019 on a soft note. The economy came to a standstill during the second half of 2018, with essentially zero growth during that period. On a sequential basis, consumer spending barely grew, while private investment spending contracted in both Q3 and Q4. For Q1-2019, the consensus forecast is for GDP to rise 0.3% quarter-over-quarter, modestly topping the 0.2% gain seen in Q4. Consumer spending likely remained subdued, with real retail sales falling on an annual basis during Q1. Given modest growth and little inflation, we expect the Swiss National Bank to maintain its expansionary monetary policy for some time. In particular the central bank will likely keep its sight deposit rate at -0.75% for an extended period, while it has also said it will intervene in foreign exchange markets as needed to prevent excessive currency strength.

Previous: 0.2%

Consensus: 0.3% (Quarter-over-Quarter)





China PMIs • Friday

After a solid start to 2019, Chinese economic trends have become more mixed in recent months. The manufacturing and service sector PMIs both declined in April, while growth in April retail sales and industrial output also slowed noticeably from their March pace. With the latest escalation in trade tensions and imposition of tariffs between China and the United States, market participants may monitor Chinese economic data even more closely going forward given the potential fallout and disruptions from the current impasse.

The manufacturing PMI for May is expected to ease to 49.9, falling back below the key 50 level, while the services PMI is expected to hold steady in May at 54.3. We currently estimate that China's Q2 GDP slowed to 6.2% year-over-year, but the risk of a more pronounced slowdown later this year could increase if the current trade tensions persist.

Previous: 50.1 (Manufacturing), 54.3 (Services)

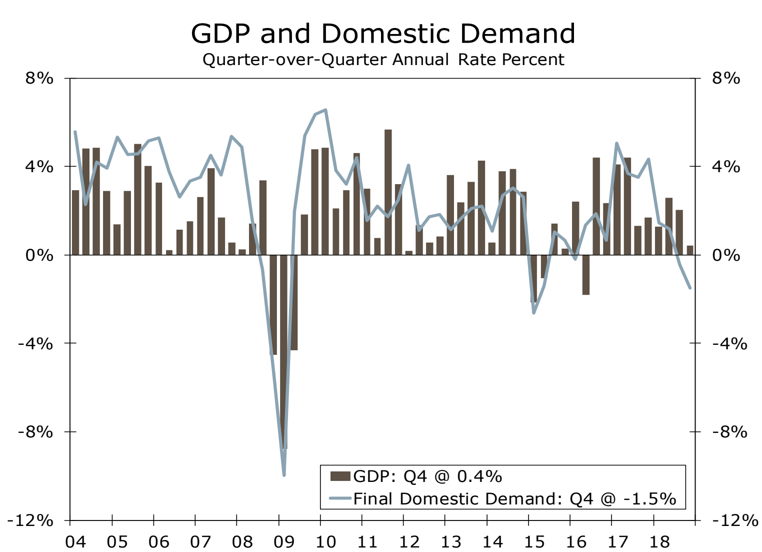
Consensus: 49.9 (Manufacturing), 54.3 (Services)

Canadian GDP • Friday

After ending 2018 on a weak note, Canadian economic growth is expected to improve moderately in Q1 2019. Q4 GDP rose just 0.4% quarter-over-quarter annualized, while final domestic demand was even softer, contracting at a 1.5% pace. While employment growth has been sturdy so far in 2019, retail sales data point to still subdued consumer spending in Q1, while mixed manufacturing sales also hint at only modest improvement in investment spending. That said, higher oil prices could impart a modest positive impulse on Canada's economic growth. The consensus is for Q1 GDP growth to rise to 0.8% quarter-over-quarter annualized, more than the 0.3% pace forecast from the Bank of Canada in its latest Monetary Policy Report. Speaking of the central bank, the Bank of Canada is widely expected to keep its policy interest rate at 1.75% given the sluggish growth backdrop and CPI inflation that is close to the central bank's target.

Previous: 0.4% **Wells Fargo: 0.8%**

Consensus: 0.8% (Quarter-over-Quarter, Annualized)



Source: Bloomberg LP, Datastream, and Wells Fargo Securities

Interest Rate Watch

"Patient" Still the Name of the Game

Minutes from the latest FOMC meeting indicated officials were more confident that the U.S. economy would continue to expand at a decent rate in the near term. A strong labor market, improvements in confidence and financial conditions and "diminished downside risks both domestically and abroad" were all cited as factors expected to support growth the rest of this year.

"Some" participants were more concerned about the inflation outlook following recent soft PCE deflator readings. However, there was consensus that at least part of the recent weakness in inflation was due to transitory factors, echoing the views of Chair Powell in the post-meeting press conference.

With growth looking firmer and low inflation not an immediate concern, most officials seemed on board with a "patient approach to policy adjustments." In other words, FOMC officials remained in no hurry to move rates up or down.

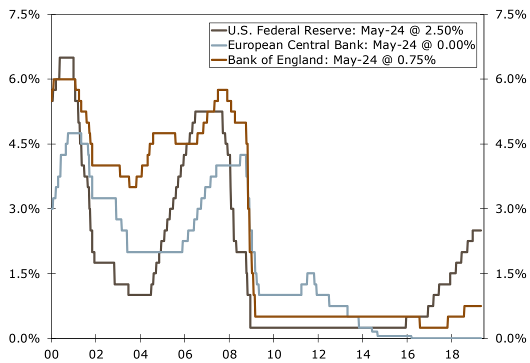
So Much for Downside Risks Abating

The minutes, however, are staler than usual. "Many" participants indicated the downside risks to growth earlier in the year had abated, but that was before U.S.-China trade tensions ratcheted up again. With downside risks rising again, it looks reasonable that markets are pricing in a rate cut as the FOMC's next move, but before year-end still looks premature in our view given the tight labor market and prospects for growth to remain above trend.

Thinking About Its Treasury Holdings

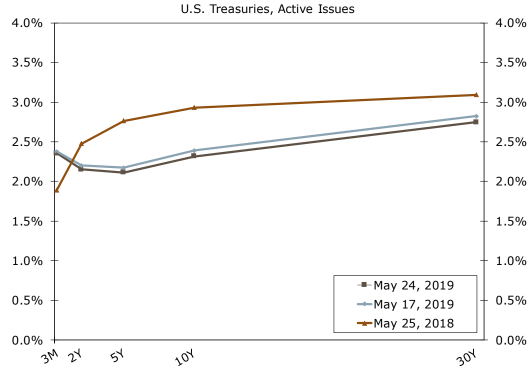
FOMC members were also presented scenarios by staff about the future maturity composition of the Fed's balance sheet. A shorter-maturity profile, where the Fed held securities maturing in three years or less, was presumed to be a better starting point if officials were to try to add accommodation at some point via a maturity extension program like "Operation Twist." However, a shorter-term profile was also thought to require a lower fed funds rate, all else equal. We expect the FOMC will eventually settle on a profile proportional to the universe of outstanding Treasury securities. That would still result in the Fed holding more short term Treasury securities, but keep the fed funds rate as its primary policy tool.

Central Bank Policy Rates



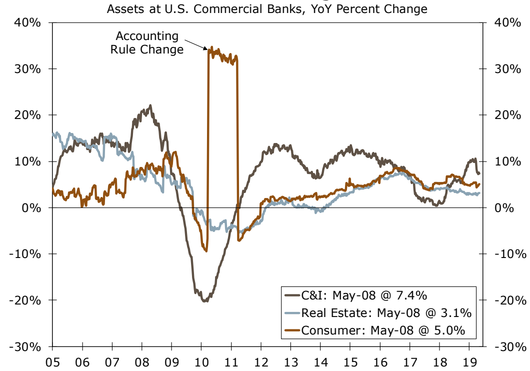
Yield Curve

U.S. Treasuries, Active Issues



Bank Lending

Assets at U.S. Commercial Banks, YoY Percent Change



Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

Credit Market Insights

China's "Hidden" Debt

The standard rule of China's financial system is that, the more state involvement, the cheaper the funding costs. Though, in areas of China where the public sector dominates the economy, US$1.1 trillion worth of debt sold by local government financing vehicles (LGFV) have the highest yields. LGFV bonds were established to stimulate growth through infrastructure investment during the global financial crisis. Investor participation has since increased, driven by the implicit government guarantee and the public's familiarity with the asset.

Recent subdued economic growth in China has increased pressure on the Chinese government to ensure LGFV bonds against default. LGFV bonds are still perceived as being "safe" since the government provides a financial backstop for the bonds. Investors remain cautious of the bonds' default risk amid China's tight credit conditions and unprecedented corporate and municipal bond defaults within the past year. The wave of defaults has placed upward pressure on LGFV bond yields, while the Chinese government's recent deleveraging efforts may have also contributed to rising bond yields.

Today, the Chinese government is focused on stabilizing the economy and implementing greater stimulus measures if trade threats continue to go back and forth with the United States. This is positive news for LGFV bonds in the near-term, as they support infrastructure projects and will be used to stimulate the Chinese economy.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.06%	4.07%	4.14%	4.66%
15-Yr Fixed	3.51%	3.53%	3.60%	4.15%
5/1 ARM	3.68%	3.66%	3.68%	3.87%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$2,344.2	-10.01%	0.90%	7.37%
Revolving Home Equity	$340.6	-12.96%	-9.09%	-7.38%
Residential Mortgages	$1,910.5	-10.59%	10.12%	3.33%
Commerical Real Estate	$2,231.6	2.49%	5.88%	4.72%
Consumer	$1,537.4	11.47%	9.75%	5.04%

Mortgage Rates Data as of 05/24/19, Bank Lending Data as of 05/08/19

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

Topic of the Week

Trade Escalation Threatens Investment

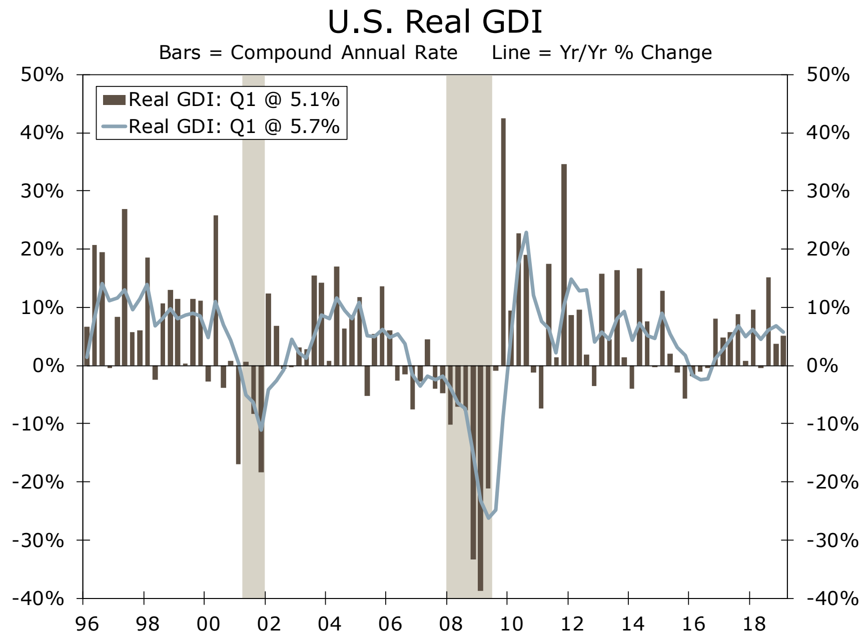
Fears about a prolonged trade battle between China and the United States flared this week, with both sides appearing to dig in. We maintain our view that the *direct* impact of an-all out trade war between the two nations would have a minimal impact on the U.S. economy. After all, exports to China account for less than 1% of GDP. The *indirect* effects, however, stand to be more pronounced, and need not wait for a full-blown trade war to ensue.

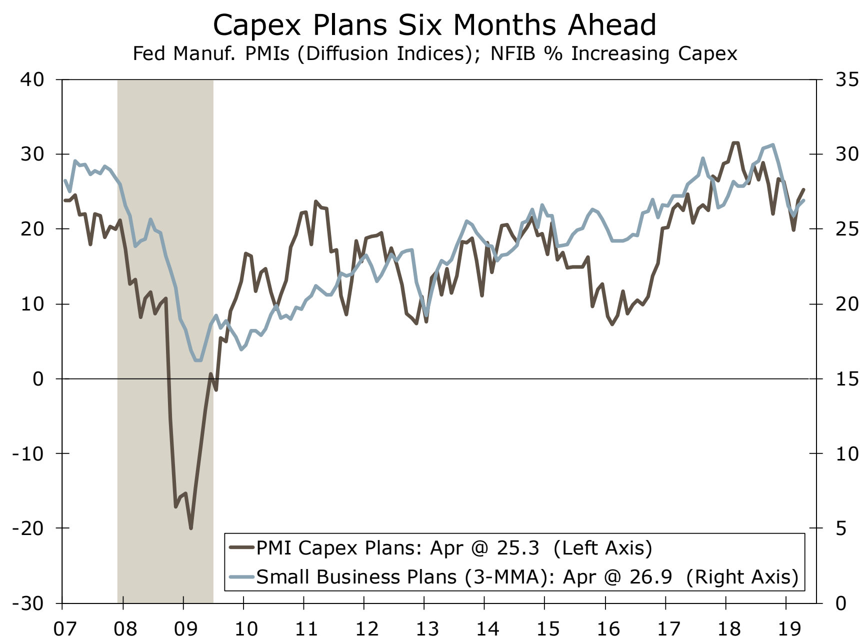
The uncertainty alone about trade relations stands to weigh on growth. The lack of clarity on input costs, and how competitive exports may be amid possible retaliatory tariffs—if allowed to be exported at all—are likely to lead some businesses to delay investment decisions. Tamped down expectations for growth, as disposable income weakens under the weight of tariffs, could further lead businesses to curtail investment.

Could merely the fear of a trade war send the U.S. economy into a recession? We shocked our macroeconomic model and found it would take about a 15% decline in real investment to send the U.S. economy into a mild recession. To put that in perspective, at the nadir of the 2001 recession, which was considered to be brought about by imbalances in the business sector, investment fell only 11% year-over-year (top chart).

How likely is a 15% decline in investment at the moment? Through April, business capex plans were holding up rather well (bottom chart), while residential investment stands to be relatively insulated from the trade issues.

To some extent, our model overstates the hit to investment that would sink the economy into a recession. Presumably, if businesses are delaying an expansion or equipment purchase, they would also be thinking twice about hiring more workers. Slower hiring would weigh on income growth, and in turn consumer spending. More immediately, the negative implications of an extended trade war would contribute to tighter financial conditions, as we saw this week with the risk-off tone in financial markets.





Source: NFIB, Federal Reserve System, U.S. Department of Commerce and Wells Fargo Securities

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 5/24/2019	1 Week Ago	1 Year Ago
1-Month LIBOR	2.44	2.43	1.97
3-Month LIBOR	2.52	2.53	2.33
3-Month T-Bill	2.35	2.37	1.89
1-Year Treasury	2.29	2.32	2.26
2-Year Treasury	2.16	2.20	2.51
5-Year Treasury	2.12	2.17	2.81
10-Year Treasury	2.32	2.39	2.98
30-Year Treasury	2.76	2.83	3.13
Bond Buyer Index	3.56	3.57	3.90

Foreign Exchange Rates

	Friday 5/24/2019	1 Week Ago	1 Year Ago
Euro ($/€)	1.119	1.116	1.172
British Pound ($/₤)	1.267	1.272	1.338
British Pound (₤/€)	0.883	0.877	0.876
Japanese Yen (¥/$)	109.640	110.080	109.260
Canadian Dollar (C$/$)	1.345	1.346	1.288
Swiss Franc (CHF/$)	1.003	1.011	0.992
Australian Dollar (US$/A$)	0.691	0.687	0.758
Mexican Peso (MXN/$)	19.080	19.170	19.574
Chinese Yuan (CNY/$)	6.900	6.918	6.378
Indian Rupee (INR/$)	69.526	70.260	68.345
Brazilian Real (BRL/$)	4.042	4.099	3.647
U.S. Dollar Index	97.743	97.995	93.775

Foreign Interest Rates

	Friday 5/24/2019	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.36	-0.36	-0.35
3-Month Sterling LIBOR	0.80	0.81	0.62
3-Month Canada Banker's Acceptance	2.02	2.02	1.75
3-Month Yen LIBOR	-0.07	-0.08	-0.03
2-Year German	-0.63	-0.65	-0.59
2-Year U.K.	0.65	0.70	0.75
2-Year Canadian	1.59	1.61	2.00
2-Year Japanese	-0.15	-0.16	-0.14
10-Year German	-0.11	-0.10	0.47
10-Year U.K.	0.96	1.03	1.40
10-Year Canadian	1.64	1.69	2.41
10-Year Japanese	-0.07	-0.05	0.05

Commodity Prices

	Friday 5/24/2019	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	58.78	62.76	70.71
Brent Crude ($/Barrel)	68.70	72.21	78.79
Gold ($/Ounce)	1281.97	1277.55	1304.61
Hot-Rolled Steel ($/S.Ton)	639.00	641.00	882.00
Copper (¢/Pound)	270.30	274.80	308.55
Soybeans ($/Bushel)	7.79	7.95	10.14
Natural Gas ($/MMBTU)	2.56	2.63	2.94
Nickel ($/Metric Ton)	11,892	12,196	14,592
CRB Spot Inds.	466.83	468.87	518.30

Source: Bloomberg LP and Wells Fargo Securities

Next Week's Economic Calendar

	Monday 27	Tuesday 28	Wednesday 29	Thursday 30	Friday 31
U.S. Data	**Memorial Day** [U.S. Markets Closed]	**Consumer Confidence** April 129.20 May 137.2 (W)		**GDP (QoQ, Second)** Q1 3.2% Q1 3.1% (W)	**Personal Spending** March 0.9% April 0.2% (W) **Michigan Consumer Sentiment** April 97.2 May 102.4 (C)
Global Data		**Switzerland** **GDP (Quarter-over-Quarter)** Q4 0.2%	**Canada** **Bank of Canada Rate Decision** Previous 1.75%	**Japan** **Industrial Production (MoM)** March -0.6%	**Canada** **Q1 Qurterly GDP Annualized** Q4 0.4% **China** **Manufacturing PMI** April 50.1

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

Source: Bloomberg LP and Wells Fargo Securities

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