

**Economics Group**

**Weekly Economic & Financial Commentary**

**U.S. Review**

**Strong Consumption Won’t Stop Fed from Cutting**

- Real GDP growth slowed to a 2.1% annualized pace in the second quarter, but exceeded expectations of a 1.8% rise.
- The 4.3% surge in personal consumption was the strongest gain since Q4-2017, but we do not expect this strength to dissuade the Fed from cutting rates 25 bps at its meeting next week.
- Net exports and inventories both weighed on headline growth, as trade and global growth uncertainties continue to swirl. These headwinds along with below-target inflation should compel the Fed to enact “insurance” rate cuts.

**Global Review**

**European Manufacturing in Freefall**

- The pain in the European manufacturing sector showed no sign of abating this week, as data released on Monday showed the Eurozone manufacturing PMI falling further in July to 46.4, the lowest reading since December 2012. We expect the ECB to cut rates and restart QE in September.
- GDP growth in South Korea rebounded in Q2, but fiscal stimulus played a big role in the bounce back. Trade woes have now opened on two fronts for this Asian bellwether economy.
- Russia’s central bank cut rates 25 bps this morning, its second cut of such magnitude this year, against a backdrop of soft economic growth and inflation that is expected to decline in the coming months.

**Wells Fargo U.S. Economic Forecast**

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<td>Corporate Profits Before Taxes</td>
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<td>10 Year Note</td>
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Forecast as of July 11, 2019

1. Compound Annual Growth Rate Quarter-over-Quarter
2. Federal Reserve Advanced Foreign Economies Index, 2006=100 - Quarter End
3. Year-over-Year Percentage Change
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

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Economics Group  U.S. Review  Wells Fargo Securities

U.S. Review

Strong Consumption Won't Stop Fed from Cutting

Real GDP growth slowed to a 2.1% annualized pace in the second quarter, but exceeded expectations of a 1.8% rise. While this is down from the 3.1% pace of growth in Q1, the 4.3% surge in personal consumption—the strongest since Q4-2017—paints a picture of a resilient American consumer sector. Consumer spending on durable goods soared at a five-year high rate of 13%, while nondurable goods and services spending rose 6.0% and 2.5%, respectively. Such strength from the largest sector of the economy has limited implications for our expectations of monetary policy. We do not expect this strength to dissuade the Fed from cutting rates 25 bps at its meeting next week. Inflation remains below-target and other GDP line items bear the mark of the ongoing trade war uncertainties. Real exports fell 5.2% as trade dragged 0.7 percentage points from the headline. Lower inventory accumulation dragged another 0.9 percentage points, as the effects of net exports and inventories flip-flopped from Q1. The uncertainty likely dragged down business fixed investment as well, which fell 0.6%, including a sharp 10.6% drop in structures investment. The monthly durable goods orders for June were slightly more encouraging, as non-defense capital goods orders rose 1.9%.

Government spending rose 5.0% and continues to be very strong in the rebound from the shutdown, while non-defense federal spending surged 15.9%. This week Congressional leaders and the White House announced a deal to increase discretionary budget caps and suspend the debt ceiling until July 31, 2021. The details of the plan are largely in-line with our existing forecast—the substantial fiscal boost from higher real government spending the past couple of years will gradually converge to zero. And while the threat of more budget drama surrounding the appropriations process will persist after Congress returns from its summer recess, the upshot for the economy and financial markets is that the next debt ceiling cliff has been pushed off until after 2021 elections.

Residential construction spending fell in Q2 for the sixth consecutive quarter as the housing market continues to tread water. Existing home sales fell 1.7% in June, constrained by historically low inventories, particularly at the entry level where demand is strongest and supply shortages are most acute. This supply-demand dynamic should keep price appreciation in positive territory, although it should continue to moderate. Affordability remains the biggest impediment to a more robust housing recovery, particularly of the strength we might ex-ante expect with mortgage rates holding around 3.75%, the unemployment rate at 3.7% and income growth picking up. The domestic housing market has not escaped the trade war unscathed either—new data from the National Association of Realtors indicate that the dollar volume of foreign residential purchases fell a whopping 36% last year to $78 billion from $121 billion, with much of the pullback emanating from China. New home sales rose 7% last month, but hefty downward revisions left the level of sales well below the consensus.
Economics Group  U.S. Outlook  Wells Fargo Securities

Personal Spending • Tuesday
On Tuesday, we will receive June estimates for personal income and spending. Given this morning’s release of second quarter GDP and the solid 4.3% annualized gain in personal consumption expenditures (PCE), spending looks to have fared pretty well in June. Given strong recent monthly data on retail spending, the solid rise in Q2 PCE came as little surprise. Indeed, the consumer looks to be in good shape after a weak start to the year. Notably, this morning’s release showed a big upward revision in the personal saving rate in the first quarter, which may, at least in part, explain the weaker consumer spending in that period. Consumer confidence, however, has waned since May, dropping almost 10 points to 121.5. But, we expect confidence to rebound to 129 in July, which should support a 0.4% gain in personal spending in June. Should the Fed cut rates next week, as we expect it will, spending could also get a boost in coming months.

Previous: 0.4%  Wells Fargo: 0.4%
Consensus: 0.3%

ISM Manufacturing • Thursday
The manufacturing sector continued to struggle in June. The ISM manufacturing index has fallen 3.6 points since March and now stands at 51.7—its lowest level since October 2016. June production was strong, rising almost three points to 54.1. That said, new orders was down to 50.0, a three and-a half year low, and barely avoided a contractionary print. Joining low prints in backlogs and supplier deliveries, new orders is the latest line item to suggest modest growth. Indeed, Wednesday’s preliminary Markit PMI tumbled another 0.6 points in July, reaching its lowest value since September 2009. U.S.-China trade tensions have stabilized for now, but uncertainty will likely continue to weigh on manufacturing activity in H2-2019. As a result, we forecast the ISM manufacturing index will rise slightly to 51.9 in July. A Fed rate cut next week may support manufacturing sentiment in the latter half of the year.

Previous: 51.7  Wells Fargo: 51.9
Consensus: 52.0

Nonfarm Payrolls • Friday
Last month, nonfarm payrolls increased 224,000, though May hiring was downgraded by 3,000. Transportation & warehousing employment growth has been trending lower as trade-related headwinds affect hiring at home. Meanwhile, domestic-oriented hiring rose; the education & health and professional & business services sectors added 61K and 51K, respectively. That said, retail trade saw its fifth straight month of payroll declines and has decreased by 56.4K since the beginning of the year. This month also saw an uptick in the unemployment rate to 3.7% due to more participants entering the labor force than getting hired. Initial jobless claims trended lower so far in July, averaging 5.6% lower than June. Even without a further escalation in the trade war, we expect a sub two-hundred trend for payrolls for the remainder of 2019 as uncertainty weighs on hiring. We expect employers added 170,000 net new jobs in July.

Previous: 224K  Wells Fargo: 170K
Consensus: 160K
Global Review

European Manufacturing in Freefall

The pain in the European manufacturing sector showed no sign of abating this week, as data released on Monday showed the Eurozone manufacturing PMI for July falling further to 46.4, the lowest reading since December 2012 (see chart on front page). The ‘hard’ data corroborate these survey readings, as German factory orders are contracting at the fastest three-month average, year-over-year pace since the Great Recession (top chart).

Yet, unlike the Great Recession or the 2011 European sovereign debt crisis, the service sector has not deteriorated at anywhere near the same pace as the manufacturing sector. Back in December 2012 when the Eurozone manufacturing PMI was 46.1, the services PMI was 47.8. Today, the Eurozone services PMI is 53.3, which is actually up a couple points from the start of the year.

Facing this conundrum, the European Central Bank (ECB) met this week and signaled that more monetary policy stimulus is on the horizon. The commentary from ECB President Draghi during the post-meeting press conference was not especially encouraging. He noted that “we don’t like what we see on the inflation front” and that the economic outlook is getting “worse and worse”, though he did reaffirm that it views the risk of recession as relatively low. In our view, an ECB rate cut in September is all but certain now the only question is how large. Our updated forecast includes a 10 bps cut to interest rates at the September meeting, as well as a resumption of the ECB’s QE program. Specifically, we think the ECB will buy €45B of sovereign bonds per month for 12 months starting in October. That will almost certainly require the ECB to raise its issuer limits for sovereigns to 50% from 33%. We are not expecting the ECB to buy corporate bonds or equities at this time.

In the first quarter, an unexpected negative GDP growth print in South Korea fanned fears that China’s economy was contracting faster than anticipated. Data released this week showed South Korea’s economy bouncing back, with quarter-over-quarter annualized growth registering a solid 4.4% (middle chart). To some extent the strong print is deceiving, however, as surging government consumption helped fuel the pick-up. Gross fixed capital formation declined on a year-over-year basis for the fifth straight quarter. Going forward, South Korea may face challenges not only related to a slowdown in China and the U.S.-China trade uncertainty, but also as a result of the recent trade spat with Japan.

The Russian central bank announced this morning that it was cutting its main policy rate 25 bps, the second cut of that magnitude this year. A quick look at inflation data could leave one scratching his head, as prices in Russia have accelerated over the past year (bottom chart). Some of this pick-up, however, can be attributed to an increase in Russia’s value-added tax that took effect on January 1, 2019. On the growth side of the equation, real GDP was up just 0.5% in Q1-2019. The ruble has appreciated about 9% this year against the dollar and if sustained could lead to further disinflationary pressure. Against that backdrop, the Bank of Russia has signaled a couple more rate cuts could still be in store.
Bank of Japan Meeting • Tuesday

Unlike several other major central banks, the Bank of Japan (BoJ) has not signaled much in the way of imminent easing. To some extent, this reflects the more limited policy options available to it. Although inflation remains well shy of the central bank’s 2% target, there have been a few encouraging developments in the Japanese economy. For example, the employment-population ratio in Japan has skyrocketed since the start of 2013.

Our forecast assumes the BoJ will not make any major changes to the current stance of policy for the foreseeable future. One risk to this outlook is a scheduled hike in the consumption tax this October, which could cause some economic disruptions. Should policy need to be eased further, the BoJ could push its policy rate deeper into negative territory, apply negative rates to a broad set of bank reserve balances or move its 10-year JGB yield target down from its current target of 0%.

Previous: -0.10% Wells Fargo: -0.10%
Consensus: -0.10% (Policy Rate)

Bank of England Meeting • Thursday

The Bank of England continued to show a bias towards eventual tightening at its June meeting. This tightening is contingent on an eventual smooth exit from the European Union, however, an effort that has at times looked increasingly like a quixotic journey. Inflation data have been stronger in the U.K. than in Europe, and according to the last statement “growth in unit wage costs has remained at target-consistent levels.”

The U.K. economy has looked a bit more wobbly of late, particularly the manufacturing sector, which may be increasingly feeling the pressure from the factory sector struggles in continental Europe. Another challenge for BoE policymakers may be the overwhelming dovish pivot of late by central bankers elsewhere around the world. For now, we expect the BoE to remain on hold and for the central bank to eventually begin tightening in 2020 once a Brexit resolution has been reached.

Previous: 0.75% Wells Fargo: 0.75%
Consensus: 0.75%

Eurozone GDP • Wednesday

The advance release for Eurozone real GDP growth in the second quarter is due out next Wednesday, and the data are likely to show that the European economy continues to sputter. Real GDP in Europe has accelerated modestly over the past few quarters, but the year-over-year pace is still just 1.2%, and our expectation is for the quarterly growth rate to downshift back down to 0.2% in Q2. If this forecast proves correct, year-over-year growth would still be stuck around 1%.

If potential growth in the Eurozone is about 1.5%, current growth rates are not quite strong enough to further close the output gap in Europe. But because growth has leveled off around 1% rather than continued to decline in freefall, policymakers at the ECB had been inclined to adopt a wait-and-see approach to monetary policy. As more time is spent barely above stall speed, however, it appears policymakers are becoming more inclined to start easing policy.

Previous: 0.4% Wells Fargo: 0.2%
Consensus: 0.2% (Quarter-over-Quarter, Not Annualized)
Why Is the Fed Likely to Cut Rates?

At its meeting next week, the FOMC is expected to do something it has not done in over a decade: cut the fed funds rate.

The timing of the rate cut might seem odd to anyone who has only followed recent data and not the commentary of FOMC officials. We are amidst the longest equity bull market on record, inflation is under control and unemployment is near a 50-year low. Sure GDP growth slowed to 2.1% in Q2, but the correction in inventories masked solid consumer spending. Core inflation is also back on track, rising at a 1.8% pace in Q2.

So why is the Fed easing right now? At the risk of oversimplification: because the global economy is showing signs of serious strain amid the ongoing trade war, and inflation has been too low for too long.

It may not be part of its mandate, but the Fed is paying attention to the cut-and-dry evidence that global trade is drying up (top chart). Trade tensions are at the heart of the pullback in global growth, and the FOMC fears the impact here at home, especially as it relates to confidence and investment.

As for inflation, the task of eventually hitting the Fed’s 2% target on a sustained basis is getting harder with every monthly shortfall. Fear is rising that the sub-2% trend shown in the middle chart is becoming entrenched as inflation expectations hover near record lows.

Suffice it to say, the FOMC is therefore in the unenviable position of loosening policy despite a soaring equity market and a labor market that is arguably overheating. The FOMC faces a daunting challenge of delivering on the expected accommodation without overshooting and engendering the next crisis, or falling short of forward-guidance and undoing the benefit of a cut.

We expect that the FOMC will cut rates 25 bps at next week’s meeting and leave the door open for some additional easing before year end. But the current state of the economy, risks to the outlook, rhetoric of FOMC officials and market positioning hardly make this meeting straightforward. For more details on what is informing our call and other potential outcomes, see our Flashlight for the FOMC Blackout Period.
**Topic of the Week**

**The Race to Recess: A Budget Deal in Reach?**

On Monday, Congressional leadership in both parties and the White House announced a budget deal that would suspend the debt ceiling through July 31, 2021 and increase the discretionary spending budget caps about $320 billion over FY-2020 and FY-2021. In our view, the key fact to understand about the $320 billion number, which is the one that has been most commonly cited in media reporting, is that it is an increase in spending relative to current law and not current spending.

As we have discussed in previous reports, absent a budget deal, discretionary budget authority subject to the sequestration level budget caps was set to decline about $125 billion in FY-2020 and $100 billion in FY 2021 relative to FY-2019 (top chart). Thus, the deal essentially amounts to just a modest increase in inflation-adjusted discretionary spending relative to current spending. The deal includes about $75 billion in budget offsets, but these savings are concentrated in the last couple years of the 10-year budget window.

The budget agreement was roughly in-line with what we already had baked into our baseline forecast. Our forecast assumes that the previous FY-2018/FY-2019 boost to growth from more spending would gradually give way to inflation-adjusted federal consumption and investment converging towards zero over time (bottom chart). Put another way, our forecast assumes discretionary spending growth will continue over the next year or two, but at a slower pace than has been the case more recently.

The House of Representatives approved the law yesterday, and the Senate will likely vote next week before sending it to the president’s desk for his signature. But, bear in mind that this is merely step one of a two-step process. Policymakers will next need to appropriate the money to the various government programs. Until this is complete, the threat of a partial federal government shutdown after September 30 will remain.

For further reading, see our special report “The Race to Recess: A Budget Deal in Reach?”

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Next Week's Economic Calendar

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<tr>
<td></td>
<td>May 0.5%</td>
<td>Q1 0.7%</td>
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<td>FOMC Rate Decision</td>
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<td>June -854.5B (W)</td>
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<td>Q1 0.4%</td>
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Note: (W) = Wells Fargo Estimate (C) = Consensus Estimate

Source: Bloomberg LP and Wells Fargo Securities