

Economics Group

MONTHLY OUTLOOK

U.S. Overview

Weakness in Q1 Not Expected to Persist

Weakness in U.S. economic growth in the first quarter of 2017 is not expected to persist or extend into the rest of the year. Weather and weather-related issues negatively affected U.S. consumers during the first quarter and made personal consumption expenditures very weak, growing by just 0.3 percent annualized during the first quarter of the year. The economy as a whole grew a scant 0.7 percent during the period, the slowest performance since the recovery from the Great Recession. However, the housing market contributed 0.5 percentage points to top-line growth as residential investment surged 13.7 percent due to the warm weather in some regions of the United States, but especially in the Northeast. This could put pressure on residential investment in the second quarter, but we still believe the housing market will continue to contribute positively to economic growth during the rest of the year. Furthermore, our forecast has a very strong recovery in personal consumption expenditures, and this is fundamentally based on the continuous strength of the U.S. labor market, which created another 211,000 jobs in April and on a very low rate of unemployment, which hit 4.4 percent in April, a 10-year low. Productivity growth was another weak performer in Q1, declining 0.6 percent. Over the past year, productivity growth remains relatively flat, up only 1.1 percent. According to the chair of the Federal Reserve, Janet Yellen, U.S. economic growth could benefit from an increase in the participation of women in the labor force.

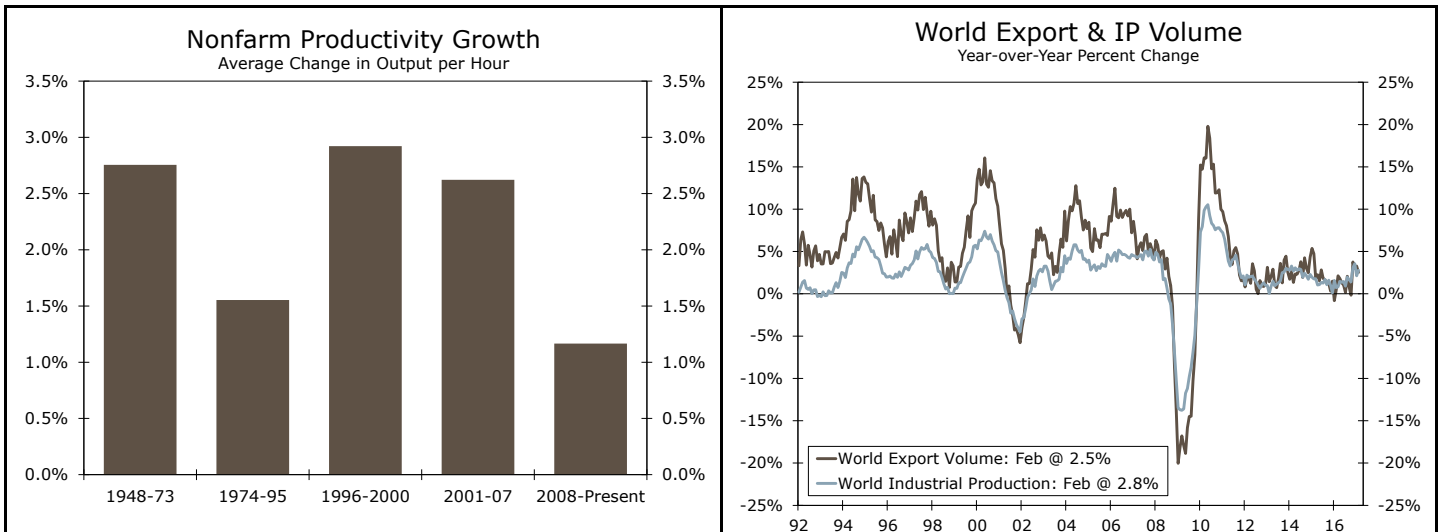
International Overview

Modest Pace of Global Expansion Should Continue

Some foreign economies have released their respective Q1 GDP growth figures in recent weeks, and the results generally suggest that the global economy is expanding at a modest pace at present. The Chinese economy grew 6.9 percent (year over year) in Q1, and real GDP in the Eurozone grew nearly 2 percent (annualized) on a sequential basis. The British economy continues to expand three quarters after the Brexit vote last June clouded its long-term economic outlook.

Rates of consumer price inflation have edged higher this year as energy prices have stabilized. That said, real GDP growth rates generally are not robust enough yet to lead to a significant increase in inflation. So, we forecast that most major foreign central banks will keep their policy rates unchanged through 2017. The ECB may further dial back its monthly QE purchases later this year and likely will cease buying bonds altogether in 2018. But, in our view, an ECB rate hike does not look likely until late 2018, at the earliest.

The election of Emmanuel Macron in the French presidential election eliminates a downside risk to the Eurozone economic outlook, because a Le Pen presidency would have called into question the very long-run viability of the European Union. There are still plenty of geopolitical risks in the world; but, assuming that the geopolitical environment generally remains “behaved,” we forecast that the modest pace of global expansion that has been underway over the past few years will generally continue.



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



Weakness in Q1 Not Expected to Persist

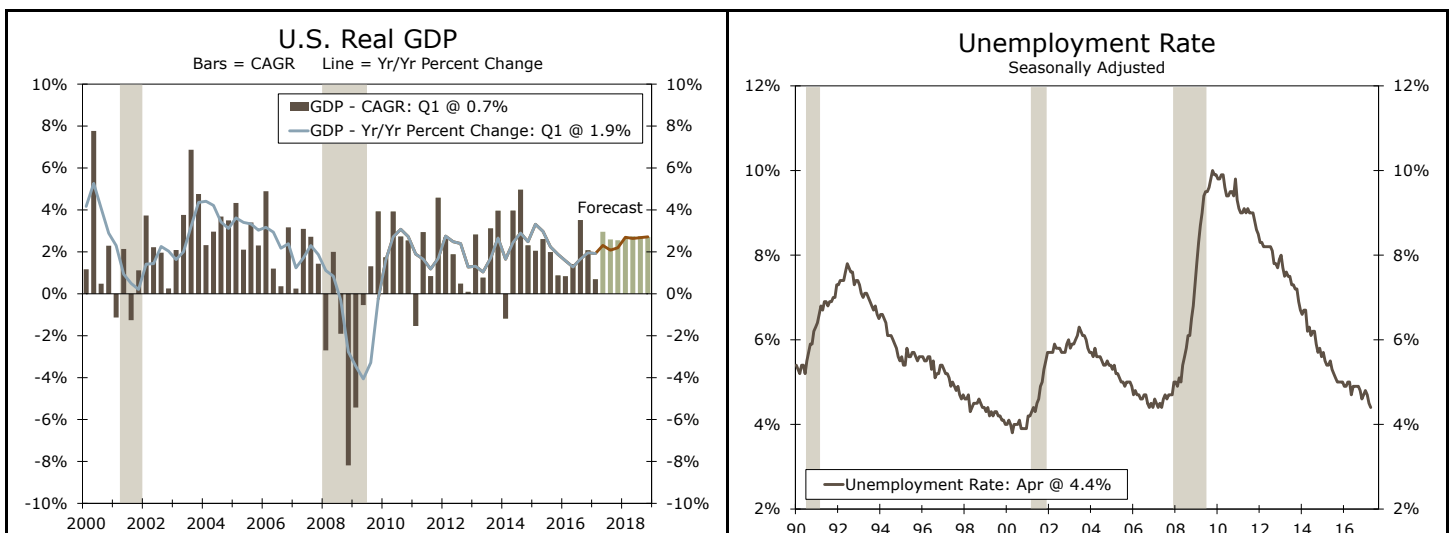
During the first quarter, the U.S. economy recorded one of its lowest growth rates since the recovery from the Great Recession, up only 0.7 percent on an annualized basis, according to the first estimate of GDP released at the end of April. However, this performance was a one-off, that is, something that is not going to be repeated during the rest of the year. The unusually low print during the first quarter was a combination of a very warm winter on the U.S. East Coast which affected the consumption of services in January and February, and a slowdown in the purchasing of automobiles that hurt overall personal consumption expenditures (PCE) during the quarter. PCE increased just 0.3 percent during the quarter on an annualized base. This was the slowest growth in PCE since the end of the Great Recession, so we do not expect this weakness to continue during the rest of the year.

On the positive side, the warm weather had a good outcome for the U.S. economy: the U.S. housing market got out to a very strong start in the year. Normally, winter conditions make it difficult for the U.S. housing market to grow. However, the warm weather, especially on the East Coast of the United States, pushed construction forward at the start of the year. Residential investment increased a strong 13.7 percent annualized during the first quarter, the strongest print since the last quarter of 2015. That is, residential investment contributed an impressive 0.5 percentage points to real GDP growth in the first quarter. Meanwhile, warm weather and the continuous increase in home prices have also encouraged homeowners to invest more in improving their homes, so, home improvement spending was also strong during the first quarter. Building materials, garden equipment and supply store sales rose a strong 3.9 percent in the first quarter and was up 6.6 percent compared to the previous year. Thus, we remain positive for U.S. housing during the rest of 2017 even if the

strong start to the year may show up as a weaker housing market print in the second quarter.

Even if the housing market slows down a bit during the second quarter of the year, however, the rest of the economy's cylinders should be in full force, supported by a still strong labor market. The employment number in April was up 211,000, with growth occurring across the economic spectrum. Meanwhile, the unemployment rate dropped to 4.4 percent in April, the lowest reading in the past 10 years. Continuous strength in the U.S. labor market should keep the economy going during the rest of the year and any slowdown in the first quarter will be more than compensated by the strength in the rest of the quarters. Thus, we are still confident that the U.S. economy will grow by 2.1 percent during 2017 and still look for it to accelerate a bit next year as some of the new administration's proposals, such as lower taxes and higher expenditures, will come into focus during 2018.

Still, the biggest issue for the U.S. economy is how to grow faster in an environment where both the labor force participation rate and productivity remains so low. Labor productivity was very weak again in the first quarter, declining 0.6 percent on an annualized basis while the year-over-year rate has stabilized at a 1.1 percent rate for the past several years. Recall that the U.S. long-run labor productivity between 1960 and 2008 was 2.2 percent, which is double what the rate is today. To delve into this issue, the chair of the Federal Reserve, Janet Yellen, suggested this week that one of the ways to make the U.S. economy grow faster is to encourage or make it easier for women to get jobs, which would help women back into the labor force, something that some have shied away from since 2000 when the female participation rate started to decline.



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

Modest Pace of Global Expansion Should Continue

Some foreign economies have released their respective Q1 GDP growth figures in recent weeks, and the results generally suggest that the global economy is expanding at a modest pace at present. For starters, the year-over-year rate of real GDP in China edged up from 6.8 percent in Q4 to 6.9 percent in Q1, which was stronger than the consensus forecast. Real GDP in the Eurozone rose 0.5 percent on a sequential basis (1.8 percent at an annualized rate) in the first quarter. Real GDP in the United Kingdom grew only 1.2 percent at an annualized rate in Q1. That said, the British economy continues to expand three quarters after the Brexit vote last June clouded the long-term economic outlook for the United Kingdom.

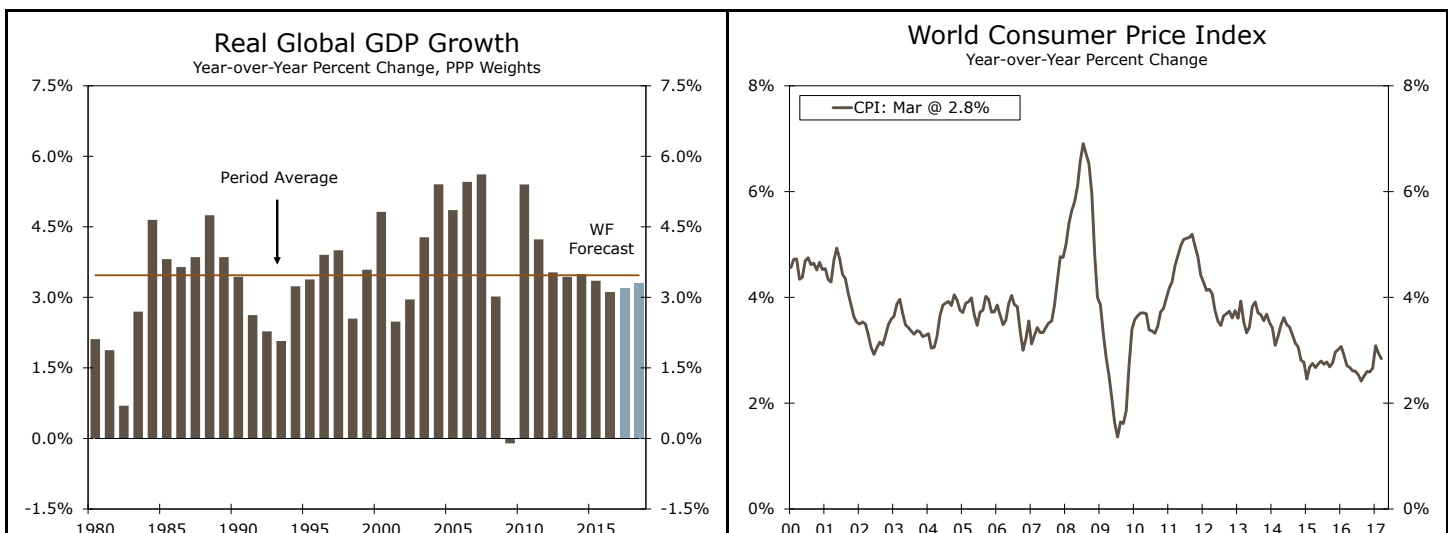
There is not a readily available measure of global GDP growth on a quarterly basis, but a series on the narrower concept of global industrial production (IP) shows that global IP was up 2.4 percent on a year-ago basis in the first two months of 2017 (see chart on front page). Although this outturn was well short of the strong rates that were registered in 2003 to 2007, it represents an improvement over the anemic growth rates of the past two years. Moreover, global trade also has accelerated recently. In short, it appears that growth in global economic activity is picking up a bit. Indeed, we look for global GDP growth to move back toward its long-run average over the course of 2017 and 2018 (left chart).

That said, the rates of GDP growth that we forecast for most economies (see page 5 for our global forecasts) are generally not strong enough to give a significant boost to inflation rates in those countries. Inflation likely will be higher in most countries this year than it was in 2016 because energy prices are not nosediving as they did at the beginning of 2016. However, the rates of consumer price inflation remain benign in most economies. On a global basis, CPI inflation is currently running around 3 percent, which is lower than at any time since the global financial crisis (right chart).

Low inflation means that most foreign central banks do not appear to be in a hurry to tighten monetary policy anytime soon. We believe the major foreign central banks of the world (i.e., the Bank of Canada, the Bank of England, the Bank of Japan and the ECB) will refrain from hiking their respective policy rates in 2017. The ECB may further dial back its monthly QE purchases later this year and likely will cease buying bonds altogether in 2018. In our view, however, a rate hike by the ECB does not look likely until late 2018 at the earliest.

Speaking of the Eurozone, a downside risk to the economic outlook dissipated recently when French voters chose Emmanuel Macron over Marine Le Pen as the next president of France. A victory by Le Pen, who is openly hostile to the very concept of the European Union, would have called into question the long-run viability of the EU. Financial markets were rocked on numerous occasions between 2010 and 2012 by successive waves of the European sovereign debt crisis as investors questioned the sustainability of the Eurozone. A Le Pen victory undoubtedly would have resulted in another bout of financial market volatility. Whether that would have been severe enough to trigger an outright recession in the Eurozone is an open question. However, growth prospects in France and more broadly the euro area would have been dented by the uncertainty that a Le Pen presidency would impart to European economic integration.

There are still plenty of geopolitical risks that, if realized, could cause our current forecast to track off in coming months. But there always are geopolitical risks imbedded in any forecast. Most forecasters, we included, generally assume that low-probability risks won't come to pass. If they do, then we change our forecast. Under the assumption that the geopolitical environment generally remains "behaved," then we forecast that the modest pace of global expansion that has been underway over the past few years will generally continue.



Source: International Monetary Fund, IHS Global Insight and Wells Fargo Securities

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2016	2017	2018	2016	2017	2018
Global (PPP Weights)	3.0%	3.2%	3.4%	3.1%	3.3%	3.6%
Global (Market Exchange Rates)	2.7%	3.0%	3.2%	3.1%	3.3%	3.6%
Advanced Economies ¹	1.8%	2.1%	2.3%	0.7%	2.0%	2.0%
United States	1.6%	2.1%	2.7%	1.3%	2.3%	2.3%
Eurozone	1.7%	1.8%	2.0%	0.2%	1.8%	2.0%
United Kingdom	1.8%	1.6%	1.7%	0.7%	2.4%	1.9%
Japan	1.0%	1.2%	0.9%	-0.1%	0.2%	0.8%
Korea	2.8%	2.8%	2.7%	1.0%	2.0%	1.7%
Canada	1.4%	2.3%	1.9%	1.4%	1.8%	2.1%
Developing Economies ¹	4.2%	4.4%	4.4%	5.5%	4.6%	5.2%
China	6.7%	6.5%	6.0%	2.0%	1.6%	2.2%
India ²	7.9%	7.1%	7.2%	5.0%	4.0%	5.4%
Mexico	2.3%	1.2%	1.8%	2.8%	5.6%	4.6%
Brazil	-3.6%	0.7%	1.9%	8.7%	4.3%	4.5%
Russia	-0.2%	1.3%	2.0%	7.1%	4.2%	4.5%

Forecast as of: May 10, 2017

¹Aggregated Using PPP Weights²Forecasts Refer to Fiscal Year

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2017			2018			2017			2018		
	Q2	Q3	Q4	Q1	Q2	Q3	Q2	Q3	Q4	Q1	Q2	Q3
U.S.	1.50%	1.75%	1.75%	1.75%	2.00%	2.25%	2.55%	2.72%	2.75%	2.76%	2.78%	2.86%
Japan	0.00%	0.00%	0.00%	0.02%	0.02%	0.03%	0.05%	0.07%	0.10%	0.12%	0.15%	0.20%
Euroland ¹	-0.35%	-0.35%	-0.32%	-0.25%	-0.10%	0.15%	0.40%	0.50%	0.60%	0.80%	1.00%	1.10%
U.K.	0.30%	0.30%	0.35%	0.45%	0.65%	0.70%	1.25%	1.40%	1.60%	1.75%	1.90%	2.00%
Canada ²	0.90%	0.90%	0.95%	1.15%	1.15%	1.40%	1.60%	1.70%	1.85%	1.95%	2.10%	2.15%

Forecast as of: May 10, 2017

¹ 10-year German Government Bond Yield² 3-Month Canada Bankers' Acceptances

Source: International Monetary Fund and Wells Fargo Securities

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