March 14, 2018

Economics Group

Monthly Outlook

U.S. Overview

Inflation Alters the Path to Point B

This month an increase in inflation expectations is the central theme. Compared to February, the new outlook anticipates a slight upswing in the pace of total and core PCE deflator measures of inflation. Higher inflation translates into a fourth increase in the funds rate this year. In the economy, real final sales has downshifted to a 2.5 percent growth rate from 2.8 percent, reflecting lower expectations for consumer spending and residential investment. Moreover, federal deficit estimates have moved up in 2018 and 2019. To restate our view, the "cautious tale" we highlighted in our Annual Outlook for 2018 is playing out, as both higher inflation and interest rates will subtract from the forward momentum in the economy. Alterations in expectations for growth (see real final sales below), inflation and interest rates continue to lead to volatility in the financial markets. We remain cautious also on the seasonality problem that has plagued first quarter GDP estimates to be released in April.

Long-term rates have moved, as the additional problem of Treasury debt supply and demand confronts the market going forward. This tension is a major concern. With the Fed focused on raising short-term rates, the Fed's reduction of the balance sheet and the upswing in Treasury finance estimates will put an upward bias to long-term rates. In terms of corporate profits, a rising interest rate environment and a tight labor market cause us to project trend like growth into 2019. However, this may well be below market expectations.

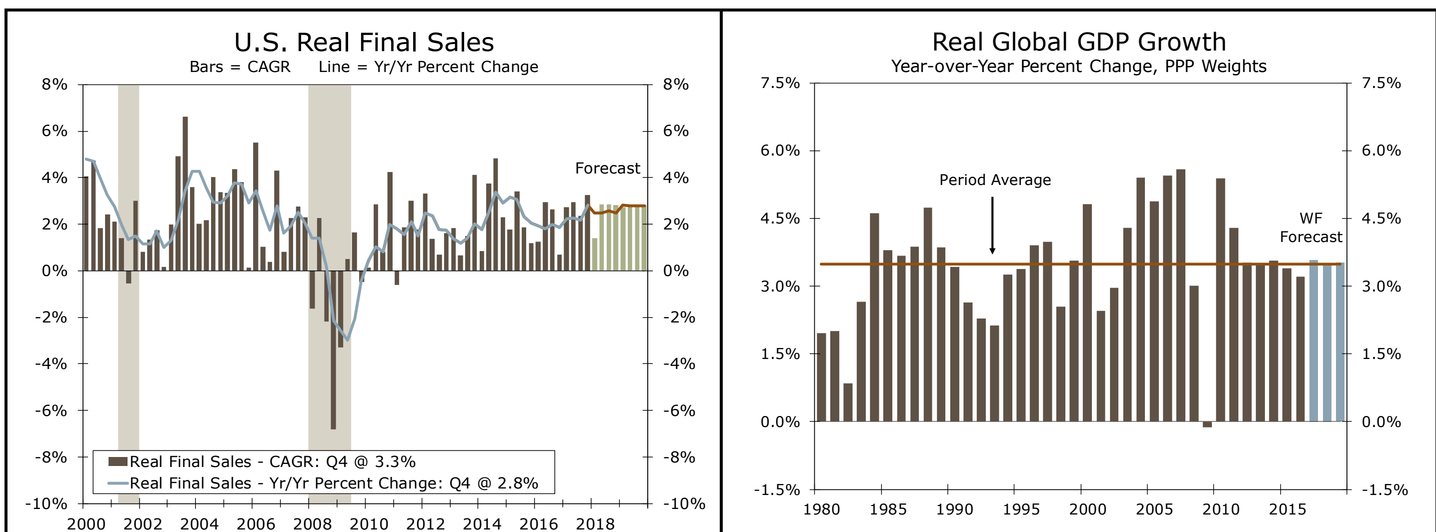
International Overview

The Weight of the World Is a Lighter Burden

There is never a time without risk, but unlike much of the past decade, the global economy, at least for the moment, is not hindered by a major and obvious negative from abroad. In the early years that followed the global slowdown of 2009, there were worries about the sovereign debt crisis in Europe in 2010 and the double-dip recession that followed in 2011. Then came concerns about a significant moderation in the pace of GDP growth in China from 2010 to 2014, and the negative knock-on effects that it had on emerging market economies across the world. After oil prices peaked in 2014, the steep drops in oil and commodity prices presented a major drag to commodity-reliant economies like Russia and, to a lesser extent, Canada in 2015 and 2016.

With no major economy going through that type of turmoil more recently, there has been a broad pick-up in economic activity the world over. We now estimate that global GDP grew 3.6 percent in 2017. We look for the global economy to expand roughly 3.5 percent this year and in 2019.

This is no time for complacency. While the global economy may be enjoying a respite from the challenges it has faced over the past decade, there clearly are a number of geopolitical events and protectionist trade policies that could raise risk aversion in financial markets and be disruptive to the business sector. A similar outcome could result if central banks become too aggressive in their removal of policy accommodation. Barring any of that, the weight of the world is a lighter burden.



Source: International Monetary Fund, U.S. Department of Commerce and Wells Fargo Securities

Growth Yes, but the Contradictions Start to Appear

Real final sales estimates were lowered this month reflecting weaker consumer and residential investment spending. This month there is a downshift in our estimate for consumer spending in response to weak January numbers, however, we view this as a one-off. Given the slower start to the year for real PCE, our projected year-over-year growth rate for consumer spending slows to 2.6 percent.

As for business investment, several favorable developments (tax cuts, improved business confidence, a better global backdrop, firming oil prices and a softer U.S. dollar) together make a compelling case for stronger capital spending. One caution here is that we are late in the economic cycle and a number of downside risks could still derail the expected pick-up.

Weaker residential spending expected for the first quarter reflects two factors. First, last summer's hurricanes have exaggerated the typical seasonal swings in residential investment. Home sales were pushed from late summer into the fall, helping drive up commission revenue. Spending on home improvements also increased in Q4 and construction ramped up, as projects that were delayed in August and September were restarted. The unusually high level of activity during the fourth quarter set the first quarter up for a big fall. Despite the likely slowdown in Q1, residential investment is expected to kick up its pace of growth in 2018–to 3.1 percent compared to 1.8 percent in 2017.

As for housing starts, there is a shortage of homes available for sale, which is restraining commission income. Housing starts are fairly strong, with more growth taking place at a lower price or in lower-priced markets in general (Texas, Florida, Georgia, Arizona, Nevada and the interior of California rather than the coast). This explains why builders are optimistic even though pending home sales (which largely reflect the existing home market) have weakened.

On trade, stronger business spending suggests a faster rate of growth in imports, which means that there will be an offset in GDP when taking trade into consideration. Bigger trade deficits also mean increased current account deficits. A negative trade shock is not out of the question. Should the United States walk away from NAFTA or slap tariffs on a broader range of Chinese goods, it could engender a rise in the price of imported goods, many of them capital goods.

Interest Rates and Inflation

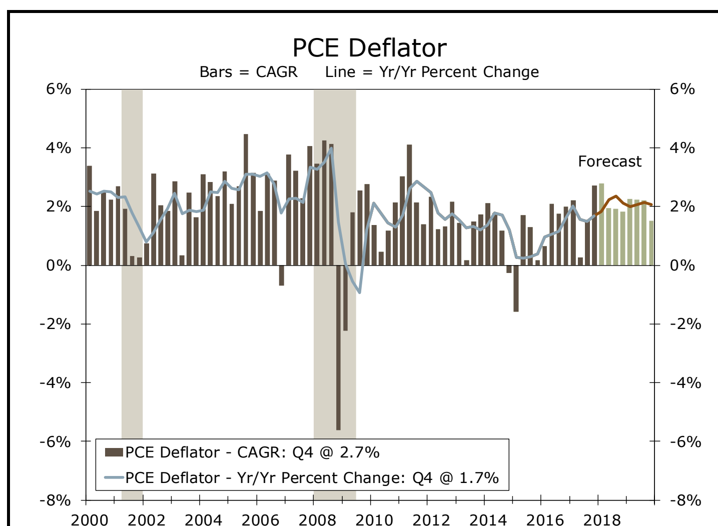
Our caution in the annual outlook is enhanced by recent developments for inflation and interest rates. Core inflation has gained momentum in recent months and inflation expectations have begun to rise—especially market-based measures. With four rate hikes now penciled in, we would expect rates to rise across the curve. Rising Treasury supply coupled with generally higher inflation expectations (especially with import tariffs) will also play a role in pushing longer-term rates higher. Higher fiscal deficits, tariffs and the drift up in inflation since the start of the year will not support anything like 3 percent growth and a steady hand at the Fed.

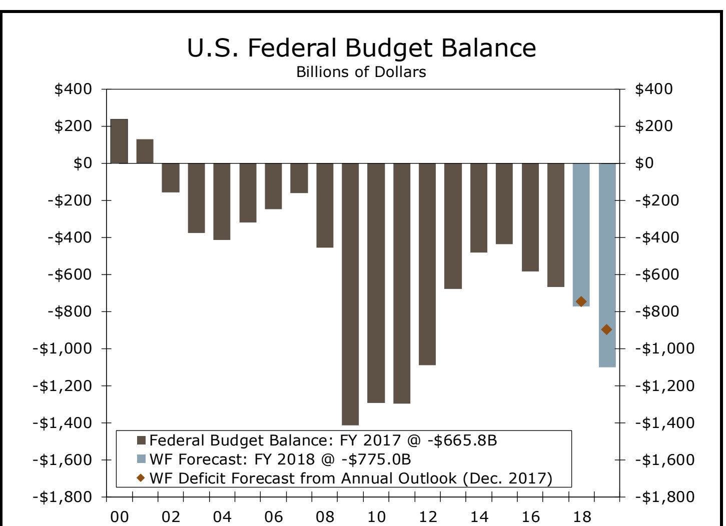
Moreover, the Fed will be tested on its commitment to 2 percent inflation and a reduction in the balance sheet in the face of widening fiscal deficits. Expansionary fiscal policy in the face of tighter monetary policy (four rate increases and a reduced balance sheet) sets up numerous tensions in interest rates, the dollar and growth.

Dollar Depreciation, Taxes and Profits

Recent dollar strength reflects softness in global equities. The trade-weighted dollar and yen tend to strengthen with equity weakness. We expect a return to dollar weakness in the second half of 2018, as the theme of policy convergence reemerges. While the Federal Reserve should continue to raise interest rates on regular occasions, that tightening appears to be less supportive of the greenback than rate hikes at the earlier stages of the cycle.

Despite the benefits of lower corporate tax rates, we remain cautious on profit growth given higher labor costs, interest rates and input costs.





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

Wells Fargo U.S. Economic Forecast

	Actual								Forecast								Actual			Forecast	
	2016				2017				2018				2019				2015	2016	2017	2018	2019
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product (a)	0.6	2.2	2.8	1.8	1.2	3.1	3.2	2.5	1.8	2.7	3.0	2.9	2.8	2.9	2.8	2.8	2.9	1.5	2.3	2.6	2.8
Personal Consumption	1.8	3.8	2.8	2.9	1.9	3.3	2.2	3.8	2.0	2.5	2.5	2.5	2.7	2.6	2.5	2.5	3.6	2.7	2.7	2.6	2.6
Business Fixed Investment	-4.0	3.3	3.4	0.2	7.2	6.7	4.7	6.6	5.7	5.9	5.4	4.7	4.2	4.6	4.5	4.1	2.3	-0.6	4.7	5.7	4.6
Equipment	-13.1	-0.6	-2.1	1.8	4.4	8.8	10.8	11.8	7.0	6.9	6.0	4.7	4.0	4.6	4.4	3.8	3.5	-3.4	4.8	8.2	4.7
Intellectual Property Products	6.3	11.1	4.2	-0.4	5.7	3.7	5.2	2.4	4.9	6.5	6.4	6.2	5.4	6.0	5.9	5.6	3.8	6.3	4.0	5.0	5.9
Structures	2.3	0.5	14.3	-2.2	14.8	7.0	-7.0	2.5	2.0	2.4	2.4	2.2	2.5	2.4	2.4	2.4	-1.8	-4.1	5.4	1.4	2.4
Residential Construction	13.4	-4.7	-4.5	7.1	11.1	-7.3	-4.7	13.0	-4.5	8.5	8.0	7.5	6.5	7.0	7.0	5.5	10.2	5.5	1.8	3.1	7.1
Government Purchases	1.8	-0.9	0.5	0.2	-0.6	-0.2	0.7	2.9	1.2	1.6	1.6	2.0	1.1	1.1	1.0	1.0	1.4	0.8	0.1	1.5	1.3
Net Exports	-584.2	-572.4	-557.3	-631.1	-622.2	-613.6	-597.5	-652.2	-679.4	-690.8	-699.8	-707.6	-713.7	-718.2	-719.2	-714.8	-545.3	-586.2	-621.4	-694.4	-716.5
Pct. Point Contribution to GDP	-0.3	0.3	0.4	-1.6	0.2	0.2	0.4	-1.1	-0.6	-0.3	-0.2	-0.2	-0.1	-0.1	0.0	0.1	-0.7	-0.2	-0.2	-0.4	-0.1
Inventory Change	40.6	12.2	17.6	63.1	1.2	5.5	38.5	8.0	44.0	40.0	48.0	50.0	52.0	54.0	56.0	58.0	100.5	33.4	13.3	45.5	55.0
Pct. Point Contribution to GDP	-0.6	-0.7	0.2	1.1	-1.5	0.1	0.8	-0.7	0.8	-0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.2	-0.4	-0.1	0.2	0.1
Nominal GDP (a)	0.8	4.7	4.2	3.8	3.3	4.1	5.3	4.9	4.7	4.8	5.0	4.7	5.1	5.2	5.1	4.4	4.0	2.8	4.1	4.8	5.0
Real Final Sales	1.2	2.9	2.6	0.7	2.7	3.0	2.4	3.3	1.4	2.8	2.8	2.8	2.7	2.8	2.8	2.8	2.6	1.9	2.4	2.5	2.8
Retail Sales (b)	2.9	2.7	2.6	3.6	5.1	3.9	4.1	5.4	4.3	5.3	5.5	4.3	5.3	5.3	5.1	5.0	2.6	2.9	4.6	4.8	5.2
Inflation Indicators (b)																					
PCE Deflator	1.0	1.0	1.2	1.6	2.0	1.6	1.5	1.7	1.8	2.2	2.3	2.1	2.0	2.1	2.1	2.1	0.3	1.2	1.7	2.1	2.1
"Core" PCE Deflator	1.6	1.7	1.8	1.9	1.8	1.5	1.4	1.5	1.6	1.8	1.9	2.0	2.0	2.1	2.1	2.1	1.3	1.8	1.5	1.8	2.0
Consumer Price Index	1.1	1.1	1.1	1.8	2.6	1.9	2.0	2.1	2.3	2.7	2.7	2.3	2.1	2.3	2.5	2.5	0.1	1.3	2.1	2.5	2.3
"Core" Consumer Price Index	2.2	2.2	2.2	2.2	2.1	1.8	1.7	1.7	1.9	2.2	2.2	2.2	2.1	2.2	2.3	2.3	1.8	2.2	1.8	2.1	2.3
Producer Price Index (Final Demand)	0.0	0.1	0.3	1.4	2.0	2.2	2.4	2.9	2.7	2.6	2.5	2.0	2.0	2.2	2.4	2.6	-0.9	0.4	2.4	2.5	2.3
Employment Cost Index	1.9	2.3	2.3	2.2	2.4	2.4	2.5	2.6	2.6	2.7	2.7	2.7	2.7	2.8	2.8	2.8	2.1	2.2	2.5	2.6	2.8
Real Disposable Income (a)	0.2	1.9	0.7	-1.8	2.9	2.7	0.7	1.1	3.8	3.0	2.5	2.5	2.8	2.6	2.6	2.6	4.2	1.4	1.2	2.4	2.6
Nominal Personal Income (b)	2.9	2.5	2.6	1.6	3.1	2.7	2.8	3.9	3.6	3.9	4.1	3.9	4.2	4.7	4.8	4.8	5.0	2.4	3.1	3.9	4.6
Industrial Production (a)	-1.3	-0.7	0.8	0.7	1.5	5.6	-1.2	8.3	2.1	2.8	2.6	2.4	2.5	2.3	2.3	2.3	-0.7	-1.2	2.0	3.3	2.5
Capacity Utilization	75.8	75.7	75.8	75.8	75.8	76.6	76.2	77.5	77.6	77.8	77.8	77.9	77.9	78.0	78.0	78.1	76.8	75.7	76.5	77.8	78.0
Corporate Profits Before Taxes (b)	-6.2	-8.2	-1.6	8.7	3.3	6.3	5.3	3.8	3.4	3.2	3.1	3.1	3.0	2.9	2.8	2.8	-1.1	-2.1	4.7	3.2	2.9
Corporate Profits After Taxes	-4.2	-8.0	-2.2	14.1	3.7	7.8	7.7	3.2	3.1	3.8	3.6	3.6	3.5	2.6	2.6	2.5	-1.5	-0.5	5.5	3.5	2.8
Federal Budget Balance (c)	-245	60	-187	-210	-317	4	-143	-225	-328	-9	-213	-333	-409	-76	-283	-375	-439	-587	-666	-775	-1100
Current Account Balance (d)	-119.2	-108.2	-110.3	-114.0	-113.5	-124.4	-100.6	-129.0	-140.0	-140.0	-140.0	-145.0	-145.0	-145.0	-150.0	-150.0	-434.6	-451.7	-467.5	-565.0	-590.0
Trade Weighted Dollar Index (e)	89.7	90.6	89.9	95.7	94.0	90.5	88.1	87.5	86.5	86.5	85.3	84.3	82.8	81.5	80.3	79.0	91.0	91.5	91.1	85.6	80.9
Nonfarm Payroll Change (f)	198	164	255	164	177	190	142	221	234	175	170	160	155	155	150	150	226	195	182	185	153
Unemployment Rate	4.9	4.9	4.9	4.7	4.7	4.3	4.3	4.1	4.1	4.0	3.9	3.8	3.8	3.7	3.8	3.7	5.3	4.9	4.4	3.9	3.8
Housing Starts (g)	1.15	1.16	1.15	1.25	1.24	1.17	1.17	1.26	1.30	1.30	1.31	1.32	1.35	1.37	1.37	1.38	1.11	1.17	1.20	1.31	1.37
Light Vehicle Sales (h)	17.3	17.2	17.5	17.8	17.1	16.8	17.1	17.7	16.9	16.8	16.7	16.7	16.6	16.6	16.5	16.5	17.4	17.5	17.2	16.8	16.5
Crude Oil - Brent - Front Contract (i)	35.2	47.0	47.0	51.0	54.6	50.8	52.2	61.4	67.3	62.8	58.8	61.0	59.0	60.0	59.0	59.0	54.0	45.1	54.7	62.4	59.3
Quarter-End Interest Rates (j)																					
Federal Funds Target Rate	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.50	2.75	2.75	3.00	0.27	0.52	1.13	2.13	2.75
3 Month LIBOR	0.63	0.65	0.85	1.00	1.15	1.30	1.33	1.69	2.05	2.30	2.55	2.80	2.80	3.05	3.05	3.30	0.32	0.74	1.26	2.43	3.05
Prime Rate	3.50	3.50	3.50	3.75	4.00	4.25	4.25	4.50	4.75	5.00	5.25	5.50	5.50	5.75	5.75	6.00	3.27	3.52	4.13	5.13	5.75
Conventional Mortgage Rate	3.69	3.57	3.46	4.20	4.20	3.90	3.81	3.94	4.35	4.37	4.45	4.60	4.72	4.77	4.82	4.87	3.85	3.65	3.99	4.44	4.80
3 Month Bill	0.21	0.26	0.29	0.51	0.76	1.03	1.06	1.39	1.85	2.10	2.15	2.40	2.60	2.65	2.70	2.75	0.05	0.32	0.95	2.13	2.68
6 Month Bill	0.39	0.36	0.45	0.62	0.91	1.14	1.20	1.53	1.95	2.20	2.25	2.50	2.70	2.75	2.80	2.85	0.17	0.46	1.07	2.23	2.78
1 Year Bill	0.59	0.45	0.59	0.85	1.03	1.24	1.31	1.76	2.12	2.25	2.30	2.55	2.75	2.80	2.85	2.90	0.32	0.61	1.20	2.31	2.83
2 Year Note	0.73	0.58	0.77	1.20	1.27	1.38	1.47	1.89	2.32	2.50	2.70	2.92	3.05	3.12	3.19	3.26	0.69	0.83	1.40	2.61	3.16
5 Year Note	1.21	1.01	1.14	1.93	1.93	1.89	1.92	2.20	2.72	2.80	2.88	2.97	3.10	3.17	3.24	3.31	1.53	1.33	1.91	2.84	3.21
10 Year Note	1.78	1.49	1.60	2.45	2.40	2.31	2.33	2.40	2.90	2.95	3.05	3.20	3.32	3.37	3.42	3.47	2.14	1.84	2.33	3.03	3.40
30 Year Bond	2.61	2.30	2.32	3.06	3.02	2.84	2.86	2.74	3.25	3.35	3.45	3.60	3.66	3.70	3.74	3.78	2.84	2.59	2.89	3.41	3.72

Forecast as of: March 14, 2018

Notes: (a) Compound Annual Growth Rate Quarter-over-Quarter
(b) Year-over-Year Percentage Change
(c) Quarterly Sum - Billions USD; Annual Data Represents Fiscal Yr.
(d) Quarterly Sum - Billions USD
(e) Federal Reserve Major Currency Index, 1973=100 - Quarter End
(f) Average Monthly Change
(g) Millions of Units - Annual Data - Not Seasonally Adjusted
(h) Quarterly Data - Average Monthly SAAR; Annual Data - Actual Total Vehicles Sold
(i) Quarterly Average of Daily Close
(j) Annual Numbers Represent Averages

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

First, Do No Harm

The global economy, without major problems to hold it back, has been gaining momentum in recent months and quarters. As one example of that, consider that the year-over-year rate of global industrial production (IP) rose to its fastest pace this past year since 2011, when the global economy was rebounding from its deep recession.

One factor that could de-rail the synchronous global expansion is protectionist trade measures, which risk an escalation of beggar-thy-neighbor policies and retaliatory tariffs among major global economies.

The recent steel and aluminum tariffs introduced in the United States, while mercifully not as expansive as originally described, could have negative effects for the business sector (See our recent special report *Steel Your Nerves*). The tariffs were also met with a cool reception by world leaders and large U.S. trading partners.

We do not anticipate the tariffs to start a broad and destructive trade war, at least not at this stage of the game. However, given the trend of nationalist and fringe political parties outperforming in European elections, the risk of escalation cannot be discounted altogether.

Another factor that could prove to be a headwind for global growth would be too swift a withdrawal of accommodative monetary policy. In the U.S. Outlook section of this report we described our rationale of a firming inflation outlook for taking up the number of Fed rate hikes this year to four.

The United States is not the only economy where growth is picking up and the threat of deflation is receding, as other central banks are removing policy accommodation as well. The ECB started to dial back its quantitative easing (QE) program last year and recently removed language about expanding it again. We look for the Governing Council to end its QE program late this year, and we forecast that it will begin a slow process of hiking rates in 2019.

The Bank of Canada (BoC) has raised its main policy rate 75 bps since last summer and we expect it will hike rates at least once more in 2018. While core CPI in Canada is getting close to the BoC's target rate, fourth quarter GDP growth came in below expectations and the growth numbers for the third quarter were revised lower.

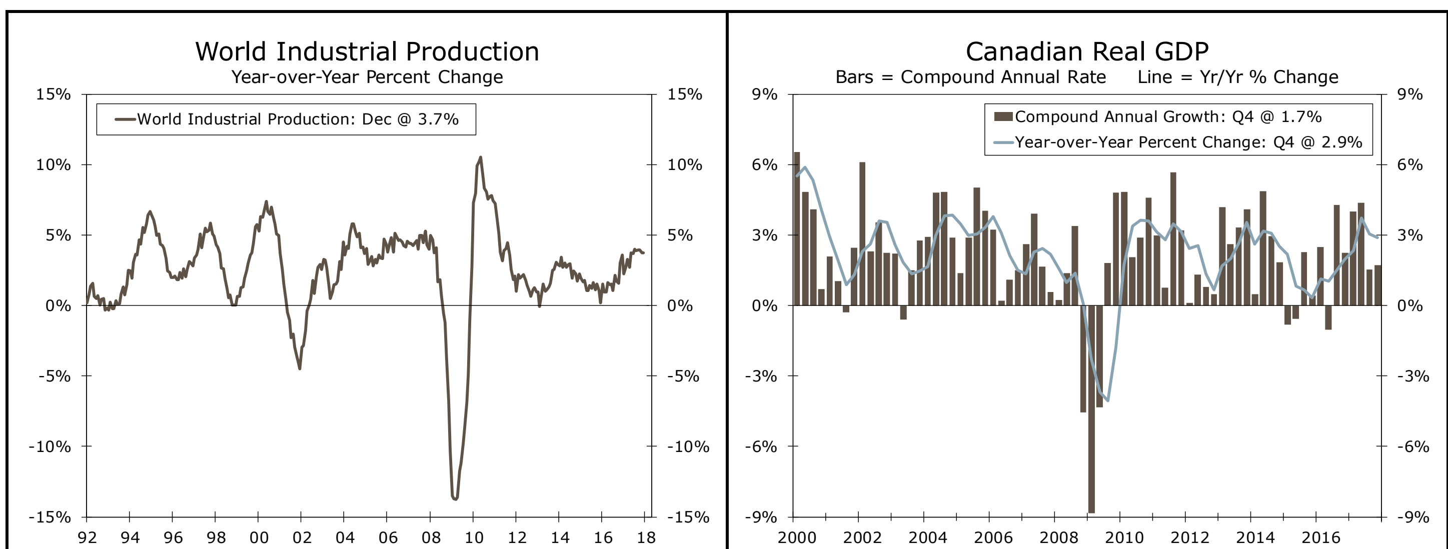
The Bank of England (BoE), which cut its main policy rate 25 bps in the immediate aftermath of the Brexit referendum in June 2016, took back that "insurance" rate cut in November. We look for the BoE to hike rates again later this year. The Bank of Japan has dialed back its pace of bond buying in recent months, but it probably will keep its deposit rate in negative territory for the foreseeable future.

Other risks to the global outlook include the fallout from some type of geopolitical event. While these risks are omnipresent, the seemingly accelerated pace of major global events including the planned visit to North Korea by a sitting U.S. president brings these risks into sharp focus.

Those risks aside, you would be hard-pressed to point to a better time for global growth conditions than those that exist at present. Part of that is because real GDP growth in the United States, the world's largest economy, will strengthen from 2.3 percent last year to 2.6 percent in 2018.

The 6.3 percent GDP growth we have penciled in for China, the world's second-largest economy, for 2018 continues to place it among the fastest growing major economies in the world. Compared to last year's growth of 6.9 percent in China, the pace of decline in growth has moderated compared to earlier in this decade.

We look for the Eurozone economy to slow to a still respectable 2.3 percent this year, from the 2.5 percent growth rate in 2017. We estimate that the global economy grew near or slightly above its long-run average of 3.5 percent last year, and we look for similar growth rates in 2018 and 2019.



Source: IHS Markit and Wells Fargo Securities

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2017	2018	2019	2017	2018	2019
Global (PPP Weights)	3.6%	3.5%	3.5%	3.1%	3.5%	3.5%
Global (Market Exchange Rates)	3.4%	3.3%	3.4%	3.1%	3.5%	3.5%
Advanced Economies[1]	2.4%	2.4%	2.4%	1.8%	2.0%	2.0%
United States	2.3%	2.6%	2.8%	2.1%	2.5%	2.3%
Eurozone	2.5%	2.3%	2.1%	1.5%	1.4%	1.8%
United Kingdom	1.7%	1.6%	1.8%	2.7%	2.5%	2.0%
Japan	1.7%	1.5%	0.9%	0.5%	1.1%	0.8%
Korea	3.1%	2.9%	2.8%	1.9%	2.2%	2.1%
Canada	3.0%	1.9%	1.8%	1.6%	1.8%	1.9%
Developing Economies[1]	4.7%	4.5%	4.6%	4.4%	5.0%	5.0%
China	6.9%	6.3%	6.0%	1.6%	2.1%	2.0%
India[2]	7.1%	6.7%	7.4%	3.3%	5.1%	4.8%
Mexico	2.0%	1.8%	2.1%	6.0%	5.8%	5.9%
Brazil	1.0%	2.8%	3.3%	3.4%	3.6%	4.2%
Russia	1.7%	2.0%	2.2%	3.7%	2.7%	3.9%

Forecast as of: March 14, 2018

[1]Aggregated Using PPP Weights [2]Forecast Refers to Fiscal Year

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2018				2019		2018				2019	
	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q2	Q3	Q4	Q1	Q2
U.S.	2.05%	2.30%	2.55%	2.80%	2.80%	3.05%	2.90%	2.95%	3.05%	3.20%	3.32%	3.37%
Japan	-0.04%	-0.02%	-0.01%	0.00%	0.01%	0.01%	0.05%	0.06%	0.07%	0.08%	0.09%	0.10%
Euroland[1]	-0.37%	-0.35%	-0.30%	-0.20%	-0.10%	0.05%	0.60%	0.70%	0.80%	0.95%	1.10%	1.20%
U.K.	0.65%	0.80%	0.80%	0.90%	1.05%	1.15%	1.50%	1.65%	1.80%	1.90%	2.00%	2.10%
Canada[2]	1.65%	1.75%	1.90%	2.00%	2.15%	2.25%	2.25%	2.30%	2.50%	2.50%	2.60%	2.65%

Forecast as of: March 14, 2018

[1] 10-year German Government Bond Yield [2] 3-Month Canada Bankers' Acceptances

Source: International Monetary Fund and Wells Fargo Securities

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