Economics

Weekly — August 11, 2023

Weekly Economic & Financial Commentary

United States: Inflation Continues to Ease

- Price pressures in the U.S. economy continue to subside. During July, both the headline and core Consumer Price Index (CPI) rose 0.2%. On a year-over-year basis, the core CPI was up 4.7% in July. Recent signs have been more encouraging, with core CPI running at a 3.1% three-month annualized pace. Furthermore, July's Producer Price Index (PPI) and NFIB Small Business Optimism Index also suggest that underlying inflation is dissipating.
- Next week: Retail Sales (Tue.), Housing Starts (Wed.), Industrial Production (Wed.)

International: U.K. Economy Shows Surprising Resilience

- The U.K. economy showed some surprising resilience in Q2, as Q2 GDP rose 0.2% quarter-over-quarter. The details showed relatively solid domestic demand, as consumer spending rose 0.7% and business investment rose 3.4%. That said, given the prior increase in inflation and interest rates over the past several quarters, we still anticipate the U.K. falling into a mild recession later this year.
- Next week: Japan GDP (Tue.), China Retail Sales & Industrial Output (Tue.), Canada CPI (Tue.)

Interest Rate Watch: Quantitative Tightening Keeps Rolling Along

- In May 2022, the FOMC announced plans to begin reducing the size of its balance sheet. At the time, the Fed's balance sheet had ballooned from roughly $4.2 trillion before the pandemic to nearly $9 trillion. Since then, the Fed's total security holdings have fallen by $900 billion amid quantitative tightening (QT), the phrase often used to describe the Fed's security runoff program.

Credit Market Insights: Household Debt Hits an All-Time High

- The Federal Reserve Bank of New York released its second quarter Household Debt and Credit Report this week, which indicated total debt balances increased by $16 billion in Q2. The uptick led household debt to notch an all-time high of just over $17 trillion.

Topic of the Week: Workforce Evolution in the World's Factory

- Known as the "world's factory," China has been a manufacturing powerhouse since the late 1990s. However, the ultra-cheap labor costs that facilitated China's role as a manufacturing hub are fading as rising labor costs and demographic challenges are putting pressure on China's manufacturers.

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Wells Fargo U.S. Economic Forecast

	Actual						Forecast		Actual		Forecast	
	2022				2023				2021	2022	2023	2024
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q				
Real Gross Domestic Product [1]	-1.6	-0.6	3.2	2.6	2.0	2.4	2.0	0.6	5.9	2.1	2.1	0.4
Personal Consumption	1.3	2.0	2.3	1.0	4.2	1.6	1.8	1.2	8.3	2.7	2.2	0.3
Consumer Price Index [2]	8.0	8.6	8.3	7.1	5.8	4.1	3.4	3.0	4.7	8.0	4.0	2.4
"Core" Consumer Price Index [2]	6.3	6.0	6.3	6.0	5.6	5.2	4.3	3.8	3.6	6.1	4.7	3.0
Quarter-End Interest Rates [3]												
Federal Funds Target Rate [4]	0.50	1.75	3.25	4.50	5.00	5.25	5.50	5.50	0.25	2.02	5.31	4.13
Conventional Mortgage Rate	4.27	5.58	6.01	6.36	6.54	6.71	6.80	6.55	3.03	5.38	6.65	5.88
10 Year Note	2.32	2.98	3.83	3.88	3.48	3.81	3.85	3.70	1.45	2.95	3.71	3.21

Forecast as of: August 11, 2023 [1] Compound Annual Growth Rate Quarter-over-Quarter [2] Year-over-Year Percentage Change
[3] Quarterly Data - Period End; Annual Data - Annual Averages [4] Upper Bound of the Federal Funds Target Range

Source: U.S. Dept. of Commerce, U.S. Dept. of Labor, Federal Reserve Board and Wells Fargo Economics

Please see our full U.S. Economic Forecast.

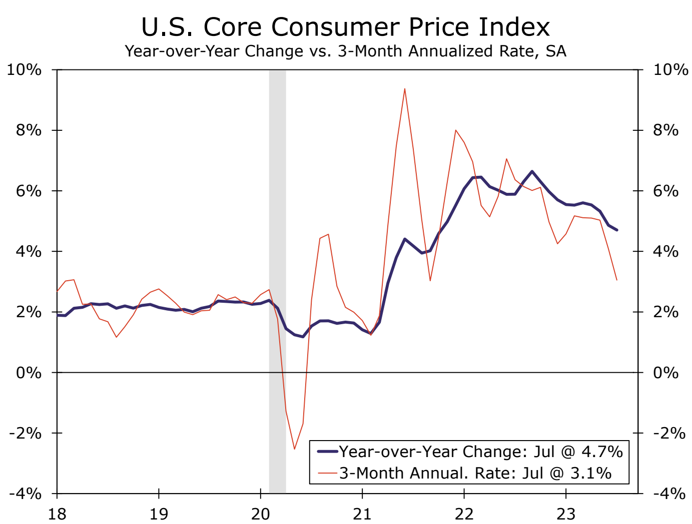
U.S. Review

Inflation Continues to Ease

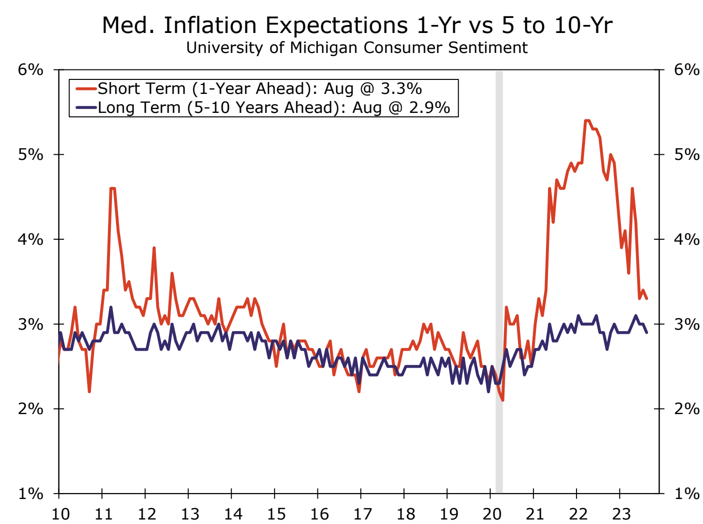
Inflation was in the spotlight this week. During July, both the headline and core measures of the Consumer Price Index (CPI) rose 0.2%. These monthly gains were largely in line with consensus expectations and provided additional evidence that price pressures are still receding. Inflation's descent, however, continues to be gradual. On a year-over-year basis, the core CPI was up 4.7% in July. Recent signs have been more encouraging. The recent string of lower core CPI prints has pushed down the three-month annualized pace to 3.1%, the lowest since September 2021. The downshift in inflation without a material deterioration in economic growth has raised the likelihood of a soft landing, a topic we cover in more detail in our macroeconomic forecast update for August.

That said, by most measures, inflation is still above the Fed's 2% target and the path from here is anything but certain. There is a bit more clarity on the trajectory of shelter costs, which have been a substantial driver of overall inflation over the past year. The pace of shelter inflation has eased in recent months, yet it still is running at a hot rate. Primary shelter inflation, which largely reflect apartment rents, rose 0.4% during July. The CPI's measure of shelter prices tends to significantly lag private measures, which have shown a considerable downshift in rent growth. In addition, apartment demand has been more modest recently, and the pipeline of new apartment construction continues to run at a near-record pace. Together, these factors point to a further moderation in shelter costs in the near term.

Outside of the heavily weighted shelter component, services price changes were mixed in July. Airfares and vehicle rental prices both declined during the month. Medical services inflation softened during the month, while motor vehicle insurance, recreation services and tuition and childcare all rose. All told, core services inflation picked up 0.4% during the month, a more temperate rate compared to earlier in the year, but a mild acceleration relative to June.The climbdown in inflation continues to be aided by smoother functioning supply chains and normalizing demand. Core goods prices dropped 0.3% in July, the largest drop since March 2022. Prices for new and used autos fell during the month. Declines in household furnishings, recreation goods, education and communication goods also contributed to the downdraft.



Source: U.S. Department of Labor and Wells Fargo Economics



Source: University of Michigan and Wells Fargo Economics

Evidence that underlying inflation pressures are not intensifying was presented elsewhere this week. The core Producer Price Index (PPI), which excludes volatile food and energy costs, increased 0.3% during July, a tad higher than market expectations. However, over the past year, the core PPI was up 2.4%, similar to June's annual change. Cost pressures also appear to be diminishing for small business owners. Small business optimism bested expectations in July, notching its third consecutive improvement to reach an index reading of 91.9. Small business confidence is still low but has brightened recently alongside more moderate inflation. Consequently, fewer firms are reporting the need to implement price hikes. The net percentage of firms raising prices over the past three months fell to 25%, its lowest level since February 2021.

Inflation expectations also remain well-anchored, at least according to the preliminary results for the University of Michigan's Consumer Sentiment index for August. The top-line sentiment index came in at a reading of 71.2, down slightly from July's reading. The slip in sentiment was in line with consensus estimates and occurred against a backdrop of rising gas prices, announcement of a U.S. debt rating downgrade and ongoing financial market volatility. The inflation expectations components were more encouraging. One-year inflation expectations eased to 3.3% during the survey period, while 5-10 year inflation expectations slipped to 2.9%. Consumers continuing to not anticipate a sharp run-up in prices in the future will come as welcome news to policymakers and bolsters our view that July's 25 bps fed funds rate hike was the last of this tightening cycle. Inflation continues to ease; however, it still remains above target. Until price pressures are convincingly set on a course for 2%, rate cuts still look to be off in the distance.

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U.S. Outlook

Weekly Domestic Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
15-Aug	Retail Sales (MoM)	Jul	0.4%	0.3%	0.2%
16-Aug	Housing Starts	Jul	1,448K	1,455K	1,434K
16-Aug	Industrial Production (MoM)	Jul	0.3%	0.2%	-0.5%

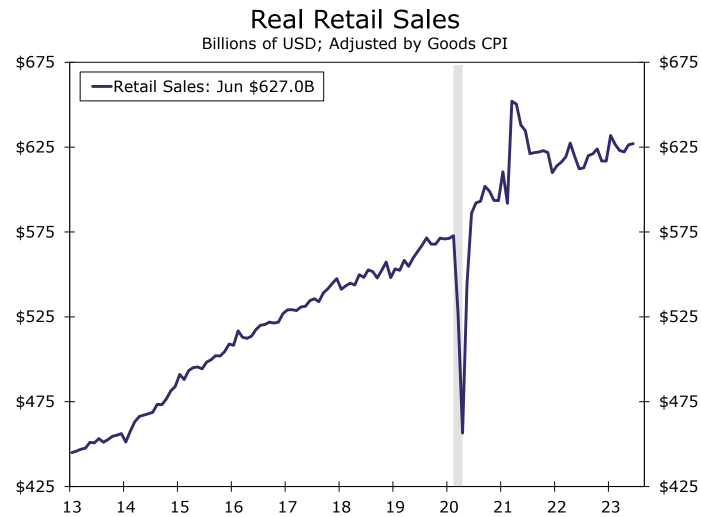
Forecast as of August 11, 2023

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Retail Sales • Tuesday

Consumer staying power remains intact, but even as households continue to spend, there has been a loss in momentum. Retail sales rose 0.2% in June, marking the third consecutive monthly gain, yet sales are still down since the start of the year. The mere sidestep in activity, rather than outright contraction, demonstrates an underlying resilience in spending throughout the first half of 2023.

We forecast a slight pickup in July and look for sales to rise 0.3% during the month. Auto sales likely somewhat held back July sales activity after three consecutive months of strong vehicle purchases. Beyond autos, sales activity has been mixed across other retailers in recent months after an unusually strong start to the year. Households' capacity to spend is dwindling as excess liquidity normalizes and credit not only becomes harder to come by but more expensive. But the tight labor market is offering up decent wage growth when met with slowing inflation. Falling goods prices are also providing some relief to consumers in terms of purchases, with the consumer price index for goods down 0.1% in July. This suggests *real* retail sales were likely a bit stronger, closer to 0.4% last month.

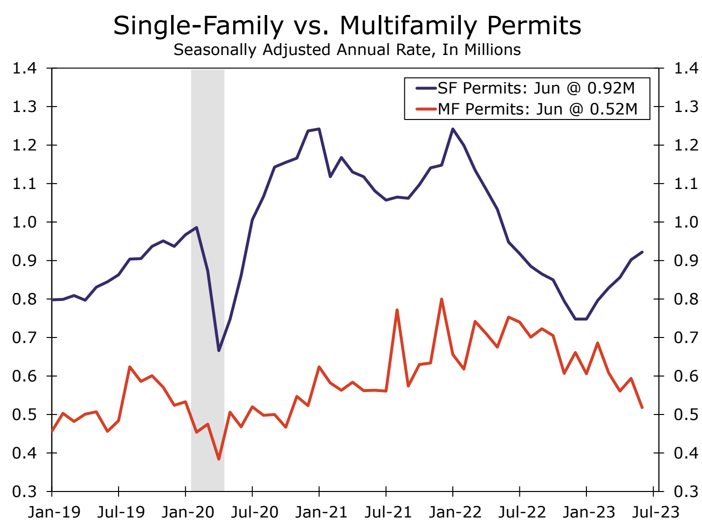


Source: U.S. Department of Commerce and Wells Fargo Economics

Housing Starts • Wednesday

The housing market has seen a bit of a bounce so far this year. While overall housing starts declined in June, all of the weakness can be traced to a steep drop in multifamily permits specifically. Single-family permits rose for the fifth straight month.

We expect this divergence in single-family and multifamily construction to continue and forecast overall housing starts to rise to a 1.455 million-unit annual pace in July from 1.434 million in June. Underlying demand for single-family homes remains sturdy. Favorable demographics combined with low resale inventory has driven many prospective buyers toward new construction. Continued demand also suggests that the shock factor of elevated rates amid still-high home prices has somewhat faded as builders have been able to utilize incentives to bridge affordability concerns. Beyond solid demand, softer material price inflation has also boosted builder sentiment. We now expect a modestly higher pace of single-family starts over the next two years, reflecting builders scaling up production to meet this stronger demand environment, as discussed in our August U.S. Economic Outlook.



Source: U.S. Department of Commerce and Wells Fargo Economics

Industrial Production • Wednesday

The industrial side of the economy remains under pressure. Industrial production slid 0.5% in June for the second straight month amid broad-based weakness. Manufacturing output was down 0.3%, mining slipped for the second straight month and utilities continued its slide after an unusually strong March.

Conditions in July do not appear much better. The ISM manufacturing index notched its ninth straight month of contraction in July. There was some improvement with new orders still signaling contraction but at a slower pace than in June. With inventories flatlining in the first half of the year, any gain in orders could somewhat help revive production. We expect industrial production rose 0.2% in July. Manufacturing activity may remain weak, but hotter-than-usual weather in the U.S., and specifically across the Southeast, last month suggests a rebound in utilities production after a string of weakness. Like broader goods spending, industrial activity has stalled after easing up considerably late last year. Business conditions remain unfavorable for new capital investment as borrowing costs have risen and banks tightened their lending standards throughout the first half of the year. Even if the Fed is done with its tightening cycle, as we presently expect, real yields are moving sharply higher as inflation slows and could spell trouble for interest rate-sensitive industrial activity.

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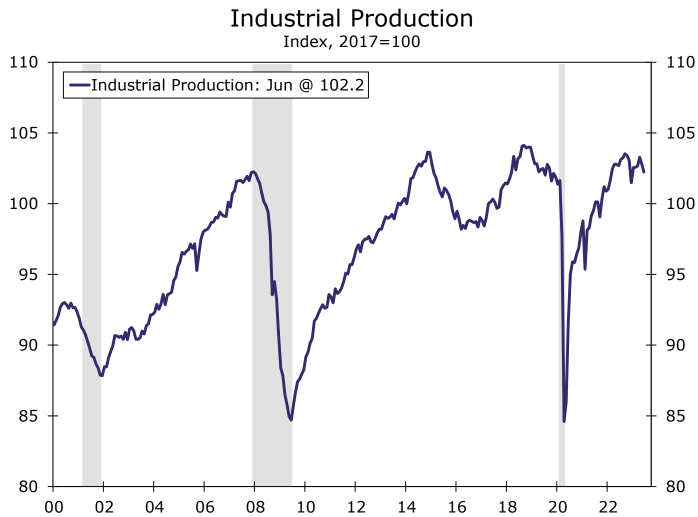


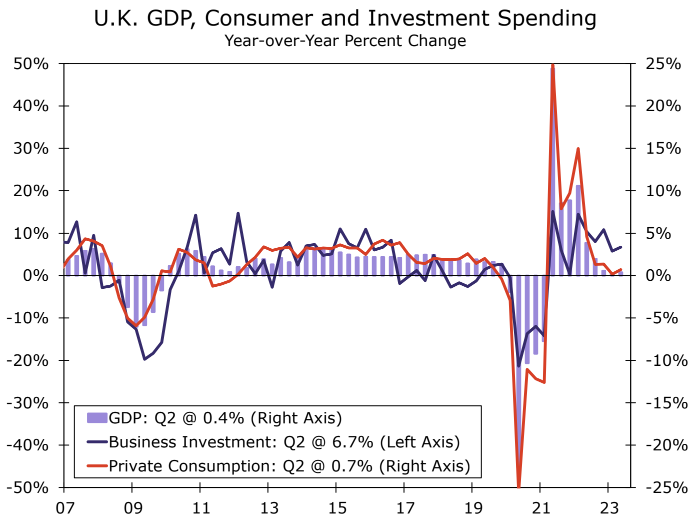
Source: Federal Reserve Board and Wells Fargo Economics

International Review

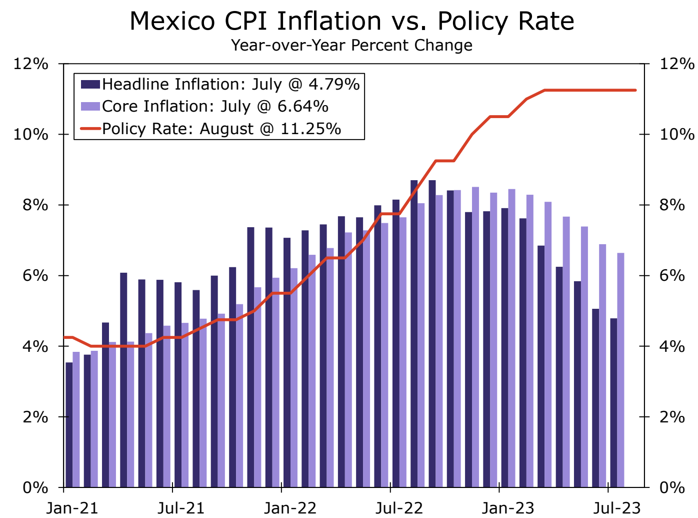
U.K. Economy Shows Surprising Resilience

This week's Q2 GDP report from the United Kingdom revealed some surprising resilience from the British economy during the second quarter. U.K. GDP rose 0.2% quarter-over-quarter, beating expectations for a flat outcome, while on a year-over-year basis growth firmed slightly to 0.4%. The details also revealed relatively solid domestic demand, as consumer spending rose 0.7% quarter-over-quarter, and business investment rose 3.4% on top of a large Q1 increase. The income details within the report were also encouraging as compensation of employees rose 1.9% quarter-over-quarter, translating into a modest quarterly increase in real terms even after adjusting for higher prices.

Separately, June GDP figures indicated the second quarter ended on a solid note, although the result was flattered by the holiday for the coronation of King Charles III, which depressed the May results and thus boosted the June results. June GDP rose 0.5% month-over-month, more than twice as much as forecast. Services activity rose a more moderate 0.2%, while industrial output jumped 1.8%. Despite the solid economic showing, given the prior increase in inflation and interest rates over the past several quarters, we still anticipate the U.K. economy falling into a mild recession later this year. Moreover, with inflation also now starting to recede more meaningfully (the consensus forecast for the U.K. July CPI, released next week, to slow to 6.8% year-over-year), our base case is for the Bank of England to deliver just one more rate hike during this tightening cycle. We expect the U.K. central bank to raise its policy rate by 25 bps to 5.50% at its September monetary policy announcement. That said, if U.K. economic activity were to continue to surprise with its resilience, the risk of a further rate hike beyond September remains.



Source: Datastream and Wells Fargo Economics



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Among the emerging economies, this week saw the latest batch of inflation readings from some key economies. In Mexico, July CPI inflation slowed further to 4.79% year-over-year, while core inflation decelerated a bit more than forecast to 6.64%. Over the past several months, the deceleration has been driven in particular by reducing price pressures for food, beverages and tobacco, housing, furniture, and transportation. For now, however, both headline and core inflation remain above the upper edge of the central bank's 2%-4% target range. Against this backdrop, the Bank of Mexico held its policy rate steady at 11.25% at this week's monetary policy meeting, as widely expected. The decision to hold rates steady was unanimous, and policymakers repeated that interest rates would need to be held at their current level for an extended period. Our view remains the Bank of Mexico will hold rates steady through the rest of 2023, and only look to begin lowering its policy interest rate from Q1-2024.

In Brazil, the July CPI rose 0.12% month-over-month and firmed to 3.99% year-over-year, with the annual increase boosted by base effects from a very low reading in July 2022. Importantly, the overall rate of headline inflation remains quite low, and we believe that services inflation remains on a gradually decelerating course. Against the backdrop, we expect Brazil's Central Bank to cut its Selic rate another 50 bps to 12.75% at its next meeting in September. Finally, China's July CPI attracted some attention as it showed the economy had moved into deflation, with the CPI falling 0.3% year-over-year, the first decline since early 2021. Still, the decline in prices is expected to be temporary, and another core measure of inflation showed subdued, but positive, growth. China's July CPI excluding food and energy firmed slightly to 0.8% year-over-year, from 0.4% in June.

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International Outlook

Weekly International Indicator Forecasts					
Date	**Indicator**	**Period**	**Consensus**	**Wells Fargo**	**Prior**
15-Aug	Japan Q2 (QoQ Annualized)	Q2	2.9%	2.4%	2.7%
15-Aug	China Retail Sales (YoY)	Jul	4.2%	--	3.1%
15-Aug	China Industrial Output (YoY)	Jul	4.3%	--	4.4%
15-Aug	Canada CPI (YoY)	Jul	2.9%	--	3.3%

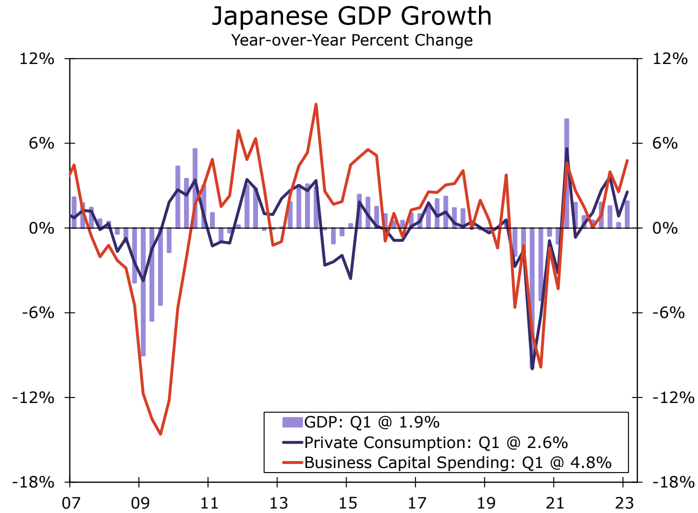
Forecast as of August 11, 2023

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Japan GDP • Tuesday

Japan's GDP report due next week is likely to show the economy continued to grow at a steady pace during the second quarter. In recent months, Japan's activity indicators and confidence surveys have remained generally encouraging, including a rise in both the manufacturing and non-manufacturing diffusion indices in the Q2 Tankan survey and generally sturdy retail sales growth. Against this backdrop, the consensus forecast sees Q2 GDP expanding by 2.9% quarter-over-quarter annualized, or by 0.7% not-annualized. With respect to non-annualized growth, consumer spending is forecast to be flat for the quarter while business capital spending is seen rising 0.4%, with much of the growth expected to come from the net export sector.

Interestingly and despite encouraging indicators, domestic demand is expected to see only a moderate increase during Q2. Indeed, with price gains so far outpacinghousehold income gains, it is an open question as to how long the current pace of Japanese economic growth can be sustained. With respect to inflation, the July CPI is expected to remain steady at 3.3% year-over-year. Given the possibility of slower growth and slower inflation over time, we believe that even with the Bank of Japan adopting a more flexible monetary policy approach, the BoJ will continue to seek a relatively gradual and orderly rise in Japanese government bond yields.

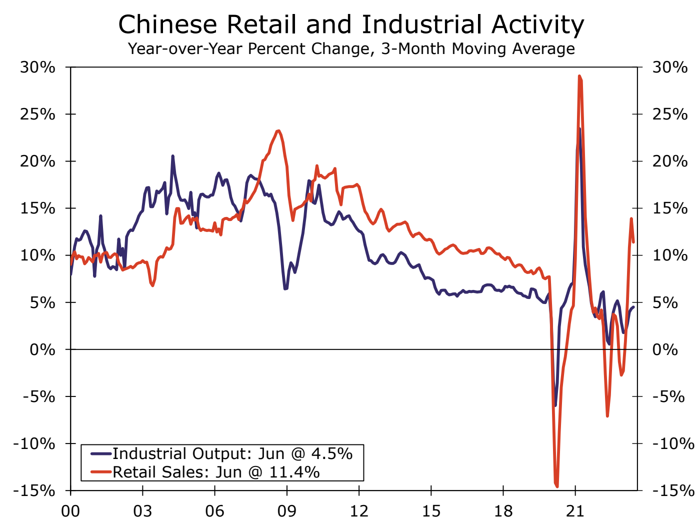


Source: Datastream and Wells Fargo Economics

China Retail Sales & Industrial Output • Tuesday

Following a burst of activity in early 2023, the most prominent theme from China during the course of this year has been a steady waning of economic momentum as the bounce from China's post-COVID opening fades. That theme continued with the PMI surveys for July. The manufacturing PMI rose to 49.3, but remained below the breakeven 50 level, while the services PMI fell further to 51.5. China's July activity data will be closely watched for any further slowing in momentum, although the consensus forecast is for mixed results. July retail sales are forecast to firm moderately to 4.2% year-over-year, which would be the first improvement in several months, while July industrial output is expected to ease to 4.3% year-over-year.

Overall, those mixed results would likely keep China on course for subpar GDP growth of 5.2% for 2023. The lack of a strong bounce in activity would suggest that recent reductions in benchmark interest rates such as the loan prime rates and interbank interest rates have been insufficient to prompt a rebound in activity. And while we do expect the People's Bank of China to lower its Reserve Requirement Ratio further in the coming months, those July activity data may not be so weak to encourage authorities to respond with aggressive monetary easing or large-scale fiscal



Source: Datastream and Wells Fargo Economics stimulus. As a result, our outlook remains for China's economy to slow through 2023, and also into 2024.

Canada CPI • Tuesday

Canada's July CPI report, due for release next week, is likely to be a key input ahead of the Bank of Canada's (BoC) monetary policy decision scheduled for early September. After pausing its tightening cycle in early 2023, the BoC resumed hiking interest rates in June and July, citing persistent excess demand and underlying inflation pressures, as well as ongoing wage growth. Since then, inflation trends have been mixed as the most recent report saw headline inflation slow, but core inflation ease only modestly. Meanwhile, the July labor market report revealed signs of softening as employment fell by 6,400 and the unemployment rate ticked up to 5.5%.

The July headline CPI print is expected to edge only moderately higher to 2.9% year-over-year. More important, however, will be the evolution of the core inflation measures. Those core inflation trends, when measured on a three-month annualized basis, have remained in a 3.5%-4.0% range for the past several months. Should that core inflation trend downshift to a 3.0%-3.5% three-month annualized pace, which we view as a distinct possibility, that may well be enough for the Bank of Canada to hold its policy interest rate steady at 5.00% at its early September announcement.

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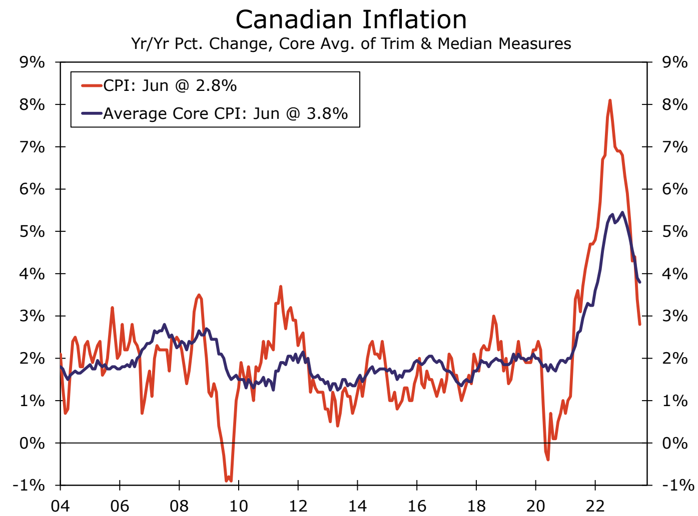


Source: Bloomberg Finance L.P. and Wells Fargo Economics

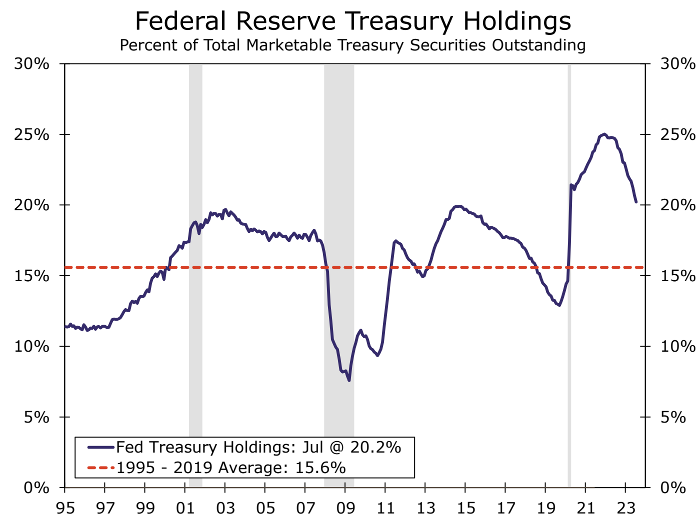
Interest Rate Watch

Quantitative Tightening Keeps Rolling Along

In May 2022, the FOMC announced plans to begin reducing the size of its balance sheet. At the time, the Federal Reserve's balance sheet had ballooned from roughly $4.2 trillion before the pandemic to nearly $9 trillion, with about 95% of its assets in securities, mostly Treasury securities and mortgage-backed securities (MBS). Since then, the Federal Reserve's total security holdings have fallen by $900 billion amid quantitative tightening (QT), the phrase often used to describe the Fed's security runoff program. The central bank's Treasury security holdings have declined by $700 billion to about $5 trillion.

While $5 trillion of Treasury security holdings is an enormous sum, so too is the size of the overall U.S. Treasury market. The total national debt is roughly $32.6 trillion. However, nearly $6.9 trillion of that is "intragovernmental debt," or money the federal government owes itself. An example would be the Social Security trust fund, which contains liabilities of the U.S. Treasury but assets of the Social Security Administration. On a consolidated basis, this debt cancels out. The more commonly cited debt held by the public measure comprises the remaining $25.7 trillion of the national debt. Of this, a relatively small share (~$600 billion) is nonmarketable securities, such as savings bonds an individual might own. The "marketable" debt, i.e., the U.S. Treasury market, accounts for the remaining $25 trillion or so of the national debt.

Thus, if the Federal Reserve holds about $5 trillion of Treasury securities and the total universe of Treasury securities is roughly $25 trillion, the central bank owns about 20% of the market. How does this compare to history? Interestingly, the Federal Reserve's total holdings are above the long-run average from 1995-2019, but perhaps by less than one might think (chart). At the current pace of runoff and Treasury issuance, the Fed's share of the Treasury market would decline to its long-run average sometime around the middle of next year.



Source: U.S. Department of the Treasury, Federal Reserve Board and Wells Fargo Economics

It will take more than just this feat to "normalize" the Fed's balance sheet. The Federal Reserve holds more Treasury notes & bonds and fewer Treasury bills relative to history, suggesting more downward pressure on long-term interest rates from its holdings, all else equal. In addition, the central bank's holdings of MBS, which currently total $2.5 trillion, remain very large. That said, as the months slip by and QT keeps rolling, some sense of "normal" for the Fed's balance sheet is slowly coming into view.

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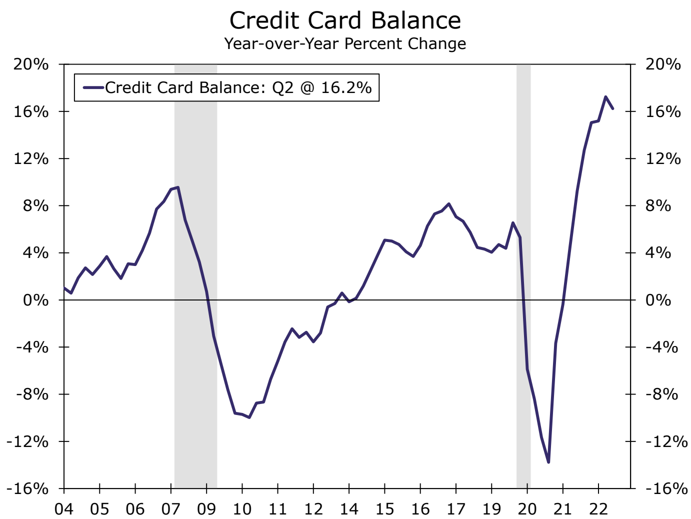
Credit Market Insights

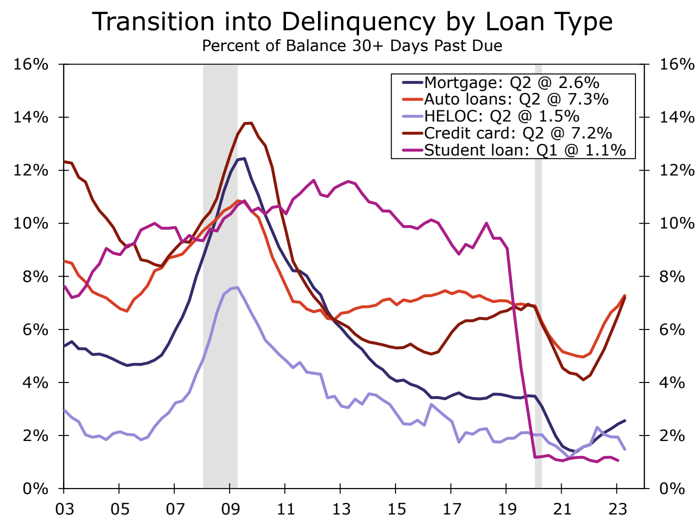
Household Debt Hits an All-Time High

The Federal Reserve Bank of New York released its second quarter Household Debt and Credit Report this week, which indicated total debt balances increased by $16 billion in Q2. The uptick led household debt to notch an all-time high of just over $17 trillion. To put this into context, that amounts to about 82% of household income, which is above the pre-pandemic ratio of near 80%, but well-below the share that prevailed on the eve of the 2008 financial crisis (105%). In short, households do not appear over-levered at this point, although debt balances are rising. Since late 2019, total household debt has increased by just under $3 trillion, though quarterly growth has waned to just 0.1%—the lowest rate of growth since the second quarter of 2020.

While total debt more or less flatlined in Q2, credit card balances crossed $1 trillion for the first time. Even with heightened uncertainty around the near-term economic outlook, as well as tightening financial standards, consumer spending remains resilient. The average annual percentage rate (APR) on credit cards reached their highest rate in data going back to the mid-1990s. Yet, consumers continue to somewhat rely on their credit cards to spend—credit card debt increased 4.6% over the quarter, equating to a 16.2% annual rate. Persistent credit-fueled spending also comes with the eventual burden of paying off this debt, and there are signs consumers are starting to fall behind. An increasing share of credit card balances are transitioning into early delinquency with the share 30+ days past due rising to 7.2% in Q2, marking the highest since 2012. We expect consumer credit usage to subside as borrowing costs remain elevated and consumers are faced with these increasing debts.



Source: New York Federal Reserve and Wells Fargo Economics



Source: New York Fed Consumer Credit Panel, Equifax and Wells Fargo Economics

The biggest source of aggregate household debt continues to be held in mortgages, with an outstanding balance of near $12 trillion in Q2. The housing market has been the primary transition mechanism for monetary policy, and we have seen financing costs for homes skyrocket amid the Federal Reserve's fastest tightening cycle in four decades. Demand for mortgage originations and refinancing has dropped as a result and outstanding mortgage debt fell for the first time since 2018, albeit by a mild $30 billion. As we discussed in a recent special report, however, the pandemic-induced refinancing boom as well as increasing homeowners' equity leaves households with a firmer financial cushion today. Households continued to slowly tap home equity lines of credit in Q2, with balances rising for the fifth straight quarter, up by about $1 billion.

Auto loans have also been on the rise over the past three years, and delinquencies have now surpassed pre-pandemic levels. Interestingly, auto loan debt outstanding has surpassed student loan debt for the first time since 2009, though these data may somewhat be distorted by the student loan moratorium that was put in place throughout the pandemic. Ahead of the pandemic, student loan debt saw some of the fastest growth, and there is about $1.6 trillion in outstanding debt as of the Q2.

We presently expect the Fed has reached the end of its monetary tightening cycle. We forecast the FOMC will keep rates at the 5.50% upper bound for some time, which will keep conditions relatively restrictive and borrowing costs elevated. Household debt dynamics are broadly moving in the wrong direction, but are not overly concerning at this point in terms of outstanding debt balances or delinquency status.

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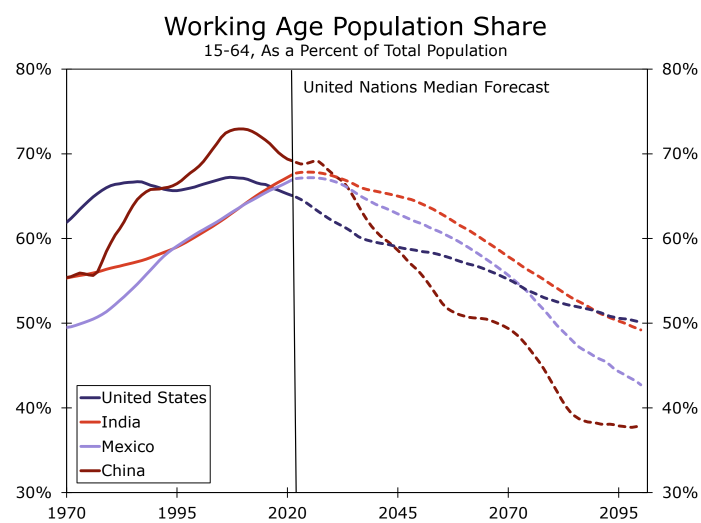
Topic of the Week

Workforce Evolution in the World's Factory

Known as the "world's factory," China became a manufacturing powerhouse in the late 1990s and ascended to one of the largest economies in the world throughout the 2000s. Cheap labor costs made durable goods relatively less expensive, with China becoming a major global exporter and one of the United States' top trading partners. However, geopolitical tensions along with China-specific challenges have made China's role as manufacturer to the world increasingly untenable. Under the Trump administration, the United States placed costly tariffs on China exporting goods to the United States. These trade tensions have taken a broader shape over time as the U.S. has imposed multiple trade restrictions, including new restrictions from the Biden administration this week aimed at limiting China's technological capabilities. Western U.S. allies have also participated in attempts to isolate China from the global marketplace. Countries across Europe, while falling short of tariffs, have also placed limitations on their respective trade relationships with China and have imposed restrictions on technology exports into the country. In addition, China's pandemic lockdowns exacerbated deteriorating trade relationships and the need/willingness for multinational corporations to begin exploring new avenues for production and diversifying supply chains.

Seeking new manufacturers and new supply chains also stems from idiosyncratic issues within China's economy and labor force. China, while still an emerging nation, has become more developed over time. As the economy matures, living costs rise, leading to an increase in employment costs. The ultra-cheap labor costs that facilitated China's role as a manufacturing hub may no longer be the case. To put this into perspective, wages in China have grown at a faster rate than labor costs in the U.S., and as of the end of 2021, were up 38% relative to 2010. While becoming a more mature economy is a positive, China's aging demographics are likely to compound its rising labor cost issue. To that point, the United Nations forecasts a considerable decline in China's population. By 2100, the UN forecasts China's total population to decline to ~800 million people and for the share of the working age population to drop below 40% of the total population, down from 69% currently. Fewer households are having children as the cost of living and raising a child has spiked over time. As of 2019, the cost of raising a child was almost seven times more than China's GDP per capita. As the supply of potential workers declines over time, manufacturing plants will need to attract new workers with higher wages, thus increasing labor costs even more. Coupled with geopolitical issues, rising wage costs are likely to result in corporations moving production away from China and finding other low-cost, or closer, providers.



Source: United Nations and Wells Fargo Economics

Evidence, both real and anecdotal, exists that the shift out of China is under way. To that point, trade flows are evolving. Southeast Asian nations are also low cost providers and have seen trade activity pick up over the course of the last five years as the movement away from China intensifies. Other alternatives such as "onshoring" or "nearshoring"— which is the process of moving operations to U.S. soil or to an adjacent country like Mexico—are gaining popularity. In fact, U.S. imports from Mexico overtook Chinese imports earlier this year, indicating the shift in the U.S.-China trade relationship is happening. (For more detail on onshoring trends, see our latest Globalization Report). The diversification away from China leads to a bleak outlook for China's economy. Should exports slow sharply, household consumption continue to fade and structural demographic issues worsen, China's economy may not be able to achieve elevated growth rates for much longer. With China holding significant influence over regional and global growth, these problems could materialize into a low global growth environment for a long period of time.

Going forward, U.S./Western-China relations will be key to China's role as a manufacturing powerhouse, but demographic issues will have a large influence as well. For now, geopolitical and structural issues do not seem to be on pace to reverse course in the near future. While Asian economies and other countries such as Mexico may benefit longer term, a sharp deceleration in China's economy could reverberate around the world and ultimately be a net negative for global growth.

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Market Data • Mid-Day Friday

U.S. Interest Rates

	Friday 8/11/2023	1 Week Ago	1 Year Ago
SOFR	5.30	5.30	2.28
Effective Fed Funds Rate	5.33	5.33	2.33
3-Month T-Bill	5.43	5.40	2.51
1-Year Treasury	5.18	5.21	3.10
2-Year Treasury	4.89	4.76	3.22
5-Year Treasury	4.30	4.13	2.99
10-Year Treasury	4.16	4.03	2.89
30-Year Treasury	4.27	4.20	3.17
Bond Buyer Index	3.71	3.75	3.27

Foreign Exchange Rates

	Friday 8/11/2023	1 Week Ago	1 Year Ago
Euro ($/€)	1.095	1.101	1.032
British Pound ($/£)	1.269	1.275	1.221
British Pound (£/€)	0.863	0.863	0.846
Japanese Yen (¥/$)	144.920	141.760	133.020
Canadian Dollar (C$/$)	1.344	1.338	1.276
Swiss Franc (CHF/$)	0.877	0.873	0.942
Australian Dollar (US$/A$)	0.649	0.657	0.711
Mexican Peso (MXN/$)	16.985	17.080	19.945
Chinese Yuan (CNY/$)	7.239	7.173	6.745
Indian Rupee (INR/$)	82.839	82.841	79.638
Brazilian Real (BRL/$)	4.893	4.876	5.157
U.S. Dollar Index	102.810	102.017	105.090

Foreign Interest Rates

	Friday 8/11/2023	1 Week Ago	1 Year Ago
3-Month German Govt Bill Yield	3.50	3.51	-0.04
3-Month U.K. Govt Bill Yield	5.37	5.38	1.81
3-Month Canadian Govt Bill Yield	5.07	5.06	2.67
3-Month Japanese Govt Bill Yield	-0.12	-0.08	-0.10
2-Year German Note Yield	3.04	3.01	0.57
2-Year U.K. Note Yield	5.03	4.92	2.00
2-Year Canadian Note Yield	4.68	4.58	3.25
2-Year Japanese Note Yield	0.02	0.03	-0.09
10-Year German Bond Yield	2.62	2.56	0.97
10-Year U.K. Bond Yield	4.53	4.38	2.06
10-Year Canadian Bond Yield	3.66	3.55	2.79
10-Year Japanese Bond Yield	0.58	0.65	0.19

Commodity Prices

	Friday 8/11/2023	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	83.64	82.82	94.34
Brent Crude ($/Barrel)	87.18	86.24	99.60
Gold ($/Ounce)	1914.37	1942.91	1789.72
Hot-Rolled Steel ($/S.Ton)	806.00	803.00	815.00
Copper (¢/Pound)	372.05	386.75	370.65
Soybeans ($/Bushel)	14.01	14.16	15.00
Natural Gas ($/MMBTU)	2.76	2.58	8.87
Nickel ($/Metric Ton)	20,173	21,369	22,422
CRB Spot Inds.	558.94	558.29	606.37

Source: Bloomberg Finance L.P. and Wells Fargo Economics

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