June 24, 2016

Economics Group

Weekly Economic & Financial Commentary

U.S. Review

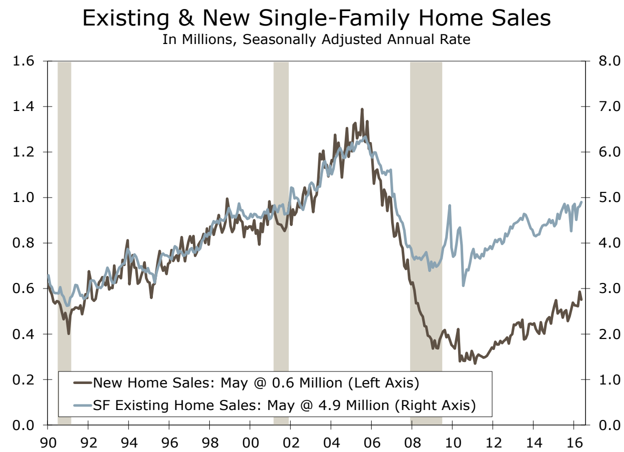
The Factory Sector Is Fragile While Housing Stays Solid

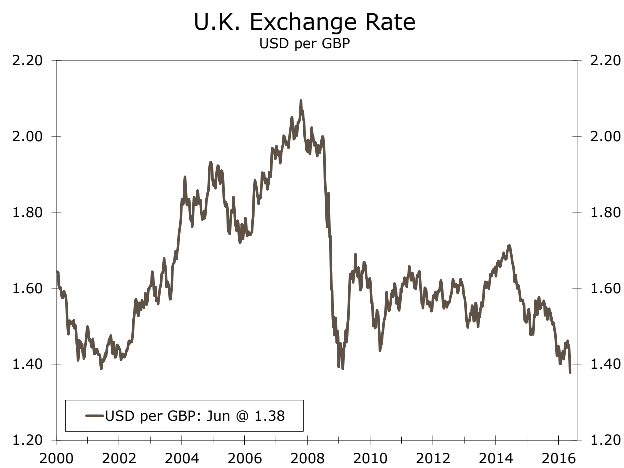
- The U.S. housing market is on solid ground heading into the busy summer selling season, according to home sales data released this week. Data still supports our expectation that housing will remain a bright spot for the U.S. economy in 2016.
- Durable goods orders point to continued weakness in business investment this year. The factory sector had been slowly making its way out of the woods as headwinds from sluggish global demand, the surge in the U.S. dollar and weak corporate profits began to wane. Now they face the fallout from the UK referendum.

Global Review

Brexit—Now What?

- The financial market reaction to the unexpected Brexit vote has been violent. The UK economy likely will bear the brunt of most of the direct effects of Brexit, with investment spending in the UK likely to take a major hit due to uncertainty. A modest recession in the UK seems increasingly likely.
- In our view, the indirect effects of Brexit on the rest of the world are more important than the direct effects. Europe has been integrating economically as well as politically for 50 years. Will globalization now go into reverse? See the "Topic of the Week" on page 7.





Wells Fargo U.S. Economic Forecast

	Actual 2015				Forecast 2016				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2013	2014	2015	2016	2017
Real Gross Domestic Product [1]	0.6	3.9	2.0	1.4	0.8	2.8	2.5	2.4	1.5	2.4	2.4	1.9	2.2
Personal Consumption	1.8	3.6	3.0	2.4	1.9	4.0	2.7	2.6	1.7	2.7	3.1	2.8	2.5
Inflation Indicators [2]													
PCE Deflator	0.2	0.3	0.3	0.5	1.0	1.0	1.2	1.5	1.4	1.4	0.3	1.2	2.0
Consumer Price Index	-0.1	0.0	0.1	0.4	1.1	1.1	1.3	1.7	1.5	1.6	0.1	1.3	2.3
Industrial Production [1]	-1.9	-2.7	1.5	-3.3	-1.6	-1.2	1.8	2.5	1.9	2.9	0.3	-0.9	2.1
Corporate Profits Before Taxes [2]	4.6	0.6	-5.1	-11.5	-5.7	-0.6	1.9	1.9	2.0	1.7	-3.1	-0.7	1.7
Trade Weighted Dollar Index [3]	92.1	90.0	92.3	94.5	89.8	89.5	90.8	92.3	75.9	78.4	91.1	90.6	95.4
Unemployment Rate	5.6	5.4	5.2	5.0	4.9	4.8	4.8	4.7	7.4	6.2	5.3	4.8	4.5
Housing Starts [4]	0.99	1.16	1.16	1.13	1.15	1.19	1.23	1.24	0.92	1.00	1.11	1.22	1.27
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.25	0.25	0.25	0.50	0.50	0.50	0.75	1.00	0.25	0.25	0.27	0.69	1.38
Conventional Mortgage Rate	3.77	3.98	3.89	3.96	3.69	3.66	3.80	3.86	3.98	4.17	3.85	3.75	4.09
10 Year Note	1.94	2.35	2.06	2.27	1.78	1.81	1.96	2.03	2.35	2.54	2.14	1.90	2.31

Forecast as of: June 17, 2016
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units
[5] Annual Numbers Represent Averages

Source: National Association of Realtors, U.S. Department of Commerce, U.S. Department of Labor, Federal Reserve Board, IHS Global Insight and Wells Fargo Securities

Inside

Together we'll go far

U.S. Review

Housing Market Still Solid. UK Leaves the EU.

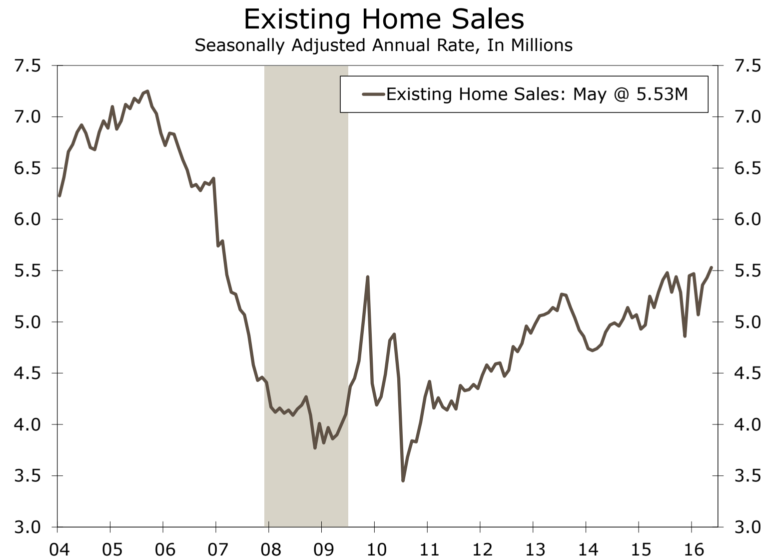
The light domestic economic calendar was overshadowed by Thursday's Brexit vote in the United Kingdom. We learned early Friday morning that that the majority opted to leave the European Union and world markets subsequently sold off. We will host a conference call on Monday to discuss in depth what that means for the economy both in the U.S. and abroad.

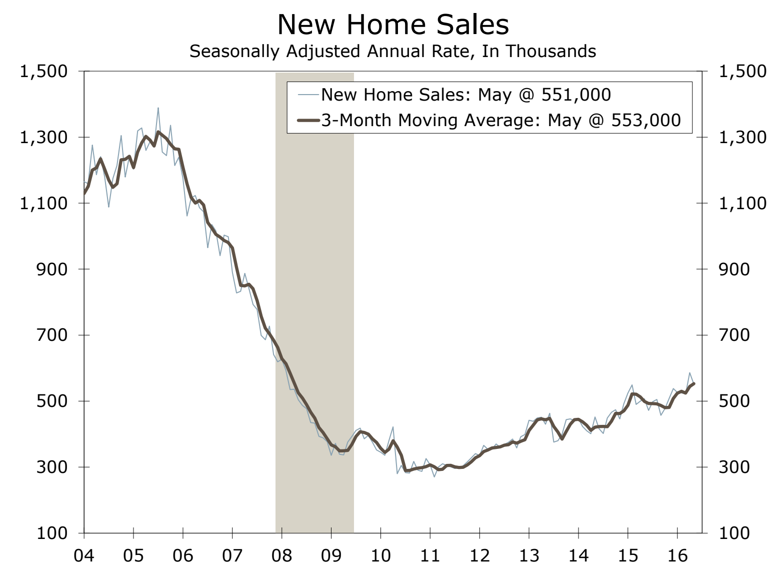
Home sales data released this week affirmed our positive outlook for the U.S. housing market in 2016. Continued gains in personal income, the resilient job market and the extended run of low mortgage rates have created favorable conditions for a strong summer season for home sellers. Spring data showed solid momentum in 2016. Existing home sales rose to its highest post-recession level in May, gaining 1.8 percent in the month to a 5.53 million unit pace. More homes were put on the market in May, but the supply of homes available for sale remains exceptionally tight at just 4.7 months.

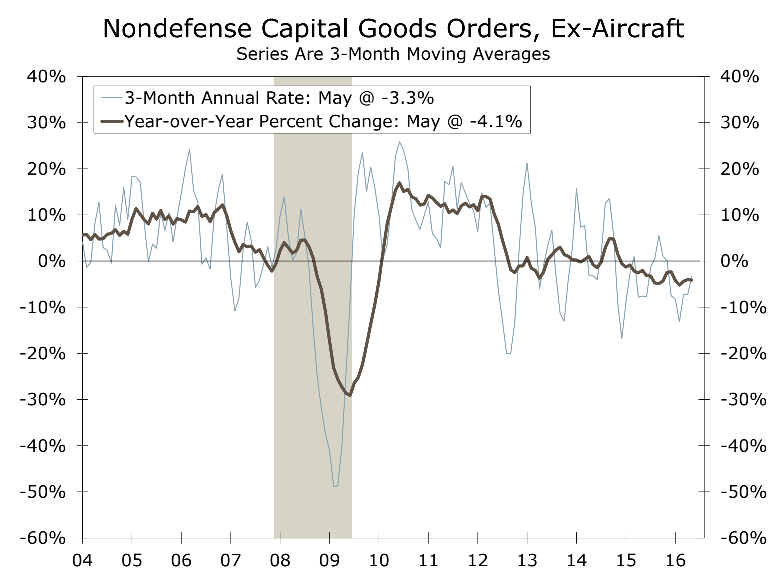
New home sales retreated 6.0 percent in May to a 5.51 million unit annual pace. The pullback in May was expected as it followed a post-recession high in April, which had an extra weekend because Easter fell in March this year. The deceleration in new home sales relieved some pressure on affordability and inventory ahead of the summer selling season. Inventory of new homes pushed up from 4.9 months in April to a healthy 5.3 months in May. Following a healthy run up, the median price of a new home has moderated more recently, with prices rising 4.1 percent over the past year, on a three-month moving average basis. Homebuilder sentiment also picked up in June with a strong gain in prospective buyer traffic.

The U.S. factory sector continued to lick its wounds from a year defined by weak global demand and the strong dollar weighing on exports. Those headwinds had started to dissipate in recent months, though manufacturing conditions are still quite fragile. Durable goods orders declined 2.2 percent in May following a 3.3 percent surge in April. Core capital goods orders fell for the third time in four months—a weak signal for future business investment. Shipments in this category, which are used directly to calculate business fixed investment in GDP, fell 0.5 percent in May and have fallen at a 5.0 percent annual rate over the past three months. While that still leaves the trend in negative territory, it is the best reading since November.

While we had not expected the manufacturing sector to have an exceptional rest of the year, we did anticipate gradual improvement in corporate profits as the headwinds from the strong dollar and weak global demand lost steam. However, the UK referendum outcome poses a big risk to American producers. The pound and euro have both weakened considerably against the dollar since the referendum. Exporters now face similar headwinds to what they saw last year. The United Kingdom is one of the United States' major trading partners and the UK's demand for American-made goods may weaken as the impact of Brexit reverberates throughout the economy.







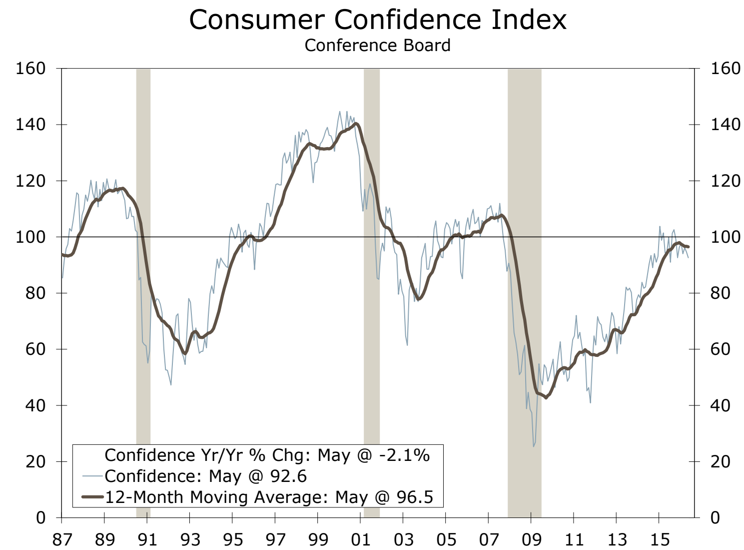
Source: National Association of Realtors, U.S. Department of Commerce and Wells Fargo Securities

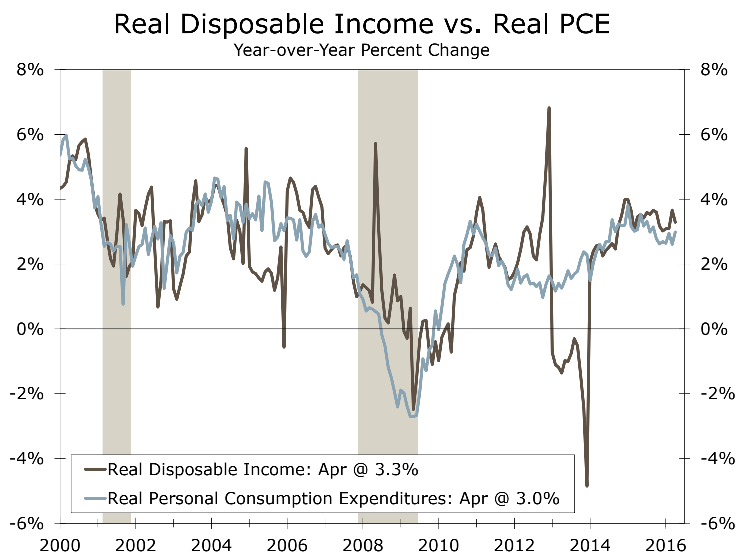
Consumer Confidence • Tuesday

Consumer confidence posted its second consecutive decline in May, falling 2.1 points to 92.6. The present condition series fell 4.2 points to the lowest reading since November. Increasing gas prices may have been a factor in the lower confidence. That said, buying plans were a bright spot in the consumer confidence report as plans to purchase an automobile rose 0.8 percentage point and plans to purchase a home rose 0.7 percentage points. In addition, the labor differential, which measures the difference between the share of respondents who reported jobs were plentiful and those stating jobs were hard to get, declined in May. While this series can bounce around on a month-to-month basis, the slower pace of improvement in the labor market is clear. Although we expect a modest rebound in June, the trend in consumer confidence has clearly deteriorated recently.

Previous: 92.6 **Wells Fargo: 94.1**

Consensus: 93.5





Personal Income & Spending • Wednesday

Despite the moderation in consumer confidence, it appears that consumer spending has picked up in the second quarter. Real spending rose 0.6 percent in April, putting the year-over-year increase at 3.0 percent. Reflecting a pickup in inflation, nominal spending rose 1.0 percent in the month. We are expecting another solid monthly increase of 0.3 percent in personal consumption.

Real personal disposable income also points to continued gains in personal consumption. Real disposable income increased 3.3 percent over the past year, ahead of the pace of spending. Consequently, the saving rate has increased over the past year. A tighter labor market should continue to support personal income and spending. We expect real disposable income and real spending will increase 3.2 percent and 2.8 percent, respectively, in 2016.

Previous: 0.4% **Wells Fargo: 0.3%**

Consensus: 0.3% (Month-over-Month)

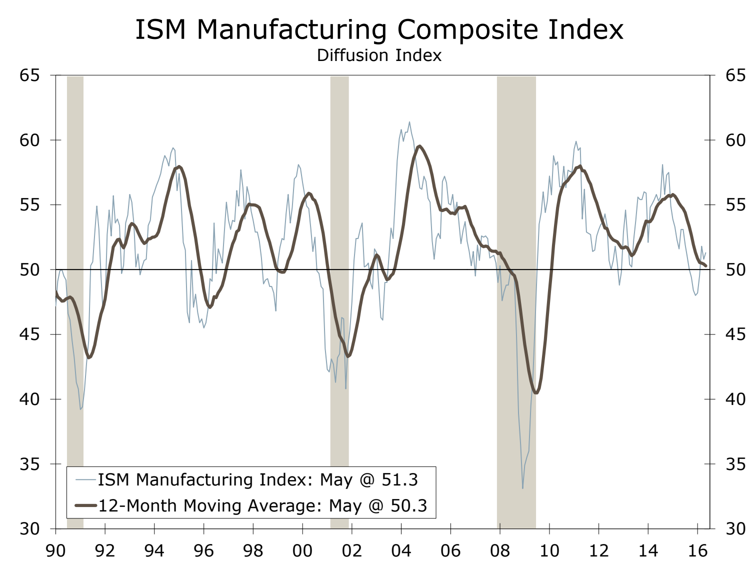
ISM Manufacturing • Friday

The ISM manufacturing index posted its third consecutive reading above breakeven in May. Improvement in the ISM over the past several months indicates the manufacturing sector is recovering from the weight of the strong dollar, collapsing commodity prices and weak global growth.

Continued expansion in production, new orders and export orders supported the composite index. That said, hiring conditions in the factory sector remained in contraction territory at 49.2. The prices paid component, however, has now risen to its highest level since 2011. Although higher prices put a squeeze on profits, it may also indicate inflation will continue to firm over the coming year. We look for the ISM manufacturing index to rise slightly in June to 51.5 as some of the headwinds facing the factory sector abate.

Previous: 51.3 **Wells Fargo: 51.5**

Consensus: 51.5



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

Global Review

What Are the Economic Implications of Brexit?

The world's attention this week was focused on Thursday's referendum in the United Kingdom on whether or not to remain a member of the European Union. In the event, the "leave" camp prevailed by a 52 percent to 48 percent margin, setting the stage for the UK to exit the EU.

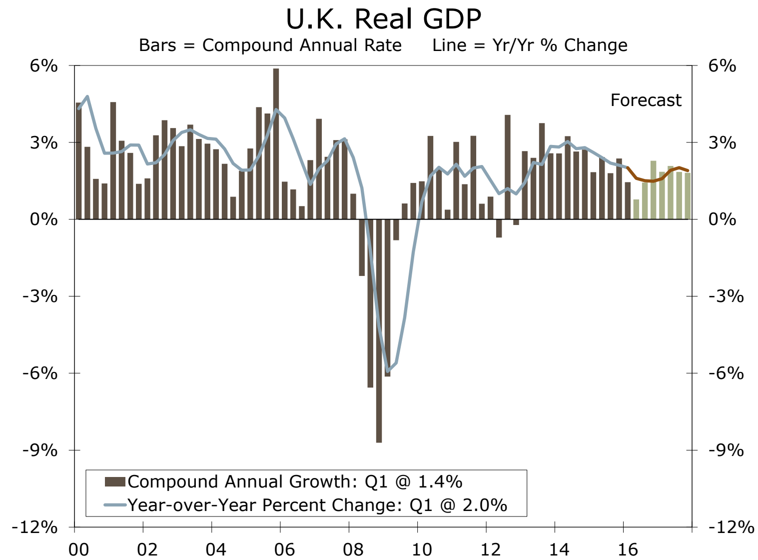
Heading into Thursday, polls suggested that the outcome of the voting would be neck and neck. However, market participants had become increasingly convinced that the "remain" camp would win because they assumed that most of the undecided voters would ultimately choose to vote "remain." Because the outcome of the voting was largely unexpected, the resulting reaction in financial markets has been violent. The Japanese Nikkei index plunged 8 percent on Friday and stock markets in many European countries are off 5 percent to 10 percent as of this writing. The British pound nose-dived, touching a 31-year low versus the U.S. dollar in overnight trading (see chart on front page). Yields on safe-haven government bonds, such as U.S. Treasury securities and German bunds, are down sharply.

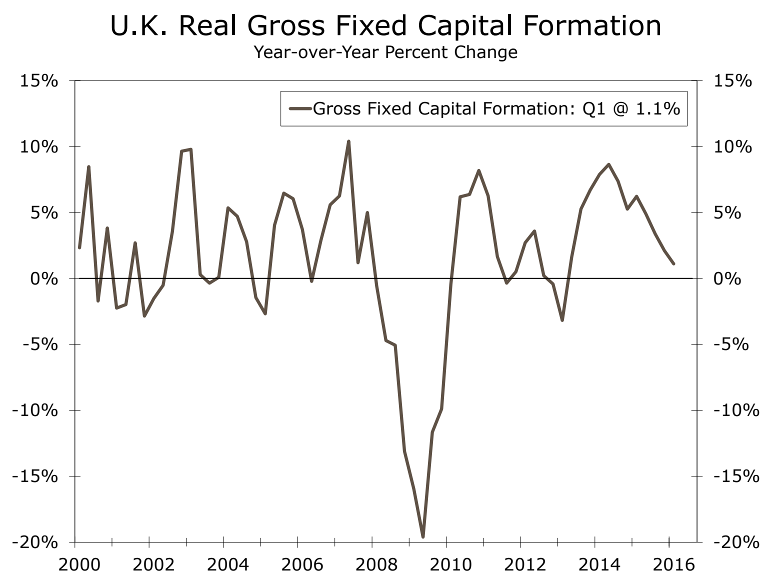
What are the economic implications of Brexit? The UK economy seems likely to experience most of the direct effects. In our most recent forecast, which was made two weeks ago, we projected that the modest pace of expansion that has characterized the UK economy for the past year or so will continue through the end of 2017 (top chart). This forecast was predicated under the assumption that British voters would decide to remain within the EU. There clearly are downside risks to this forecast now.

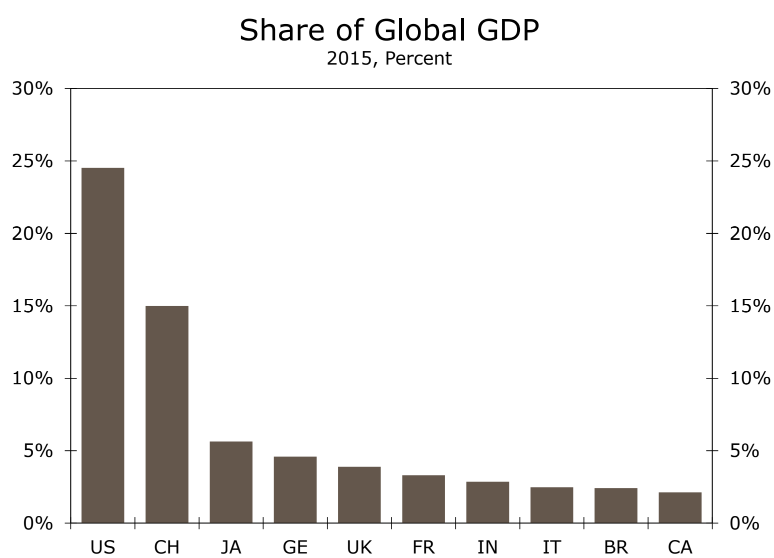
The biggest fallout likely will be on investment spending in the UK. The UK currently enjoys free movement of goods, services and people with the other 27 member countries of the EU (EU-27) under the terms of the Single Market. Although this free movement will not go away overnight, the UK will need to renegotiate the terms under which trade with the EU-27 will be conducted going forward. Whether or not this trade will continue under duty-free terms will be a matter of negotiation. However, the uncertainty surrounding the outcome of these complex negotiations likely will weigh on investment spending in the UK. Growth in capital spending has already weakened (middle chart), and a drop into negative territory in coming quarters seems likely. Will the 2 million individuals of EU-27 origin who currently live in the UK want to buy homes now that their legal status to remain in the UK is questionable? Will the City of London remain the financial capital of Europe if the UK is no longer under the EU regulatory umbrella?

The direct effects of Brexit on the rest of the world should be manageable. The UK economy accounts for only 4 percent of global GDP (bottom chart) and most other countries do not have massive financial exposure to British assets. As we continue in the Topic of the Week on page 7, however, the indirect effects of Brexit on the rest of the world could be large.

For further reading, see "Brexit–Now What?" which will be posted on our website.







Source: IHS Global Insight and Wells Fargo Securities

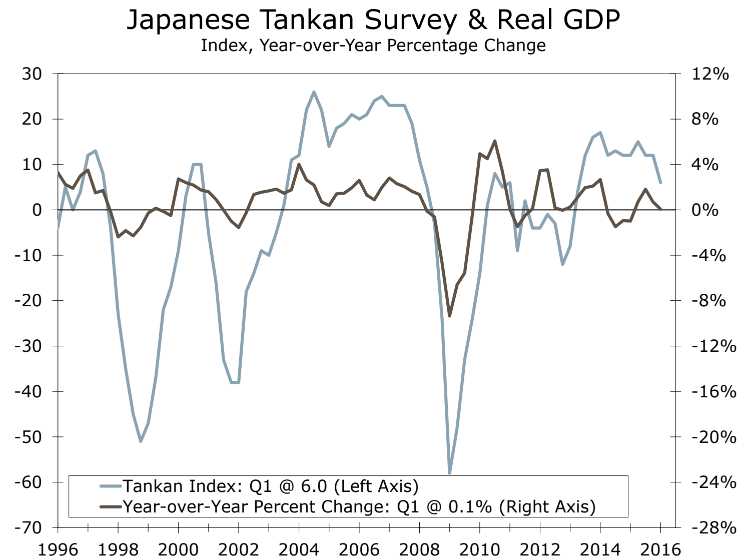
Japan Tankan Survey • Thursday

Japan will release a barrage of indicators next week that include, among many others, retail trade and retail sales, consumer prices, industrial production, vehicle production, construction orders, jobless rate, etc. All of these data points will be important to get a glimpse at the state of the Japanese economy. In particular, consumer prices, which have gone back to deflationary levels, will be on deck next week.

Furthermore, both the large and the small firm Tankan manufacturing indices have been on a downward trajectory during the last several months and markets seem to expect this trend to have continued during the second quarter of the year. The industrial production number for May, which will be released a day earlier, will also probably reflect this weakness.

Previous: 6.0

Consensus: 4.0



China Manufacturing PMI • Thursday

The official Chinese manufacturing PMI has been close to the 50 demarcation point for more than four years in a directionless state of affairs for the sector. The last time the manufacturing PMI was above 52 was on April 2012, which underscores the staying power of this new, stagnant state for the country's manufacturing sector. Consensus expects that this directionless state of affairs remained essentially in place in June with a forecast of 50.0 for the index, nearly the same level recorded in May. On the other hand, the non-manufacturing index has remained above 50, clearly showing that the domestic economy is still delivering growth.

Meanwhile, the Caixin manufacturing PMI, which draws its information from exporting manufacturing firms, has remained below the 50 demarcation point since February 2015. Having said this, the index has improved somewhat to record a level of 49.2 in May.

Previous: 50.1

Consensus: 50.0

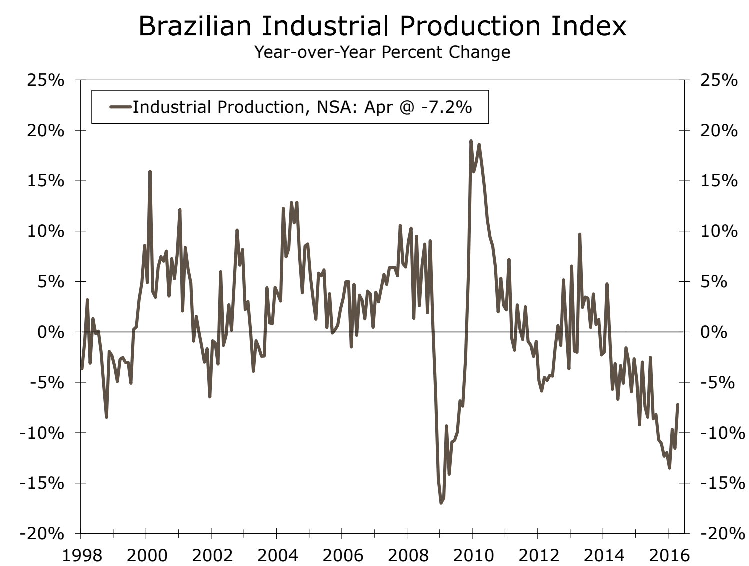
Brazil Industrial Production • Friday

On Friday the IBGE, the Brazilian statistical institute will release its industrial production index for May while Markit will release its Brazilian manufacturing PMI for June. Both indices will complement each other and will be a good gauge of the recent performance of the Brazilian industrial sector. Hopefully, both will tend to confirm recent comments by members of the temporary government that the end of the recession is in sight.

Although industrial production has improved over the past several months, it remains in deep negative territory. That is, even if we have seen some improvement a return to positive growth is still not in sight, even if members of the temporary government say so. Furthermore, the 41.6 reading for the Markit manufacturing index in May was the lowest reading since the statistic was started in 2013. Thus, even if industrial production improves compared to its year-over-year number, the road ahead is still very difficult.

Previous: 0.1%

Consensus: 0.0% (Month-over-Month)



Source: IHS Global Insight and Wells Fargo Securities

Interest Rate Watch

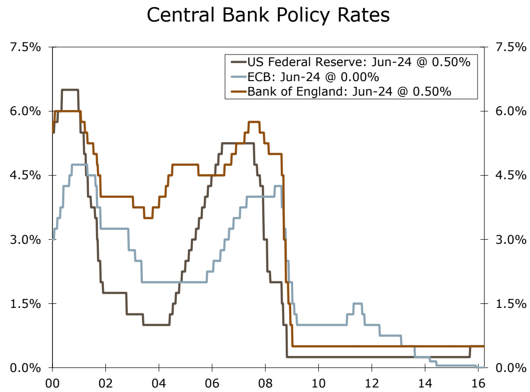
The British Are Leaving

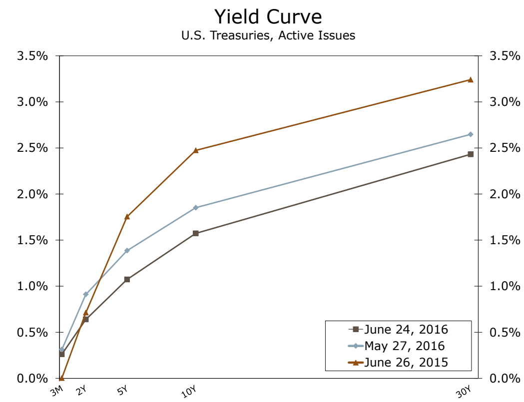
The British voted to exit the European Union (EU) this week, with the vote coming after a series of polls had suggested voters would choose to remain in the EU. While the vote does not immediately take Britain out of the EU, the British Parliament is expected to invoke Article 50 and request to leave the EU. The surprising vote tally, at least from the financial markets' perspective, pushed long-term yields back near cycle lows and has reduced expectations for future interest rate hikes by the Federal Reserve both in the near term and over the long run.

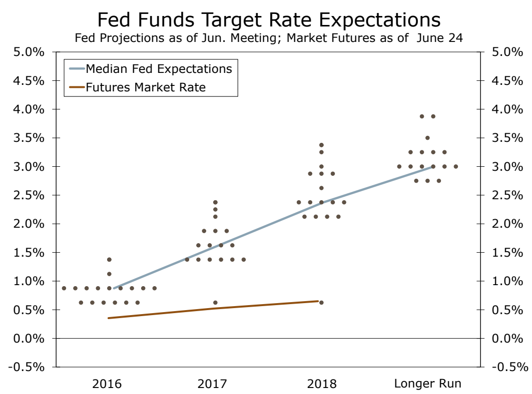
We have not changed our forecast, as of yet, and continue to have two quarter point hikes in 2016, just as the Fed's latest dot plot shows. The financial markets clearly have their doubts. The federal funds futures curve does not have a rate hike it in until sometime in 2018.

Caution should be utilized when assessing the interest rate environment in the immediate aftermath of the Brexit vote. While the surprise outcome has led to even more heightened uncertainty about the global economic outlook, the financial markets should settle down once we have some clarity about how a British exit from the EU will proceed and what the fallout will be on the European economy. Global central banks are likely to provide additional liquidity as financial market participants reset their expectations for economic growth and monetary policy.

As far as the impact on the U.S. is concerned, the direct effects of Britain's exit from the EU are rather small. Britain accounts for just 4 percent of U.S. exports and exports account for just 0.4 percent of U.S. GDP. The secondary effects, however, are less certain and potentially quite significant. The dollar will strengthen in the near term and the global economy will likely be weaker. Commodity prices will also likely reverse some of their recent gains. In addition, there is less appetite for risk, which will widen credit spreads. The critical question is will these adjustments trigger an event in one of the many possible flashpoints around the world? Fed policy will remain on hold until there is a more definitive answer to this question.







Source: IHS Global Insight, Bloomberg LP, Federal Reserve Board and Wells Fargo Securities

Credit Market Insights

Household Balancing Act

In the aggregate, households' continued to deleverage in Q1 2016. As a percentage of both assets and disposable personal income, household liabilities are at or near their lowest point of this expansion.

Household liabilities have grown at an average year-over-year pace of just 0.2 percent since the last recession ended. Although liabilities have accelerated to a 2.7 percent pace in Q1 2016, this remains well below the 10.5 percent rate averaged during the last expansion in the 2000s.

Lackluster growth in mortgage debt, which comprises the bulk of household debt, has played a key role in this significantly slower pace of liability accumulation. Home mortgage debt is up just 1.5 percent over the past year, and only returned to positive territory in Q2 2015. Consumer credit this expansion has grown at a rate more consistent with previous business cycles, but it comprises a much smaller share of the total pie.

Steady improvement in household balance sheets is a welcome development for U.S. consumers. As we discussed in this space last week, the asset side of the balance sheet has continued to advance, led by real estate and bank deposits. In addition to these gains, households have exhibited restraint in their borrowing habits relative to the previous cycle, at least in the aggregate. This combination has yielded healthy household balance sheets that should be supportive of continued consumption growth in the quarters ahead.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.56%	3.54%	3.66%	4.02%
15-Yr Fixed	2.83%	2.81%	2.92%	3.21%
5/1 ARM	2.74%	2.74%	2.88%	2.98%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$2,060.1	3.51%	6.08%	9.74%
Revolving Home Equity	$422.7	-4.86%	-5.07%	-5.36%
Residential Mortgages	$1,688.3	-12.15%	-1.14%	5.10%
Commerical Real Estate	$1,872.2	8.16%	9.43%	11.39%
Consumer	$1,318.1	14.24%	8.72%	7.87%

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

Topic of the Week

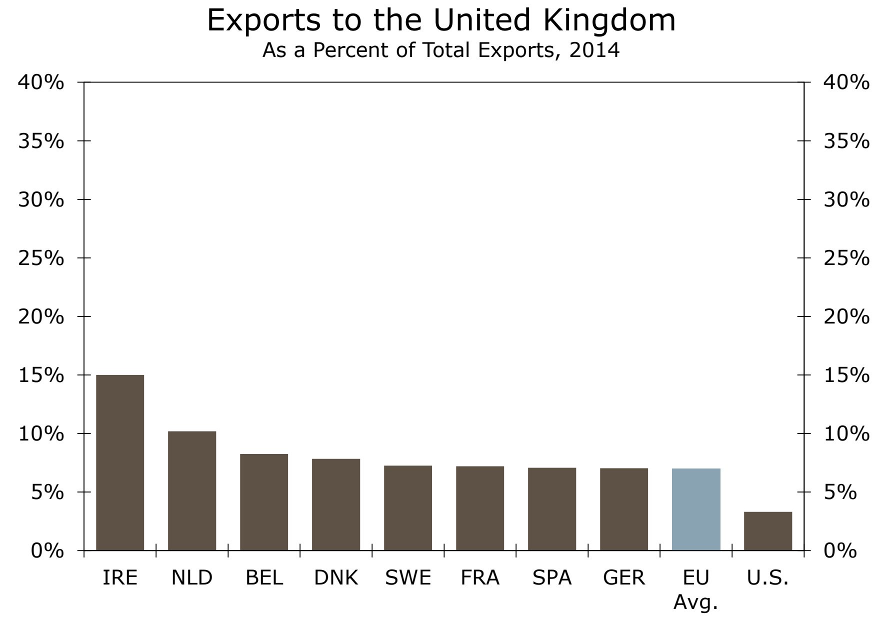
Important Indirect Effects of Brexit

As noted on page 4, the British economy likely will suffer most of the direct effects of Brexit in the near term. On average, countries in the EU-27 send 7 percent of their exports to the UK (top chart). American exports to the UK totaled $56 billion in 2015, but this amount accounts for only 4 percent of U.S. exports or only 0.4 percent of U.S. GDP. Even if the U.K. economy slips into a modest recession in coming quarters, which now seems increasingly likely, the direct trade ties between the EU-27 and the UK and the US and the UK are too small to drag these economies down as well.

In our view, however, the indirect effects of Brexit on the rest of the world could be more important than the direct effects. First, there are the financial market effects to consider. As discussed on page 4, there has been a notable tightening in financial market conditions today and markets likely will remain volatile in the near term. If financial market tightness continues, economic activity in other countries could be negatively affected.

There is also political fallout to consider. Anti-EU nationalist parties in many European countries have been emboldened by the Brexit vote and are now calling for their own referenda. Most of these nationalist parties are on the political fringe, and we do not expect a wave of EU referenda anytime soon on the continent. However, the EU bureaucracy is not warmly embraced in most European countries, and the idea of exiting the EU could fall on fertile political ground there.

Europe has been integrating economically and politically for the past 50 years or so. Brexit is the first reversal of that integration. It seems that populist and nationalist sentiment around the world has not been this high since the 1930s, and there are some important elections coming up this year and in 2017 (e.g., in the United States, France and Germany). In our view, Brexit is a monumental decision that could set in train an unwinding of the globalization that has occurred over the past few decades. These geopolitical effects could have important economic implications in coming years.



Source: IHS Global Insight and Wells Fargo Securities

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 6/24/2016	1 Week Ago	1 Year Ago
3-Month T-Bill	0.26	0.25	0.00
3-Month LIBOR	0.64	0.66	0.28
1-Year Treasury	0.66	0.53	0.30
2-Year Treasury	0.64	0.69	0.68
5-Year Treasury	1.07	1.11	1.67
10-Year Treasury	1.57	1.61	2.37
30-Year Treasury	2.43	2.42	3.15
Bond Buyer Index	3.18	3.18	3.79

Foreign Exchange Rates

	Friday 6/24/2016	1 Week Ago	1 Year Ago
Euro ($/€)	1.110	1.128	1.121
British Pound ($/₤)	1.383	1.436	1.571
British Pound (₤/€)	0.803	0.785	0.713
Japanese Yen (¥/$)	102.510	104.160	123.850
Canadian Dollar (C$/$)	1.295	1.289	1.238
Swiss Franc (CHF/$)	0.973	0.960	0.934
Australian Dollar (US$/A$)	0.748	0.739	0.770
Mexican Peso (MXN/$)	18.756	18.838	15.499
Chinese Yuan (CNY/$)	6.624	6.587	6.207
Indian Rupee (INR/$)	67.969	67.085	63.598
Brazilian Real (BRL/$)	3.370	3.417	3.097
U.S. Dollar Index	95.457	94.206	95.264

Source: Bloomberg LP and Wells Fargo Securities

Foreign Interest Rates

	Friday 6/24/2016	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.29	-0.28	-0.01
3-Month Sterling LIBOR	0.58	0.57	0.57
3-Month Canada Banker's Acceptance	0.87	0.89	1.00
3-Month Yen LIBOR	-0.03	-0.04	0.10
2-Year German	-0.65	-0.61	-0.20
2-Year U.K.	0.30	0.39	0.65
2-Year Canadian	0.54	0.52	0.60
2-Year Japanese	-0.27	-0.25	0.00
10-Year German	-0.06	0.02	0.84
10-Year U.K.	1.11	1.14	2.13
10-Year Canadian	1.18	1.12	1.77
10-Year Japanese	-0.17	-0.15	0.46

Commodity Prices

	Friday 6/24/2016	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	48.01	47.98	60.27
Gold ($/Ounce)	1311.73	1299.00	1175.47
Hot-Rolled Steel ($/S.Ton)	628.00	628.00	464.00
Copper (¢/Pound)	211.85	205.10	262.45
Soybeans ($/Bushel)	11.17	11.27	9.86
Natural Gas ($/MMBTU)	2.66	2.62	2.76
Nickel ($/Metric Ton)	9,179	8,823	12,818
CRB Spot Inds.	452.68	451.72	466.91

Next Week's Economic Calendar

	Monday 27	Tuesday 28	Wednesday 29	Thursday 30	Friday 1
U.S. Data		**GDP** Q1 2nd Revision 0.8% Q1 3rd Revision 0.9% (W) **Consumer Confidence** May 92.6 June 94.1 (W)	**Personal Income & Spending** April 0.4% & 1.0% May 0.3% & 0.3% (W) **Pending Home Sales (MoM)** April 5.1% May -1.0% (C)		**ISM Manufacturing** May 51.3 June 51.5 (W) **Construction Spending (MoM)** April -1.8% May 0.6 (W)
Global Data			**Argentina** **GDP (YoY)** Previous (Q4) 0.9%	**China** **Manufacturing PMI** Previous (May) 50.1 **Japan** **CPI (YoY)** Previous (April) -0.3%	**Brazil** **Industrial Production (YoY)** Previous (April) -7.2%

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

Source: Bloomberg LP and Wells Fargo Securities

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