November 16, 2018

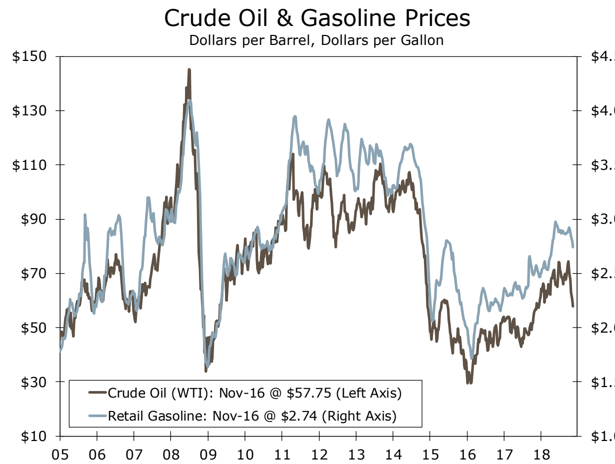
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Despite Recent Price Drop, Oil Still Swaying Econ Data

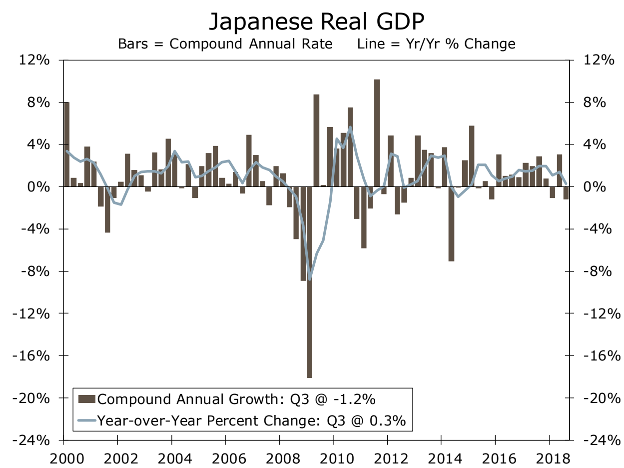
- At the start of October, the WTI price for a barrel of oil was over $75. Since then it has been a mostly downward slide. This week it slipped below $60/barrel for the first time since February.
- A batch of October economic indicators this week, however, are still under the influence of the higher price dynamic in place at the start of the month. Lifted by higher energy costs, CPI inflation rose 0.3% in October. Retailers reported the biggest monthly sales increase since May, but gas stations saw the largest increase.



Global Review

Incoming Data Reinforce Slower Pace of Global Growth

- Data out of Asia were largely lackluster in nature this week. Japanese real GDP contracted in Q3, while several key indicators in China reinforce the fundamental slowdown occurring in its economy amid ongoing trade tensions.
- In the U.K., wage and price data were generally positive, although key developments on the Brexit front reinforce that the U.K. economy will likely face continued uncertainty in the coming months.
- Mexico's central bank raised its policy rate in an attempt to combat currency depreciation in the wake of rising political uncertainty after the recent presidential election.



Wells Fargo U.S. Economic Forecast

	Actual 2018				Forecast 2019				Actual		Forecast		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2016	2017	2018	2019	2020
Real Gross Domestic Product [1]	2.2	4.2	3.5	2.5	2.3	2.6	2.5	2.3	1.6	2.2	2.9	2.7	2.2
Personal Consumption	0.5	3.8	4.0	2.8	2.2	2.9	2.6	2.5	2.7	2.5	2.7	2.8	2.2
Inflation Indicators [2]													
PCE Deflator	1.9	2.2	2.2	2.1	2.3	2.4	2.7	2.7	1.1	1.8	2.1	2.5	2.4
Consumer Price Index	2.3	2.6	2.6	2.4	2.4	2.6	2.9	2.9	1.3	2.1	2.5	2.7	2.6
Industrial Production [1]	2.5	5.3	3.3	3.6	2.4	4.2	1.2	4.0	-1.9	1.6	3.8	3.2	2.8
Corporate Profits Before Taxes [2]	5.9	7.3	8.0	6.2	5.6	1.8	0.5	-0.8	-1.1	3.2	6.9	1.7	-2.4
Trade Weighted Dollar Index [3]	86.3	90.0	90.1	92.0	91.0	89.3	88.3	87.0	91.5	91.1	89.6	88.9	84.5
Unemployment Rate	4.1	3.9	3.8	3.7	3.7	3.6	3.6	3.5	4.9	4.4	3.9	3.6	3.3
Housing Starts [4]	1.32	1.26	1.22	1.29	1.30	1.31	1.32	1.32	1.17	1.20	1.27	1.31	1.34
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	0.52	1.13	2.13	3.06	3.19
Conventional Mortgage Rate	4.44	4.57	4.63	4.90	5.05	5.15	5.25	5.30	3.65	3.99	4.63	5.19	5.23
10 Year Note	2.74	2.85	3.05	3.30	3.45	3.55	3.65	3.70	1.84	2.33	2.99	3.59	3.63

Forecast as of: November 7, 2018

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

Inside

Together we'll go far

U.S. Review

Inflation Under Control

The CPI report released at the start of the week offers the latest evidence that inflation is more or less right in-line with where the Fed wants it to be. The headline monthly increase was nudged higher by gasoline prices, but there was also broadly based support from a number of other categories. Also, a big drop in oil prices may not mean consumers will see smaller energy outlays across the board. The cost of energy services, i.e., electricity and natural gas, saw the biggest monthly gains since early 2014 in October.

Core inflation rose 0.19% in October after softer prints in the preceding months, which should alleviate fears that inflation has hit another soft patch. Core goods prices posted the largest monthly increase since January, unwinding some weakness from the previous month. Tariffs are a top-of-mind worry for goods prices, but the dollar's climb this year should keep goods prices from rising too rapidly.

The rebound in core inflation suggests the underlying trend is modestly higher which should keep the Fed on course to gradually lift short term interest rates. While businesses are beginning to see a break on some commodity prices, tariffs and a tight labor market are pushing other costs higher. We expect core inflation to trend up in the year ahead, spurred by more businesses willing to raise prices.

If the Stores Were Any Less Hotter Than They Are

It was the best month at the nation's stores since May as retail sales surged 0.8%. While we do expect holiday sales to increase 4.5% over last year, we would caution against getting too wound up based on the latest retail sales report.

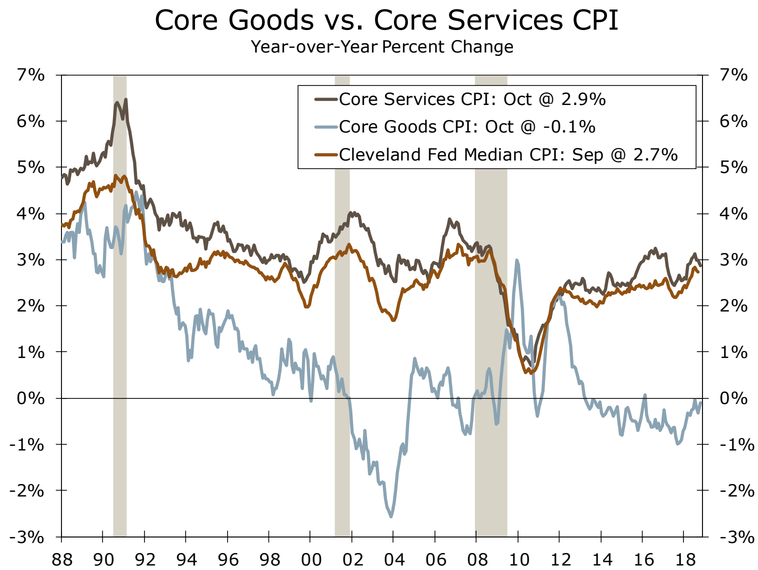
In addition to the 3.5% pop in gas station sales, motor vehicle sales were also up 1.1% in October and neither of these components reflects core retail spending. The three-month annualized rate of control group retail sales slowed in October to 2.8%, which is a bit of a slowdown from where it was a few months ago.

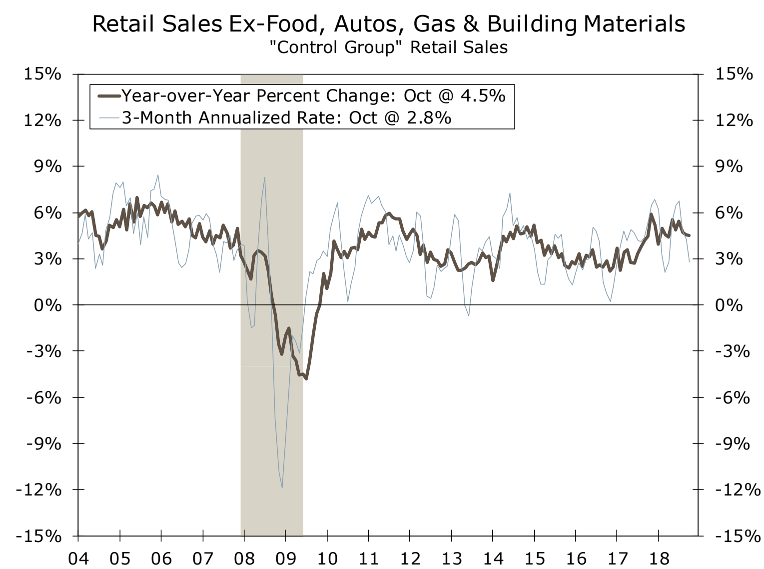
As the calendar flips to 2019, we expect further moderation in spending, as the boost from tax cuts will start to fade for consumers amid rising prices and less accommodative monetary policy.

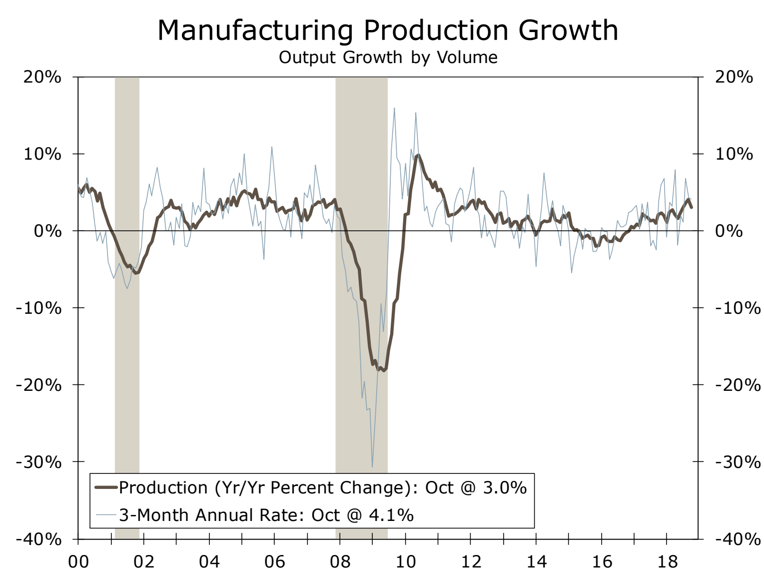
Industrial Production: Up Where It Counts

Industrial production rose less than expected in October (+0.1%) and production for December was revised down a tick. A warm October sent utilities production down 0.5% while mining production edged lower for a second straight month.

The juggernaut of IP–manufacturing—posted a better than expected gain of 0.3% in October. Production for September was also revised a bit higher, and points to factory activity being on somewhat firmer ground than previously thought. Most major manufacturing categories posted gains over the month, with the notable exception of autos, where sales have softened this year. Despite the decent production numbers this month, there are hints that slowing global growth, a strong dollar and trade issues are beginning to weigh on manufacturing. On a year-over-year basis, manufacturing production growth slowed to 3.0%.







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

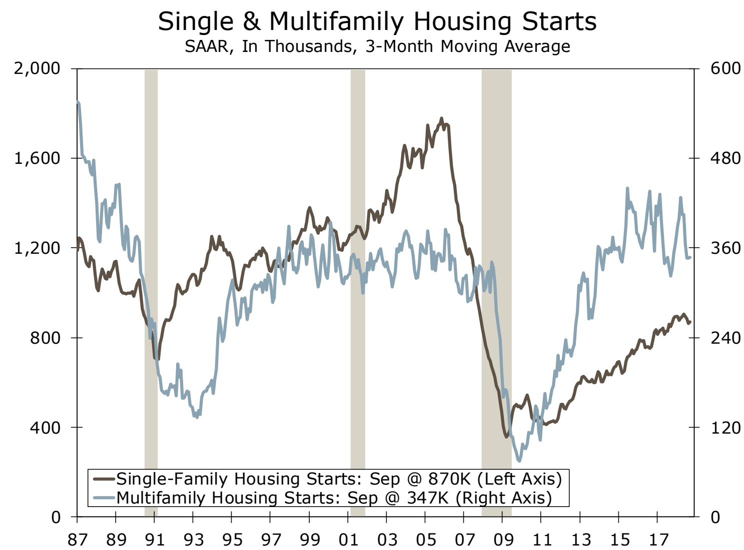
Housing Starts • Tuesday

Housing starts dropped in September, with most of the decline stemming from a 15.2% drop in multifamily starts. But, single-family starts were also sluggish, declining a more modest 0.9%. Housing is unlikely to make a significant breakout to the upside at this point in the business cycle. Higher mortgage rates and steadily rising home prices have significantly reduced affordability. Rising input costs have made it more difficult to build homes at lower price points, where demand is strongest, and labor costs continue to rise amid a shortage of skilled construction workers.

Building permit data for September appear to tell a slightly brighter story. Initially reported as a drop of 0.6% in September, permits were revised up to a 1.7% gain. Permits traditionally lead starts by two to three months, but with buyers and builders facing significant headwinds, we do not expect renewed strength in starts.

Previous: 1201K **Wells Fargo: 1252K**

Consensus: 1230K



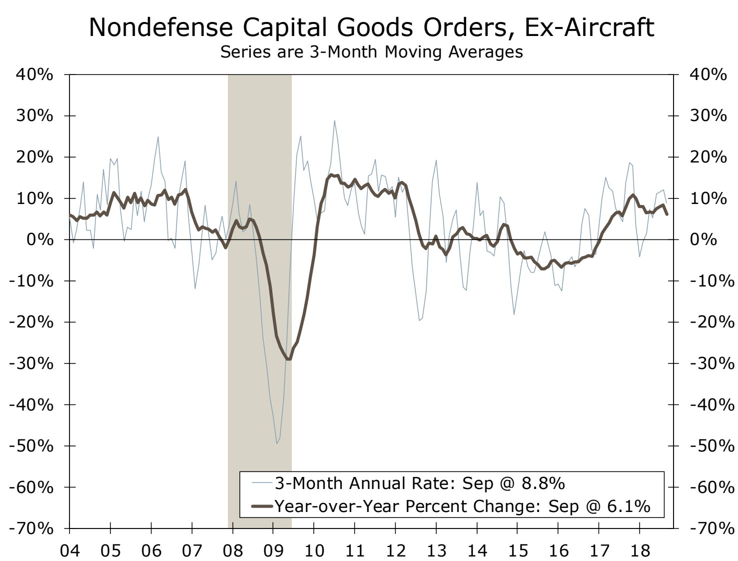
Durable Goods • Wednesday

Durable goods orders rose 0.7% in September, propelled by defense aircraft orders, which more than doubled, up 118.7%. This coupled with a modest 0.5% bump in motor vehicle orders more than offset declines in commercial aircraft orders. Aside from defense aircraft, however, September orders were broadly modest. Nondefense excluding aircraft, orders and shipments were both down 0.1% over the month, the second monthly decline for both categories.

This week, however, we learned that business equipment production was up 0.8% in October, following a surge of 9.3% in Q3. While equipment spending was weaker than expected in Q3, we look for a rebound in Q4. The regional Fed manufacturing surveys thus far for October confirm orders holding up. A simple average of the Philadelphia, New York, Richmond, Kansas City and Dallas new orders components did fall 0.8 points in October, but remains near cycle highs.

Previous: 0.7% **Wells Fargo: -2.1%**

Consensus: -2.2% (Month-over-Month)



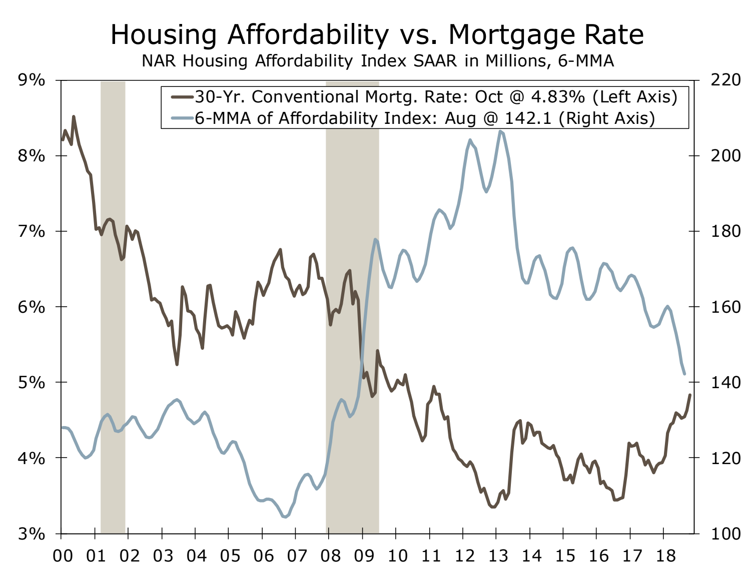
Existing Home Sales • Wednesday

Existing home sales fell for the sixth consecutive month in September. The continued slowdown in existing sales has not been wholly surprising. Pending home sales, mortgage purchase applications and the proportion of consumers stating now is a good time to buy a home have all been trending lower in recent months. Another dynamic at play are inventories, which had been trending lower for more than three years. With fewer homes for sale, existing home sales were destined to fall. The slide in home buying has coincided with rising mortgage rates and follows years of rapid price appreciation, which have collectively taken a toll on affordability.

We suspect the housing market will continue to cool in coming months, as virtually every leading indicator of housing has continued to weaken. While we expect to see less typical seasonal weakness over the winter months, we expect the overall sales to remain anemic.

Previous: 5.15M **Wells Fargo: 5.22M**

Consensus: 5.20M



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

Global Review

Incoming Data Reinforce Slower Pace of Global Growth

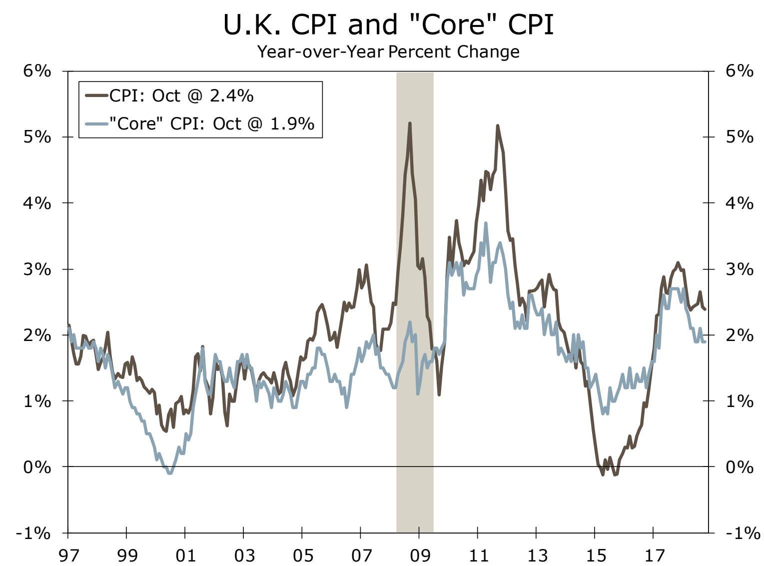
Economic data released this week in parts of Asia were generally lackluster in nature. In Japan, real GDP contracted in Q3, with the 1.2% drop on an annualized basis a sharp reversal from the 3% annualized growth rate registered in Q2 (see chart on page 1). While much of the slowdown might be temporary in nature due to recent natural disasters weighing on output, multiple sectors still contributed to weakness in the broader economy. Notable declines in private consumption and non-residential investment were registered in Q3. In particular, non-residential investment spending declined at a 0.9% annualized pace over the quarter after a large jump in Q2. While a rebound in Q4 looks likely, we still only see the Japanese economy expanding at a sluggish pace over the next two years, as a proposed sales tax increase and other structural headwinds weigh on a more rapid pace of growth.

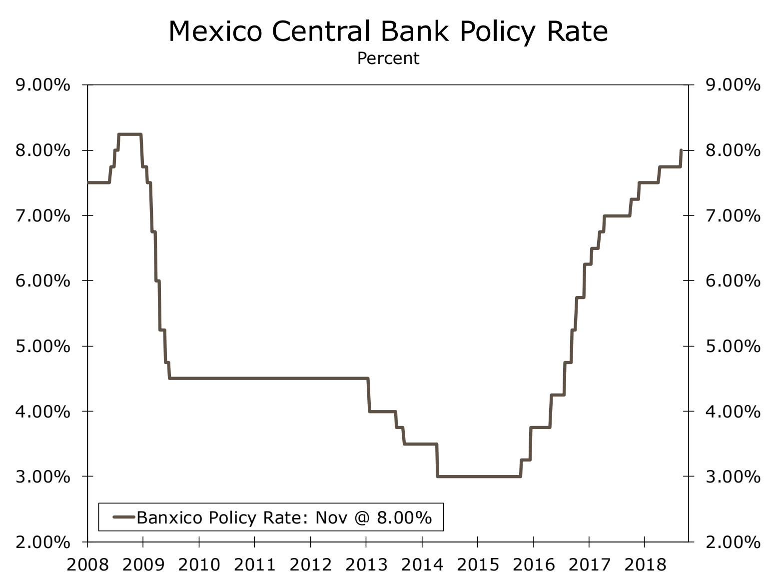
In China, growth in retail sales slowed in October, and while fixed investment spending and industrial output picked up slightly from a year ago, growth remains significantly lower than the double-digit rates registered earlier in the expansion (top chart). The Chinese economy continues to remain a key point of concern in the global arena, as ongoing trade tensions with the U.S. weigh on the outlook amid a more fundamental domestic slowdown. We recently downgraded our growth forecasts for the next two years, and now look for real GDP to rise 6.1% in 2019 and 6.0% in 2020.

Turning to Europe, data released in the U.K. showed that inflation continues to move back toward the Bank of England's 2% target, at 2.4% in October (middle chart). As price pressures have receded after skyrocketing in the wake of the Brexit referendum in 2016, wage growth has begun to show signs of picking up. Average weekly earnings grew 3% year-over-year in September, the fastest pace of growth since 2015. However, retail sales data for October missed consensus estimates, declining 0.5% over the month.

Although inflation is moving back toward target and wage growth is picking up, the U.K. economy continues to face uncertainty surrounding the ultimate fate of Brexit negotiations. While policymakers reportedly reached an agreement over the last major issue of the Irish border this week, the final deal must still be approved by U.K. parliament. This now looks to be more difficult, as key U.K. ministers resigned this week in the wake of the initial deal agreement. Our base case view is still for a deal to be approved before the March 2019 deadline, however we acknowledge that uncertainty is likely to persist both in finalizing an agreement before the deadline, and after as policymakers must then negotiate a more comprehensive U.K.-E.U. trade deal.

Finally, Mexico's central bank raised its policy rate 25 bps to 8.00% this week in what appears to be a move to stem further currency depreciation (bottom chart). The Mexican peso has dropped more than 6% against the dollar since mid-October as uncertainty has risen surrounding the likely policy agenda of the incoming president. While in the near term economic fundamentals remain solid, with real GDP rising 2.6% year-over-year in Q3, longer-term growth prospects could be a concern amid restrictive financial conditions and ongoing political uncertainty.





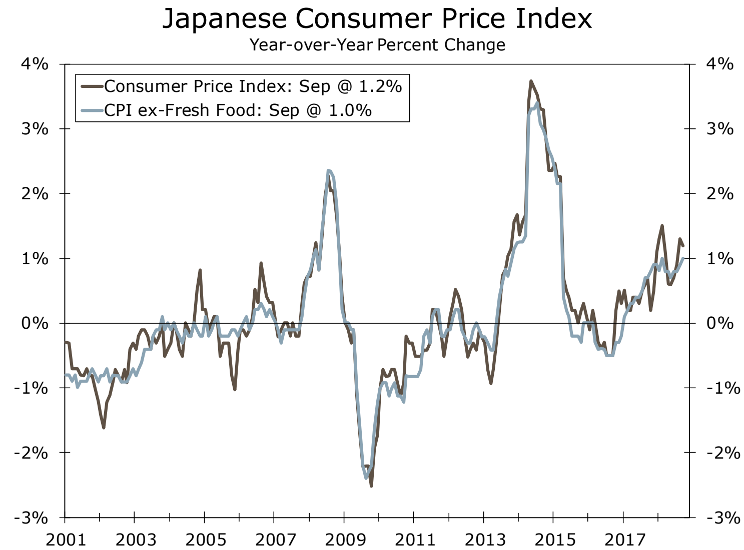
Source: Datastream, IHS Markit, Bloomberg LP and Wells Fargo Securities

Japan CPI • Wednesday

Price pressures remain lackluster in Japan, with the CPI rising 1.2% year-over-year in September, while the core index increased just 1% for the same period. Core inflation has remained around 1% for several months, and persistently low inflation remains an issue for the Bank of Japan (BoJ). As such, interest rates have remained in negative territory as the bank has adopted unconventional monetary policy measures and amassed assets on its balance sheet that now total around 100% of GDP. At the same time, the economy contracted in Q3, with real GDP shrinking at a 1.2% annualized rate. Generally subdued economic growth has likely restrained a more rapid acceleration in price growth. In our view, the BoJ will continue to remain firmly accommodative until price pressures show signs of a convincing upward trend. This looks unlikely to happen anytime soon, and we look for the CPI to rise just 1.4% year-over-year in October.

Previous: 1.2% **Wells Fargo: 1.4%**

Consensus: 1.4% (Year-over-Year)



Eurozone PMIs • Friday

The Markit PMIs in the Eurozone continue to trend lower, with the manufacturing PMI declining to 52.0 in October from 53.2 in September. Eurozone industrial production data largely confirm the survey data, with production growing less than 1% year-over-year in August after run rates surpassed 5% by the end of 2017. This slowing in production is indicative of the broader lackluster growth picture across much of Europe. Eurozone real GDP expanded at only a 0.7% annualized rate in Q3, the slowest since 2013. German GDP figures released this week showed an outright decline in Q3, while growth in Italy was broadly flat over the quarter. Concerns surrounding Italy's fiscal situation and growth prospects remain on the forefront, and the European Central Bank will likely be watching next week's PMI release for signs of a production rebound and stronger growth prospects as it looks to normalize policy in coming quarters.

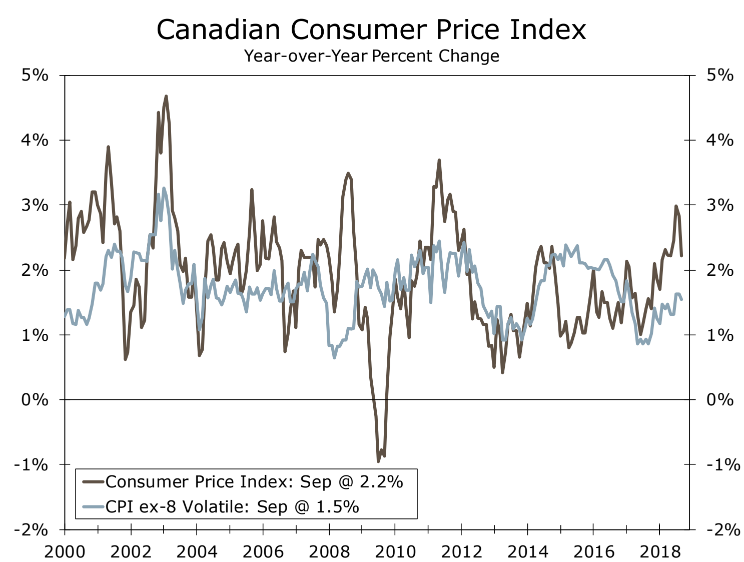
Previous: 52.0 (Manufacturing), 53.7 (Services)

Consensus: 52.0 (Manufacturing), 53.6 (Services)

Canada CPI • Friday

Canadian inflation moderated in September, with headline inflation rising 2.2% year-over-year, lower than the 2.8% print registered in August. However, September's drop was largely due to one-off factors, such as a pullback in typically higher summer airfare prices. Inflation has moved closer to the Bank of Canada's (BoC) 2% target, and at its most recent policy announcement the BoC looked for inflation to remain near target through 2020 as other temporary factors such as higher oil prices and minimum wage increases should fade. Indeed, global oil prices have declined sharply in recent weeks, and point to lower price pressures going forward. At the same time, real GDP expanded at a solid 2.9% annualized pace in Q2, while wage growth has also remained steady enough. These measures point to a Canadian economy that is functioning with little slack. Given these fundamentals, we look for the BoC to hike rates three times in 2019, as inflation stays within target and growth remains sturdy.

Previous: 2.2% (Year-over-Year) **Wells Fargo: 2.1%**



Source: IHS Markit, Bloomberg LP and Wells Fargo Securities

Interest Rate Watch

Will the Fed Continue to Tighten?

There have been two developments recently that could lead some observers to question how much more tightening the Fed actually will deliver. First, will the Federal Open Market Committee (FOMC) hike further if the stock market goes further south?

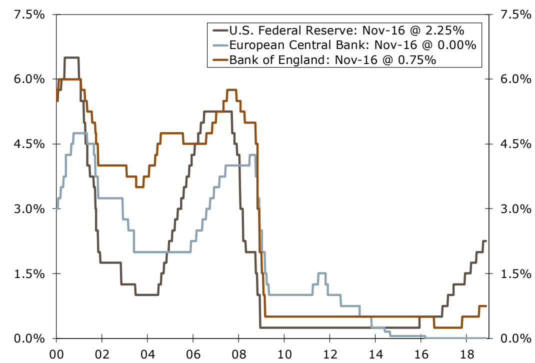
The Federal Reserve has two objectives: “full employment” and “price stability.” To the extent that the value of the stock market affects those two variables, then the FOMC may change course. But as of this writing, the S&P 500 index is down only 7% or so from its peak in September. In our view, the decline in the stock market to date is not large enough to have a meaningful effect on the Fed’s two primary objectives. In other words, the FOMC probably won’t deviate from its publicly communicated tightening path, unless the downdraft in the stock market becomes much deeper.

Of arguably more importance is the recent decline in oil prices. (The price of West Texas Intermediate is down about 25% since early October.) This significant decline in oil prices likely will pull the overall rate of CPI inflation lower in coming months which, conceivably, could threaten the Fed’s objective of “price stability.”

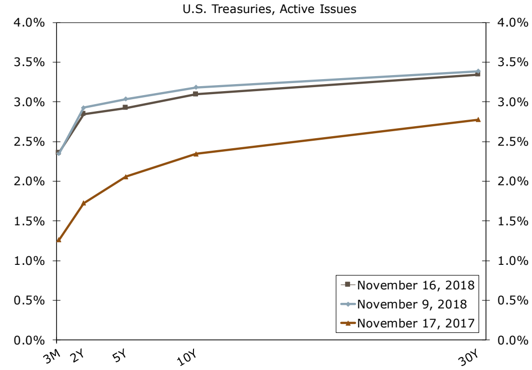
In our view, however, the FOMC is likely to look through any near-term decline in the overall rate of CPI inflation. Unless the recent swoon in oil prices pulls down the core CPI inflation rate, which excludes food and energy prices, then the FOMC will probably continue to hike rates, albeit at a gradual rate.

The core rate of inflation followed the overall rate of inflation lower in 2015-16. However, there are reasons to expect that the core rate of inflation won’t respond as much this time around as then. First, oil prices nosedived about 80% between mid-2014 and early 2016. The decline thus far has been much less extreme. Second, the sharp rise in the value of the dollar, which rose roughly 30% in trade-weighted terms during the previous episode, helped to depress import prices. Third, the labor market today is much tighter than it was three years ago. Unless the core CPI inflation rate recedes, the FOMC is likely to continue on its path of gradual tightening.

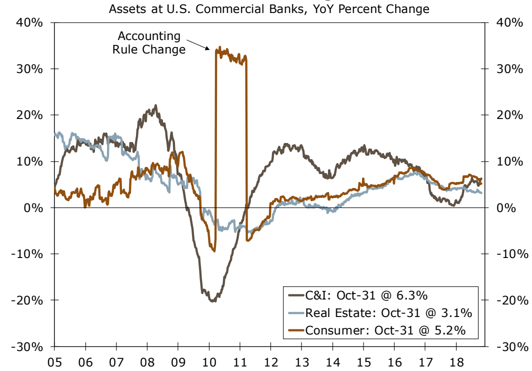
Central Bank Policy Rates



Yield Curve
U.S. Treasuries, Active Issues



Bank Lending
Assets at U.S. Commercial Banks, YoY Percent Change



Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

Credit Market Insights

Bank Lending and the Yield Curve

Banks loosened lending standards in Q3 while demand for loans contracted, according to data released this week in the Fed’s Senior Loan Officer Survey. The supply of loanable funds remained strong as banks eased availability for commercial & industrial and residential loans, and left standards unchanged for CRE, auto and credit card lending. The most commonly cited reasons were increased competition among lenders and a generally sanguine outlook for economic activity.

Demand on the other hand was broadly weaker, particularly for residential loans. With mortgage rates up nearly one percentage point over the past year to near a seven-year high, this is not surprising. Residential investment has been a drag on GDP growth five of the past six quarters, and ongoing weakness in existing home sales portends further weakness. Firms reported reduced equipment investment as a major driver of the decline in demand, consistent with the underwhelming 0.8% pace of business fixed investment growth in Q3.

Banks also responded to a special question regarding the slope of the yield curve by indicating that the much discussed flattening over the past year has not impacted lending practices. However, if it were to moderately invert, they reported on net that they would tighten standards, viewing it as a signal of deteriorating economic conditions. With the 2yr-10yr U.S. Treasury spread hovering under 30 bps, this bears monitoring as a window into lending.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.94%	4.94%	4.86%	3.95%
15-Yr Fixed	4.36%	4.33%	4.29%	3.31%
5/1 ARM	4.14%	4.14%	4.14%	3.21%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$2,246.6	11.49%	11.69%	6.32%
Revolving Home Equity	$351.8	-8.66%	-5.76%	-8.52%
Residential Mortgages	$1,876.5	0.72%	3.06%	3.80%
Commerical Real Estate	$2,170.1	-10.17%	0.77%	4.72%
Consumer	$1,490.6	15.26%	6.24%	5.23%

Mortage Rates Data as of 11/16/18, Bank Lending Data as of 10/31/18

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

Topic of the Week

Bears Vs. Oilers

The WTI price for a barrel of oil fell another four dollars or so this week which was sufficient to take the percentage decline since October's high to more than 25%, handily surpassing the 20% drop which is the threshold for a bear market. Will the decline in oil prices weigh on business spending as it did earlier in this cycle?

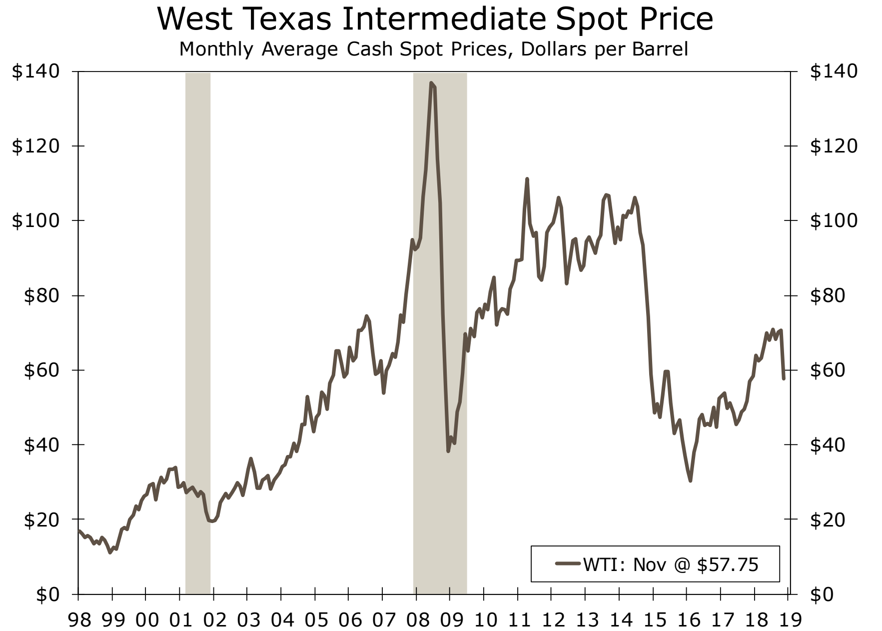
In the second half of 2014, oil prices went through an even worse decline than we are experiencing now. In that period, the WTI oil price was cut in half, going from over $100 to less than $50 in the span of about six months.

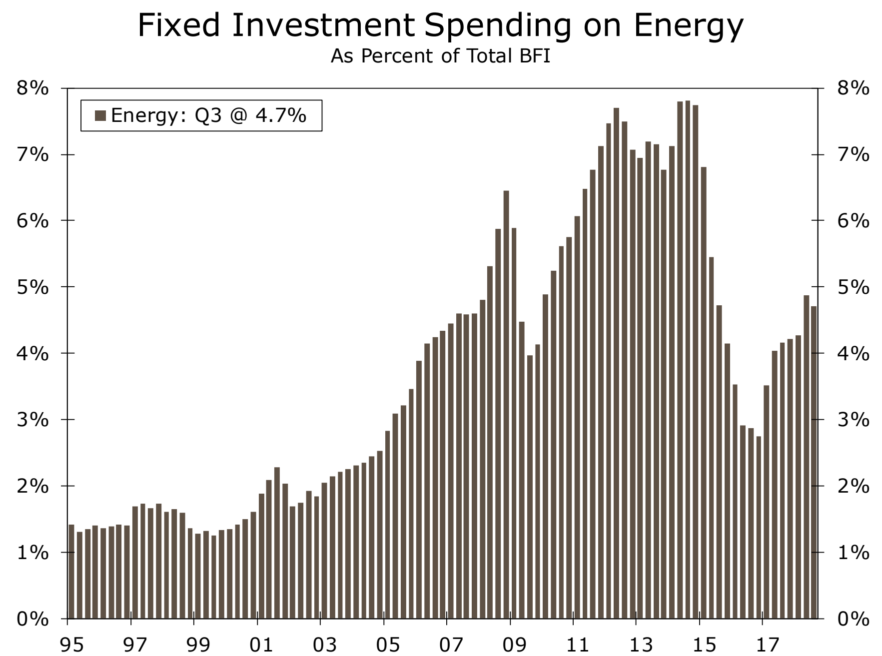
Led by steep cutbacks in the mining and energy sector, business fixed investment spending went into a steep decline, culminating in the annualized growth rate of overall business fixed investment (BFI) falling in three consecutive quarters and the year-over–year rate also in outright decline in late 2015. There were questions being asked at the time about whether or not there was a "manufacturing recession."

We argued at the time that the weakness was broadly concentrated in energy spending. Yes, there were knock-on effects in other industries, and BFI outside the mining sector also slowed, but it never slipped into negative territory on a year-over-year basis. Energy spending, however, went from an almost 8% share of BFI at the start of 2015, to less than 3% by the start of 2017.

We do expect equipment spending broadly to moderate throughout the forecast period, but that has more to do with late business cycle dynamics than oil prices. We are not yet rushing to make steep downward revisions to our spending forecast because of oil's recent price decline.

In order for that to happen we'd need to see prices remain at current depressed levels for several months. Note in the bottom chart how spending cuts in the energy sector did not begin in earnest until the start of 2015, which was roughly six months after oil prices peaked in that cycle. If we are still below $60/barrel in the spring, we'd be less sanguine. For now, however, we are not rushing to make changes.





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 11/16/2018	1 Week Ago	1 Year Ago
1-Month LIBOR	2.31	2.32	1.26
3-Month LIBOR	2.63	2.60	1.42
3-Month T-Bill	2.36	2.34	1.25
1-Year Treasury	2.66	2.64	1.56
2-Year Treasury	2.85	2.92	1.71
5-Year Treasury	2.92	3.04	2.07
10-Year Treasury	3.09	3.18	2.38
30-Year Treasury	3.34	3.38	2.83
Bond Buyer Index	4.30	4.36	3.52

Foreign Exchange Rates

	Friday 11/16/2018	1 Week Ago	1 Year Ago
Euro ($/€)	1.133	1.134	1.177
British Pound ($/£)	1.282	1.297	1.320
British Pound (£/€)	0.883	0.874	0.892
Japanese Yen (¥/$)	113.130	113.830	113.060
Canadian Dollar (C$/$)	1.318	1.321	1.276
Swiss Franc (CHF/$)	1.008	1.006	0.994
Australian Dollar (US$/A$)	0.726	0.723	0.759
Mexican Peso (MXN/$)	20.362	20.136	19.056
Chinese Yuan (CNY/$)	6.950	6.957	6.630
Indian Rupee (INR/$)	71.928	72.495	65.323
Brazilian Real (BRL/$)	3.757	3.730	3.277
U.S. Dollar Index	96.897	96.905	93.932

Source: Bloomberg LP and Wells Fargo Securities

Foreign Interest Rates

	Friday 11/16/2018	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.37	-0.36	-0.38
3-Month Sterling LIBOR	0.89	0.85	0.53
3-Month Canada Banker's Acceptance	2.22	2.21	1.40
3-Month Yen LIBOR	-0.11	-0.10	-0.04
2-Year German	-0.59	-0.60	-0.71
2-Year U.K.	0.73	0.78	0.50
2-Year Canadian	2.23	2.34	1.48
2-Year Japanese	-0.14	-0.14	-0.19
10-Year German	0.36	0.41	0.38
10-Year U.K.	1.40	1.49	1.31
10-Year Canadian	2.37	2.51	1.97
10-Year Japanese	0.10	0.12	0.05

Commodity Prices

	Friday 11/16/2018	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	57.44	60.19	55.14
Brent Crude ($/Barrel)	67.94	70.18	61.36
Gold ($/Ounce)	1217.11	1209.85	1278.70
Hot-Rolled Steel ($/S.Ton)	800.00	812.00	611.00
Copper (¢/Pound)	274.30	268.45	304.80
Soybeans ($/Bushel)	8.29	8.14	9.41
Natural Gas ($/MMBTU)	4.15	3.72	3.05
Nickel ($/Metric Ton)	11,183	11,710	11,634
CRB Spot Inds.	485.16	483.48	498.31

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	19	20	21	22	23
U.S. Data	**NAHB Housing Market Index** October 68 November 68 (C)	**Housing Starts** September 1201K October 1252K (W) **Building Permits** September 1270K October 1260K (C)	**Durable Goods** Sepember 0.7% October -2.1% (W) **Existing Home Sales** September 5.15M October 5.22M (W)	**Thanksgiving Day** **[U.S. Markets Closed]**	
Global Data	**Chile** **GDP (QoQ)** Q2 0.7%		**Japan** **Natl CPI (YoY)** September 1.2%		**Eurozone** **Purchasing Managers Index** October 52.0 (Manuf.) 53.7 (Serv.) **Canada** **CPI (YoY)** September 2.2%

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

Source: Bloomberg LP and Wells Fargo Securities

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