September 12, 2018

Economics Group

MONTHLY OUTLOOK

U.S. Overview

The U.S. economy continues to maintain strong momentum headed into fall 2018. Nonfarm employment growth, consumer spending and capital goods orders suggest real GDP will grow at around a 3% pace during the third quarter, and we expect growth will remain close to that pace through 2019. Our forecast now extends through 2020, where we see growth moderating somewhat to 2.2%. The current expansion will become the longest on record if growth continues into the second half of 2019.

From a bottom up perspective the economy looks incredibly sound. Strong job growth, higher asset prices and a relatively high saving rate should continue to support consumer spending. Business fixed investment also looks set to grow solidly, with an emphasis on productivity enhancing investment. Inventories are relatively low and government spending looks set to improve modestly in coming quarters.

Forecasting economic growth this far into a business cycle is a bit perilous. Recessions are hard to see, even in real time, and even harder to predict several quarters into the future. Reforms enacted in the aftermath of the financial crisis and the generally slow start to the economic expansion have created a great deal of resiliency, and few of the obvious excesses that typically have preceded past recessions are present today.

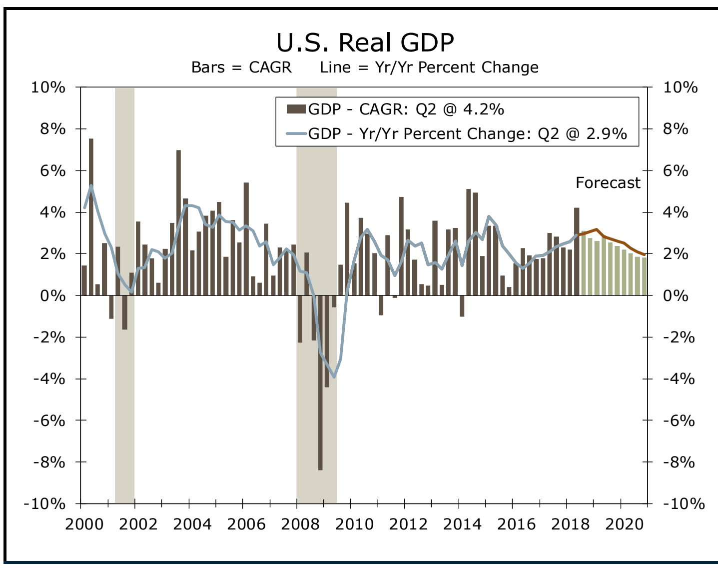
We expect the Fed to continue nudging interest rates up a quarter point higher each quarter until the second half of 2019, when we believe the funds rate will be above its neutral rate. The yield curve is expected to remain positive, however, as long term rates rise modestly.

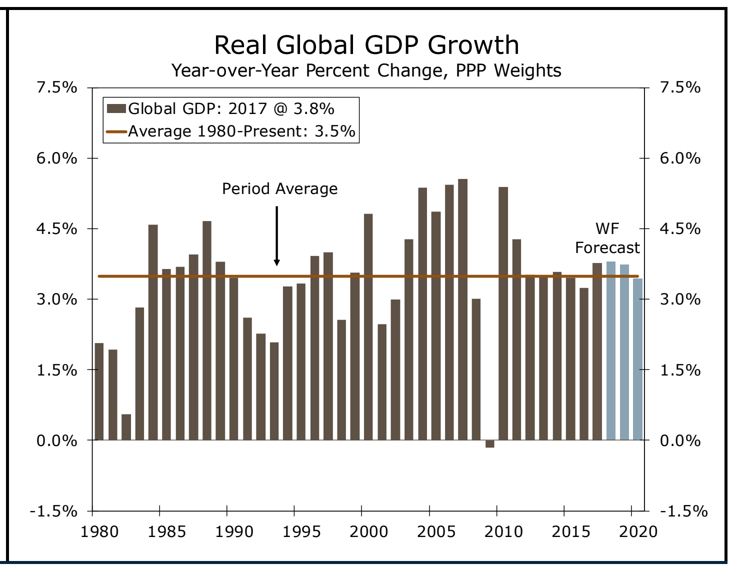
International Overview

In 2017, the global economy experienced a broad-based swing to the upside, as most advanced and developing economies experienced a synchronized pick-up in economic growth. In some ways, 2018 has been a bit more of a one-man show, as the U.S. economy has seen a marked acceleration this year. Conversely, many of the world's other major economies, such as the Eurozone, United Kingdom, Japan, Canada and China, have thus far been growing at a slower pace this year relative to 2017.

As we look to the coming quarters, the U.S. outperformance will likely continue in the near term as the fiscal stimulus from tax cuts and increased government spending flow through the economy. For the rest of the world, we look for a leveling off rather than a continued slide in economic growth. Central bankers in regions such as Europe and Japan have so far maintained very accommodative monetary policy, while policymakers in China have also taken measures to support growth. Looking a bit farther out, our preliminary forecast for 2020 has the gap between the United States and the rest of the world narrowing further as U.S. growth moves closer to potential.

Perhaps the biggest risk to the near-term global economic outlook is a continued movement toward a full-fledged trade war. Developments over the past month in this area have been mixed. United States negotiators appear to have reached a preliminary agreement with Mexico on NAFTA renegotiation, but a tri-party deal with Canada remains elusive. In addition, the Trump administration appears to be moving toward another round of tariffs on $200 billion of Chinese goods.





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

Onward

Real economic growth appears set to average a 3% pace during the second half of 2018, led by continued growth in consumer spending and strong gains in business fixed investment. While growth is expected to moderate somewhat from the 4.2% pace hit during Q2, the economy still has plenty of fuel in the tank. Most importantly, job and income growth remain exceptionally strong, which is keeping consumers in good spirits and supporting hearty gains in consumer spending.

Nonfarm employment came in ahead of expectations in August, with payrolls rising by 201,000 jobs. While job growth was revised down slightly during the prior two months, an average 185,000 jobs were added during the past three months and hiring for all of 2018 is still running slightly ahead of its year-ago pace. Moreover, wage growth appears to be accelerating, as businesses are having to boost wages in order to attract and retain quality staff. Average hourly earnings have risen 2.9% over the past year, which is consistent with most other measures of wage gains.

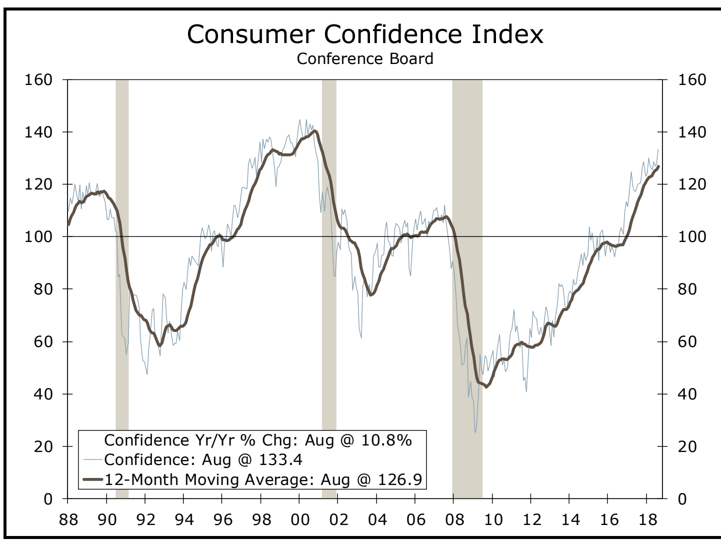
The strength in the labor market has not gone unnoticed by consumers. The Consumer Confidence Index rose to its highest level in 18 years during August, with most of the gain coming from consumers' more upbeat assessment of labor market conditions. Actual spending data through July show real personal consumption on pace to rise at a 2.9% rate during the current quarter. Consumers also have a bit of a cushion, with the saving rate currently at a fairly lofty 6.7%.

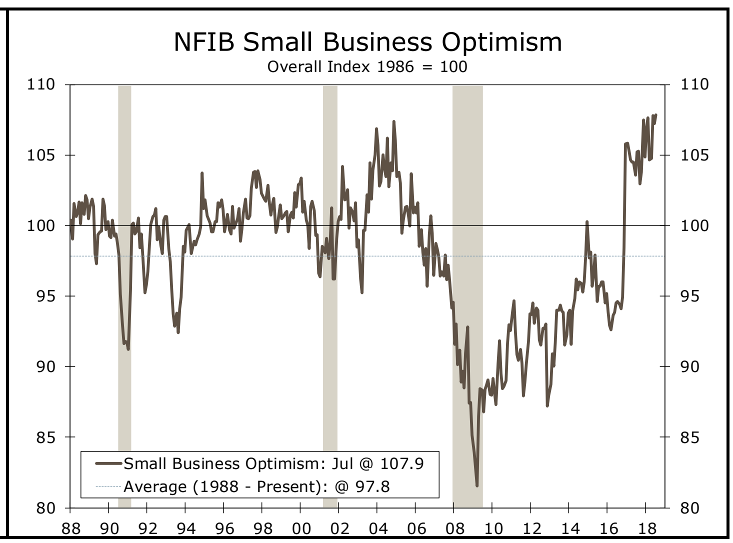
The saving rate should provide considerable resilience to consumer spending in coming quarters, particularly with job growth as strong as it has been and layoffs as low as they have been. Weekly initial claims for unemployment insurance have averaged just 209,400 over the past four weeks and are currently at their lowest level since 1969. We see consumer spending modestly outpacing income growth over the forecast period. Consumers have shown a great deal of restraint during this cycle, with spending for experiences accounting for a larger share of outlays.

While the advanced age of the current business cycle and flattening of the yield curve have raised fears that economic trouble may be lurking around the corner, there are few signs of the excesses present today that have typically preceded economic recessions in the past. Most notably, with the exception of apartments, there are few signs of overbuilding. Moreover, banks remain well capitalized, interest rates remain historically low and fiscal policy remains exceptionally stimulative. Still, financial conditions are beginning to turn a bit. Corporate profit margins are getting squeezed by higher labor costs and rising input prices. Risk tolerance is also growing a bit tired, after the longest bull market in history and an extraordinary run-up in asset prices in general.

But, even with this expansion a little long in the tooth, businesses are still showing a proclivity to expand. Various surveys of business confidence show business owners remain exceptionally upbeat. The NFIB Small Business Optimism Index hit a new all-time high in August and measures of confidence at middle-market and large businesses also show considerable optimism. With the exception of the energy and technology sectors, business fixed investment has been in slow gear throughout most of the cycle, which has left many businesses in need of upgrading plant and equipment, particularly in light of rising wage pressures. We see capital spending continuing to rise solidly but look for investment to taper off over the forecast period as interest rates rise and profits come under pressure.

We expect the Federal Reserve to continue to nudge the federal funds rate a quarter point higher each quarter until the second half of 2019, when we believe the funds rate will be above its neutral level. While this is a more aggressive path than the financial markets currently expect, we do not expect the yield curve to invert. Long-term rates should rise modestly, as economic growth proves stronger and more durable.





Source: National Federation of Independent Business (NFIB), The Conference Board and Wells Fargo Securities

Wells Fargo U.S. Economic Forecast

	Actual							Forecast									Actual	Forecast		
	2017				2018				2019				2020				2017	2018	2019	2020
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q				
Real Gross Domestic Product (a)	1.8	3.0	2.8	2.3	2.2	4.2	3.1	2.8	2.6	2.9	2.6	2.4	2.2	2.0	1.9	1.8	2.2	2.9	2.8	2.2
Personal Consumption	1.8	2.9	2.2	3.9	0.5	3.8	2.9	2.8	2.2	2.9	2.6	2.5	2.1	2.2	1.8	1.7	2.5	2.6	2.7	2.2
Business Fixed Investment	9.6	7.3	3.4	4.8	11.5	8.5	6.8	5.1	4.7	4.9	4.4	4.0	3.7	3.6	2.9	2.8	5.3	7.4	5.2	3.7
Equipment	9.1	9.7	9.8	9.9	8.5	4.4	6.9	4.3	3.8	4.2	3.7	3.1	2.7	2.6	2.1	2.0	6.1	7.7	4.3	2.8
Intellectual Property Products	8.0	6.6	1.7	0.7	14.1	11.0	7.1	5.2	4.8	5.3	4.7	4.6	4.7	4.6	3.7	3.6	4.6	7.5	5.6	4.5
Structures	12.8	3.8	-5.7	1.3	13.9	13.2	7.0	7.0	6.5	6.0	5.5	5.0	4.5	4.0	3.5	3.5	4.6	6.8	6.7	4.5
Residential Construction	11.1	-5.5	-0.5	11.1	-3.4	-1.6	2.0	4.0	5.5	5.0	4.5	4.0	3.5	3.0	2.5	2.0	3.3	0.9	4.0	3.5
Government Purchases	-0.8	0.0	-1.0	2.4	1.5	2.4	3.4	2.9	2.2	1.4	0.8	0.7	0.7	0.5	0.3	0.1	-0.1	1.7	2.1	0.6
Net Exports	-845.5	-844.1	-845.9	-899.2	-902.4	-843.7	-900.0	-928.9	-943.2	-965.5	-980.0	-990.2	-991.4	-1000.7	-997.9	-991.6	-858.7	-893.7	-969.7	-995.4
Pct. Point Contribution to GDP	-0.1	0.1	0.0	-0.9	0.0	1.2	-1.2	-0.6	-0.3	-0.5	-0.3	-0.2	0.0	-0.2	0.1	0.1	-0.4	-0.2	-0.4	-0.1
Inventory Change	-2.4	11.9	64.4	16.1	30.3	-26.9	30.0	35.0	41.0	52.0	57.0	56.0	56.0	55.0	55.0	55.0	22.5	17.1	51.5	55.3
Pct. Point Contribution to GDP	-0.8	0.2	1.0	-0.9	0.3	-1.0	1.2	0.1	0.1	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0
Nominal GDP (a)	3.9	4.2	4.8	5.1	4.3	7.6	4.6	5.0	5.3	5.5	5.2	4.8	4.4	4.3	4.0	4.4	4.2	5.2	5.3	4.6
Real Final Sales	2.6	2.8	1.8	3.2	1.9	5.3	2.5	2.7	2.5	2.6	2.5	2.4	2.2	2.0	1.9	1.8	2.2	3.0	2.7	2.2
Retail Sales (b)	4.9	4.1	4.2	5.6	4.5	5.7	6.2	5.1	5.6	5.0	4.6	4.5	4.5	4.4	4.4	3.7	4.7	5.4	4.9	4.2
Inflation Indicators (b)																				
PCE Deflator	2.0	1.6	1.6	1.8	1.9	2.2	2.2	2.1	2.1	2.3	2.5	2.5	2.4	2.3	2.2	2.3	1.8	2.1	2.3	2.3
"Core" PCE Deflator	1.8	1.6	1.5	1.6	1.7	1.9	2.0	2.0	2.1	2.1	2.2	2.2	2.2	2.2	2.2	2.2	1.6	1.9	2.1	2.2
Consumer Price Index	2.6	1.9	2.0	2.1	2.3	2.6	2.6	2.4	2.2	2.4	2.6	2.7	2.6	2.5	2.3	2.4	2.1	2.5	2.5	2.5
"Core" Consumer Price Index	2.1	1.8	1.7	1.7	1.9	2.2	2.3	2.3	2.3	2.5	2.5	2.5	2.4	2.3	2.4	2.4	1.8	2.2	2.4	2.4
Producer Price Index (Final Demand)	2.0	2.2	2.4	2.8	2.8	3.0	3.1	2.7	2.6	2.5	2.7	2.9	2.8	2.8	2.5	2.5	2.3	2.9	2.7	2.7
Employment Cost Index	2.4	2.4	2.5	2.6	2.7	2.8	2.8	2.9	2.9	3.0	3.1	3.2	3.2	3.3	3.3	3.3	2.5	2.8	3.1	3.3
Real Disposable Income (a)	4.5	2.2	2.2	2.3	4.4	2.5	2.5	2.5	2.8	2.6	2.6	2.6	2.6	2.5	2.2	2.0	2.6	2.9	2.6	2.5
Nominal Personal Income (b)	4.1	4.3	4.5	4.6	4.3	4.6	4.6	4.3	4.4	4.7	4.8	4.8	4.6	4.3	4.2	3.9	4.4	4.4	4.7	4.2
Industrial Production (a)	1.0	5.0	-1.5	7.7	2.5	6.0	3.0	3.3	2.4	4.2	1.2	4.0	2.5	4.7	0.7	0.1	1.6	3.9	3.1	2.8
Capacity Utilization	75.4	76.2	75.8	77.0	77.2	78.0	78.2	78.4	78.5	78.6	78.6	78.8	78.9	79.1	79.0	78.9	76.1	78.0	78.6	79.0
Corporate Profits Before Taxes (b)	3.0	3.6	2.8	3.3	5.9	7.7	8.0	6.2	5.6	1.8	0.5	-0.8	-1.6	-2.2	-2.6	-3.4	3.2	6.9	1.7	-2.4
Corporate Profits After Taxes	6.0	6.2	6.4	7.3	15.1	16.1	17.0	12.5	4.7	1.9	0.3	-1.0	-1.8	-2.4	-2.9	-3.7	6.5	15.1	1.4	-2.7
Federal Budget Balance (c)	-317	4	-143	-225	-375	-7	-168	-321	-396	-63	-270	-337	-416	-63	-283	-364	-666	-775	-1050	-1100
Trade Weighted Dollar Index (d)	94.0	90.5	88.1	87.5	86.3	90.0	90.0	90.5	90.0	89.0	87.8	86.3	85.8	83.5	82.0	80.0	91.1	89.2	88.3	82.8
Nonfarm Payroll Change (e)	177	190	142	221	218	217	179	180	170	170	160	160	150	140	100	90	182	199	165	120
Unemployment Rate	4.7	4.3	4.3	4.1	4.1	3.9	3.9	3.8	3.7	3.6	3.6	3.5	3.4	3.3	3.3	3.3	4.4	3.9	3.6	3.3
Housing Starts (f)	1.23	1.17	1.17	1.26	1.32	1.25	1.27	1.33	1.34	1.37	1.39	1.42	1.42	1.43	1.43	1.42	1.20	1.30	1.38	1.43
Light Vehicle Sales (g)	17.1	16.8	17.1	17.6	17.1	17.2	16.7	16.8	16.8	16.7	16.7	16.6	16.6	16.5	16.4	16.3	17.1	17.0	16.7	16.5
Crude Oil - Brent - Front Contract (h)	54.6	50.8	52.2	61.4	66.9	74.6	75.0	72.0	75.0	80.0	85.0	80.0	76.0	71.0	70.0	65.0	54.7	72.1	80.0	70.5
Quarter-End Interest Rates (i)																				
Federal Funds Target Rate	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.25	3.25	3.25	3.00	1.13	2.13	3.06	3.19
3 Month LIBOR	1.15	1.30	1.33	1.69	2.31	2.34	2.45	2.70	2.95	3.15	3.40	3.40	3.40	3.40	3.40	3.15	1.26	2.45	3.23	3.34
Prime Rate	4.00	4.25	4.25	4.50	4.75	5.00	5.25	5.50	5.75	6.00	6.25	6.25	6.25	6.25	6.25	6.00	4.13	5.13	6.06	6.19
Conventional Mortgage Rate	4.20	3.90	3.81	3.94	4.44	4.57	4.60	4.80	4.95	5.05	5.15	5.20	5.15	5.15	5.10	5.05	3.99	4.60	5.09	5.11
3 Month Bill	0.76	1.03	1.06	1.39	1.73	1.93	2.15	2.40	2.65	2.90	3.05	3.05	3.00	3.00	2.95	2.75	0.95	2.05	2.91	2.93
6 Month Bill	0.91	1.14	1.20	1.53	1.93	2.11	2.35	2.60	2.80	3.00	3.10	3.10	3.05	3.05	3.00	2.80	1.07	2.25	3.00	2.98
1 Year Bill	1.03	1.24	1.31	1.76	2.09	2.33	2.55	2.80	3.00	3.05	3.15	3.15	3.10	3.10	3.05	2.85	1.20	2.44	3.09	3.03
2 Year Note	1.27	1.38	1.47	1.89	2.27	2.52	2.75	2.90	3.05	3.10	3.20	3.20	3.15	3.15	3.10	3.00	1.40	2.61	3.14	3.10
5 Year Note	1.93	1.89	1.92	2.20	2.56	2.73	2.85	3.05	3.20	3.30	3.40	3.40	3.35	3.35	3.30	3.25	1.91	2.80	3.33	3.31
10 Year Note	2.40	2.31	2.33	2.40	2.74	2.85	3.00	3.20	3.35	3.45	3.55	3.60	3.55	3.55	3.50	3.45	2.33	2.95	3.49	3.51
30 Year Bond	3.02	2.84	2.86	2.74	2.97	2.98	3.15	3.40	3.55	3.70	3.80	3.90	3.90	3.85	3.85	3.80	2.89	3.13	3.74	3.85

Forecast as of: September 12, 2018

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

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

Keeping Up with the Joneses

Global growth has been relatively steady in 2018, roughly matching the pace seen in 2017. This steadiness in the aggregate masks some divergences beneath the surface, however, as an acceleration in the U.S. economy has been offset by a deceleration in some of the world's other advanced and developing economies. In Europe, economic growth has eased from its Q3-2017 peak, but actual growth has remained above potential. With the economy still growing faster than potential, economic slack should continue to be absorbed and core inflation should gradually pick up. Monetary policy in Europe remains highly accommodative and should continue to support growth going forward, and, while fiscal policy is not as expansionary as it is in the United States, it is no longer exerting strong headwinds on GDP growth as it was a few years ago when austerity held sway at the height of the European debt crisis.

Indeed, there could even be some scope for near-term fiscal stimulus in Europe as the new Italian government weighs possible tax cuts and/or new public spending. This comes with its own possible risks, however, as Italian bond spreads have widened to a four-year high relative to their German peers. Though the contagion effect has so far been limited, a more pronounced sell-off in the €2.3 trillion Italian sovereign debt market could prompt some rise in borrowing costs across Europe, potentially slowing economic growth further and delaying the first rate hike from the European Central Bank, which we currently expect in Q3-2019.

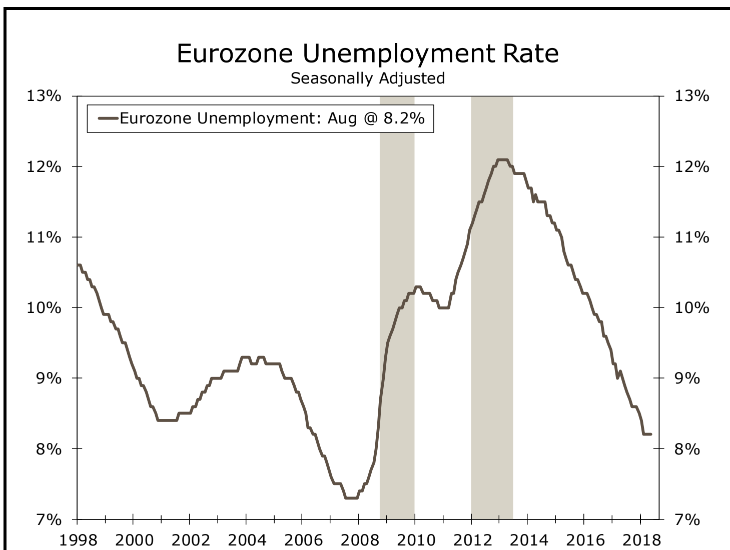
Elsewhere in the advanced world, economic indicators out of the United Kingdom have been a bit firmer of late. A monthly GDP series for the United Kingdom has accelerated each month since April, a welcomed sign given potential vulnerability to Brexit-related uncertainties. With Brexit negotiations likely to ramp up further over the next few months, however, we remain cautious on our outlook for growth and the Bank of England (BoE). We do not look for another rate hike by the BoE until Q3-2019.

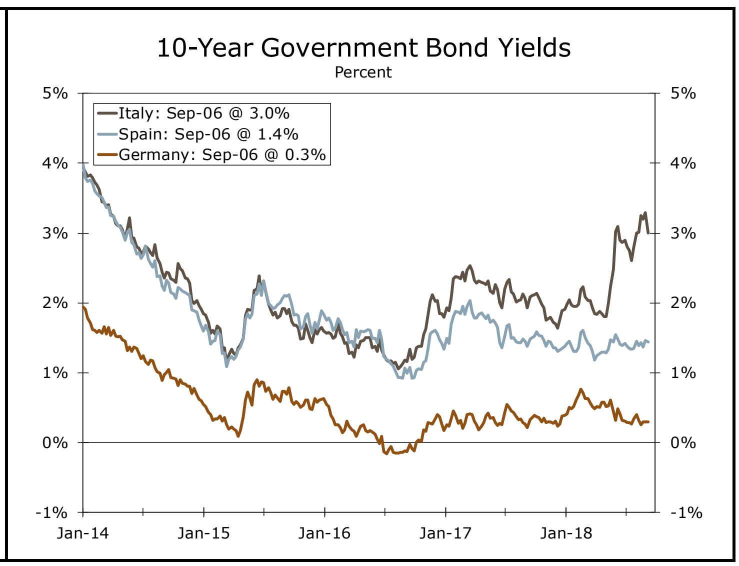
Conditions have been stormier in emerging market economies, with multiple factors driving the weakness. Turkey has been at the eye of the storm, hampered by political uncertainty, concerns about central bank independence and a wide current account deficit. Generally speaking, the more closely an emerging market country mirrors Turkey in these categories, the more macroeconomic stress that country has been under. The structural trend toward more monetary policy tightening in the advanced world appears to be putting pressure on the most vulnerable emerging market economies.

Perhaps most important for the EM outlook and the global growth outlook more broadly is the brewing trade spat between the United States and some of its major trading partners. So far, the United States has imposed a combination of country-specific and good-specific tariffs on imports into the country. The Trump administration appears to be moving toward another round of tariffs on China worth an estimated $200 billion, with the rate and potential effective date still unclear.

A breakthrough between the United States and Mexico on NAFTA renegotiation was a reversal of this protectionist trend, but a full resolution to the NAFTA knot is still likely months away, if not years. Canada has yet to join a tri-party agreement, and even were this to occur a vote in Congress on the plan would likely not occur until 2019.

As we have stated previously, a trade war would be painful for China, the world's largest developing economy, but it probably would not completely derail the economy either. Chinese policymakers have both the will and the firepower to ease monetary and/or fiscal policy if necessary. The central bank has already eased liquidity, which has led to lower short-term interest rates, and deleveraging efforts appear to have been put on pause for the time being given the uncertain outlook. We look for Chinese economic growth to continue gradually slowing, with real GDP growth of 6.6% this year and 6.3% in 2019.





Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2018	2019	2020	2018	2019	2020
Global (PPP Weights)	3.8%	3.7%	3.4%	3.5%	3.7%	3.7%
Advanced Economies[1]	2.5%	2.5%	2.0%	2.2%	2.2%	2.3%
United States	2.9%	2.8%	2.2%	2.5%	2.5%	2.5%
Eurozone	2.1%	2.1%	1.7%	1.7%	1.8%	1.9%
United Kingdom	1.3%	1.5%	1.5%	2.3%	2.0%	2.0%
Japan	1.2%	1.2%	0.6%	1.0%	1.1%	2.0%
Canada	1.9%	2.0%	1.6%	2.3%	2.1%	2.0%
Developing Economies[1]	4.7%	4.6%	4.4%	4.5%	4.8%	4.7%
China	6.6%	6.3%	6.1%	2.1%	2.3%	2.3%
India	7.5%	7.4%	7.2%	4.7%	5.0%	4.8%
Mexico	2.2%	2.7%	2.4%	4.7%	3.9%	3.7%

Forecast as of: September 12, 2018

[1]Aggregated Using PPP Weights

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2018		2019				2018		2019			
	Q3	Q4	Q1	Q2	Q3	Q4	Q3	Q4	Q1	Q2	Q3	Q4
U.S.	2.45%	2.70%	2.95%	3.15%	3.40%	3.40%	3.00%	3.20%	3.35%	3.45%	3.55%	3.60%
Japan	-0.02%	-0.01%	0.00%	0.00%	0.00%	0.01%	0.12%	0.16%	0.20%	0.22%	0.24%	0.25%
Euroland[1]	-0.35%	-0.35%	-0.30%	-0.25%	-0.15%	0.05%	0.45%	0.60%	0.75%	0.90%	1.00%	1.10%
U.K.	0.80%	0.80%	0.85%	0.95%	1.05%	1.10%	1.40%	1.50%	1.60%	1.70%	1.90%	2.00%
Canada[2]	1.95%	2.20%	2.25%	2.40%	2.50%	2.65%	2.30%	2.40%	2.50%	2.60%	2.70%	2.75%

Forecast as of: September 12, 2018

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

Source: International Monetary Fund and Wells Fargo Securities

Wells Fargo Securities Economics Group

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