September 23, 2016

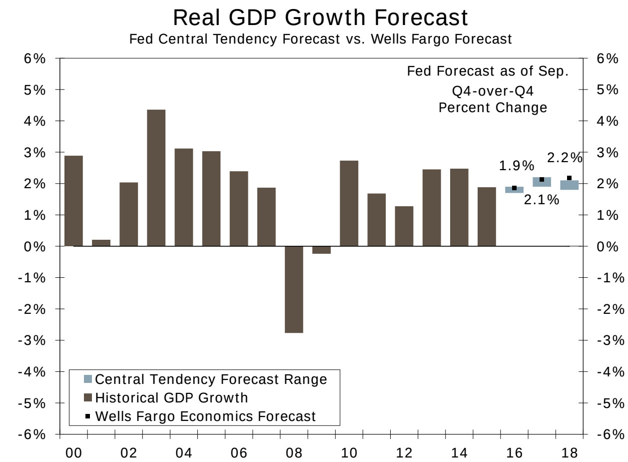
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Fed Holds Off Rate Hike

- The FOMC voted 7 to 3 to hold off on raising rates in the September meeting. Fed officials noted the strengthened case for a rate hike but decided to wait for more data to confirm that notion. New language added in the statement suggests the committee is priming markets for a near-term move, which we expect will take place at the December meeting.
- The housing market dominated the data calendar this week, with housing starts, building permits and existing home sales all coming in softer than expected in August. Tight inventory of available homes continues to grip many U.S. housing markets.



Global Review

Brazil and Argentina in Recession; Better Manufacturing PMI in the Eurozone

- The Argentine economy recorded a deep downturn in the second quarter battered by a very weak performance from real investment, one of the sectors the new Macri administration was counting on to boost economic growth. Meanwhile, the Brazilian recession deepened in the first month of the third quarter.
- The Eurozone showed a better-than-expected manufacturing sector in September, according to the release of the manufacturing PMI number for the month, even as the service sector PMI was slightly weaker than expected.

Wells Fargo U.S. Economic Forecast

	Actual 2016 1Q	Actual 2016 2Q	Forecast 2016 3Q	Forecast 2016 4Q	Forecast 2017 1Q	Forecast 2017 2Q	Forecast 2017 3Q	Forecast 2017 4Q	Actual 2014	Actual 2015	Forecast 2016	Forecast 2017	Forecast 2018
Real Gross Domestic Product [1]	0.8	1.1	3.1	2.4	2.1	2.2	2.1	2.0	2.4	2.6	1.5	2.2	2.1
Personal Consumption	1.6	4.4	3.8	2.5	2.3	2.6	2.5	2.2	2.9	3.2	2.8	2.7	2.5
Inflation Indicators [2]													
PCE Deflator	0.9	1.0	0.9	1.3	1.7	1.8	2.0	2.0	1.5	0.3	1.0	1.9	2.0
Consumer Price Index	1.1	1.1	1.1	1.4	2.1	2.1	2.3	2.3	1.6	0.1	1.2	2.2	2.4
Industrial Production [1]	-1.7	-0.8	4.5	2.9	2.6	2.2	2.3	2.1	2.9	0.3	-0.5	2.6	1.8
Corporate Profits Before Taxes [2]	-6.6	-4.9	-1.3	2.6	2.3	1.8	1.7	1.7	5.9	-3.0	-2.7	1.9	1.7
Trade Weighted Dollar Index [3]	89.8	90.6	90.3	91.3	92.8	94.3	95.8	97.3	78.4	91.1	90.5	95.0	97.1
Unemployment Rate	4.9	4.9	4.9	4.7	4.7	4.6	4.6	4.5	6.2	5.3	4.8	4.6	4.4
Housing Starts [4]	1.15	1.16	1.22	1.23	1.23	1.24	1.25	1.26	1.00	1.11	1.18	1.24	1.30
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	0.25	0.27	0.56	1.00	1.50
Conventional Mortgage Rate	3.69	3.57	3.58	3.59	3.61	3.62	3.66	3.69	4.17	3.85	3.61	3.65	3.86
10 Year Note	1.78	1.49	1.53	1.56	1.59	1.62	1.68	1.73	2.54	2.14	1.59	1.66	1.92

Forecast as of: September 7, 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: U.S. Department of Commerce, U.S. Department of Labor, Federal Reserve Board, IHS Global Insight and Wells Fargo Securities

Inside

U.S. Review

Housing Inventory Shortage Worsens

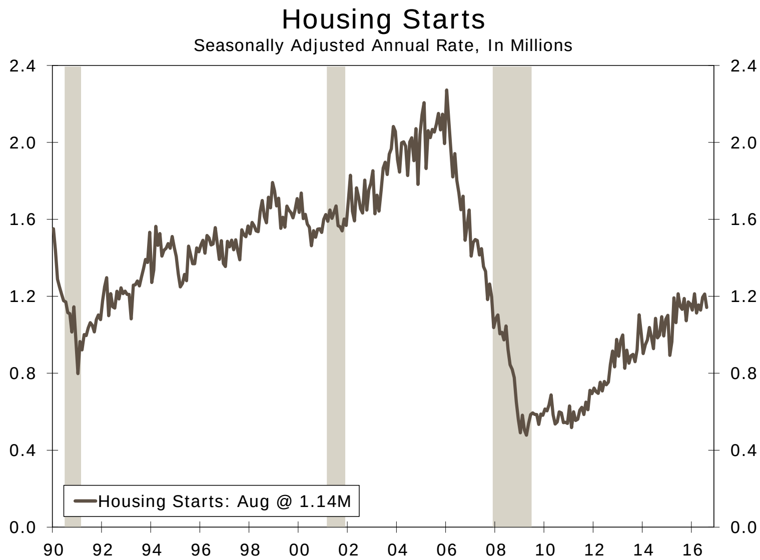
Housing market indicators released this week came in largely below the consensus estimates for August. Housing starts fell 5.8 percent in August to an annualized rate of 1.14 million units after averaging over 1.2 million units in the previous two months. Despite the August drop, we are comfortable with the trend in the housing recovery. New home building has averaged a seasonally adjusted annual rate of 1.16 million units in 2016. Moreover, single-family home building appears to be gaining momentum as apartment development levels off. Permits for future home construction were down slightly in August, although the decline was in multifamily permits. Single-family building permits rose 3.7 percent on the month which suggests solid single-family starts in coming months. More single-family homebuilding should be a welcomed relief to homebuyers. The inventory of pre-owned housing available for sale in the U.S. remains painfully short, with only a 4.6-month supply. Tight inventory likely played a large role in the unexpected 0.9 percent drop in existing home sales in August. Sales of single-family homes were behind the soft reading as they declined 2.3 percent. Homebuyers are likely finding it difficult to find an affordable home as the inventory of homes for sale shrank 10.1 percent over the past year, while the median price of a sold home rose 5.1 percent.

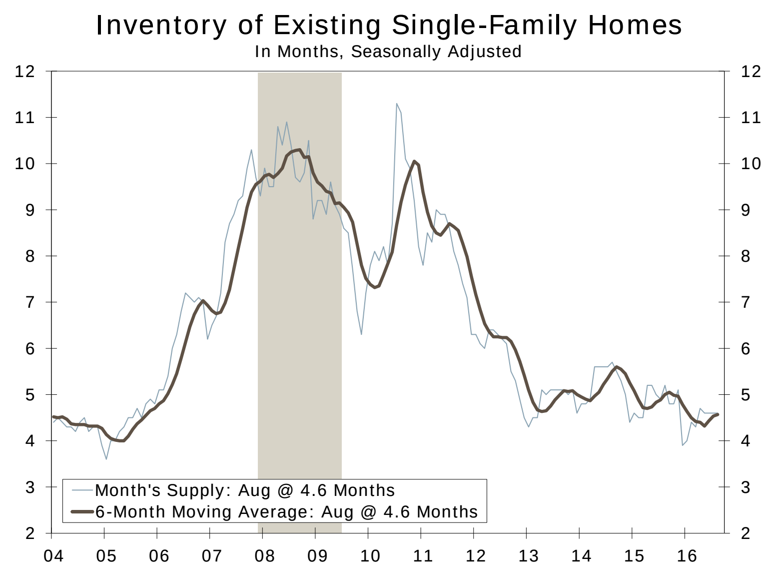
Confidence among home builders is encouraging for the housing outlook for the rest of 2016. The NAHB/Wells Fargo Housing Market Index jumped to a post-recession high. Confidence soared in both builders' assessment of present and future sales as buyer traffic picked up. Fundamentals are supportive of a solid period of housing market activity as mortgage rates are low, job growth remains solid, apartment rents continue to rise and millennials are aging into homeownership age. We expect the housing market to contribute positively to GDP growth in the second half of the year, with the bulk of the improvement in the fourth quarter.

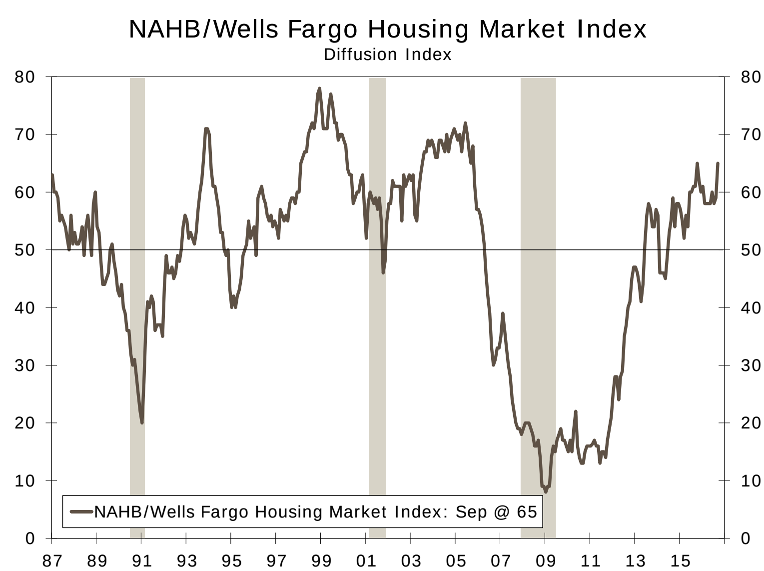
Rates Unchanged as Fed Waits for More Data

The FOMC judges that while the case for a rate hike strengthened, it will wait for further evidence of continued progress for the time being. New wording in the official statement noted "roughly balanced" near-term risks to the economic outlook, a notably hawkish change to the previous "diminished" risk described in July. The tone in both the official statement and Chair Yellen's press-conference remarks indicate that the Fed is teeing up markets for an increase in the federal funds rate in the near future. Moreover, two regional bank presidents joined President Esther George in the dissenting camp, Presidents Rosengren and Mester, highlighting the increasing eagerness among Fed officials to move toward normalization.

Federal Reserve officials lowered their projections for GDP growth in 2016 and the "longer run," with the median committee member forecast now at 1.8 percent, down from 2.0 percent in June. Three quarters of soft productivity numbers are clearly impacting members' outlook of potential economic growth. We expect the Fed to move rates higher at the December meeting.







Source: National Association of Realtors, National Association of Home Builders, U.S. Dept. of Commerce and Wells Fargo Securities

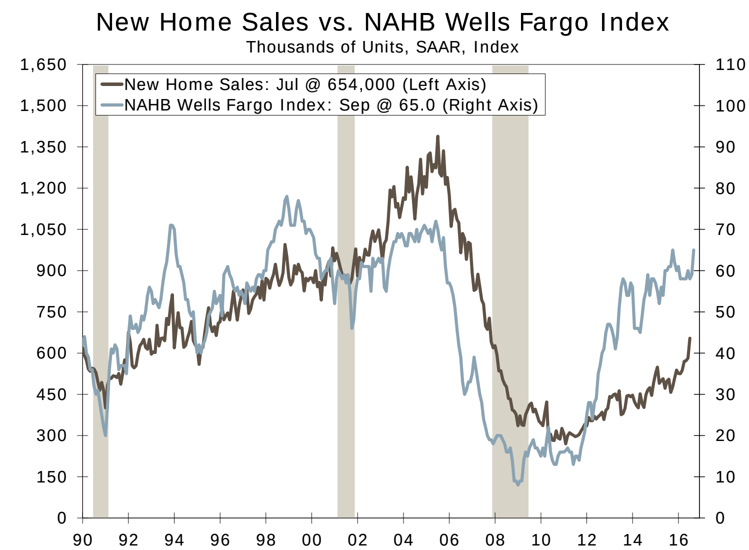
New Home Sales • Monday

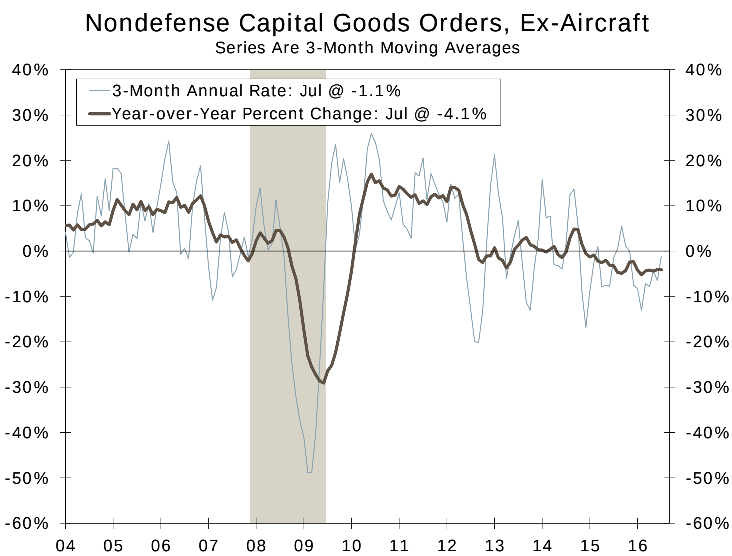
New home sales took off in July, jumping 12.4 percent to a seasonally adjusted annual rate of 654,000 homes. July's hefty increase puts the rate of new home sales at its highest level since the housing boom. New home sales are up a staggering 31.3 percent from a year ago, with the largest increase seen in the South at nearly 40 percent. The South accounts for more than half of all new home sales nationwide and has seen sales and construction soar this year as job growth and in-migration have strengthened.

Challenges remain for the home sales market, however, as affordability hurdles and inventory shortages continue to hold back sales. The average price for a new home climbed 4.1 percent from a year earlier in July and the month's supply of homes for sale dropped to a low 4.3 months. We expect that the pace of new home sales fell from July's breakneck pace, and look for sales to come in at a 612,000 unit annual rate in August.

Previous: 654,000 **Wells Fargo: 612,000**

Consensus: 600,000





Durable Goods • Wednesday

Durable goods orders rose a larger-than-expected 4.4 percent in July, signaling some improvement in the factory sector. The surge in orders is partly attributable to a double-digit gain in aircraft orders, which are notoriously volatile. Stripping away the more volatile components, core capital goods orders, a closely watched proxy for business investment, rose for the second straight month in July, up 1.6 percent.

More recent readings on the manufacturing sector, however, signal disappointment to Q3 expectations. The ISM manufacturing index slipped below breakeven in July, with the ISM orders index also returning to contraction territory. Industrial production notched a lower print in August, as output has now declined in four of the first eight months of 2016. We expect durable goods orders edged down 1.9 percent in August.

Previous: 4.4% **Wells Fargo: -1.9%**

Consensus: -1.4% (Month-over-Month)

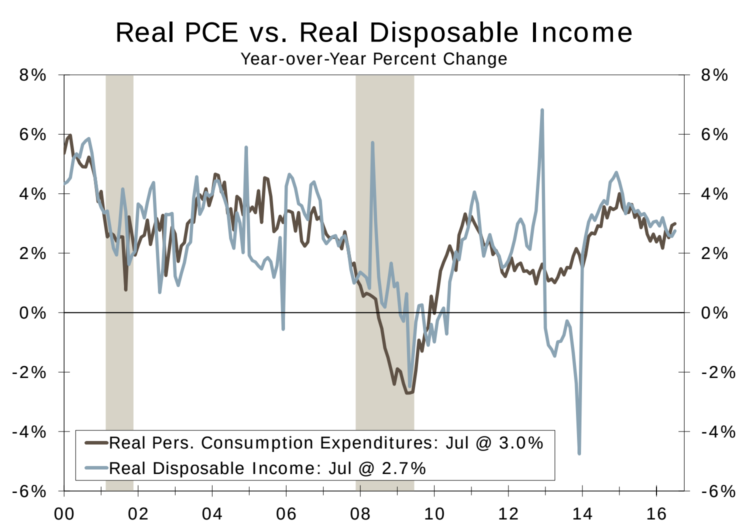
Personal Spending • Friday

Personal spending started the third quarter on pretty solid footing, rising 0.3 percent in July, marking the fourth consecutive monthly increase. Incomes also rose over the month, reporting a 0.4 percent pickup in both personal and after-tax income. Notably, the year-over-year pace of real personal spending growth outpaced real disposable income growth for the second straight month in July, signaling continued strength in consumer spending and blunted income growth. We expect personal spending to remain a mainstay for economic growth and look for real personal consumption to rise at an annualized rate of 3.8 percent in the third quarter.

The PCE deflator, the Fed's preferred measure of inflation, was flat in July and the core PCE was up a modest 0.1 percent. We expect the core PCE deflator to notch a slightly larger 0.2 percent gain in August. Fed officials will continue to watch this key inflation metric as the December policy meeting nears.

Previous: 0.3% **Wells Fargo: 0.2%**

Consensus: 0.1% (Month-over-Month)



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

Global Review

Mixed PMI Readings in the Eurozone

The Eurozone showed a better-than-expected manufacturing sector in September, according to the release of the manufacturing PMI number for the month, even as the service sector PMI was slightly weaker than expected. Both indices remained in expansion territory, with the manufacturing PMI recording 52.6 compared to 51.7 in August, and the service sector index printed 52.6 compared to 52.9 a month prior. Perhaps the not-so-good news with the PMI release is that the index has been range-bound and close to the 50 demarcation point for a relatively long time, underscoring the fact that economic activity is neither improving nor deteriorating. This is probably good news considering the state of economic activity in the rest of the global economy.

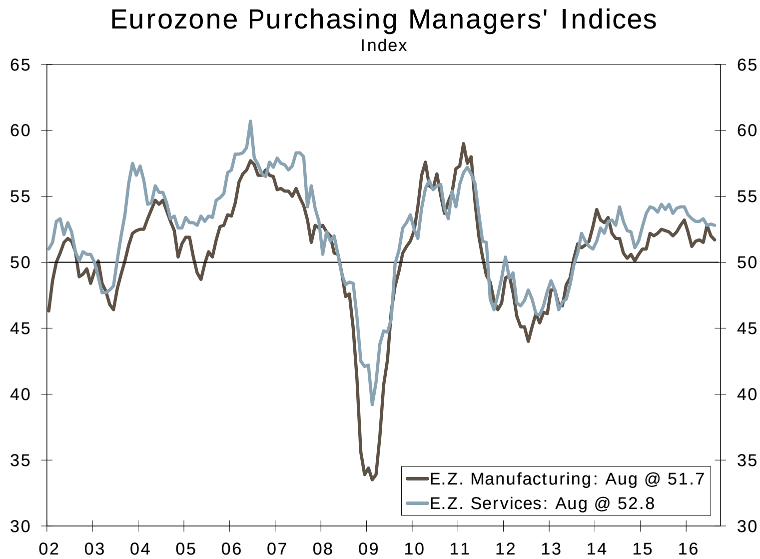
Brazilian Economy Weakens Further

For all the talk regarding an ensuing Brazilian economic recovery that was in the making, the July monthly economic activity index was not very reassuring. The index dropped 0.09 percent on a seasonally adjusted basis in July after improving an upwardly revised 0.37 percent in June. Furthermore, the year-earlier rate also weakened considerably to a collapse of 5.2 percent in July from an upwardly revised 2.9 percent decline in June. The next couple of releases will probably show little improvement, especially August's release. That is, the August reading will include a measure of economic activity during the Summer Olympics, which is certainly going to cloud the result even if Rio de Janeiro is not the largest production region in the country as it is the case of the state of São Paulo. We believe that the Brazilian economy has started to improve, but the improvement is going to be slow and not as strong, especially given the state of the global and regional economy is in no better position today than it has been during the past several years.

Argentina's Economy Plunges in Q2

With the release of Argentina's GDP for the second quarter of the year, it is clear that the measures the new Macri administration has taken have continued to deepen the problems for the economy. According to the INDEC statistical agency, the country's economy plunged 2.1 percent (not annualized) in Q2 compared to Q1 and fell by 3.4 percent compared to Q2 of last year.

Every sector of economic activity was down during the quarter with personal consumption expenditures (PCE) dropping 0.1 percent, government consumption declining 2.0 percent, exports of goods and services down 1.9 percent and gross fixed capital formation plunging 4.9 percent. Meanwhile, imports of goods and services, which enter the calculation of GDP with a negative sign, were up 8.7 percent. Perhaps the biggest disappointment for the Macri administration was the collapse in real investment, which the new administration was counting on to boost economic growth. However, the uncertainty created by the increase in inflation and the ensuing slowdown in PCE is having a larger impact on businesses' expectations of future economic growth and this has impacted investment in future production capacity.



Source: IHS Global Insight and Wells Fargo Securities

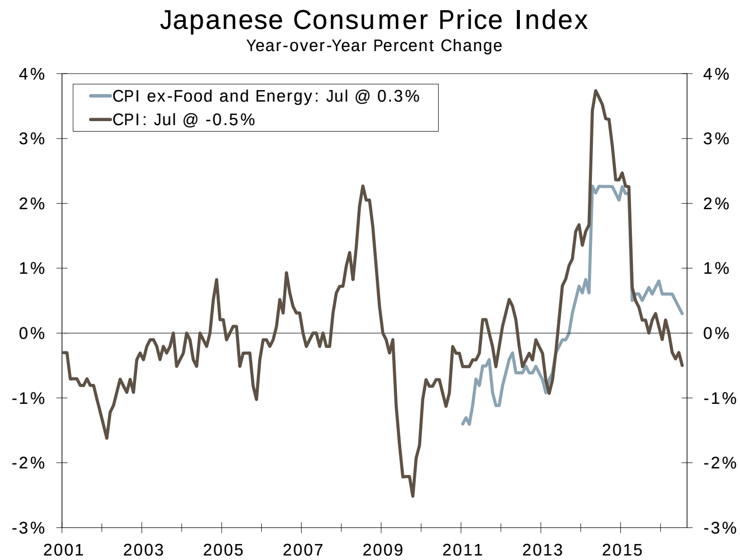
Japanese CPI • Friday

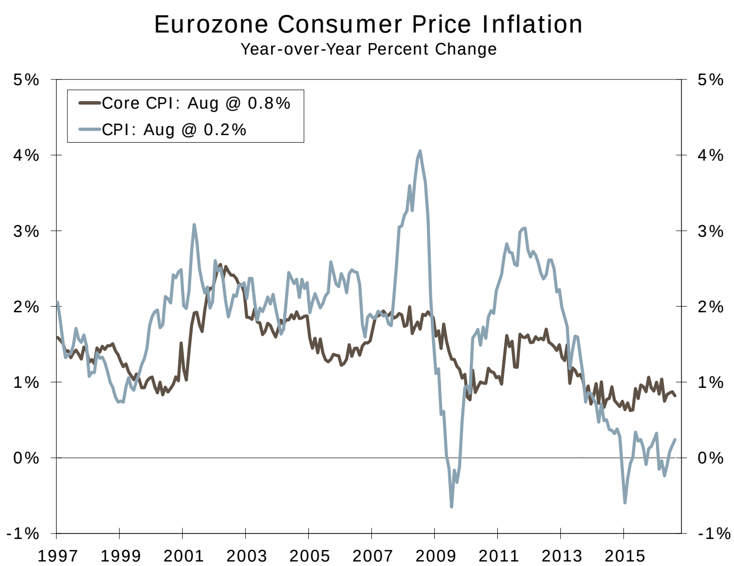
In its comprehensive review of recent monetary policy, the Bank of Japan (BoJ) stated earlier this week that the "price stability target of 2 percent has not been achieved. In the course of the Bank's attempt to raise inflation expectations toward 2 percent, the Bank has observed inflation rates decline due to a variety of exogenous factors such as a fall in crude oil prices. Under these circumstances, inflation expectations declined, as the adaptive mechanism has been playing a relatively large role in the formation of inflation expectations in Japan. This seems to be the main factor that hampers achieving the price stability target of 2 percent."

We discuss the BoJ's latest measures in greater detail in the Topic of the Week on page 7 of this report. Financial markets will be watching the release of August inflation figures when those numbers hit the wire on Friday.

Previous: -0.4% **Wells Fargo: -0.5%**

Consensus: -0.5% (Year-over-Year)





Eurozone CPI • Friday

Consumer prices will also be in focus in Europe next week when the Eurozone CPI report for September is released on Friday. As is the case in many parts of the world, the headline figures for inflation in Europe have been lower than the core readings owing to steep declines in oil and commodity prices.

European Central Bank (ECB) President Draghi made headlines earlier this month when he said there was no discussion of expanding QE at the ECB's latest meeting. We do not expect deposit rate cuts further into negative territory, although we would not be surprised to see some degree of QE extension, perhaps by December. The focus at that point would be whether such an extension would be paired with moves to clarify the degree to which issuance of covered bonds are sufficient to satisfy ECB purchases.

Previous: 0.2% **Wells Fargo: 0.1%**

Consensus: 0.4% (Year-over-Year)

Chinese PMIs • Friday

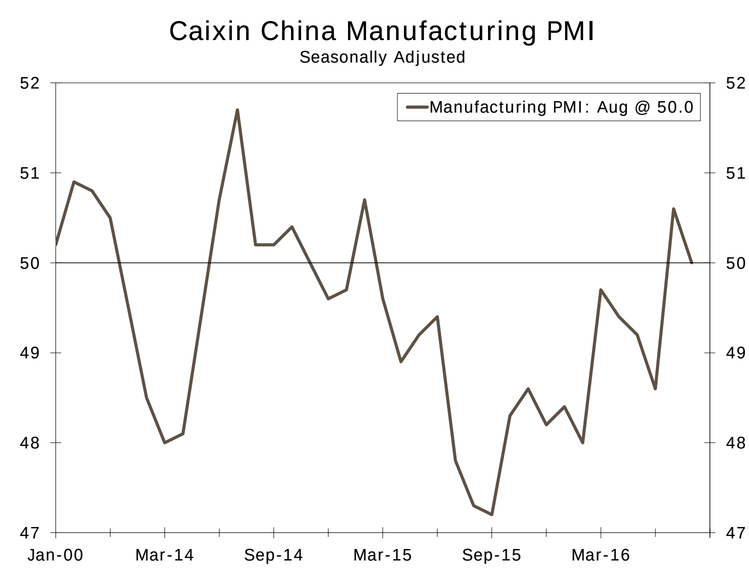
In recent weeks, data out of China have not been as bad as feared by what are admittedly low consensus expectations. The world's second largest single-nation economy has two primary purchasing manager surveys. The Caixin PMI tends to better reflect activity in China's private sector whereas the official PMI tends to be the preferred gauge of state-owned enterprises.

Both the Caixin (at 50.0 in August) and the official PMI (50.4 in August) have been at or near the breakeven 50 in recent months.

On Friday of next week, we will learn what the September numbers are for both measures, which will help inform growth expectations. Ordinarily, a one-point move may not be a significant development, but with numbers remaining so close to 50, a one-point move can mean the difference between growth and contraction.

Previous: 50.4 (official); 50.0 (Caixin)

Consensus: 50.5 (official); 50.1 (Caixin)



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

Interest Rate Watch

FOMC Alters Financial Outlook

Once again, the FOMC has altered the financial outlook for decision makers. In the short-run, the lower fed funds rate projections support the theme of lower for longer, which follows our outlook. However, longer term there is the issue that moderate (2.0-2.25 percent) growth expectations exceed the FOMC's projection of long-run potential growth thus setting up a conflict of modest real growth and upward pressure on wages/prices and thereby further FOMC action to raise the funds rate.

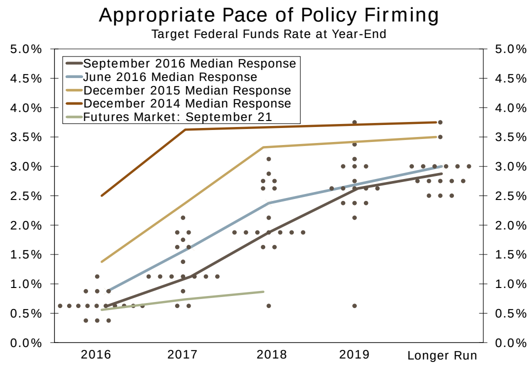
Lower-for-Longer Short Rates

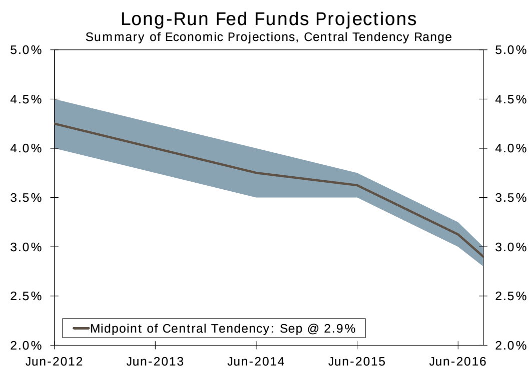
For the immediate future, the FOMC has lowered its projection for the funds rate for 2016 as well as 2017 and 2018, as illustrated in the top graph. This continues to follow the pattern of consistent downgrades in the projections of the longer-run fed funds that we have witnessed (middle graph). This follows the FOMC's continued overestimation of both growth and inflation over this period.

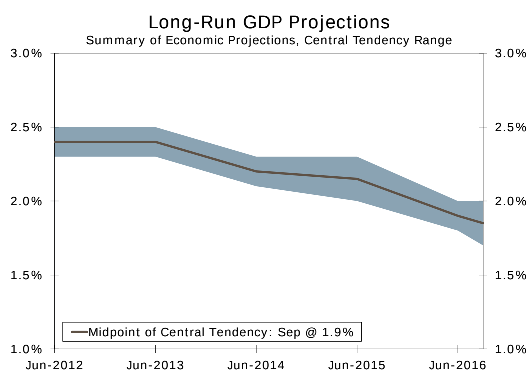
For decision makers, these overestimates create two problems—there is continued uncertainty about the effectiveness of monetary policy to drive economic growth as well as achieve the FOMC's 2 percent target inflation. Secondly, the continued overestimations create skepticism on the ability of the FOMC to model the economy in a way that leads to effective forward guidance in the economy.

Longer-Run: A Question on Potential

Long-run GDP projections by the FOMC have dipped below the 2 percent pace (bottom graph), which has now fallen below the trend pace of growth of the economy since 2014 and falls a bit below our expectations for 2017-2018. As a result, the excess capacity of the economy is expected to be under continued pressure to decline and thereby lead to rising wage/inflation pressures and thereby support the view that the FOMC will continue to raise the funds rate even though there is a perception by some that the pace of overall growth remains disappointing. For decision makers, there is continued pressure on profits and financing options going forward.







Source: Federal Reserve, Bloomberg LP and Wells Fargo Securities

Credit Market Insights

Another Record High for Household Net Worth

Household net worth rose $1.1 trillion in Q2 2016, according to the Federal Reserve's recent Flow of Funds report. Aggregate household net worth stands at $89.1 trillion, the third consecutive quarter in which an all-time high has been set. Household net worth is now more than $20 trillion above its pre-recession peak.

On the asset side of the ledger, households' holdings of financial and real estate assets both rose steadily in the quarter as a result of rising home prices and financial market gains. On the liability side, obligations rose by $163 billion, with growth in consumer credit outpacing mortgage debt. As we have highlighted in our monthly consumer credit write-ups, credit growth this cycle has been more robust in non-mortgage sectors, such as student and auto loans.

Even with these recent gains, household credit growth remains slower than in previous expansions. Liabilities are up 2.8 percent over the past year, which matches a cycle high, but they are still growing at a slower year-ago pace than they did in every quarter prior to 2007. As a share of disposable personal income, liabilities are at their lowest level since 2002.

In the aggregate, household balance sheets look healthy, with rising asset values and only modest liability growth. This has likely supported the healthy growth in consumer spending in recent quarters and should support continued gains moving forward, albeit at a more moderate pace.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.48%	3.50%	3.46%	3.86%
15-Yr Fixed	2.76%	2.77%	2.77%	3.08%
5/1 ARM	2.80%	2.82%	2.83%	2.91%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$2,068.9	35.13%	6.53%	8.80%
Revolving Home Equity	$416.6	-9.86%	-7.48%	-5.30%
Residential Mortgages	$1,722.8	-19.40%	5.05%	6.84%
Commerical Real Estate	$1,915.8	6.15%	9.72%	11.00%
Consumer	$1,342.1	-4.89%	2.41%	8.49%

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

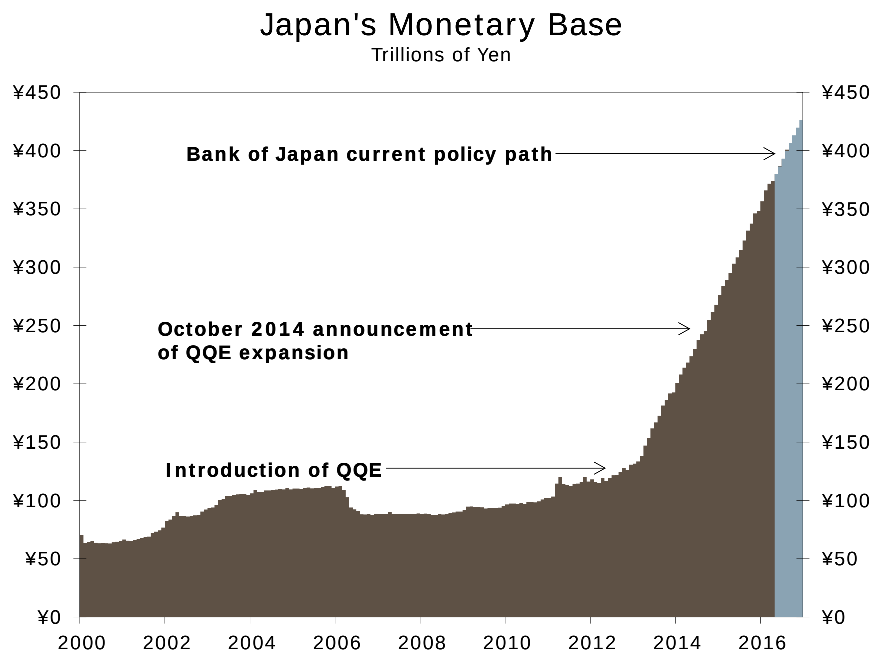
Topic of the Week

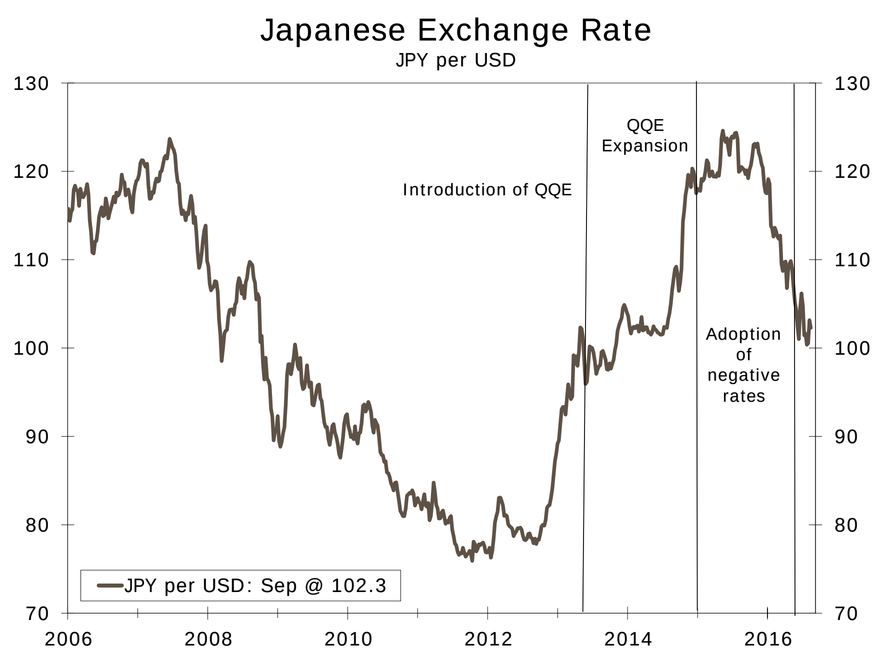
BoJ Eyes 10-Year JGB, Pledges Inflation Overshoot

At its meeting this week, the Bank of Japan (BoJ) introduced a new plan involving the active targeting of 10-year Japanese Government bond (JGB) yield—at "more or less at the current level (around zero percent)" and also made a promise to overshoot its inflation target of 2.0 percent. The BoJ's comprehensive review of recent monetary policy found a number of outside influences, including the drop in oil prices, the softening in domestic demand following the consumption tax hike in 2014 and slower global growth, all conspired to undo the BoJ's previous efforts to lift inflation and failed to break the entrenched Japanese mindset regarding inflation expectations. In our view, the pledge to overshoot the inflation target is a gambit to disrupt that mindset and convince Japanese households and businesses of its intention to deliver on its 2.0 percent inflation target, despite the challenges it has encountered since the rollout of Quantitative and Qualitative Easing (QQE).

Will the New Acme Rocket Work?

The initial foreign exchange response to the rollout of QQE in March 2013 was substantial yen weakening. The expansion of the pace of QQE in 2014 was met with a more lukewarm reception. Earlier this year, following the decision to adopt a negative short-term interest rate regime, the yen actually strengthened. Watching the BoJ reveal each successive package of new policy tools is not unlike watching Wile E. Coyote conjuring up another complex contraption to catch the Road Runner. It is hard not to admire the ingenuity and the novel attempts by taken by Japan's central bank, but reversing the entrenched consumer expectations of deflation, decades of sidewise economic growth and a shrinking population will require more than a ballooning monetary base. We have been unwavering in our assessment that Japan's lack of serious commitment to structural reform (the so-called "third arrow" of Abenomics) is what stands in the way of a viable growth plan there. We wish the BoJ the best with the new plan but then we always rooted for the Coyote too, although things never worked out for him.





Source: IHS Global Insight and Wells Fargo Securities

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 9/23/2016	1 Week Ago	1 Year Ago
3-Month T-Bill	0.17	0.28	0.01
3-Month LIBOR	0.86	0.86	0.33
1-Year Treasury	0.63	0.63	0.40
2-Year Treasury	0.75	0.76	0.70
5-Year Treasury	1.15	1.20	1.45
10-Year Treasury	1.61	1.69	2.15
30-Year Treasury	2.34	2.45	2.95
Bond Buyer Index	2.98	2.96	3.78

Foreign Exchange Rates	Friday 9/23/2016	1 Week Ago	1 Year Ago
Euro ($/€)	1.123	1.116	1.119
British Pound ($/£)	1.297	1.300	1.525
British Pound (£/€)	0.866	0.858	0.734
Japanese Yen (¥/$)	100.990	102.290	120.280
Canadian Dollar (C$/$)	1.316	1.321	1.332
Swiss Franc (CHF/$)	0.970	0.980	0.980
Australian Dollar (US$/A$)	0.763	0.749	0.700
Mexican Peso (MXN/$)	19.725	19.611	17.118
Chinese Yuan (CNY/$)	6.669	6.675	6.384
Indian Rupee (INR/$)	66.655	66.985	65.988
Brazilian Real (BRL/$)	3.231	3.263	4.178
U.S. Dollar Index	95.443	96.108	96.068

Foreign Interest Rates	Friday 9/23/2016	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.32	-0.32	-0.04
3-Month Sterling LIBOR	0.38	0.38	0.58
3-Month Canada Banker's Acceptance	0.89	0.90	0.78
3-Month Yen LIBOR	-0.02	-0.04	0.08
2-Year German	-0.67	-0.65	-0.26
2-Year U.K.	0.10	0.15	0.58
2-Year Canadian	0.53	0.58	0.52
2-Year Japanese	-0.21	-0.26	0.01
10-Year German	-0.08	0.01	0.60
10-Year U.K.	0.73	0.87	1.80
10-Year Canadian	1.05	1.19	1.49
10-Year Japanese	-0.05	-0.04	0.31

Commodity Prices	Friday 9/23/2016	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	44.59	43.03	44.48
Gold ($/Ounce)	1338.76	1310.25	1130.32
Hot-Rolled Steel ($/S.Ton)	542.00	545.00	450.00
Copper (¢/Pound)	219.55	215.15	230.55
Soybeans ($/Bushel)	9.62	9.56	8.54
Natural Gas ($/MMBTU)	2.95	2.95	2.57
Nickel ($/Metric Ton)	10,616	9,663	9,655
CRB Spot Inds.	457.21	454.38	437.21

Source: Bloomberg LP and Wells Fargo Securities

Next Week's Economic Calendar

	Monday 26	Tuesday 27	Wednesday 28	Thursday 29	Friday 30
U.S. Data	**New Home Sales** July 654K August 612K (W)	**Consumer Confidence Index** August 101.1 September 97.6 (W)	**Durable Goods Orders** July 4.4% August -1.9% (W)	**GDP Annualized QoQ** 2Q 2nd Revision 1.1% 2Q 3rd Revision 1.3% (W) **Pending Home Sales (MoM)** July 1.3% August -0.1% (C)	**Personal Income & Spending** July 0.4% & 0.3% August 0.2% & 0.2% (W) **U. of Mich. Sentiment** August 91.9 September 90.0 (C)
Global Data	**Germany** **IFO Expectations** Previous (August) 100.1			**Japan** **CPI Inflation (YoY)** Previous (July) -0.4% **China** **Caixin Chin PMI** Previous (August) 50.4	**United Kingdom** **GDP Q2 Final (YoY)** Previous (Q2) 2.2% **Eurozone** **CPI (YoY)** Previous (August) 0.2%

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

Source: Bloomberg LP and Wells Fargo Securities

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