October 19, 2018

WELLS FARGO SECURITIES

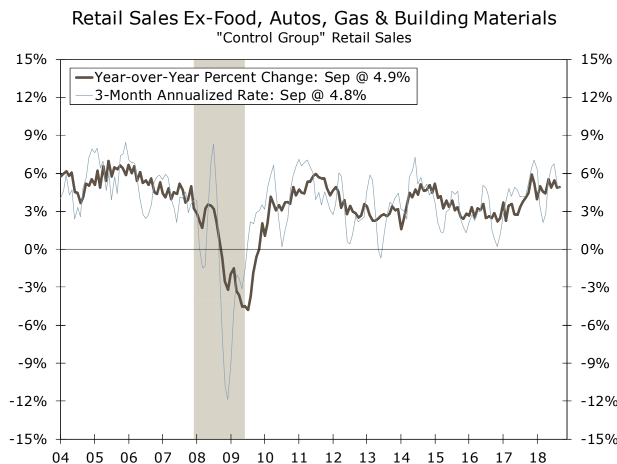
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Signs Pointing to Solid Third Quarter Growth

- Retail sales rose 0.1% in September. Less-volatile control group sales, which feed into GDP, increased 0.5%.
- Industrial production improved 0.3% in September as mining and durable goods orders advanced. Production of business equipment grew a strong 8.0% in Q3.
- Housing continues to underwhelm. Existing home sales fell 3.4% to a 5.15 million-unit pace. Total starts declined 5.3% in September due to a drop in the multifamily segment.
- The federal government ran a $779 billion deficit during FY 2018. Tax collections grew 0.4%, while spending rose 3.2%.



Global Review

Chinese Economic Growth Continues to Edge Lower

- Chinese GDP growth softened to 6.5% year over year in Q3, the slowest pace since 2009. That slowdown comes despite monetary policy easing from China's central bank this year, and highlights the potential for more central bank support going forward.
- U.K. and E.U. officials failed to reach a Brexit deal at a key E.U. leadership summit this week, adding to concerns about the potential for a "no-deal" Brexit. Uncertainty around Brexit developments should keep the Bank of England on hold for now, but it is likely watching rising U.K. wage pressures closely.

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Wells Fargo U.S. Economic Forecast

	Actual		Forecast						Actual		Forecast		
	2018				2019				2016	2017	2018	2019	2020
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	2.2	4.2	3.3	2.7	2.5	2.7	2.6	2.4	1.6	2.2	2.9	2.8	2.2
Personal Consumption	0.5	3.8	3.4	2.8	2.2	2.9	2.6	2.5	2.7	2.5	2.6	2.8	2.2
Inflation Indicators [2]													
PCE Deflator	1.9	2.2	2.2	2.2	2.4	2.5	2.7	2.6	1.1	1.8	2.1	2.5	2.4
Consumer Price Index	2.3	2.6	2.7	2.6	2.6	2.8	3.0	2.9	1.3	2.1	2.5	2.8	2.6
Industrial Production [1]	2.5	5.1	3.4	3.7	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	90.5	89.8	88.5	87.3	86.3	91.5	91.1	89.2	87.9	83.3
Unemployment Rate	4.1	3.9	3.8	3.8	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	1.25	1.33	1.34	1.36	1.36	1.38	1.17	1.20	1.29	1.36	1.41
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	4.95	5.05	5.15	5.25	5.30	3.65	3.99	4.65	5.19	5.23
10 Year Note	2.74	2.85	3.05	3.35	3.45	3.55	3.65	3.70	1.84	2.33	3.00	3.59	3.63

Forecast as of: October 10, 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: Bloomberg LP, Federal Reserve Board, IHS Markit, U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities

U.S. Review

Signs Pointing to Solid Third Quarter Growth

An abundance of data poured in this week and largely pointed to economic growth remaining solid in the third quarter. We estimate real GDP grew at a 3.3% annualized rate in that period, driven by strong consumer spending, a substantial inventory build and an added boost from fiscal stimulus.

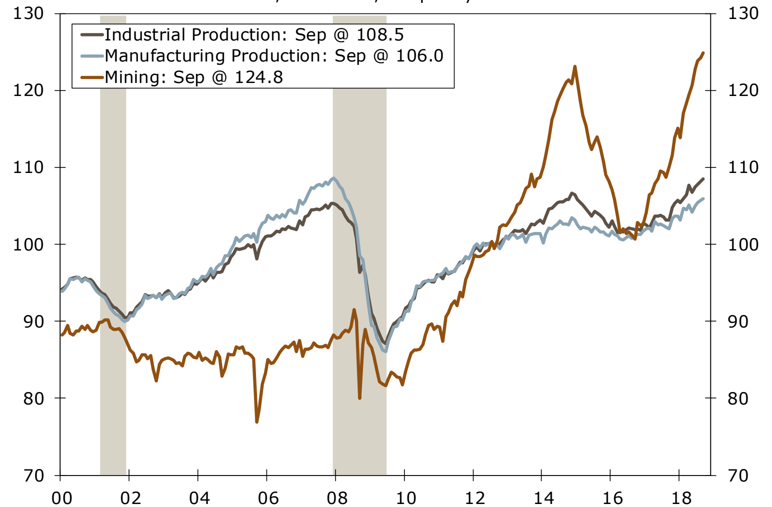
Retail sales fell short of expectations and rose 0.1% in September, primarily due to slower sales at gas stations and bars and restaurants, which dipped 0.8% and 1.8%, respectively. However, control group sales, which feed into GDP and exclude volatile categories like auto, gas and building materials, came in better than expected, increasing a solid 0.5% during the month.

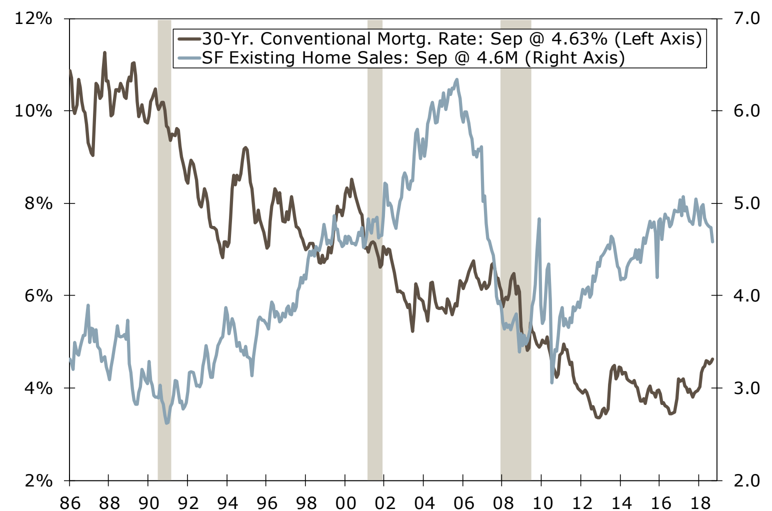
Industrial production rose 0.3% in September as mining and durable goods orders advanced. Higher oil prices continue to support mining production, while manufacturing activity was bolstered by upticks in motor vehicles and machinery. A robust 8.0% rise in production of business equipment over the past three months bodes well for equipment spending being supportive of real GDP growth in Q3.

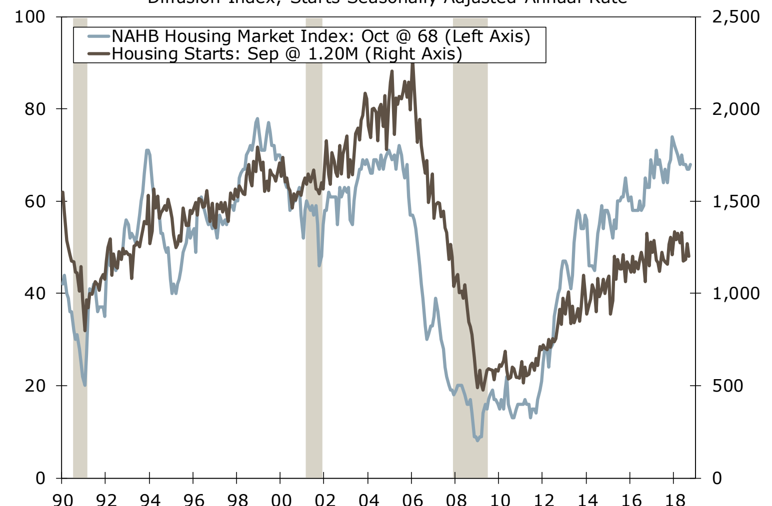
The Leading Economic Index (LEI) climbed 0.5% higher in September, further evidence that economic growth will remain solid in the final quarter of the year. Meanwhile, the underlying strength of the labor market was apparent in the August JOLTS report, which showed a record number of job openings. The rate of workers quitting their jobs also hit the highest point since 2001, which signals that workers have a high degree of confidence in the labor market. The subject of a strengthening labor market was also discussed in the minutes for the most recent September 25-26 FOMC meeting released this week. The minutes revealed that participants generally anticipate further increases in the federal funds rate if such broadly positive conditions persist. This reaffirms our stance that the Fed will cap the year with a rate hike in December, followed by three additional hikes in 2019.

However, housing continues to lag behind the upshift in economic activity. Existing homes sales fell short of expectations and dropped 3.4% in September. Housing starts also came in slightly below consensus and declined 5.3% during that same period. Much of that decline occurred in the volatile multifamily segment, while new single-family units were essentially flat. Hurricane Florence may have had an undue influence as the South saw starts drop 13.7% during the month. The NAHB Housing Market Index edged higher, reflecting strong builder confidence surrounding current demand for new homes. Given that material prices have eased recently and demand appears to be holding its own, we expect activity to gradually improve in coming months.

Meanwhile, the federal government ran a $779 billion deficit during FY 2018, a number just slightly ahead of what we had expected given the recent budget deal and tax reform. Tax collections rose just 0.4%, while spending increased 3.2%. Given that these policy changes will be in effect for the entirety of the next fiscal year, we expect the deficit to widen further to just north of $1 trillion in FY 2019.







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

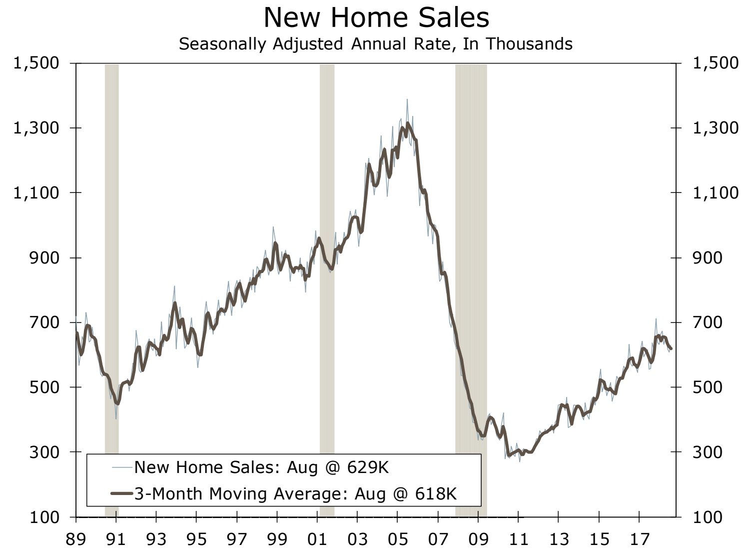
New Home Sales • Wednesday

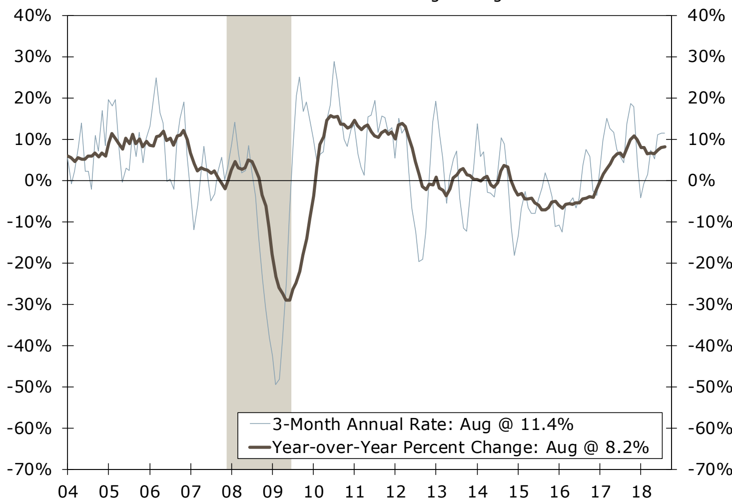
New home sales rose to a 629,000-unit pace in August, up 3.5% over the month after two consecutive months of declines. While sales are up nearly 7% year to date, rising mortgage rates could be restraining sales growth. Price appreciation has slowed from earlier this year, but the median new home price was still up 1.9% from a year ago in August. Sales in the Northeast rebounded sharply but fell 1.7% in the South, where most new sales occur, and could point to higher rates and prices weighing on buyers.

While affordability could still be a headwind, new home inventories have been steadily rising this year and should help relieve some price appreciation in coming months. Rising personal incomes and continued job growth should also be supportive of new home sales. However, a rising rate environment makes an upside breakout at this point in the cycle unlikely in our view. We look for new homes sales to fall to a 619,000-unit pace in September.

Previous: 629K **Wells Fargo: 619K**

Consensus: 625K





Durable Goods • Thursday

While durable goods orders rose 4.4% in August, much of the gain can be traced to a sharp pickup in the typically volatile aircraft component, up almost 70% on the month. Core capital goods orders fell 0.9%, and shipments in this category declined 0.2% in August. But data released earlier this week showed that business equipment production rose at an 8% rate in Q3, supporting a likely solid equipment spending reading in next week's GDP release. A 1.3% rise in defense capital goods shipments in August also bodes well for the Q3 pickup we forecast for government purchases.

While we look for orders to fall in September as equipment spending is likely still moderating from the highs registered in 2017, inventories look poised to contribute a sizable lift to Q3 GDP growth after proving a drag in Q2. Durable goods inventories rose at a 3.8% 3-month annualized rate in August, and we look for inventories to boost Q3 GDP growth 1.8 percentage points.

Previous: 4.4% **Wells Fargo: -1.3%**

Consensus: -1.3% (Month-over-Month)

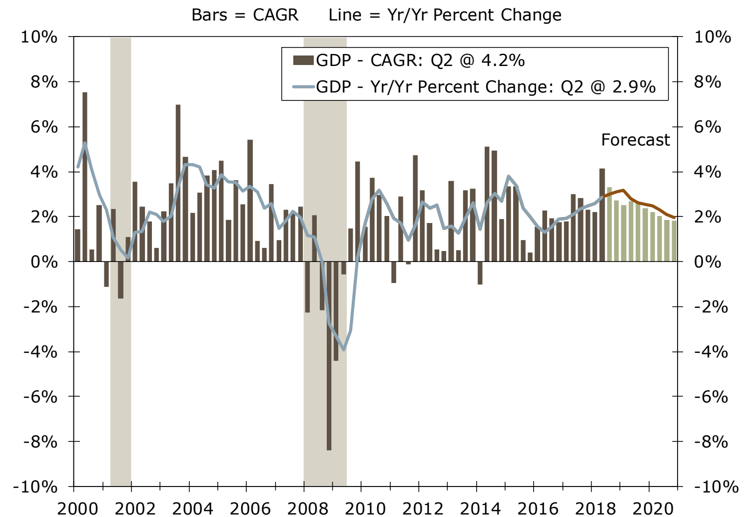
GDP • Friday

After rising at a robust 4.2% annualized rate in Q2, we look for Q3 GDP growth to clock in at a more moderate 3.3% annualized rate, as some components supporting the breakneck Q2 pace should pullback in Q3. We look for some payback in international trade after net exports contributed 1.2 percentage points to growth in Q2, partially due to record shipments for items such as soybeans as exporters attempted to get ahead of retaliatory tariffs. We expect consumer spending to register a 3.4% annualized pace in Q3, but income growth that is only slowly picking up and tightening financial conditions could weigh on spending growth in coming quarters.

Although trade should prove a drag, we look for inventories to contribute nearly 2 percentage points to topline growth after a large drawdown in Q2. Government spending should also pick up as the state and local sector continues to expand, and we see business investment maintaining a solid pace of growth in Q3.

Previous: 4.2% **Wells Fargo: 3.3%**

Consensus: 3.4% (Quarter-over-Quarter, Annualized)



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

Global Review

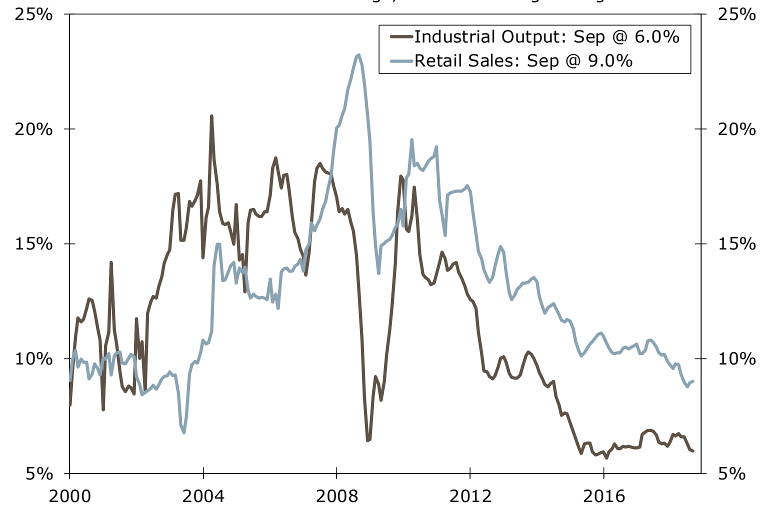
Chinese Economic Growth Continues to Edge Lower

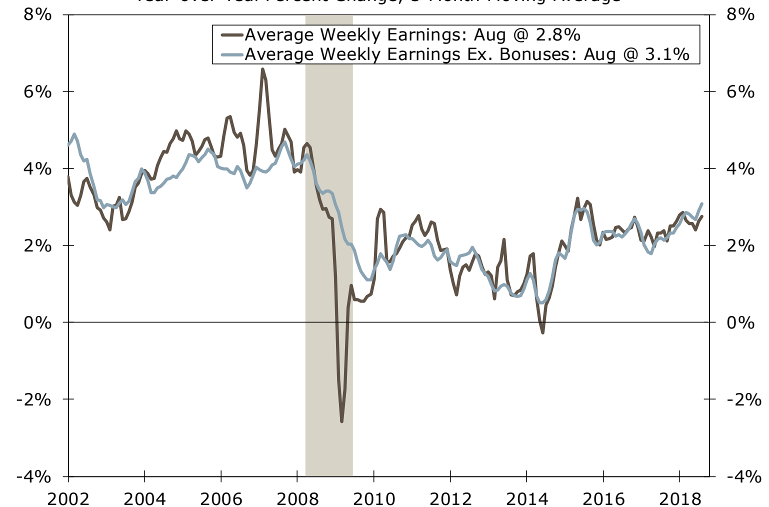
China remained at the center of market focus this week, with a number of key economic and policy developments. On the data front, China released growth and activity figures that were generally softer than expected. Real GDP growth slowed to 6.5% year over year in Q3, the slowest pace since 2009, while higher frequency activity numbers were more mixed. Retail sales accelerated slightly to 9.2% year over year in September, while growth in industrial output growth slowed to 5.8%. That mix of activity is probably a welcome development, given China's longer-term goal of rebalancing toward consumption and away from investment. However, as overall growth continues to show signs of slowing, there is potential for further monetary policy easing measures from China's central bank. As a reminder, the central bank has already cut its reserve requirement ratio (RRR) for major banks by a cumulative 250 bps to 14.50% in 2018, including a 100-bp cut at the start of this month, while interbank interest rates have generally trended lower since the start of this year. In other policy developments, the U.S. refrained from naming China a currency manipulator, although it ratcheted up its language with regard to recent Chinese currency developments.

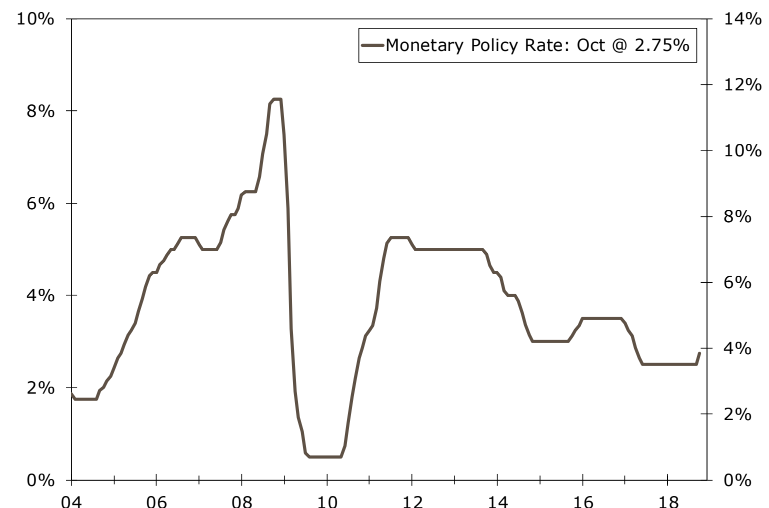
The United Kingdom was also in focus for markets this week. U.K. September inflation figures were softer than expected, with CPI inflation slowing more than expected to 2.4% year over year and core CPI inflation easing to 1.9%. However, the U.K. labor market report showed strong wage growth, telling a different story on U.K. price pressures. Excluding bonuses, wage growth during the three months to August firmed to 3.1% year over year, the quickest pace since 2009. U.K. price pressures will be important to monitor in the context of Bank of England monetary policy, which is likely hesitant to raise rates further in the near term, given ongoing Brexit uncertainty. Recent developments suggest that uncertainty around Brexit is unlikely to abate any time soon, as the E.U. and U.K. failed to strike a deal at this week's E.U. leadership summit. Officials noted that a deal may not be reached until December, although the timing and overall standing of negotiations is likely to remain fluid in the coming weeks. Meanwhile, reports indicated the U.K. parliament would not approve the withdrawal deal in its current form, a sign that even if a deal is reached by the Eurozone and United Kingdom, it may run into roadblocks when it comes to U.K. parliament for consideration.

Elsewhere, Canadian inflation and retail activity fell well short of expectations. Retail sales unexpectedly fell 0.1% month over month in August, while CPI inflation slowed sharply to 2.2% year over year in September. These weak data probably do not derail a Bank of Canada rate hike next week, but officials could adopt more cautious language with regard to future rate moves.

It was a mostly uneventful week for global central banks, with perhaps the one exception being Chile's central bank. After ending its rate cut cycle in early 2017, Chile's central bank raised its overnight rate target 25 bps to 2.75% amid above-trend growth and steadily rising inflation pressures.







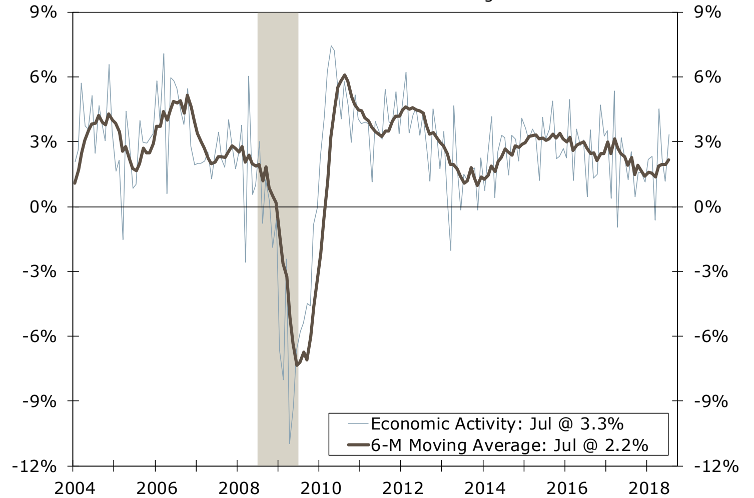
Source: Datastream, IHS Markit and Wells Fargo Securities

Mexico Economic Activity • Tuesday

Mexico's economy has shown some resilience in recent months, with the economic activity index accelerating since the start of the year. The industrial sector has led the way, with manufacturing and mining activity rebounding over the past few months, although more recently, the services sector has also seen a pickup in activity. The resilience in Mexican growth is notable particularly given monetary policy is still tight, with the central bank's policy rate of 7.75% well above the rate of inflation. Solid U.S. growth has probably helped, given Mexico's close economic ties to the U.S. economy.

Going forward, it will be particularly interesting to monitor investment figures in Mexico now that a "new NAFTA" deal (USMCA) has been reached. That reduction in uncertainty could bring some investment that has been on the sidelines until now, while strength in the U.S. economy should also continue to support Mexico's economy.

Previous: 3.3% (Year-over-Year)



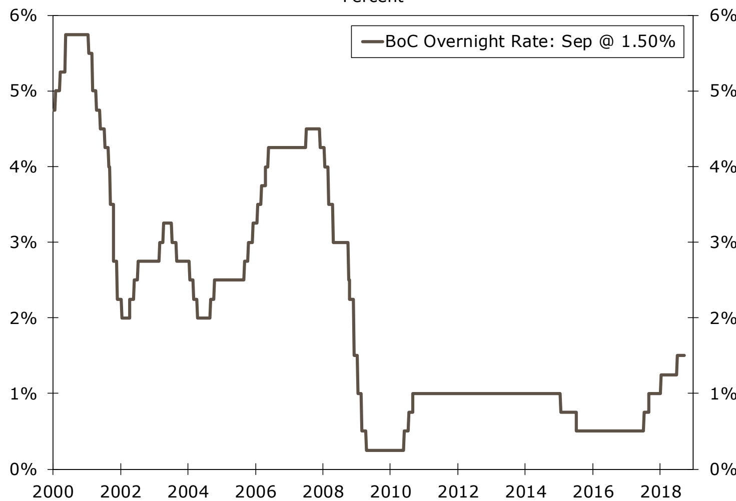
Bank of Canada • Wednesday

The Bank of Canada (BoC) is widely expected to raise its target for the overnight rate 25 bps to 1.75% at its meeting next week. The BoC has already raised rates a cumulative 100 bps since mid-2017, and an additional rate hike at next week's meeting would be consistent with an economy that continues to grow quicker than its potential rate of growth. While recent inflation figures were weaker than expected, core inflation remains solid in Canada and is right around the BoC's 2% target, suggesting further rate hikes are likely ahead.

Another sign the BoC will push ahead with additional rate increases in the coming quarters is the resolution of NAFTA uncertainty now that the USMCA has been agreed to by the United States, Mexico and Canada. BoC policymakers had noted that NAFTA uncertainty was a reason to be more cautious in their approach to policy, and the removal of that uncertainty should allow the central bank to return focus to constructive Canadian fundamentals.

Previous: 1.50% **Wells Fargo: 1.75%**

Consensus: 1.75%



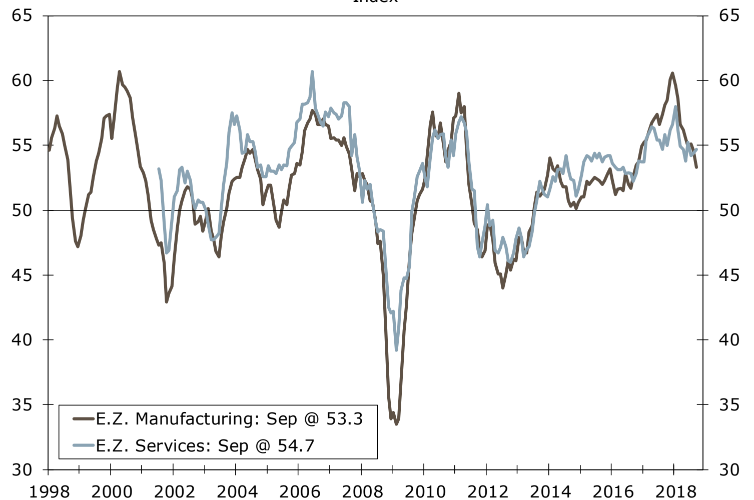
European Central Bank • Thursday

While the European Central Bank's (ECB) is unlikely to adjust policy at its announcement next week, the language and tone of the statement will be key to watch for clues on its next policy move. The ECB's current guidance is that it will end bond purchases in December and keep rates on hold at least through summer 2019. However, policymakers' recent comments have been leaning more hawkish, as ECB President Draghi discussed "vigorous" underlying inflation pressures and other policymakers have highlighted the possibility of bringing forward the timing of the first rate hike.

Also out next week are the manufacturing and service sector purchasing managers' indices (PMIs) for the Eurozone. These PMIs have clearly softened since the start of the year but remain firmly in expansion territory (i.e., above 50), consistent with an economy that is growing steadily, albeit modestly.

Previous: -0.40% **Wells Fargo: -0.40%**

Consensus: -0.40% (Deposit Rate)



Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

Interest Rate Watch

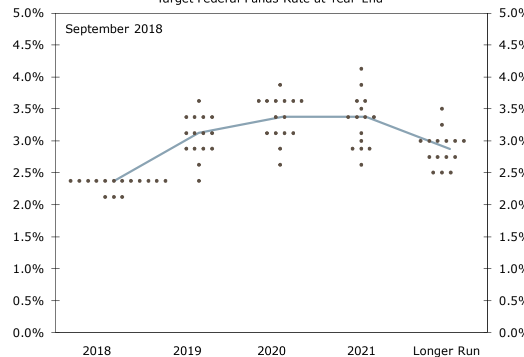
Lost in Translation?

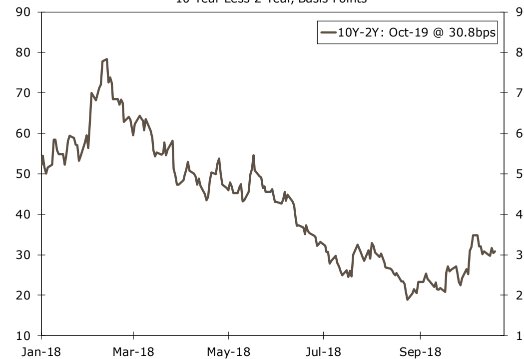
The minutes from the September FOMC meeting once again showed that the Fed's words have invoked more fear into the financial markets than their actions. Expectations for a rate hike in September were running around 100% when the Fed met. The odds of a rate hike in December, and further rate hikes in 2019, were also fairly high. What has changed since the meeting is that the rhetoric from the Fed, with the exception of a small minority of Federal Reserve Bank presidents, has become more hawkish. As a result, fears the Fed might hike rates faster, longer and to an ultimately higher level have increased.

Moral suasion or 'open mouth operations' is an important and often overlooked policy tool. The Fed's messaging to the markets is carefully crafted in policy statements and public comments. The message currently is that the economy is very strong and the majority of FOMC members believe the federal funds rate is still below its neutral level, despite removing the word accommodative from the last policy statement.

The intended target for the Fed's message is the financial markets, specifically the bond market, which appears to have been skeptical that the Fed would raise interest rates as much as implied by the Fed's dot plot. In the early years of the dot plot, the Fed overpromised and under delivered in terms of raising interest rates. This time, the Fed's rhetoric has coincided with this cycle's strongest run of economic growth and firming wage and inflation pressures. Treasury financial needs have also increased and the temporary boost in demand for securities to bolster private pensions has ended. The net result has been a pop in long-term interest rates and steepening of the yield curve.

With bond yields rising, equity prices have moved broadly lower. Housing activity has also cooled further, which has slowed the pace of price increases. While the Fed is not likely targeting asset prices, the recent moderation is likely not being viewed unfavorably. Asset prices are one of the few excesses that have built up in this cycle and a pullback or pause there might help extend this business cycle even further.





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

Credit Market Insights

Home Turnover and Equity

Existing home sales have now fallen for six consecutive months as the housing market continues to lose steam. Facing sharply higher financing costs, 78% of respondents now view renting as more affordable than buying, according to Freddie Mac survey data released this week. This proportion is up 11 points over just the past six months, as mortgage rates reached a seven-year high of 4.9% last week. Furthermore, 58% of renters say they have no plan to buy a home.

Related to this weakness in home sales is the depressed level of housing turnover. The ratio of home sales to housing stock remains a full third below the level reached in 2005. Why are homeowners staying put? For one, there has been a marked decline in interstate migration. The propensity of many—particularly Millennials—to rent rather than buy plays a role. The legacy of the Great Recession also looms large. Many homeowners refinanced at very low rates in the aftermath and are now opting to stay in their current home and build equity. Indeed, home equity rose to a record $14.4 trillion in 2017. And unlike the bevy of housing metrics that remain below their pre-crisis peaks, home equity surpassed its 2006 level by 2016 and continues to climb.

Of course, while this household deleveraging can be viewed as a positive for the financial health of the consumer sector, it nevertheless may be a factor behind the observed slowdown in the housing market. Thus, while the broader economy charges ahead, the housing market largely stays put.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.85%	4.90%	4.72%	3.88%
15-Yr Fixed	4.26%	4.29%	4.16%	3.19%
5/1 ARM	4.10%	4.07%	3.97%	3.17%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$2,228.0	31.49%	4.39%	5.21%
Revolving Home Equity	$353.3	-6.00%	-8.38%	-8.73%
Residential Mortgages	$1,871.8	-2.33%	8.70%	4.05%
Commerical Real Estate	$2,167.7	2.36%	6.74%	5.06%
Consumer	$1,483.5	8.58%	2.07%	6.14%

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

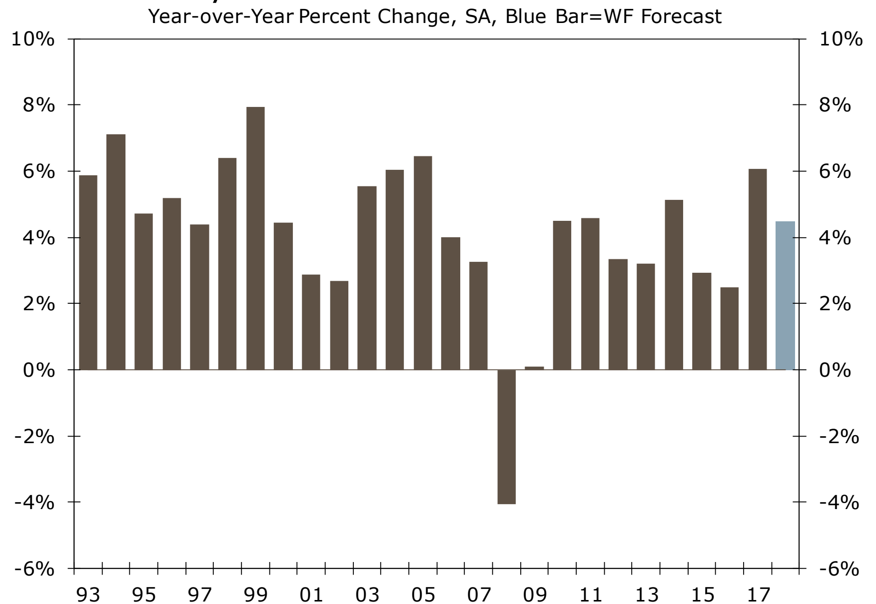
Topic of the Week

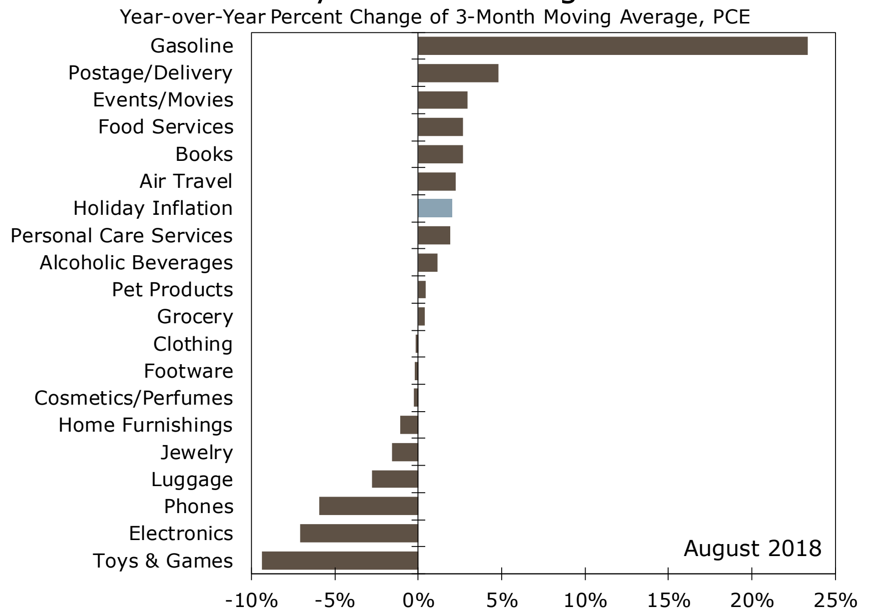
The Goose Is Getting Fat: Holiday Sales Outlook

Coming off the best holiday season in more than a decade last year, retailers are poised for another good year, at least in terms of the most important measure—sales. We already have data for the first nine months on the books for 2018. If we compare that to the same period in 2017, our measure of holiday sales–which excludes motor vehicles, gasoline and receipts at bars and restaurants–is up 4.8%. With consumer confidence surging and household financial conditions improving, there is scope for holiday sales to ramp up in the remaining months of the year. Strong spending momentum exists across almost all of the categories included in our spending measure of holiday sales. That momentum, coupled with the fact that on average, every category of holiday spending–with the exception of building and garden equipment retailers–sees its largest portion of annual sales take place in the month of December, points to a merry spending season for retailers. Overall, we expect holiday sales to increase about 4.5% this season.

This will be a record-tying 10th consecutive holiday season without a recession. But, a booming economy brings its own challenges. With sales set for another strong season, retailers are facing a challenge they have not seen in years: finding workers. The tight labor market makes it tricky and more costly to find seasonal workers, but it also makes services, which are more labor-intensive than goods, cost more. However, headed into the holiday season, prices for many traditional gifts are down compared to a year ago. Excluding gas form our inflation index of common holiday outlays, the holidays are likely to cost about 0.5% less than last year, although, that is the smallest decline in about three years. Yet, even if consumers are not seeing the same breaks in prices as in recent years, the holidays still look like a bargain compared to the broader economy, where inflation is up 2.2%

Our full report, takes a sneak peek inside the packages, boxes and bags to help you frame your thinking for the holiday shopping season, and how the labor market backdrop and price environment provide unique challenges at this late stage of the cycle.





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 10/19/2018	1 Week Ago	1 Year Ago
1-Month LIBOR	2.28	2.28	1.24
3-Month LIBOR	2.45	2.43	1.36
3-Month T-Bill	2.30	2.26	1.09
1-Year Treasury	2.58	2.60	1.43
2-Year Treasury	2.89	2.85	1.53
5-Year Treasury	3.04	3.01	1.95
10-Year Treasury	3.19	3.16	2.32
30-Year Treasury	3.38	3.33	2.84
Bond Buyer Index	4.35	4.37	3.53

Foreign Exchange Rates	Friday 10/19/2018	1 Week Ago	1 Year Ago
Euro ($/€)	1.150	1.156	1.185
British Pound ($/£)	1.305	1.315	1.316
British Pound (£/€)	0.881	0.879	0.901
Japanese Yen (¥/$)	112.480	112.210	112.540
Canadian Dollar (C$/$)	1.311	1.302	1.249
Swiss Franc (CHF/$)	0.997	0.993	0.976
Australian Dollar (US$/A$)	0.713	0.711	0.788
Mexican Peso (MXN/$)	19.166	18.860	18.805
Chinese Yuan (CNY/$)	6.929	6.922	6.614
Indian Rupee (INR/$)	73.325	73.573	65.040
Brazilian Real (BRL/$)	3.709	3.781	3.172
U.S. Dollar Index	95.872	95.221	93.266

Source: Bloomberg LP and Wells Fargo Securities

Foreign Interest Rates	Friday 10/19/2018	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.35	-0.36	-0.38
3-Month Sterling LIBOR	0.80	0.80	0.38
3-Month Canada Banker's Acceptance	2.13	2.09	1.43
3-Month Yen LIBOR	-0.08	-0.08	-0.03
2-Year German	-0.60	-0.56	-0.73
2-Year U.K.	0.79	0.84	0.42
2-Year Canadian	2.29	2.27	1.49
2-Year Japanese	-0.12	-0.11	-0.14
10-Year German	0.44	0.50	0.40
10-Year U.K.	1.56	1.63	1.28
10-Year Canadian	2.48	2.50	2.01
10-Year Japanese	0.15	0.15	0.07

Commodity Prices	Friday 10/19/2018	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	69.53	71.34	51.29
Brent Crude ($/Barrel)	80.41	80.43	57.23
Gold ($/Ounce)	1227.51	1217.95	1290.10
Hot-Rolled Steel ($/S.Ton)	826.00	835.00	595.00
Copper (¢/Pound)	276.70	280.05	316.75
Soybeans ($/Bushel)	8.07	8.01	9.50
Natural Gas ($/MMBTU)	3.23	3.16	2.87
Nickel ($/Metric Ton)	12,276	12,602	11,586
CRB Spot Inds.	483.26	483.45	498.07

Next Week's Economic Calendar

	Monday 22	Tuesday 23	Wednesday 24	Thursday 25	Friday 26
U.S. Data			**New Home Sales** August 625K September 619K (W)	**Durable Goods (YoY)** August 4.5% September -1.3% (W) **Pending Home Sales (MoM)** August -1.8% September -0.2% (C)	**GDP Annualized (QoQ)** Q2 4.2% Q3 3.3% (W)
Global Data		**Mexico** **Economic Acitivity Index (YoY)** July 3.3%	**Bank of Canada** **Rate Decision** Previous 1.50% **South Korea** **GDP (YoY)** Q2 2.8%	**European Central Bank** **Rate Decision** Previous -0.40% **Mexico** **Retail Sales (YoY)** July 4.2%	

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

Source: Bloomberg LP and Wells Fargo Securities

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