April 06, 2016

Economics Group

Monthly Outlook

U.S. Overview

Markets react to information that differs from what is expected. Already this year, we have witnessed a downgrade in expectations for equipment, nonresidential construction and residential spending, while comments by Federal Reserve officials suggest a path of Federal funds increases that exceed market expectations.

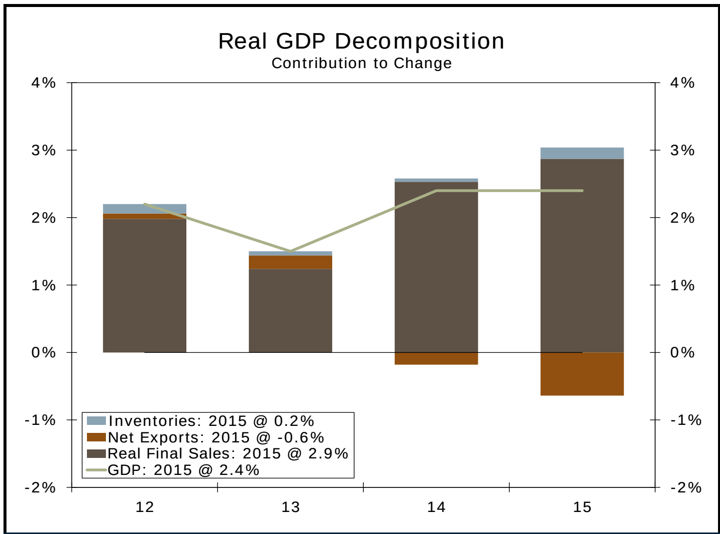
For domestic spending, consumer spending continues to support the growth narrative as job gains and wage improvements indicate continued real disposable income gains. Meanwhile, government spending will also take a step up. However, expectations for equipment and nonresidential structures have downshifted. The weakness in energy and broader commodity prices continues to weigh on these sectors. Overall, real final sales (left graph) remain in the 2.5 percent to 3 percent range.

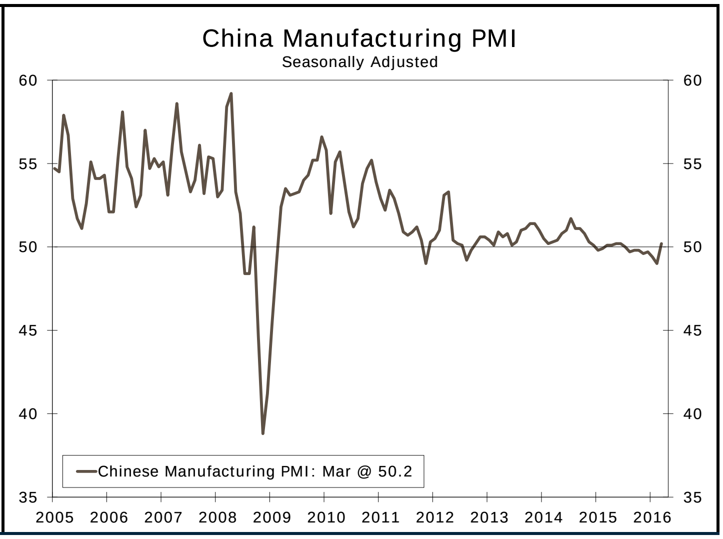
Inflation patterns are another major uncertainty. Expectations are that the year-over-year inflation measures will rise. But at what pace? Moreover, what does that tell us about the outlook for 2017? Given the outlook for growth and inflation, we suspect that the Fed will enact two increases in the funds rate, which is roughly in-line with the pace indicated by the Fed's dot plot. Yet, we anticipate that longer U.S. benchmark rates will rise less so that the yield curve and will flatten out in the year ahead. Given the rise in the funds rate and continued uncertainty over global growth, we anticipate the dollar's value will continue to rise in the year ahead.

International Overview

Global markets have calmed down considerably since the start of the year, with a second quarter that promises some cooler heads regarding the risks for the global economy. China surprised on the upside with March's manufacturing PMI crossing the 50-demarcation point, to 50.2, for the first time since July of last year (right graph). Additional "good" news recently has been the firming in oil prices, which largely preceded the decision by the U.S. Federal Open Market Committee (FOMC) to take back some of the expected increases in interest rates this year.

Still, it is too soon to celebrate as many concerns about the global economy remain. In Latin America, the Brazilian political crisis and economic meltdown continues with markets expecting President Rousseff to be impeached during the second or third quarter of the year. Moreover, the Brazilian economy continues to sink without anyone giving much credence to any potential for improvement. However, there seems to be a feeling that the worst has passed for emerging markets and the global economy and, even though it is probably too early to be sure, returns on emerging market bonds have improved considerably during the past several quarters. This tends to convey that capital seems to be "settling" down after several years of mayhem, as capital was reallocated across the global economy due to changes in monetary policy and growth prospects.





Source: U.S. Department of Commerce, IHS Global Insight and Wells Fargo Securities, LLC

Together we'll go far

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

Uncertainty Drives Volatility, Caution

Markets react to information that differs from what is expected. Entering this election year, the range of economic and political outcomes widens into an aging business cycle. Construction spending and factory orders both declined in February. As a result, we have witnessed a downgrade in expectations for first quarter equipment and nonresidential and residential construction spending.

On the plus side, consumer spending continues to support the growth narrative as job gains as well as wages and salary improvements indicate continued real disposable income gains. Meanwhile, government spending will also take a step up supported by gains in spending at the state and local level.

However, expectations for equipment and nonresidential structures have downshifted. The weakness in energy and broader commodity prices continues to weigh on these sectors. As a result, first quarter GDP is now expected to come in close to zero as trade subtracts about three-quarters of a percentage point from the overall GDP growth rate.

Weakness at the start of this year will impact business and consumer sentiment going forward, and therefore, the pace of consumer spending and business investment is likely to downshift relative to prior market expectations.

Inflation patterns are a major uncertainty. Expectations are that the year-over-year inflation measures will rise. But at what pace? Moreover, what does that tell us about the outlook for inflation in 2017?

For decision makers, the problem is that measured inflation will rise due to the low base of inflation a year ago. But, what about the underlying inflation fundamentals? Moreover, after the base effects, do these fundamentals signal further upward inflation looking into 2017? Our view is that the upward push from employment costs will be modest and that the outlook for inflation will also be very modest.

Fed Actions and the Yield Curve

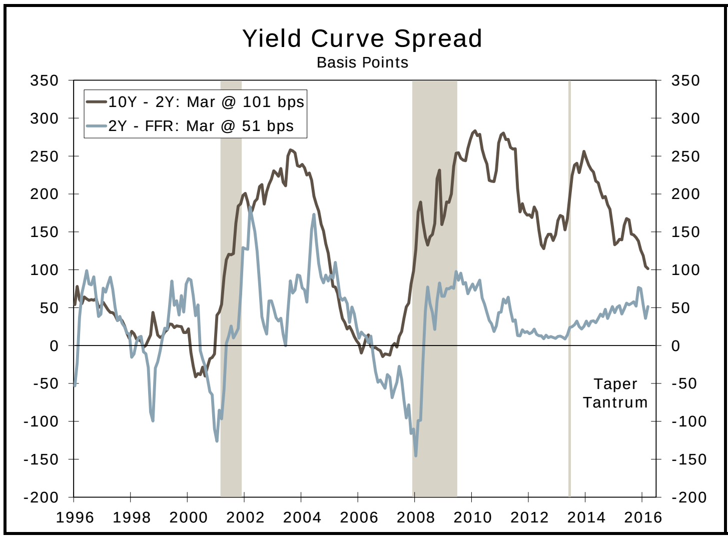
Although comments by Federal Reserve officials suggest a path of Federal funds increases that outperform market expectations, we anticipate that the Fed actions will remain at two increases in the funds rate this year, given the outlook for growth and inflation.

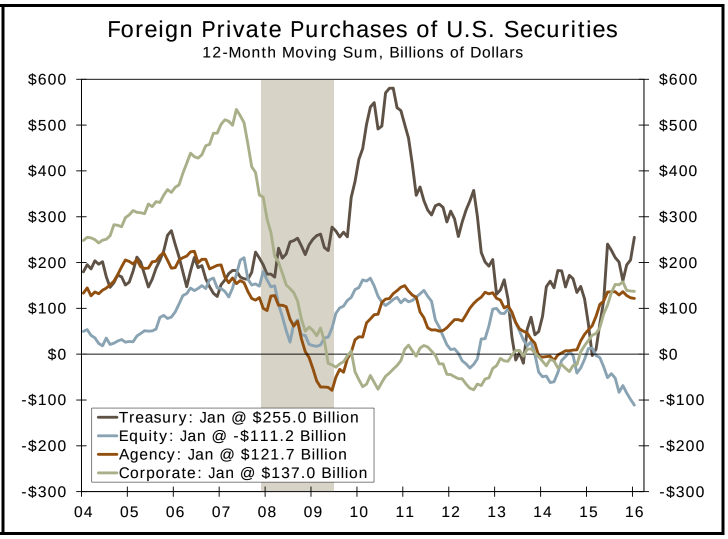
Meanwhile, we anticipate that longer U.S. benchmark rates will rise less so than the yield curve and will flatten out in the year ahead. Foreign demand for U.S. financial assets, including agencies, corporates and U.S. Treasury debt, has been very positive so far. However, there is a risk that foreign interest, especially from China and Brazil, may drop off sharply and thereby raise long-term rates above a level consistent with nominal GDP growth and Fed actions.

The Dollar

Given the rise in the funds rate and continued uncertainty over global growth, we anticipate the dollar's value will continue to rise in the year ahead, although the extent of the gain will be more modest than in 2015.

Over the past year, the sharp rise in the dollar has been concentrated in three of our major trading partners—Canada, Mexico and the Eurozone. Meanwhile, the dollar appreciation against China and Japan has been quite modest. Yet, the driving factor for the U.S. trade position has been global growth and the disappointing outlook for growth limits trade improvement.





Source: U.S. Department of the Treasury, Federal Reserve Board and Wells Fargo Securities, LLC

Wells Fargo U.S. Economic Forecast

	Actual								Forecast								Actual			Forecast	
	2014				2015				2016				2017				2013	2014	2015	2016	2017
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product (a)	-0.9	4.6	4.3	2.1	0.6	3.9	2.0	1.4	0.1	2.3	2.6	2.4	2.1	2.2	2.4	2.2	1.5	2.4	2.4	1.7	2.3
Personal Consumption	1.3	3.8	3.5	4.3	1.8	3.6	3.0	2.4	1.9	2.7	2.7	2.6	2.4	2.3	2.3	2.3	1.7	2.7	3.1	2.5	2.5
Business Fixed Investment	8.3	4.4	9.0	0.7	1.6	4.1	2.6	-2.1	-2.3	2.1	3.3	3.5	4.7	4.7	4.9	4.8	3.0	6.2	2.8	0.6	4.2
Equipment	3.5	6.5	16.4	-4.9	2.3	0.3	9.9	-2.1	-2.3	2.5	3.0	3.5	4.1	4.2	4.5	4.4	3.2	5.8	3.1	1.3	3.8
Intellectual Property Products	7.8	4.9	6.5	6.9	7.4	8.3	-0.8	-0.1	3.2	6.0	5.8	5.3	4.9	4.7	4.8	4.7	3.8	5.2	5.7	3.3	5.1
Structures	19.1	-0.2	-1.9	4.3	-7.4	6.2	-7.2	-5.1	-10.5	-5.0	0.0	0.5	6.0	6.0	6.0	6.0	1.6	8.1	-1.5	-5.1	3.5
Residential Construction	-2.7	10.4	3.4	9.9	10.1	9.4	8.2	10.1	9.0	9.0	9.0	8.5	8.5	8.5	8.0	8.0	9.5	1.8	8.9	9.1	8.5
Government Purchases	0.0	1.2	1.8	-1.4	-0.1	2.6	1.8	0.1	0.8	2.1	1.8	1.7	1.2	1.0	1.0	0.9	-2.9	-0.6	0.7	1.3	1.4
Net Exports	-434.0	-443.3	-429.1	-463.6	-541.2	-534.6	-546.1	-551.9	-584.3	-599.0	-616.8	-634.7	-654.2	-671.6	-687.7	-701.7	-417.5	-442.5	-543.5	-608.7	-678.8
Pct. Point Contribution to GDP	-1.4	-0.2	0.4	-0.9	-1.9	0.2	-0.3	-0.1	-0.8	-0.4	-0.4	-0.4	-0.5	-0.4	-0.4	-0.3	0.2	-0.2	-0.6	-0.4	-0.4
Inventory Change	36.9	77.1	79.9	78.2	112.8	113.5	85.5	78.3	70.0	65.0	70.0	70.0	64.0	60.0	61.0	55.0	61.4	68.0	97.5	68.8	60.0
Pct. Point Contribution to GDP	-1.3	1.1	0.0	0.0	0.9	0.0	-0.7	-0.2	-0.2	-0.1	0.1	0.0	-0.1	-0.1	0.0	-0.1	0.0	0.0	0.2	-0.2	-0.1
Nominal GDP (a)	0.6	6.9	6.0	2.2	0.8	6.1	3.3	2.3	0.6	4.6	4.7	4.3	4.2	4.2	4.4	4.5	3.1	4.1	3.5	3.1	4.3
Real Final Sales	0.4	3.5	4.3	2.1	-0.2	3.9	2.7	1.6	0.4	2.5	2.5	2.4	2.3	2.3	2.3	2.4	1.4	2.4	2.3	1.9	2.4
Retail Sales (b)	2.2	4.5	4.4	4.3	2.8	1.9	2.3	1.9	2.8	2.2	2.1	2.7	3.9	4.1	4.2	4.2	3.9	3.9	2.2	2.5	4.1
Inflation Indicators (b)																					
PCE Deflator	1.3	1.7	1.6	1.1	0.2	0.3	0.3	0.5	1.1	1.1	1.3	1.6	2.0	1.9	2.0	2.1	1.4	1.4	0.3	1.3	2.0
Consumer Price Index	1.4	2.0	1.8	1.2	-0.1	0.0	0.1	0.4	1.2	1.2	1.5	1.9	2.4	2.3	2.2	2.2	1.5	1.6	0.1	1.4	2.3
"Core" Consumer Price Index	1.6	1.9	1.8	1.7	1.7	1.8	1.8	2.0	2.3	2.2	2.3	2.2	2.1	2.1	2.1	2.2	1.8	1.7	1.8	2.3	2.1
Producer Price Index (Final Demand)	1.4	2.0	1.8	1.2	-0.5	-0.8	-1.0	-1.2	0.0	0.4	0.8	1.8	2.3	2.2	2.2	2.2	1.4	1.6	-0.9	0.8	2.2
Employment Cost Index	1.8	2.0	2.2	2.3	2.6	2.0	2.0	2.0	1.9	2.3	2.4	2.5	2.6	2.6	2.7	2.8	1.9	2.1	2.1	2.3	2.7
Real Disposable Income (a)	4.0	3.0	2.7	4.7	3.9	2.6	3.2	2.3	3.4	2.8	2.8	2.8	2.7	2.7	2.6	2.6	-1.4	2.7	3.4	2.9	2.7
Nominal Personal Income (b)	3.9	4.2	4.5	5.2	4.5	4.5	4.5	4.0	4.2	4.0	4.1	4.4	4.5	4.5	4.4	4.4	1.1	4.4	4.4	4.2	4.4
Industrial Production (a)	2.2	5.5	2.5	3.7	-1.9	-2.7	1.5	-3.2	-0.6	1.4	1.1	2.2	2.6	2.2	1.1	2.5	1.9	2.9	0.3	-0.2	2.0
Capacity Utilization	77.6	78.4	78.4	78.6	77.7	76.6	76.6	75.8	75.6	75.9	76.1	76.6	76.8	77.0	77.2	77.3	76.9	78.2	76.7	76.1	77.1
Corporate Profits Before Taxes (b)	-3.6	1.2	5.8	3.4	4.6	0.6	-5.1	-11.5	-3.3	-0.7	1.9	1.8	1.5	1.8	1.7	1.7	2.0	1.7	-3.1	-0.1	1.6
Corporate Profits After Taxes	-7.5	-2.6	4.9	2.7	4.7	-0.6	-8.2	-15.0	-4.3	-2.2	0.8	1.1	1.1	1.4	1.4	1.4	1.2	-0.6	-5.1	-1.2	1.3
Federal Budget Balance (c)	-241	47	-117	-177	-263	123	-123	-216	-187	13	-185	-180	-180	-40	-190	-160	-680	-484	-439	-575	-590
Current Account Balance (d)	-96.4	-92.0	-97.9	-103.1	-118.0	-110.8	-129.9	-125.3	-130.0	-135.0	-140.0	-145.0	-150.0	-155.0	-155.0	-160.0	-376.8	-389.5	-484.1	-550.0	-620.0
Trade Weighted Dollar Index (e)	76.7	75.8	81.1	85.1	92.1	90.0	92.3	94.5	89.8	89.8	91.5	93.3	94.8	96.3	97.0	96.5	75.9	78.4	91.1	91.1	96.1
Nonfarm Payroll Change (f)	209	276	245	274	190	251	192	282	209	185	185	180	175	170	165	160	193	251	229	190	168
Unemployment Rate	6.7	6.2	6.1	5.7	5.6	5.4	5.2	5.0	4.9	4.8	4.7	4.6	4.5	4.5	4.4	4.4	7.4	6.2	5.3	4.7	4.5
Housing Starts (g)	0.93	0.98	1.03	1.06	0.98	1.16	1.16	1.14	1.17	1.22	1.23	1.24	1.24	1.25	1.26	1.28	0.92	1.00	1.11	1.20	1.25
Light Vehicle Sales (h)	15.8	16.5	16.7	16.8	16.7	17.1	17.8	17.8	17.1	17.2	17.1	17.0	16.9	16.8	16.7	16.6	15.5	16.4	17.3	17.1	16.8
Crude Oil - Brent - Front Contract (i)	107.6	109.5	103.7	77.3	55.6	63.9	51.6	45.0	35.2	38.5	43.5	46.5	47.0	51.0	57.0	52.0	108.4	99.5	54.0	40.9	51.8
Quarter-End Interest Rates (j)																					
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.75	2.00	0.25	0.25	0.27	0.75	1.63
3 Month LIBOR	0.23	0.23	0.24	0.26	0.27	0.28	0.33	0.61	0.63	0.95	0.95	1.20	1.45	1.70	1.95	2.20	0.27	0.23	0.32	0.93	1.83
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.50	3.75	3.75	4.00	4.25	4.50	4.75	5.00	3.25	3.25	3.27	3.75	4.63
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.77	3.98	3.89	3.96	3.69	3.89	3.95	4.06	4.12	4.26	4.33	4.42	3.98	4.17	3.85	3.90	4.28
3 Month Bill	0.05	0.04	0.02	0.04	0.03	0.01	0.00	0.16	0.21	0.61	0.69	0.87	1.15	1.30	1.57	1.87	0.06	0.03	0.05	0.60	1.47
6 Month Bill	0.07	0.07	0.03	0.12	0.14	0.11	0.08	0.49	0.39	0.67	0.78	0.92	1.18	1.40	1.63	1.95	0.09	0.06	0.17	0.69	1.54
1 Year Bill	0.13	0.11	0.13	0.25	0.26	0.28	0.33	0.65	0.59	0.82	0.93	1.01	1.29	1.52	1.79	2.03	0.13	0.12	0.32	0.84	1.66
2 Year Note	0.44	0.47	0.58	0.67	0.56	0.64	0.64	1.06	0.73	1.08	1.20	1.34	1.57	1.81	1.97	2.08	0.31	0.46	0.69	1.09	1.86
5 Year Note	1.73	1.62	1.78	1.65	1.37	1.63	1.37	1.76	1.21	1.58	1.67	1.74	1.84	1.94	2.05	2.14	1.17	1.64	1.53	1.55	1.99
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.35	2.06	2.27	1.78	1.94	2.01	2.13	2.22	2.38	2.47	2.54	2.35	2.54	2.14	1.97	2.40
30 Year Bond	3.56	3.34	3.21	2.75	2.54	3.11	2.87	3.01	2.61	2.69	2.78	2.84	2.89	2.95	3.00	3.05	3.45	3.34	2.84	2.73	2.97

Forecast as of: April 6, 2016

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) Quarterly Sum - Billions USD
(e) Federal Reserve Major Currency Index, 1973=100 - Quarter End
(f) Average Monthly Change
(g) Millions of Units - Annual Data - Not Seasonally Adjusted
(h) Quarterly Data - Average Monthly SAAR; Annual Data - Actual Total Vehicles Sold
(i) Quarterly Average of Daily Close
(j) 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, LLC

Relative Calm after the Tempest

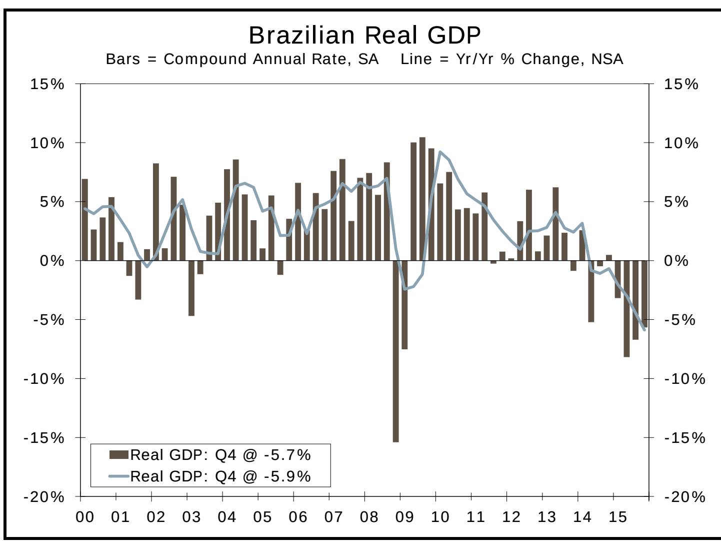
Global markets have calmed down considerably since the start of the year with a second quarter that promises some cooler heads regarding the risks for the global economy. For starters, China surprised on the upside with March's manufacturing PMI crossing the 50-demarcation point, to 50.2, for the first time since July of last year, while the service sector PMI strengthened further, to the highest reading since December 2015. Still, the level for the manufacturing PMI is just slightly above 50, which is marginally better compared to the previous month's reading of 49.0. However, the fact that it is not falling anymore could be a signal that the measures taken by the Chinese government are starting to make some inroads. The global economy and emerging markets in particular, are probably happy to see some improvement in the growth prospects of the Chinese economy.

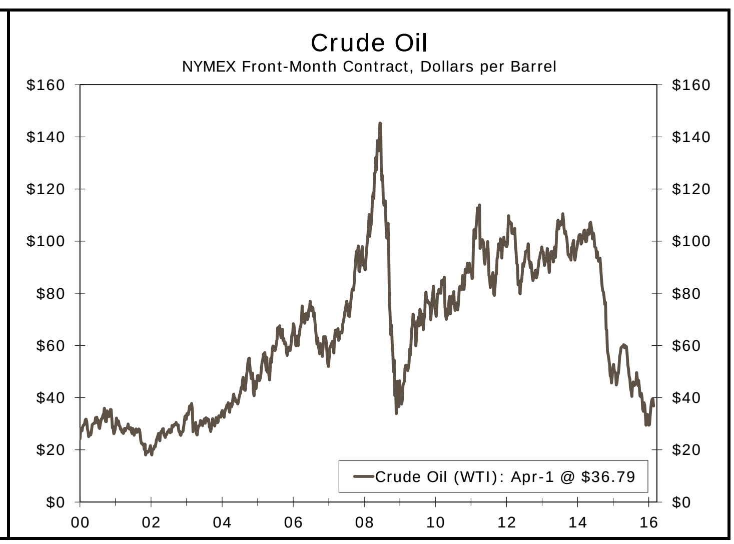
Additional "good" news recently has been the firming in oil prices, which largely preceded the decision by the U.S. FOMC to take back some of the expected increases in interest rates this year, from a potential of four rate increases to only two. Furthermore, the more dovish stance by the Federal Reserve has also pushed the U.S. dollar lower, which is a bit more supportive of at least stable commodity prices.

Still, it is too soon to celebrate as many concerns about the global economy remain. In Latin America, the Brazilian political crisis and economic meltdown continues with markets expecting President Rousseff to be impeached during the second or third quarter of the year. Moreover, the economy continues to sink without anyone giving much credence to any potential for improvement. Meanwhile, markets are also watching the performance of the Mexican economy as the government has had to continuously decrease fiscal expenditures to adjust to the collapse in oil prices over the past almost two years. At the same time, Moody's decision to change Mexico's outlook to negative from stable is another indication that Brazil is not the only one facing issues due to weak global growth and still "low" petroleum prices.

On the more positive side, Argentina's senate just approved the government's proposal to end the fight with the "vulture" funds after more than 10 years of litigation. With these changes to Argentine laws that prevented a solution, markets are expecting the country to start taping global credit markets and credit markets are "salivating" with the potential of higher yields as the country issues debt in the international market for the first time since before 2001. Of course, the return to the international financial markets will not be cheap for the country in terms of yields as well as indebtedness but it is something that needed to be done sooner rather than later. Furthermore, although Argentina's economy is expected to improve, the new administration will have to untangle the cobweb of subsidies created by the previous administration, which means inflation will continue to rise in the short to medium term.

There seems to be a feeling that the worse has passed for emerging markets and the global economy and even though it is probably too early to be sure, returns on emerging market bonds have improved considerably during the past several quarters. This tends to convey that capital seems to be "settling" down after several years of mayhem as capital was reallocated across the global economy due to changes in monetary policy and growth prospects. Still, it is too early to know if this better expectation on emerging market potential growth is sustainable or just a temporary hiatus in the capital reallocation process or if it has teeth. However, for now, markets seem to be giving it the benefit of doubt, and that could be all that is needed to give a boost to expectations on future growth after a very difficult couple of years.





Source: IHS Global Insight and Wells Fargo Securities, LLC

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2015	2016	2017	2015	2016	2017
Global (PPP Weights)	2.9%	2.8%	3.2%	3.3%	3.3%	3.6%
Global (Market Exchange Rates)	2.8%	2.5%	3.0%	n/a	n/a	n/a
Advanced Economies[1]	2.0%	1.7%	2.2%	0.2%	0.9%	1.8%
United States	2.4%	1.7%	2.3%	0.1%	1.4%	2.3%
Eurozone	1.5%	1.7%	2.0%	0.0%	0.3%	1.1%
United Kingdom	2.3%	1.6%	1.9%	0.1%	0.7%	1.5%
Japan	0.5%	-0.1%	0.7%	0.8%	0.4%	1.1%
Korea	2.6%	2.7%	3.1%	0.7%	0.9%	1.9%
Canada	1.2%	1.8%	2.5%	1.1%	1.3%	1.9%
Developing Economies[1]	3.7%	3.8%	4.2%	6.1%	5.6%	5.3%
China	6.9%	6.3%	5.8%	1.4%	2.0%	1.9%
India[2]	7.2%	7.5%	7.2%	6.0%	4.9%	4.9%
Mexico	2.5%	2.4%	2.6%	2.7%	3.2%	3.2%
Brazil	-3.9%	-3.5%	1.4%	9.0%	9.6%	8.4%
Russia	-3.7%	-0.5%	2.2%	15.6%	7.4%	6.1%

Forecast as of: April 6, 2016

[1]Aggregated Using PPP Weights [2]Forecasts Refer to Fiscal Year

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond				
	2016			2017			2016			2017	
	Q2	Q3	Q4	Q1	Q2	Q3	Q2	Q3	Q4	Q1	Q2
U.S.	0.95%	0.95%	1.20%	1.45%	1.70%	1.95%	1.94%	2.01%	2.13%	2.22%	2.38%
Japan	-0.02%	-0.05%	-0.10%	-0.10%	-0.10%	-0.05%	-0.10%	-0.10%	-0.05%	0.00%	0.02%
Euroland[1]	-0.27%	-0.30%	-0.30%	-0.30%	-0.25%	-0.20%	0.15%	0.20%	0.30%	0.40%	0.55%
U.K.	0.58%	0.58%	0.65%	0.90%	0.95%	1.15%	1.50%	1.60%	1.70%	2.00%	2.10%
Canada[2]	0.90%	0.90%	0.95%	1.00%	1.25%	1.50%	1.30%	1.35%	1.50%	1.70%	1.80%

Forecast as of: April 6, 2016

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

Source: Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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