

# Economics Group

## MONTHLY OUTLOOK

### U.S. Overview

#### The New Year Is Off to a Strong Start

The United States appears to have completed 2017 on a solid note, with holiday retail sales easily topping consensus expectations. Capital spending also finished the year on a solid note, although the most recent factory orders and shipments data pulled back a bit from their recent torrid pace. Home sales and housing starts also perked back up following some earlier distortions tied to the late summer hurricanes. We expect that real GDP grew at a 2.2 percent pace during the fourth quarter and 2.2 percent for 2017 as a whole. The coming year should see stronger growth, with real GDP rising 2.8 percent.

The recently enacted tax reform creates some potential upside risks for the economy in the near term. Lower tax rates will provide a much needed boost to take-home pay, which has lagged behind consumer spending in recent months. Business fixed investment may also be touch stronger. We had expected tax reform in our forecast, however, so we only need to adjust for the time and some of the latest specifics.

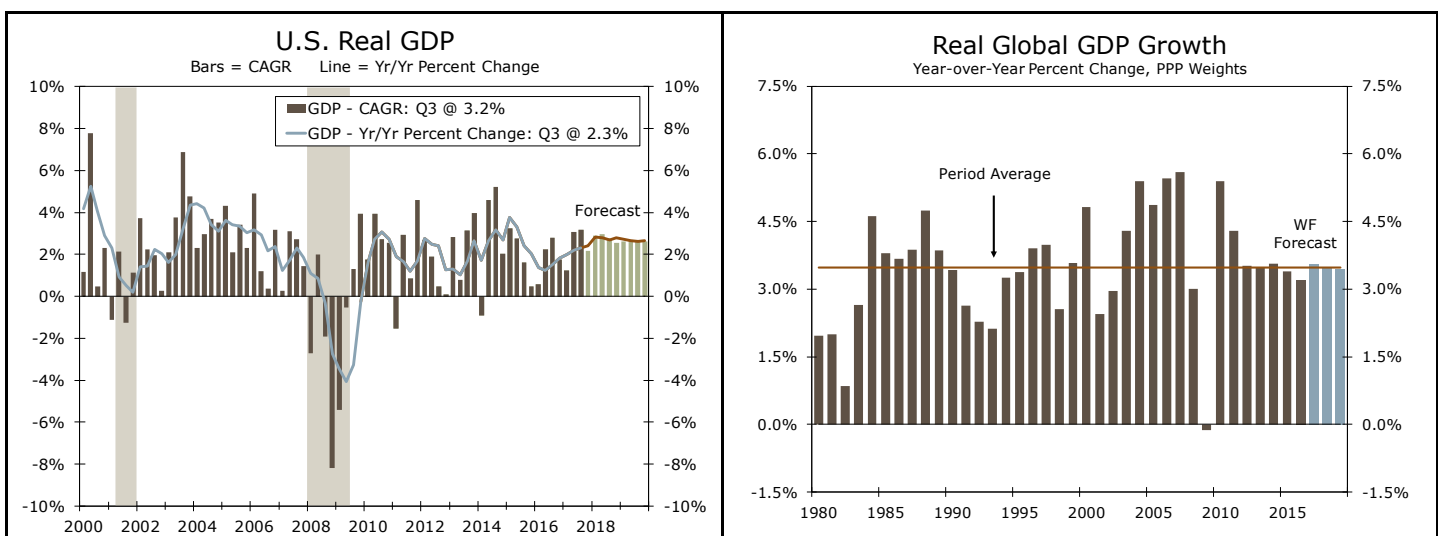
The new tax law is taking effect at a time when the economy, by most traditional measures, is at full employment. This is raising concerns that the Fed may need to hike interest rates a bit more aggressively than the three quarter-point hikes implied by its most recent Summary of Economic Projections. We do not share this concern. Improvement is only now reaching many areas, including large parts of the South and Midwest. There is scant evidence that inflation is about to break out to the upside. Overheating may yet be an issue but most likely not in 2018.

### International Overview

#### Global Economic Expansion to Continue in 2018

The global economy is expected to continue its expansion in 2018, even as historically expansive monetary measures taken across the globe since the Great Recession are slowly being undone by the major central banks. Still, today, it is only the U.S. Federal Reserve, and to a lesser degree the Bank of Canada that seem to be charging ahead, with other large central banks starting to revise their views on their own policies to accommodate for higher economic growth and even the potential of higher inflation.

Perhaps one of the caveats that would probably make economic growth in the United States stronger than in some other developed countries is the stance of fiscal policy in that country. This is what seems to be driving some of the emphasis on interest rates in the United States as the U.S. Congress passed a fiscal package that could add several decimal points to economic growth in the U.S. economy in the coming years. We also remain concerned with several risks that are political in nature and as we argued in our recent report, [The Global Economic Expansion: Mind the Risks](#), available on our website, are difficult to quantify. However, for now, we remain positive for the global economy as we enter 2018, even if we agree that upward surprises in economic growth as well as inflation could make central bankers in the large developed countries pull the levers of monetary policy across the world faster than what we currently foresee.



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



**Will 2018 Be a Goldilocks Type of Year?**

The economy appears to have had strong momentum at the end of 2017. Holiday retail sales appear to have topped expectations, with online and traditional retailers posting strong sales. We estimate real personal consumption rose at a 3.0 percent annual rate during the fourth quarter, once again easily outpacing the growth in real take-home pay. The saving rate has fallen 0.8 percentage points over the past year to 2.9 percent. In the past, consumer spending has pulled back after such as a strong run and that may happen again in early 2018.

The recent strength in consumer spending appears to be driven by growing confidence about employment and income prospects, as well as the persistent rise in the stock market. The Consumer Confidence Index has risen 9.4 percent over the past year, with the increase in the proportion of consumers stating that jobs are plentiful providing much of the increase. The run-up in share prices that has taken the Dow Jones Industrial Average past the 25,000 mark may also be sparking a bit of a wealth effect, which is giving consumers the confidence to spend a larger portion of their earnings.

December's employment data were somewhat disappointing, with payrolls adding just 148,000 jobs during the month and gains for the prior months were revised slightly lower. For the year, an average of 171,000 jobs were added each month and the unemployment rate fell 0.7 percentage points to 4.1 percent. The labor force grew by just an average of 160,000 per month, which suggests that the economy has not all that much slack available.

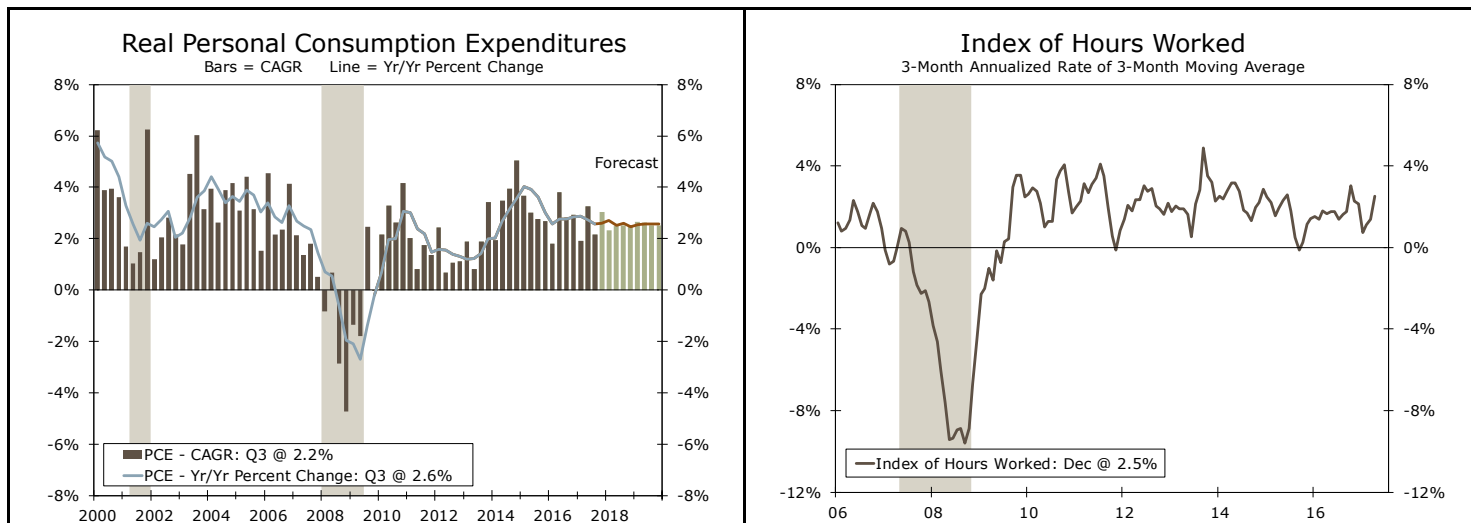
While the overall number of jobs added in December was less than expected, the composition is encouraging. Manufacturing employment increased by 25,000 jobs in December and has risen by 196,000 jobs in 2017. Construction employment also increased solidly, with gains in residential and nonresidential categories. Construction activity benefitted from unseasonably mild weather during most of the fourth quarter. Those conditions now seem like a distant memory.

The rise in the production categories bodes well for GDP growth. Aggregate hours worked rose at a 2.5 percent pace during the quarter and, with minimal productivity gains, would imply that output expanded solidly during the quarter. While that presents some upside risks to our GDP forecast, inventory building slowed during the quarter and the trade deficit likely widened significantly. Combined the two are expected to subtract 1.1 percentage points from fourth quarter growth.

Stronger economic growth may also push inflation higher. In past business cycles, the Federal Reserve would have likely been proactive at tightening policy ahead of a potential acceleration in inflation. With the core PCE deflator stuck well below 2 percent, however, and little sign of an imminent pick up, most Fed policymakers feel they now have the luxury of waiting to see if labor force growth and productivity growth will rebound and give the aging expansion more room to run.

One critical question for policymakers is whether growth will revive in parts of the economy that have not seen all that much growth, principally business fixed investment outside of oil and gas exploration and single-family home construction. The evidence is encouraging. The recent strength in the ISM surveys and diffusion indices in the employment report suggests that the economic growth is broadening to include more industries, which should produce only minimal inflationary pressures. We see overall inflation headed toward 2 percent over the course of the year, which should cause the Fed to remain on its cautious and measured pace in hiking short-term interest rates.

With interest rates remaining low, the housing market should continue to gain momentum. The strong numbers reported for the fourth quarter probably exaggerated the extent of the improvement, however. Sales and housing starts had been helped by unseasonably warm weather and a rebound following disruptions from the hurricanes. We look for housing starts to rise 8.3 percent this year to a 1.31 million unit pace. Most of that gain will come from increased single-family starts.



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

Wells Fargo U.S. Economic Forecast																					
	Actual								Forecast								Actual		Forecast		
	2016				2017				2018				2019				2015	2016	2017	2018	2019
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product (a)	0.6	2.2	2.8	1.8	1.2	3.1	3.2	2.2	2.9	3.0	2.7	2.6	2.6	2.7	2.6	2.6	2.9	1.5	2.2	2.8	2.7
Personal Consumption	1.8	3.8	2.8	2.9	1.9	3.3	2.2	3.0	2.3	2.5	2.5	2.5	2.7	2.6	2.5	2.5	3.6	2.7	2.7	2.6	2.6
Business Fixed Investment	-4.0	3.3	3.4	0.2	7.2	6.7	4.7	6.8	6.6	5.9	5.5	4.7	4.2	4.6	4.5	4.1	2.3	-0.6	4.7	6.0	4.7
Equipment	-13.1	-0.6	-2.1	1.8	4.4	8.8	10.8	10.4	8.0	6.9	6.0	4.7	4.0	4.6	4.4	3.9	3.5	-3.4	4.7	8.2	4.7
Intellectual Property Products	6.3	11.1	4.2	-0.4	5.7	3.7	5.2	4.1	7.2	6.5	6.4	6.2	5.4	6.0	5.9	5.6	3.8	6.3	4.1	5.9	5.9
Structures	2.3	0.5	14.3	-2.2	14.8	7.0	-7.0	1.5	2.5	2.4	2.4	2.2	2.5	2.4	2.4	2.4	-1.8	-4.1	5.3	1.3	2.4
Residential Construction	13.4	-4.7	-4.5	7.1	11.1	-7.3	-4.7	9.0	6.0	8.0	7.5	7.0	5.5	6.0	6.0	4.5	10.2	5.5	1.6	4.9	6.3
Government Purchases	1.8	-0.9	0.5	0.2	-0.6	-0.2	0.7	2.7	0.6	1.2	1.2	0.9	0.8	0.8	0.8	0.8	1.4	0.8	0.1	1.2	0.9
Net Exports	-584.2	-572.4	-557.3	-631.1	-622.2	-613.6	-597.5	-633.0	-643.5	-655.6	-662.8	-670.1	-674.1	-678.2	-679.5	-679.1	-545.3	-586.2	-616.6	-658.0	-677.7
Pct. Point Contribution to GDP	-0.3	0.3	0.4	-1.6	0.2	0.2	0.4	-0.8	-0.2	-0.3	-0.2	-0.2	-0.1	-0.1	0.0	0.0	-0.7	-0.2	-0.2	-0.2	-0.1
Inventory Change	40.6	12.2	17.6	63.1	1.2	5.5	38.5	27.0	40.0	50.0	48.0	45.0	44.0	43.0	40.0	40.0	100.5	33.4	18.0	45.8	41.8
Pct. Point Contribution to GDP	-0.6	-0.7	0.2	1.1	-1.5	0.1	0.8	-0.3	0.3	0.2	0.0	-0.1	0.0	0.0	-0.1	0.0	0.2	-0.4	-0.1	0.2	0.0
Nominal GDP (a)	0.8	4.7	4.2	3.8	3.3	4.1	5.3	5.0	6.0	5.0	4.6	4.2	4.9	5.1	5.0	4.2	4.0	2.8	4.1	5.1	4.7
Real Final Sales	1.2	2.9	2.6	0.7	2.7	3.0	2.4	2.9	2.6	2.7	2.8	2.6	2.7	2.7	2.7	2.6	2.6	1.9	2.4	2.7	2.7
Retail Sales (b)	2.9	2.7	2.6	3.8	5.1	3.9	4.1	5.2	5.4	6.3	6.5	5.2	5.3	5.3	5.1	5.0	2.6	3.0	4.6	5.9	5.2
Inflation Indicators (b)																					
PCE Deflator	1.0	1.0	1.2	1.6	2.0	1.6	1.5	1.7	1.9	2.3	2.4	2.1	1.9	2.0	2.1	2.1	0.3	1.2	1.7	2.1	2.0
"Core" PCE Deflator	1.6	1.7	1.8	1.9	1.8	1.5	1.4	1.5	1.5	1.7	1.8	1.8	1.9	1.8	1.9	1.9	1.3	1.8	1.5	1.7	1.9
Consumer Price Index	1.1	1.1	1.1	1.8	2.6	1.9	2.0	2.1	2.2	2.7	2.7	2.1	1.8	2.0	2.2	2.3	0.1	1.3	2.1	2.4	2.1
"Core" Consumer Price Index	2.2	2.2	2.2	2.2	2.2	1.8	1.7	1.7	1.6	2.0	2.1	2.1	2.1	2.0	2.1	2.1	1.8	2.2	1.8	2.0	2.1
Producer Price Index (Final Demand)	0.0	0.1	0.2	1.4	2.0	2.2	2.3	2.9	2.8	2.8	2.9	2.3	2.1	2.2	2.3	2.4	-0.9	0.4	2.3	2.7	2.3
Employment Cost Index	1.9	2.3	2.3	2.2	2.4	2.4	2.5	2.6	2.4	2.5	2.5	2.6	2.6	2.6	2.7	2.7	2.1	2.2	2.5	2.5	2.7
Real Disposable Income (a)	0.2	1.9	0.7	-1.8	2.9	2.7	0.5	2.1	2.3	2.5	2.5	2.5	3.5	2.6	2.6	2.6	4.2	1.4	1.3	2.1	2.8
Nominal Personal Income (b)	2.9	2.5	2.6	1.6	3.1	2.7	2.6	3.7	3.3	3.6	3.9	3.8	4.2	4.7	4.8	4.8	5.0	2.4	3.1	3.6	4.6
Industrial Production (a)	-1.3	-0.7	0.8	0.7	1.5	5.6	-0.9	5.8	2.4	2.2	2.3	2.1	2.5	2.3	2.3	2.3	-0.7	-1.2	1.9	2.8	2.3
Capacity Utilization	75.8	75.7	75.8	75.8	75.8	76.6	76.2	77.0	77.0	77.2	77.4	77.5	77.7	77.8	78.0	78.0	76.8	75.7	76.4	77.3	77.9
Corporate Profits Before Taxes (b)	-6.2	-8.2	-1.6	8.7	3.3	6.3	5.3	3.8	3.4	3.2	3.1	3.1	3.0	2.9	2.8	2.8	-1.1	-2.1	4.7	3.2	2.9
Corporate Profits After Taxes	-4.2	-8.0	-2.2	14.1	3.7	7.8	7.7	3.2	3.1	3.8	3.6	3.6	3.5	2.6	2.6	2.5	-1.5	-0.5	5.5	3.5	2.8
Federal Budget Balance (c)	-245	60	-187	-210	-317	4	-143	-319	-266	25	-190	-365	-300	-55	-230	-375	-439	-587	-666	-750	-950
Current Account Balance (d)	-119.2	-108.2	-110.3	-114.0	-113.5	-124.4	-100.6	-123.0	-130.0	-130.0	-135.0	-140.0	-140.0	-145.0	-145.0	-150.0	-434.6	-451.7	-461.5	-535.0	-580.0
Trade Weighted Dollar Index (e)	89.8	90.6	90.0	95.8	94.0	90.5	88.1	87.5	86.5	85.5	84.3	82.8	81.5	80.5	79.5	78.5	91.1	91.6	91.1	84.8	80.0
Nonfarm Payroll Change (f)	196	164	239	148	166	187	128	204	170	165	160	155	150	150	145	145	226	187	171	163	148
Unemployment Rate	4.9	4.9	4.9	4.7	4.7	4.3	4.3	4.1	4.1	4.0	3.9	3.8	3.8	3.7	3.8	3.7	5.3	4.9	4.4	4.0	3.8
Housing Starts (g)	1.15	1.16	1.15	1.25	1.24	1.17	1.17	1.26	1.28	1.30	1.31	1.32	1.35	1.37	1.37	1.38	1.11	1.17	1.21	1.31	1.37
Light Vehicle Sales (h)	17.3	17.2	17.5	17.8	17.1	16.8	17.1	17.7	16.8	16.8	16.7	16.7	16.6	16.6	16.5	16.5	17.4	17.5	17.2	16.8	16.5
Crude Oil - Brent - Front Contract (i)	35.2	47.0	47.0	51.0	54.6	50.8	52.2	61.4	63.0	57.0	55.0	58.0	57.0	58.0	57.0	57.0	54.0	45.1	54.7	58.3	57.3
Quarter-End Interest Rates (j)																					
Federal Funds Target Rate	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.50	2.50	2.75	2.75	0.27	0.52	1.13	2.06	2.63
3 Month LIBOR	0.63	0.65	0.85	1.00	1.15	1.30	1.33	1.69	1.90	2.15	2.40	2.40	2.65	2.65	2.90	2.90	0.32	0.74	1.26	2.21	2.78
Prime Rate	3.50	3.50	3.50	3.75	4.00	4.25	4.25	4.50	4.75	5.00	5.25	5.25	5.50	5.50	5.75	5.75	3.27	3.52	4.13	5.06	5.63
Conventional Mortgage Rate	3.69	3.57	3.46	4.20	4.20	3.90	3.81	3.94	3.97	4.05	4.22	4.35	4.45	4.50	4.62	4.67	3.85	3.65	3.99	4.15	4.56
3 Month Bill	0.21	0.26	0.29	0.51	0.76	1.03	1.06	1.39	1.60	1.85	2.10	2.15	2.35	2.40	2.60	2.65	0.05	0.32	0.95	1.93	2.50
6 Month Bill	0.39	0.36	0.45	0.62	0.91	1.14	1.20	1.53	1.70	1.95	2.20	2.25	2.45	2.50	2.70	2.75	0.17	0.46	1.07	2.03	2.60
1 Year Bill	0.59	0.45	0.59	0.85	1.03	1.24	1.31	1.76	1.80	2.05	2.25	2.30	2.50	2.55	2.75	2.80	0.32	0.61	1.20	2.10	2.65
2 Year Note	0.73	0.58	0.77	1.20	1.27	1.38	1.47	1.89	2.00	2.25	2.45	2.60	2.70	2.80	2.93	3.00	0.69	0.83	1.40	2.33	2.86
5 Year Note	1.21	1.01	1.14	1.93	1.93	1.89	1.92	2.20	2.39	2.58	2.75	2.85	2.90	2.97	3.10	3.17	1.53	1.33	1.91	2.64	3.04
10 Year Note	1.78	1.49	1.60	2.45	2.40	2.31	2.33	2.40	2.52	2.65	2.82	2.95	3.05	3.10	3.22	3.27	2.14	1.84	2.33	2.74	3.16
30 Year Bond	2.61	2.30	2.32	3.06	3.02	2.84	2.86	2.74	3.05	3.25	3.37	3.50	3.53	3.56	3.66	3.70	2.84	2.59	2.89	3.29	3.61

Forecast as of: January 10, 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) 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: Federal Reserve Board, IHS Global Insight, U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities

### Global Economy Expected to Continue Its Expansion

The global economy is expected to continue its expansion in 2018, even as historically expansive monetary measures taken across the globe since the Great Recession are slowly being undone by the major central banks. Still, today, it is only the U.S. Federal Reserve and to a lesser degree, the Bank of Canada and Mexico, who seem to be charging ahead with other large central banks starting to revise their views on their own policies to accommodate for higher economic growth and even the potential of higher inflation. However, even as economic growth has improved across the globe, this growth has had little effect on global inflation (see figure below), which historically tends to raise eyebrows of policymakers and make them take a harder look at their monetary policy stance. For now, with the exception of the United States and Canada as major players, the policy prescription seems to be clear: stay the course but be watchful for potential surprises and prepare the markets for changes ahead.

In this global environment, it is clear that the manufacturing sector in the developed world is charging ahead, while manufacturing activity in the developing world, including China, is lagging behind. This could be a sign of things to come as Chinese economic growth strategy continues to shift from an investment/export driven one, to a more domestically oriented strategy over the coming years.

What is new this year, and a change from our thoughts more than a year ago, is that we are expecting the U.S. dollar to weaken somewhat. We expect that the rest of the developed world's central banks will start to slowly move into more of a synchronized monetary policy effort, rather than the U.S. Federal Reserve being a lone ranger in terms of monetary policy tightening.

This has implications not only for interest rates across the world but also for commodities, as we have seen some upward

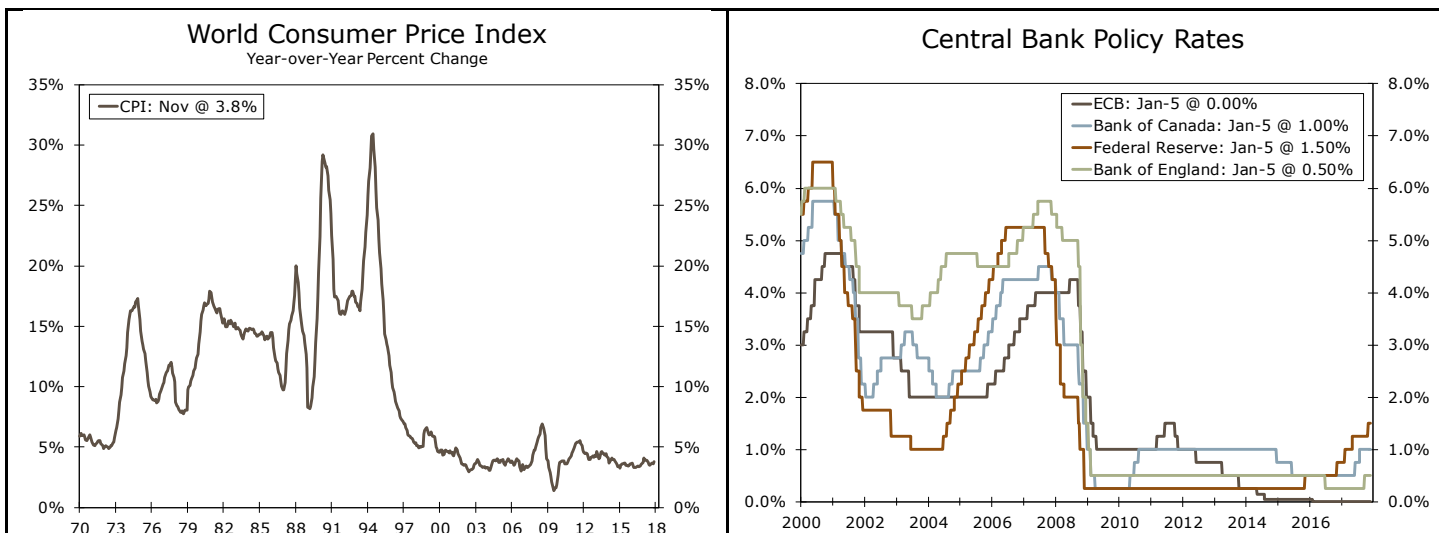
pressure on commodity prices lately, which could help the commodity exporting world during the year. At the same time, higher economic growth across the world would probably put some more pressure on commodity prices, even though we are not expecting a China-driven commodity price/commodity export boom, as the global economy experienced during the first decade and a half of this century.

Perhaps, one of the caveats that would probably make economic growth in the United States stronger than in some other developed countries is the stance of fiscal policy in that country. This is what seems to be driving some of the emphasis on interest rates in the United States, as the U.S. Congress passed a fiscal package that could meaningfully boost economic growth in the U.S. economy over the next several years. This has the risk of potentially resetting inflation expectations in the United States that is currently absent in the global economic environment.

This is, perhaps, one of the reasons why we still believe that although moving in a tightening direction, the other large developed countries' central banks are probably not as pressured to tighten as is the case in the United States. This view could change over the course of the year if economic growth takes off further, but for now, the risks of this happening are relatively low.

We also remain concerned with several risks that are political in nature and as we argued in our recent report, [The Global Economic Expansion: Mind the Risks](#), available on our website, are difficult to quantify.

However, for now, we remain positive for the global economy as we enter 2018, even if we acknowledge that upward surprises in both economic growth as well as inflation could make central bankers in the large developed countries pull the levers of monetary policy across the world faster than what we currently foresee.



Source: Bloomberg LP, International Monetary Fund and Wells Fargo Securities

## Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2017	2018	2019	2017	2018	2019
Global (PPP Weights)	3.6%	3.5%	3.4%	3.1%	3.5%	3.5%
Global (Market Exchange Rates)	3.3%	3.4%	3.3%	3.1%	3.5%	3.5%
Advanced Economies <sup>1</sup>	2.4%	2.4%	2.3%	1.8%	2.1%	1.9%
United States	2.2%	2.8%	2.7%	2.1%	2.4%	2.1%
Eurozone	2.4%	2.2%	2.0%	1.5%	1.7%	1.8%
United Kingdom	1.8%	1.3%	1.8%	2.7%	2.3%	2.0%
Japan	1.8%	1.3%	1.0%	0.4%	1.1%	1.1%
Korea	3.3%	2.8%	2.7%	1.9%	1.8%	2.1%
Canada	2.9%	2.0%	1.7%	1.7%	1.9%	1.9%
Developing Economies <sup>1</sup>	4.7%	4.5%	4.5%	4.4%	5.0%	5.1%
China	6.8%	6.4%	6.0%	1.6%	2.2%	2.2%
India <sup>2</sup>	7.1%	6.6%	7.1%	3.3%	5.0%	4.7%
Mexico	2.0%	1.9%	2.6%	6.0%	5.4%	5.6%
Brazil	1.0%	2.6%	3.0%	3.4%	3.6%	4.1%
Russia	1.8%	2.0%	2.2%	3.7%	3.4%	4.5%

Forecast as of: January 10, 2018

<sup>1</sup>Aggregated Using PPP Weights<sup>2</sup>Forecast Refers to Fiscal Year

## Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2018				2019		2018				2019	
	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q2	Q3	Q4	Q1	Q2
U.S.	1.90%	2.15%	2.40%	2.40%	2.65%	2.65%	2.52%	2.65%	2.82%	2.95%	3.05%	3.10%
Japan	-0.02%	-0.01%	0.00%	0.01%	0.01%	0.02%	0.05%	0.07%	0.09%	0.12%	0.14%	0.16%
Euroland <sup>1</sup>	-0.38%	-0.35%	-0.30%	-0.20%	-0.10%	0.15%	0.50%	0.65%	0.80%	1.00%	1.10%	1.20%
U.K.	0.52%	0.55%	0.60%	0.80%	0.90%	1.05%	1.35%	1.50%	1.60%	1.75%	1.85%	1.95%
Canada <sup>2</sup>	1.65%	1.75%	1.90%	2.00%	2.15%	2.25%	2.10%	2.30%	2.40%	2.50%	2.60%	2.65%

Forecast as of: January 10, 2018

<sup>1</sup> 10-year German Government Bond Yield <sup>2</sup> 3-Month Canada Bankers' Acceptances

Source: International Monetary Fund and Wells Fargo Securities

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