

WELLS
FARGO

SECURITIES

Ten Issues as the Credit Cycle Matures

PCBE

John E. Silvia, Chief Economist

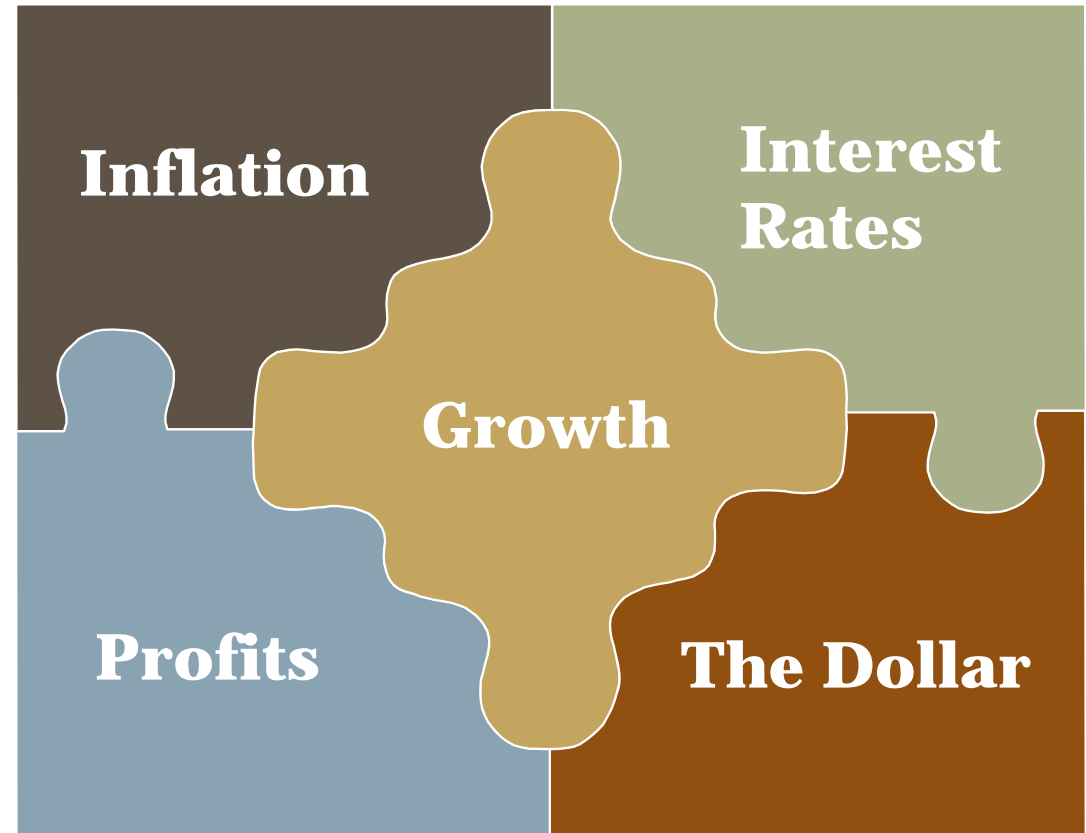
October 4, 2017

Together we'll go far



Where Are We Now?

Five benchmarks for good
decision making



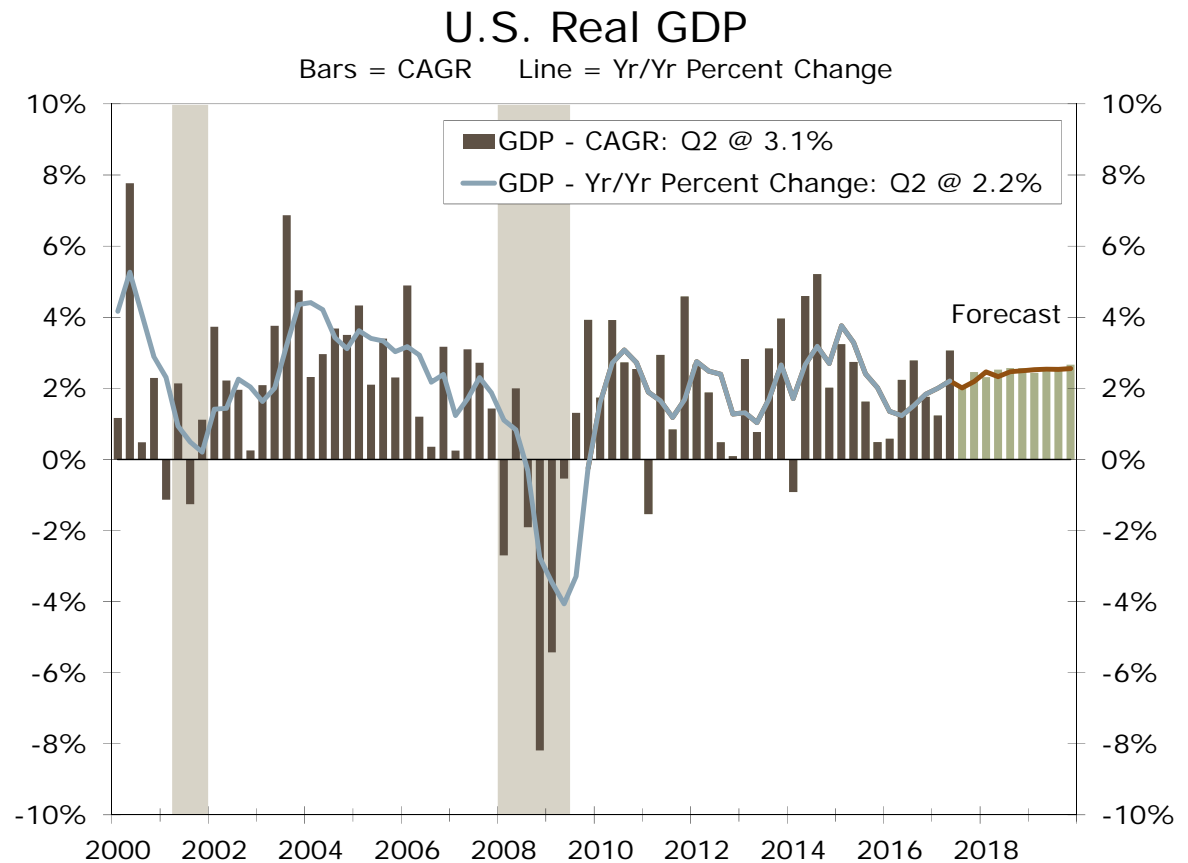
How do we compare to consensus?

Expectations for the Future

- Sustained trend growth, no recession in the forecast
- Employment—cyclical and structural change
- Consumer solid—key support to growth
- Below consensus on housing starts and auto sales
- Trade will be a drag on economic growth in the U.S.
- Unsustainable long-run fiscal policy
- Europe growth remains steady post-Brexit
- China growth slower for 2017, 2018

Sustained Growth—The Anchoring Bias

Trend growth at 2-2.5 percent in the year ahead. A more balanced composition of domestic growth should prevail, but trade will be a drag going forward.

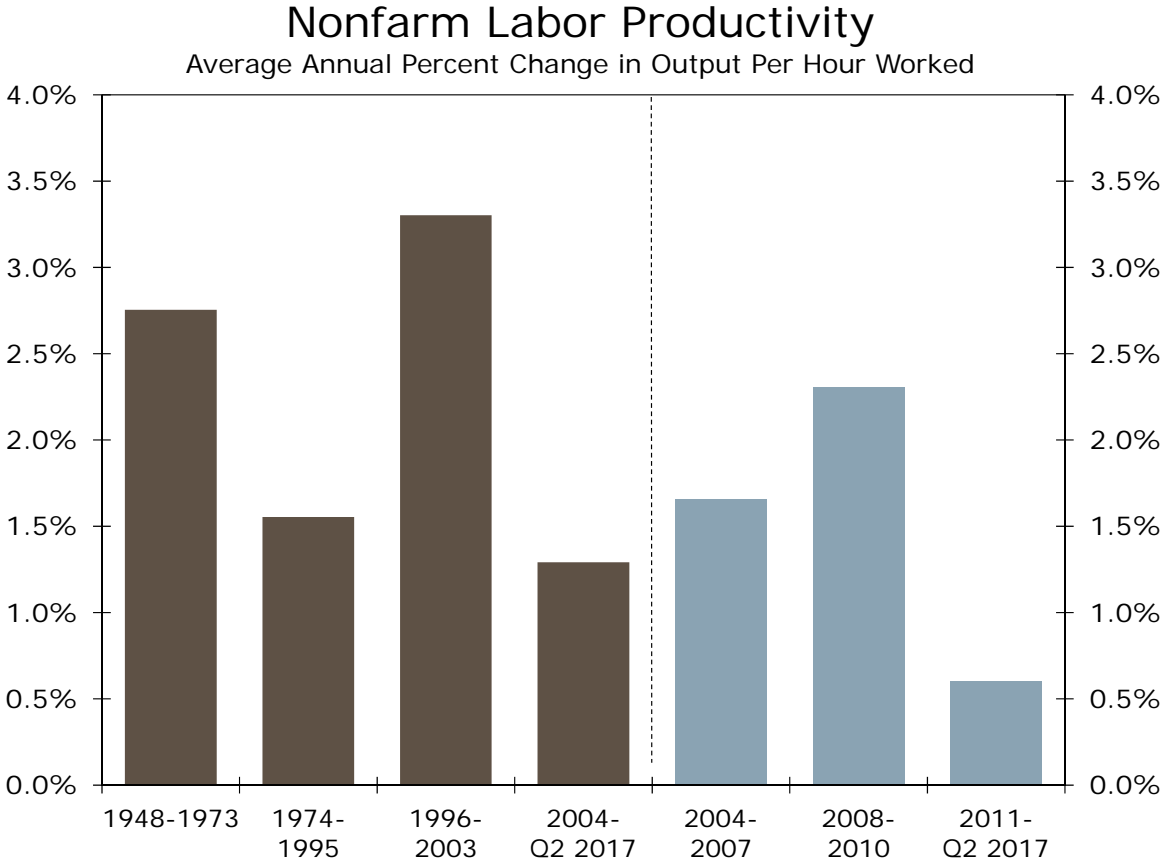


Source: U.S. Department of Commerce and Wells Fargo Securities

Supply-Side Challenges

Potential Growth—Little Help From Productivity

Productivity growth has downshifted over the past cycle

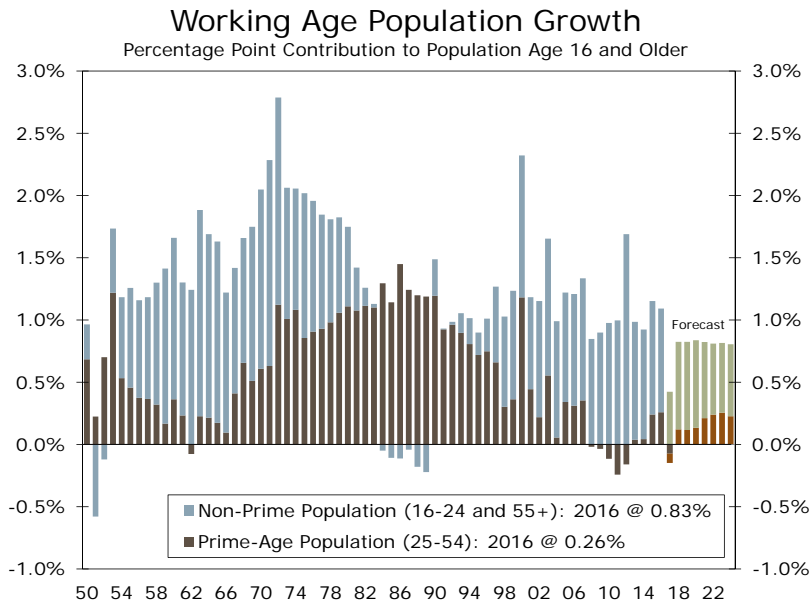


Source: U.S. Department of Labor and Wells Fargo Securities

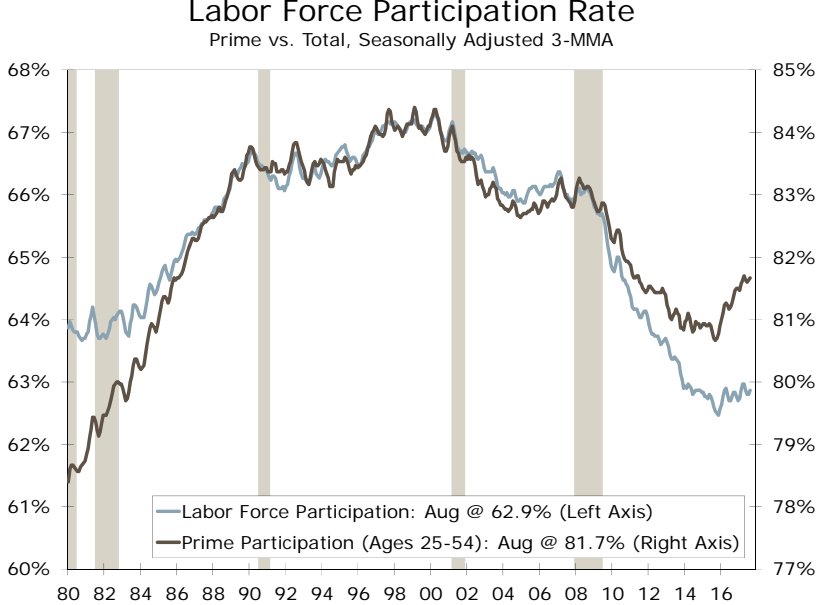
Potential Growth—Little Help from Labor

Labor supply growth is slowing, particularly for prime-age workers. Labor force participation has improved but remains historically low.

Working Age Population



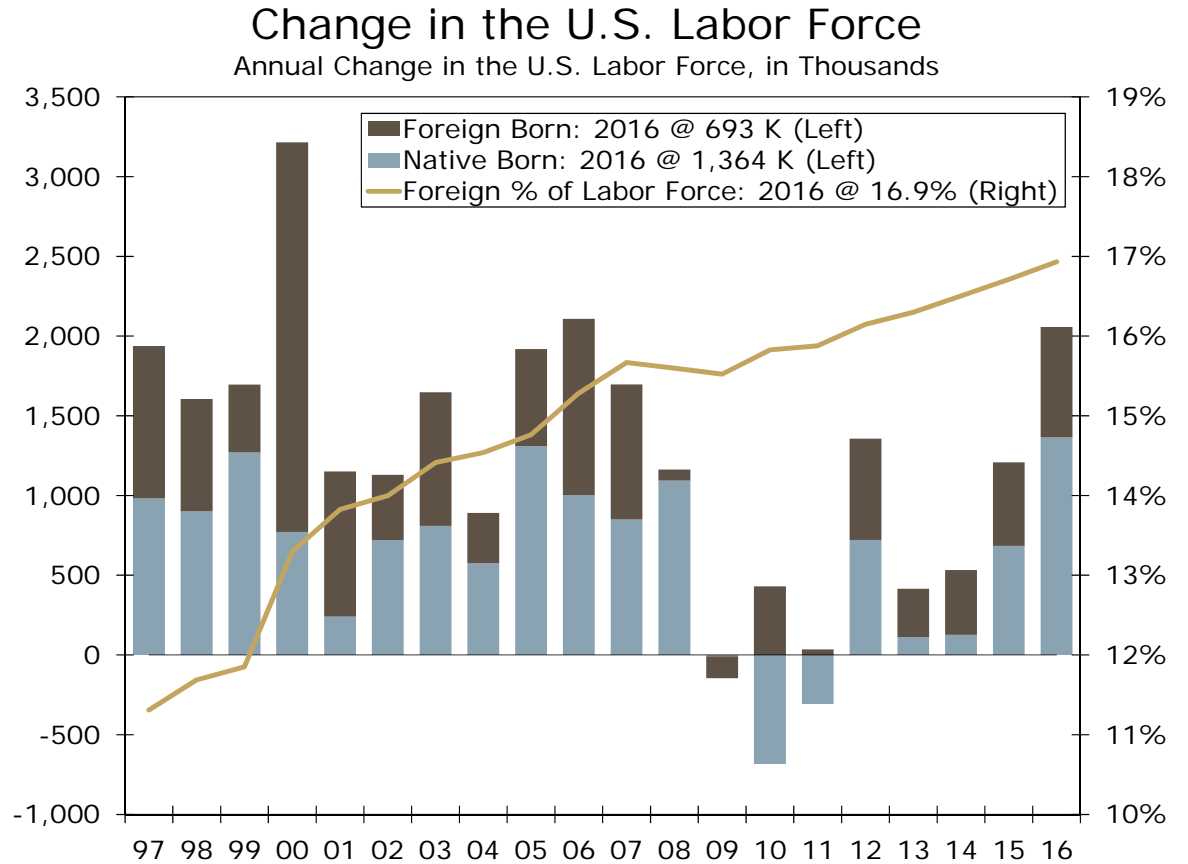
Labor Force Participation



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

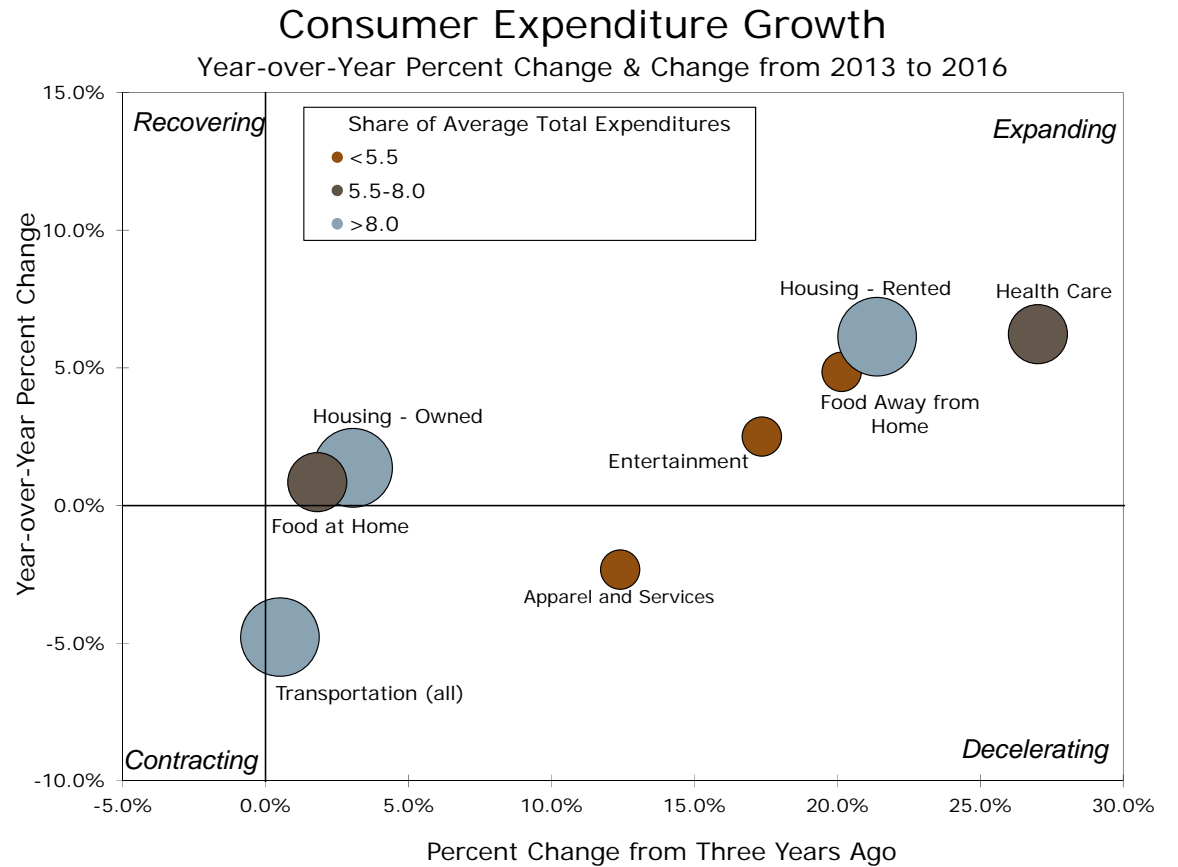
Potential Growth—Evolving Human Capital

Foreign-born workers have accounted for half the growth in the labor supply over the past decade



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

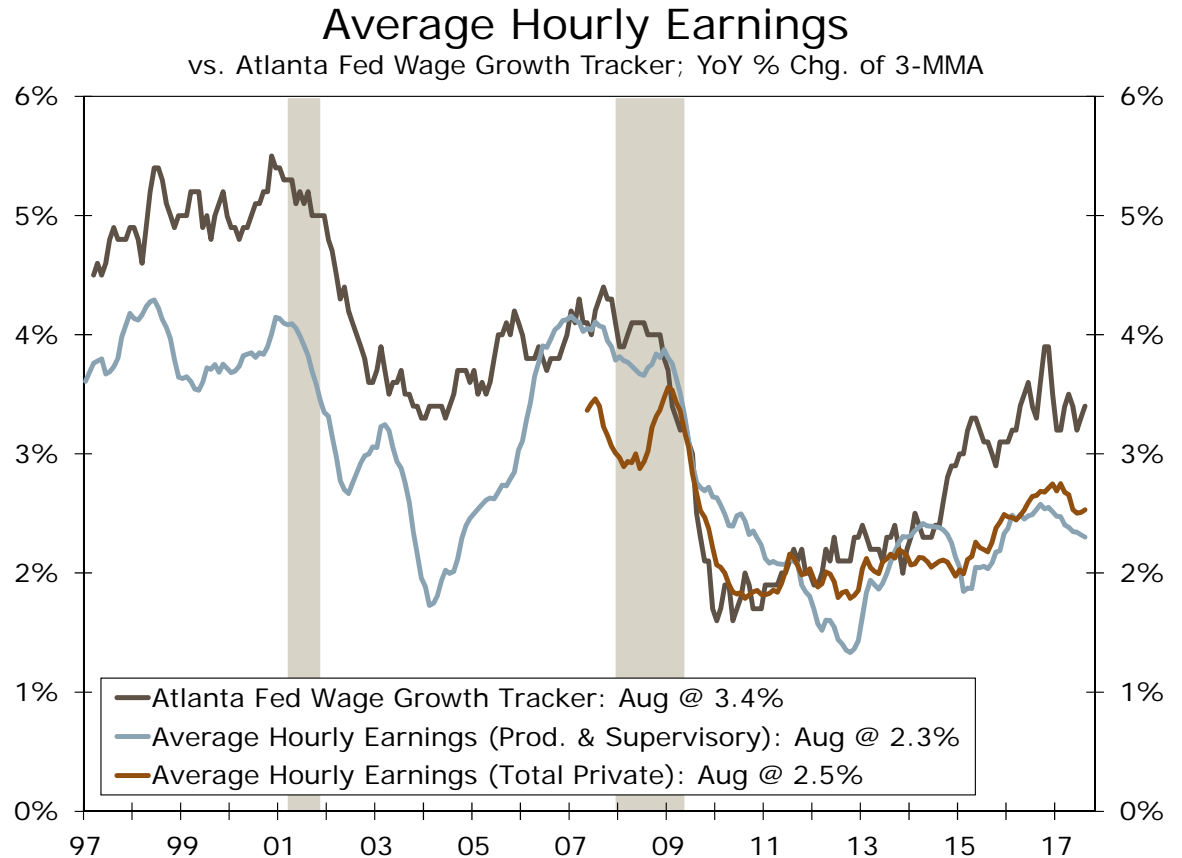
Food away from home, rental housing, and health care spending have improved as the economy has picked up



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

Workers' Earnings

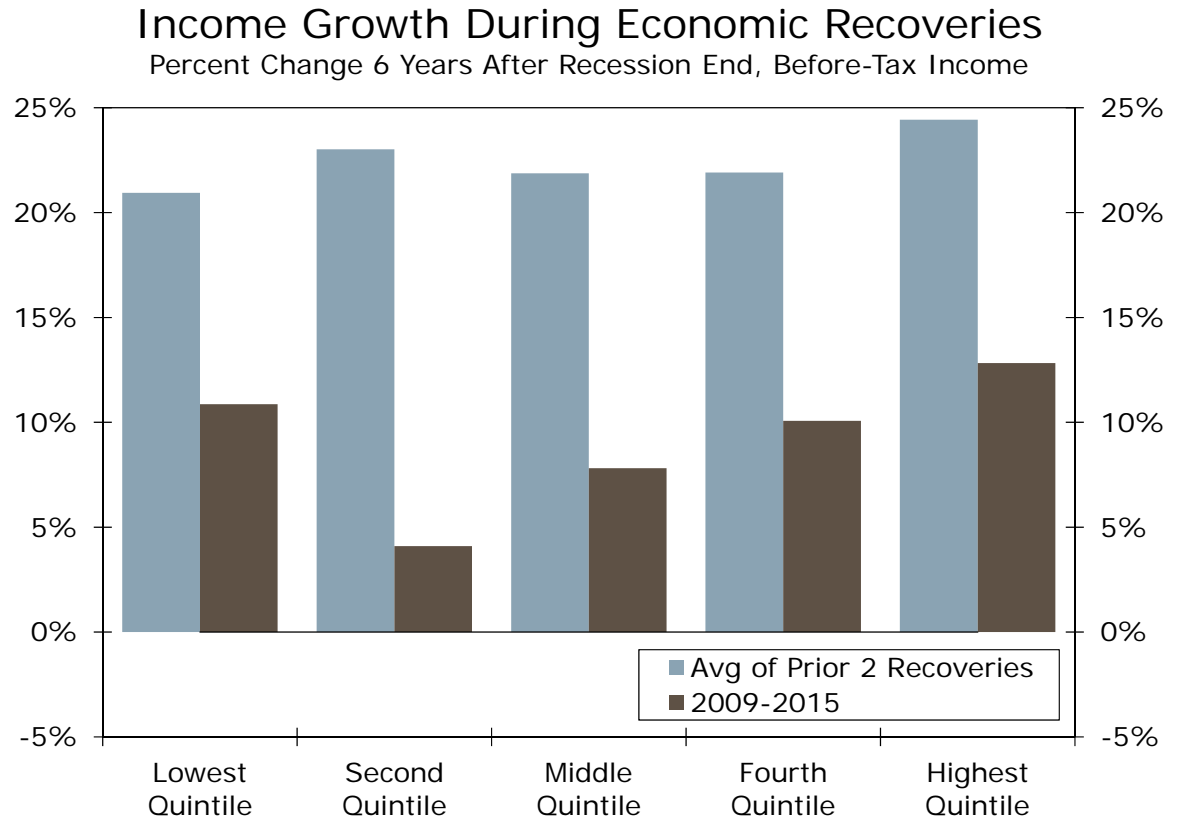
Average hourly earnings growth has picked up modestly but remains limited by lower-skilled workers entering the workforce and Baby Boomers beginning to retire—the Atlanta Fed measure tracks individuals over time, eliminating compositional effects on wage growth



Source: U.S. Department of Labor, Federal Reserve Bank of Atlanta and Wells Fargo Securities

Personal Income Gains: Disparity

Income growth has finally begun to turn around but still lags prior recoveries

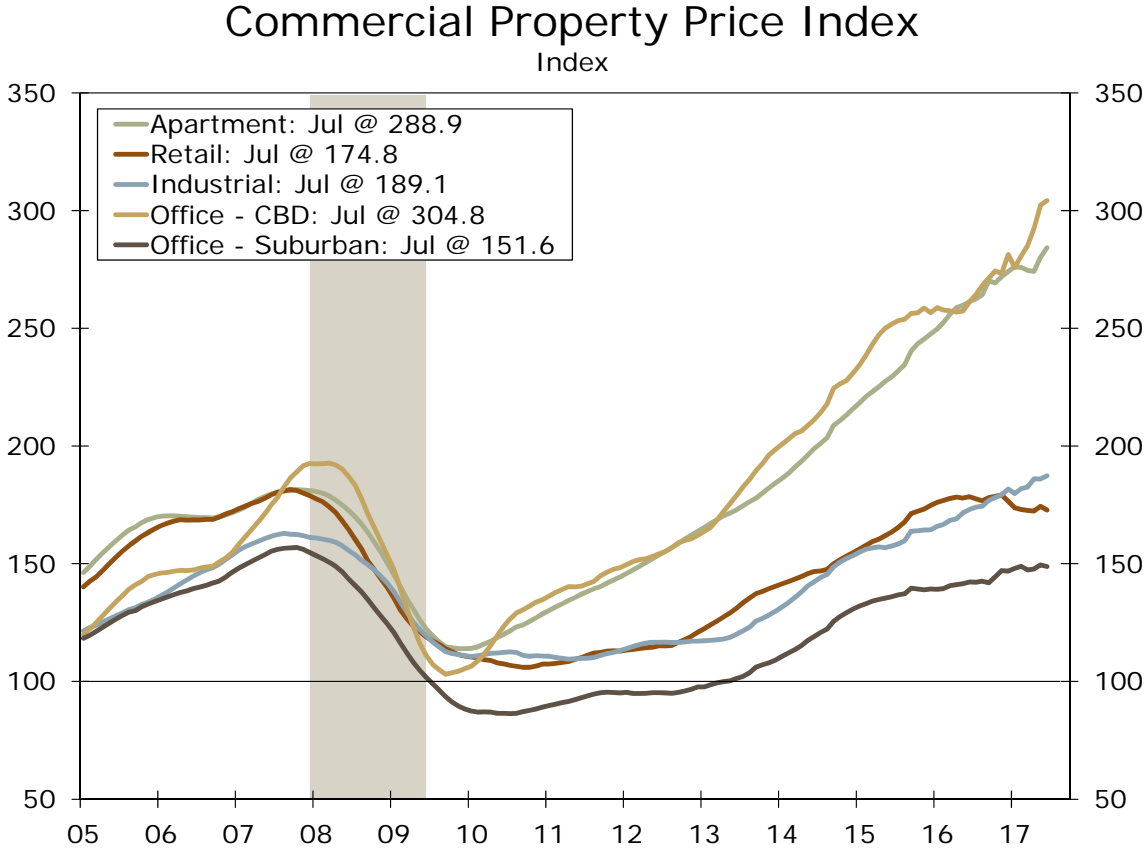


Source: U.S. Department of Labor and Wells Fargo Securities

Divergence in Commercial Real Estate

Property Prices: CBD, Suburbs Differ

High valuations have caught the Fed's attention

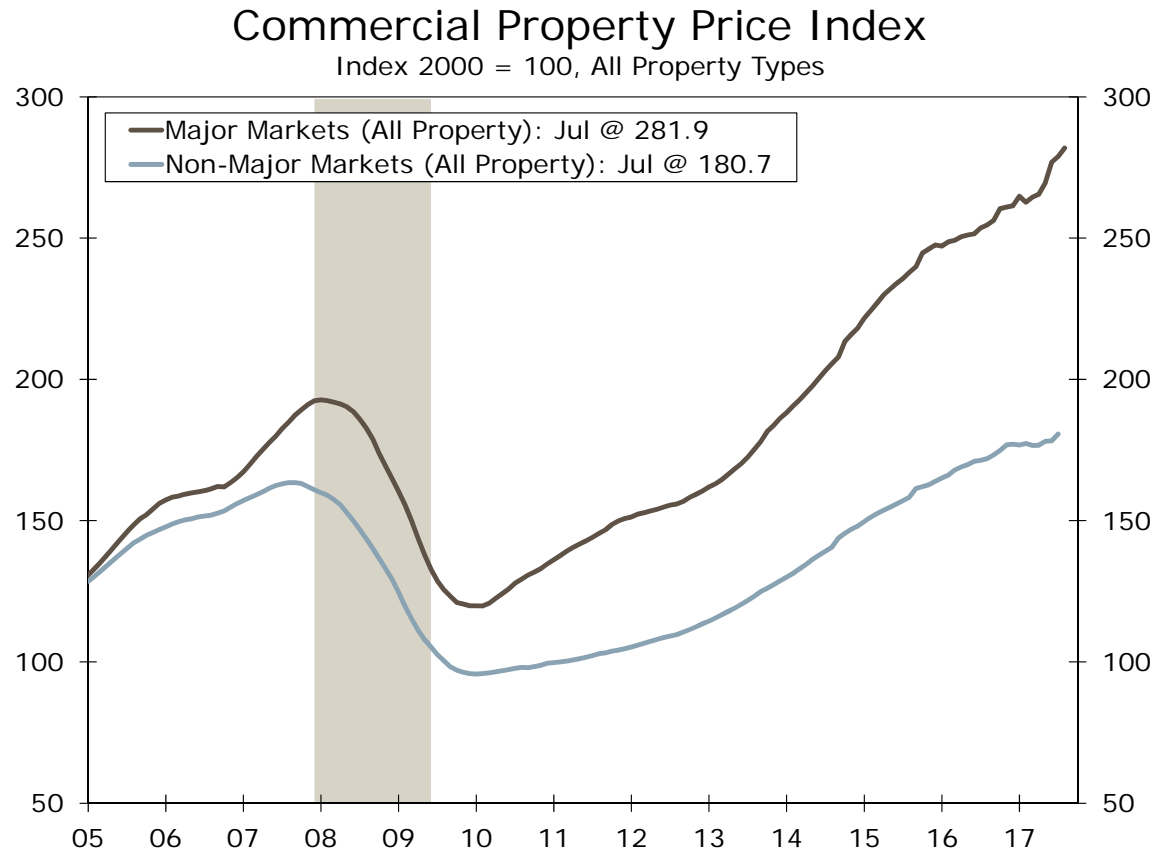


Apartment: Jul @ 288.9
Retail: Jul @ 174.8
Industrial: Jul @ 189.1
Office - CBD: Jul @ 304.8
Office - Suburban: Jul @ 151.6

Source: RCA and Wells Fargo Securities

Property Prices: Major/Non-Major Market Splits

Valuations have grown the fastest in major markets



Source: RCA and Wells Fargo Securities

Unsustainable Fiscal Policy

Timeline

<u>Key Dates</u>	<u>Policy Area</u>
Sept. 30 th	Fiscal Year 2018 Budget Resolution (Vehicle for Tax Cuts) Children's Health Insurance Program (CHIP) Expires National Flood Insurance Program Expires Federal Aviation Administration (FAA) Authorization Expires
Oct. 1	Fiscal Year 2018 Begins (Funding Bill Must Be Passed)
Oct./Nov.	Individual/Corporate Tax Cut Framework Expected
Dec.	Section 702 of the Foreign Intelligence Surveillance Act Expires
March 2018	Primary Elections Begin

The Tax Policy Outlook

1986 Tax Reform Act

- Sweeping reform effort – lowered rates and broadened the tax base.
- Revenue neutral and permanent. Individual taxes cut \$120 billion over five years, offset by a \$120 billion *increase* on the corporate side.
- Bipartisan: Democratically controlled House, Republican led Senate and White House.
- Many tough pills to swallow: depreciation schedules restricted, deductibility of consumer loan interest eliminated, taxes on long-term capital gains aligned with top marginal rate, etc.

2001/2003 Bush Tax Cuts

- Not revenue neutral.
- Set to expire after 10 years, although most of the cuts were eventually made permanent in 2012.
- Primarily addressed the individual side of the tax code. Little on the corporate side.
- Cost estimate at the time was approximately \$1.5 trillion over 10 years, about 1 percent of GDP.
- Passed at a time when the CBO projected a \$5.6 trillion *surplus* from 2001-2011.

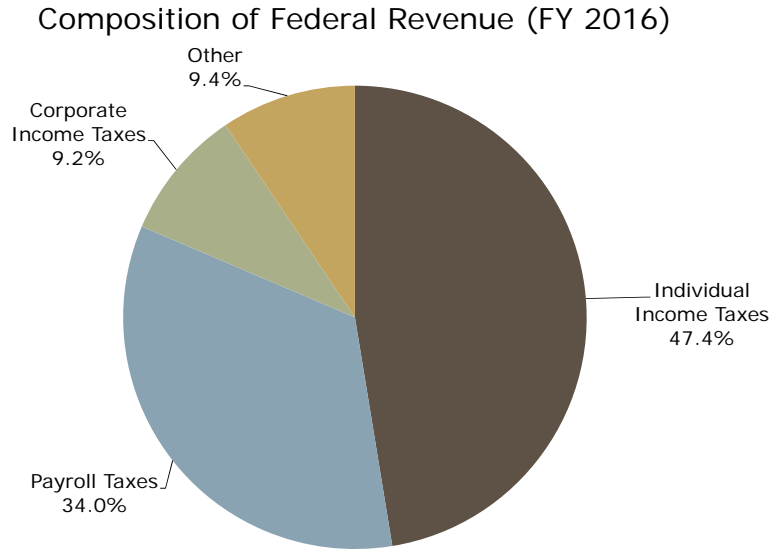
Outlook for Today

- Plans to make major changes to individual *and* corporate tax codes while also maintaining deficit-neutrality.
- Lowering rates and eliminating credits/deductions more challenging in today's political climate compared to 1986.
- Tax cuts rather than reform likely to be more popular.
- But, CBO's current law baseline projects a \$10.1 trillion deficit over the next 10 years – fiscally very difficult to achieve.
- Expectations likely still too high on tax policy changes.

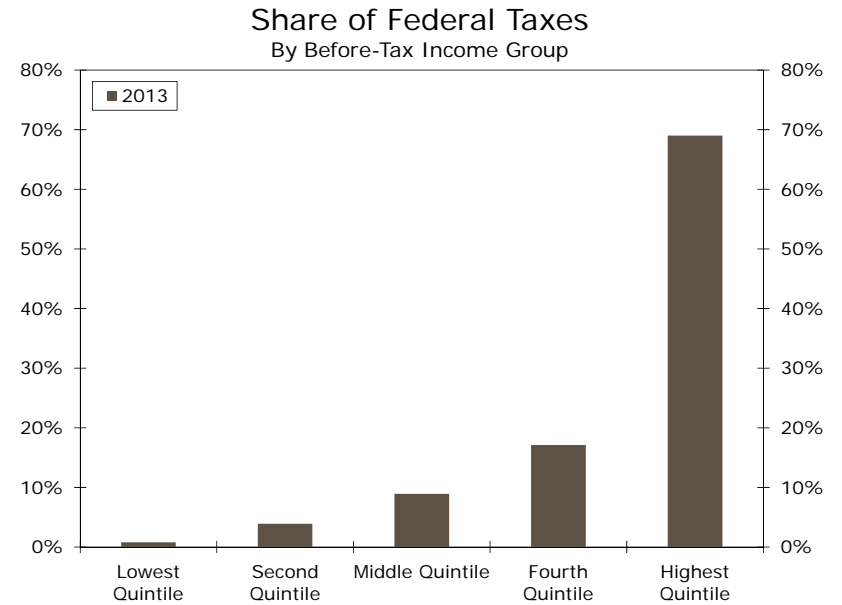
Federal Fiscal Policy: Tax Cuts for Taxpayers

Corporate income tax receipts accounted for less than 10 percent of federal revenues in FY 2016. The top income quintile pays an outsized share of federal taxes.

Composition of Federal Revenues



Federal Taxes Paid by Income Quintile



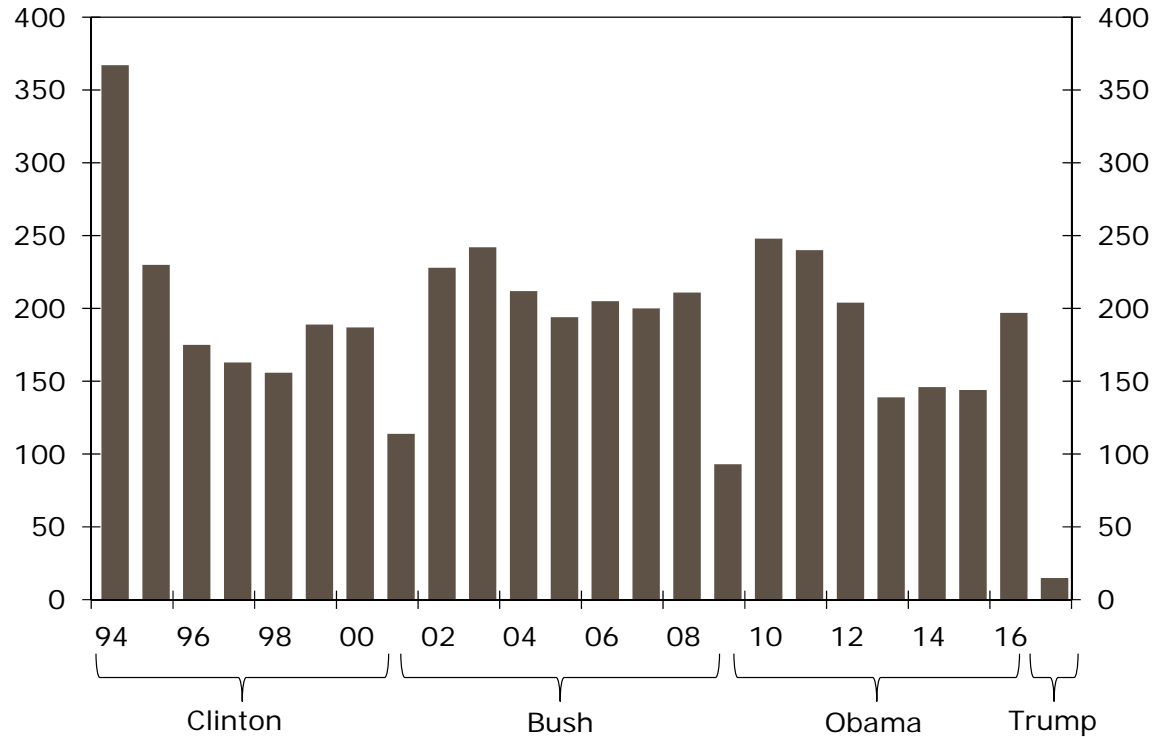
Source: Congressional Budget Office and Wells Fargo Securities

Major Regulatory Changes

The number of new regulations put in place in the first five months of the Trump administration is the lowest among the last four administrations

Major New Regulatory Changes

By the OIRA, President's First Five Months of the Year

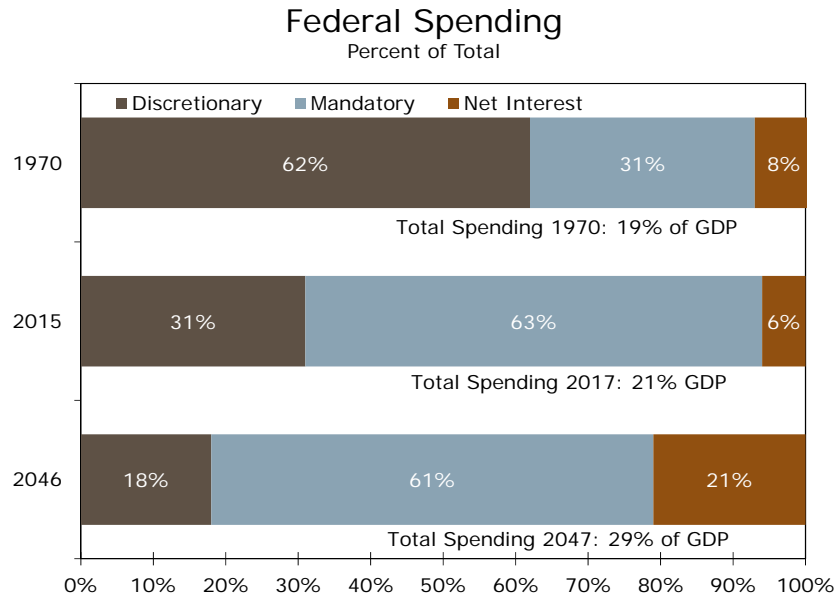


Source: Office of Information and Regulatory Affairs and Wells Fargo Securities

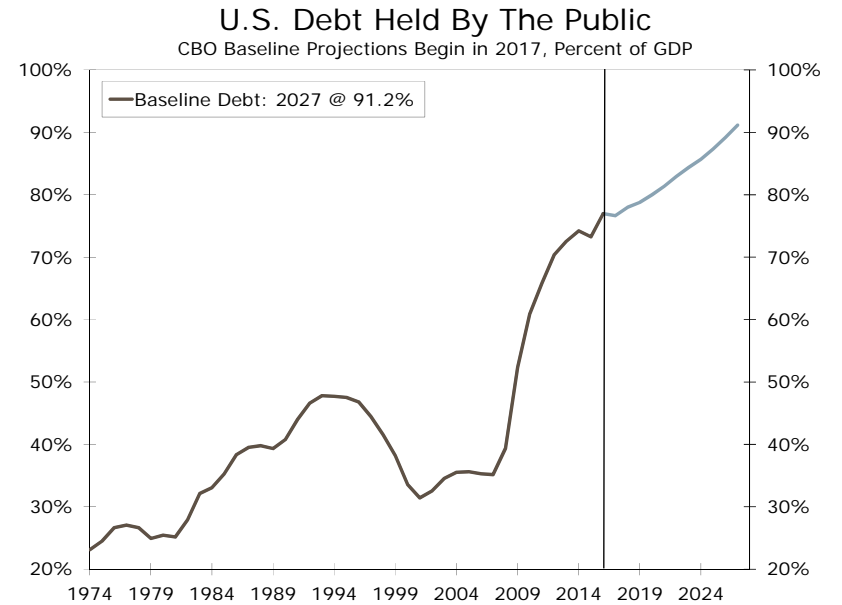
Federal Fiscal Policy

The composition of federal spending has shifted dramatically.
The CBO projects that the debt-to-GDP ratio will surpass 91 percent by 2027.

Composition of Federal Spending



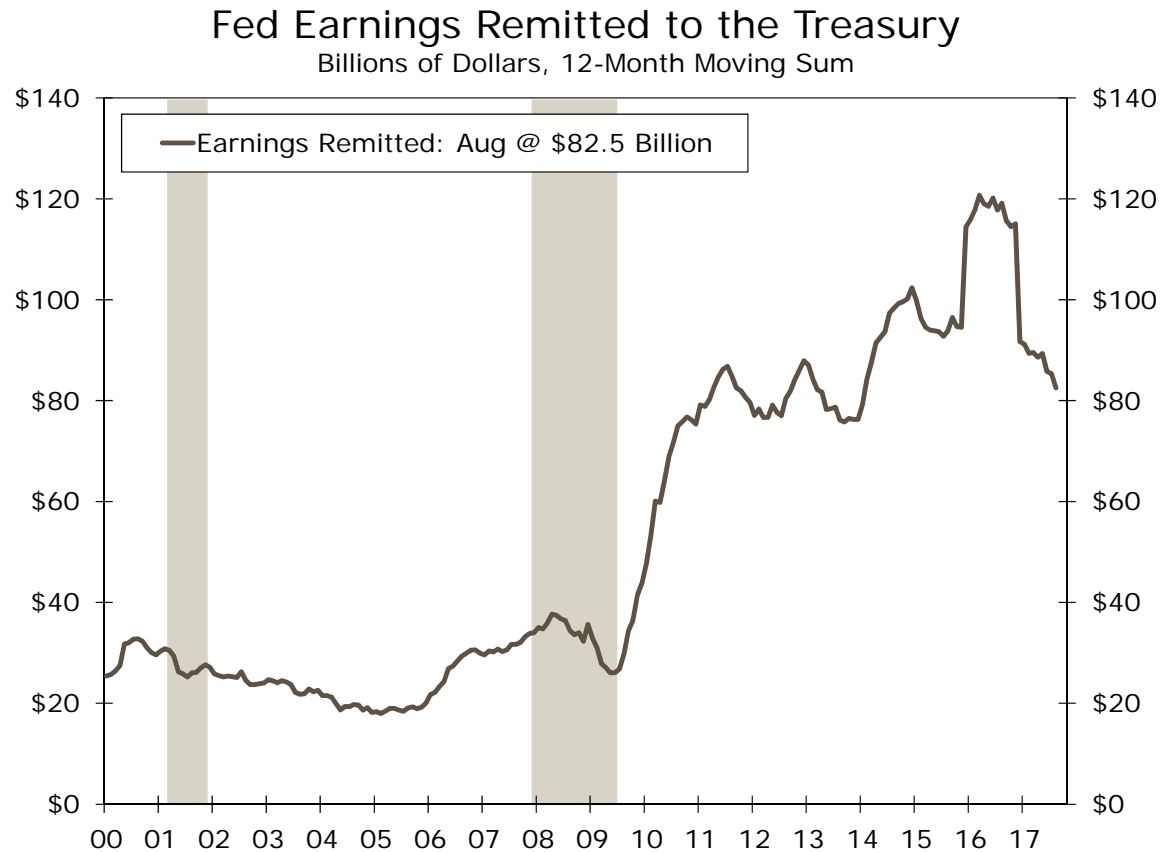
Federal Debt Continues to Rise



Source: Congressional Budget Office and Wells Fargo Securities

Balance Sheet Unwind: Record Remittances due to Recede

Balance sheet reductions and the federal budget are inextricably linked



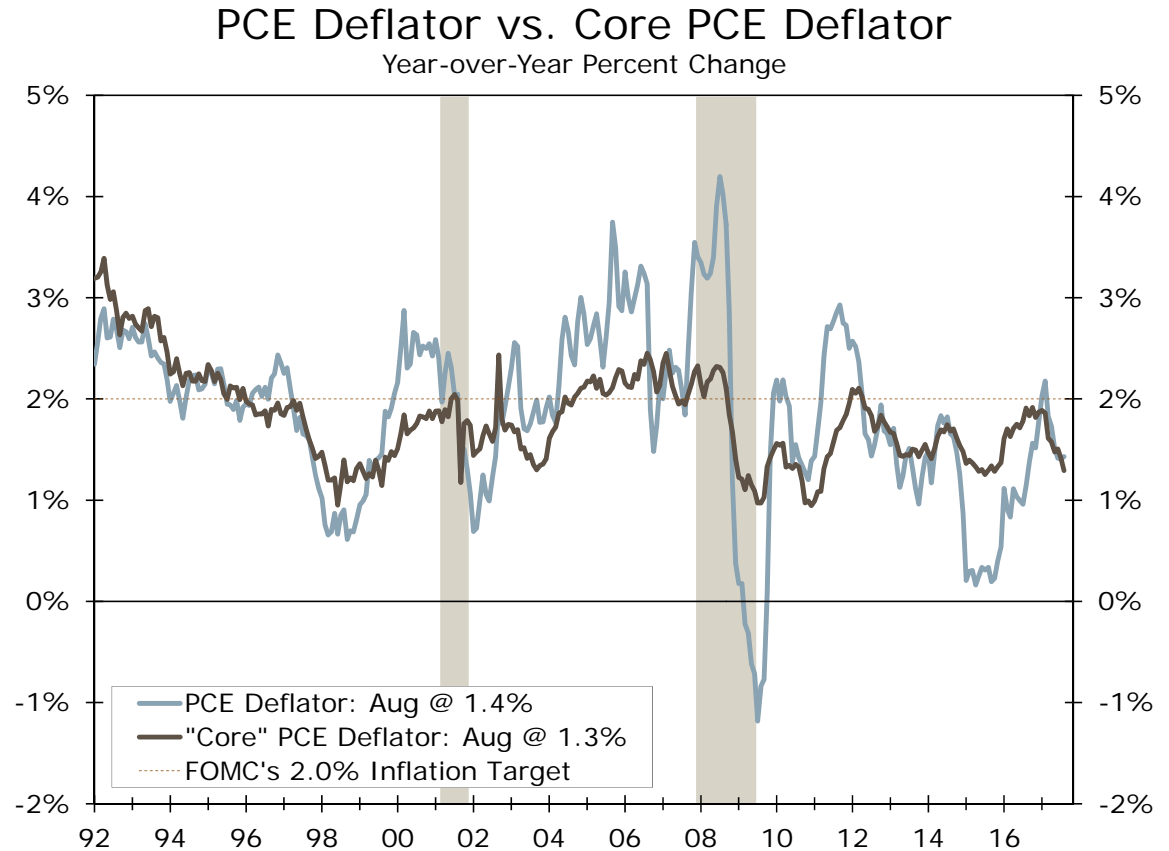
Source: U.S. Department of the Treasury and Wells Fargo Securities

Inflation: Bifurcation



Inflation: Rising Toward the Two Percent Target

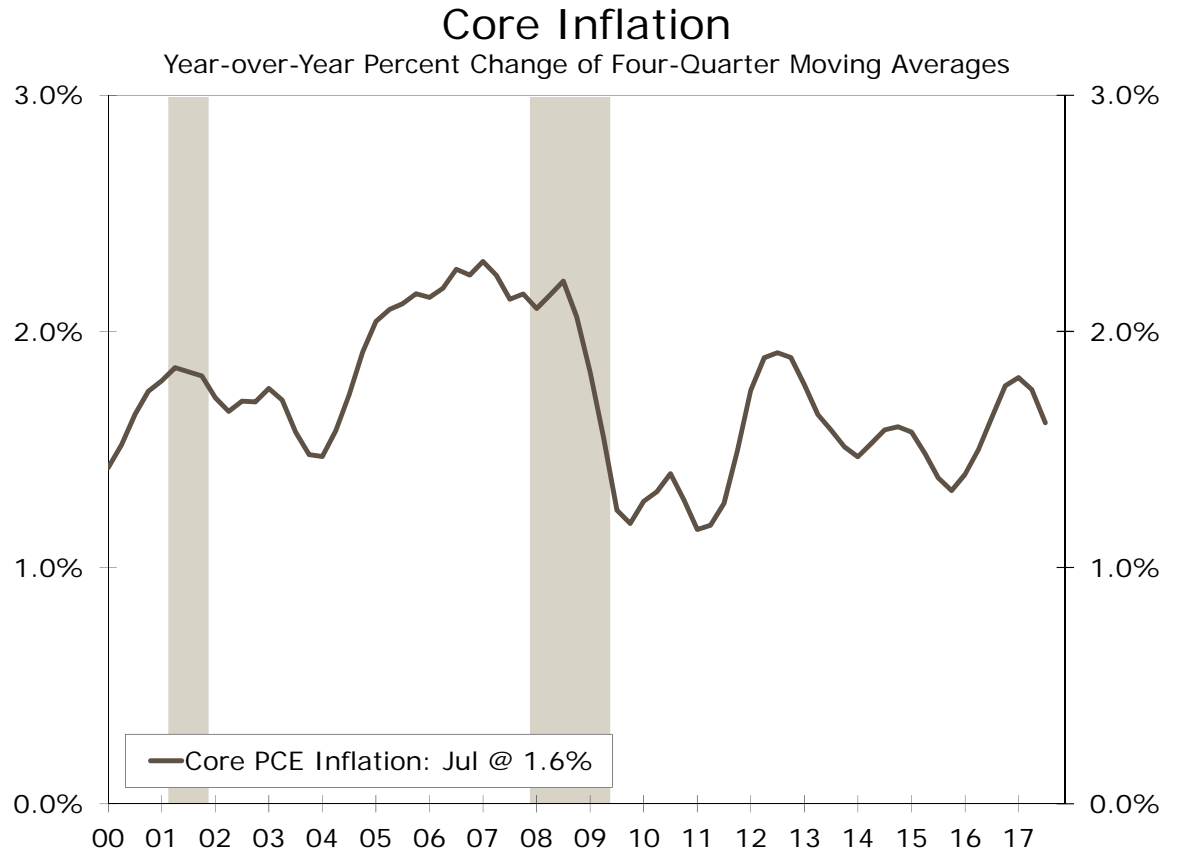
Inflation has retreated from the FOMC's target—average less than two percent since 1992



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

Inflation: Rising Toward the Two Percent Target

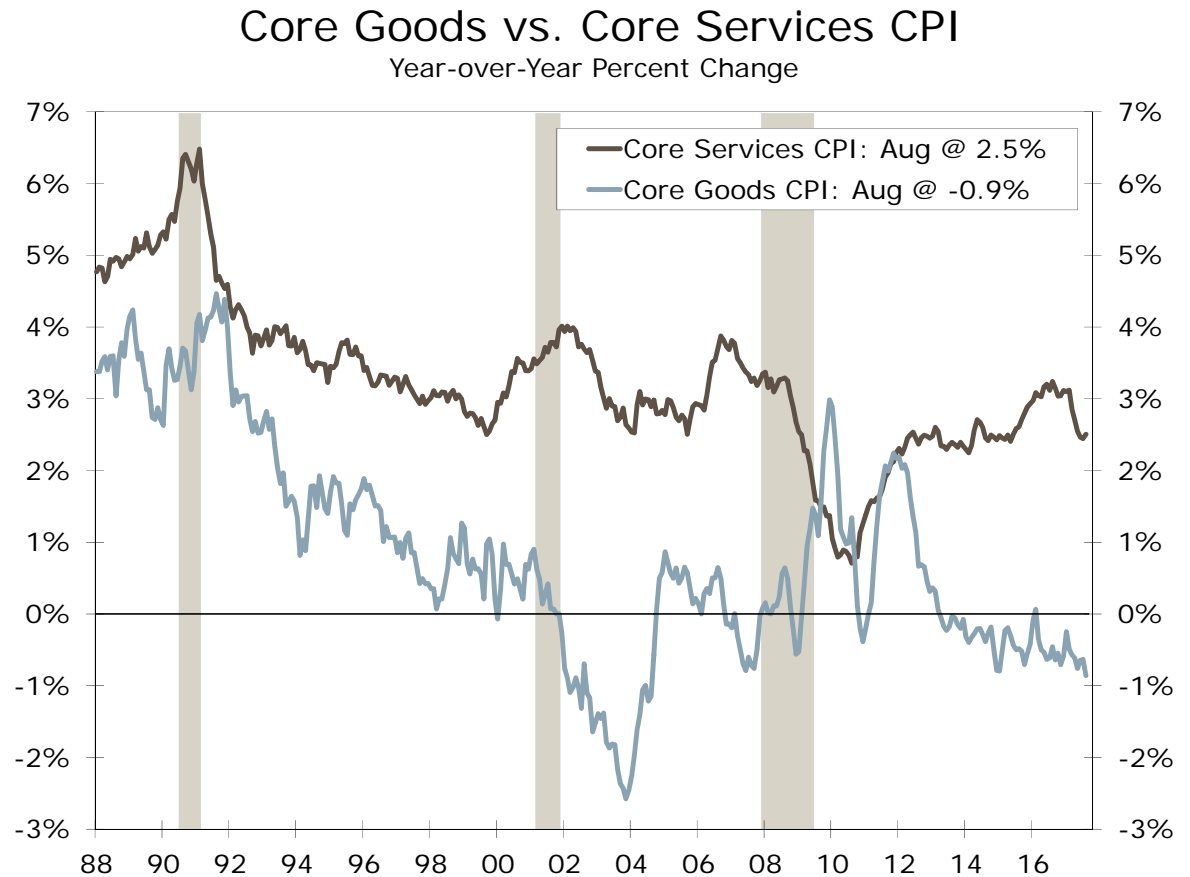
Core inflation has yet to reach two percent



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

Inflation: A Divide in Goods vs. Services

Inflation for services has been much firmer than for commodities

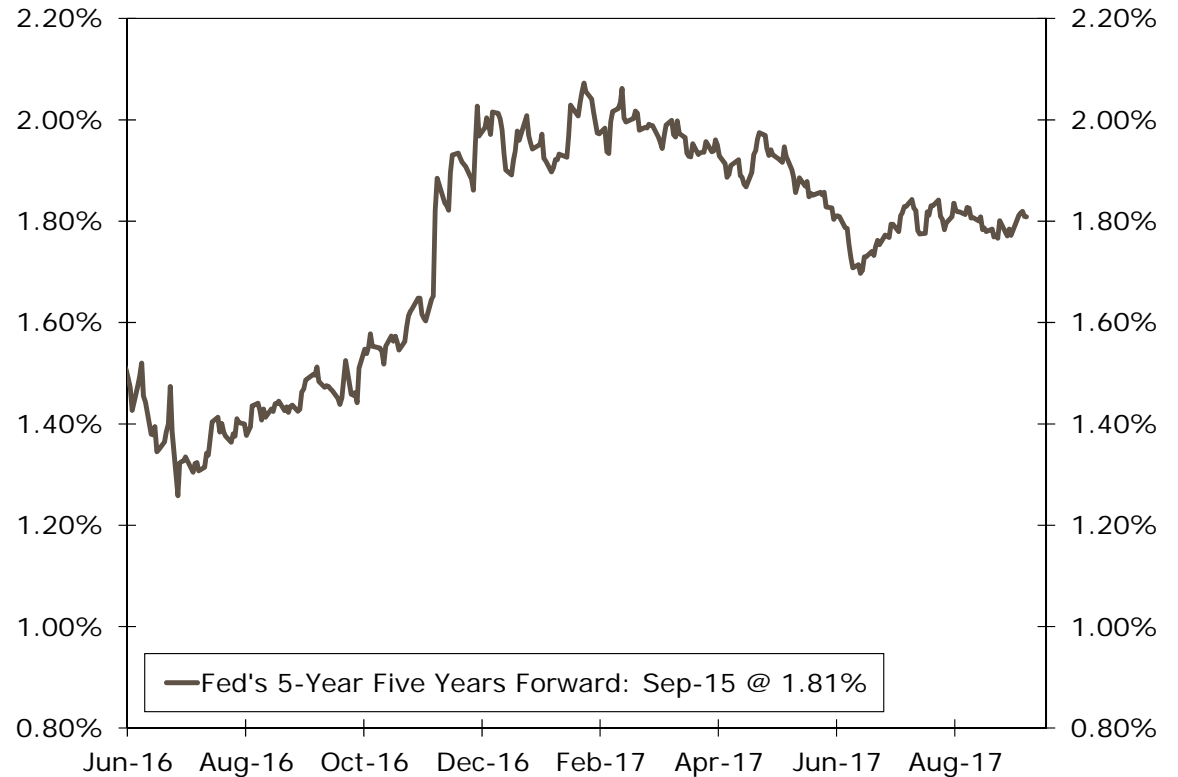


Source: U.S. Department of Labor and Wells Fargo Securities

Inflation Expectations

The jump in inflation expectations was sharp following the election. However, its sustainability has faltered.

Fed's 5-Year Five Years Forward



Source: Bloomberg LP and Wells Fargo Securities

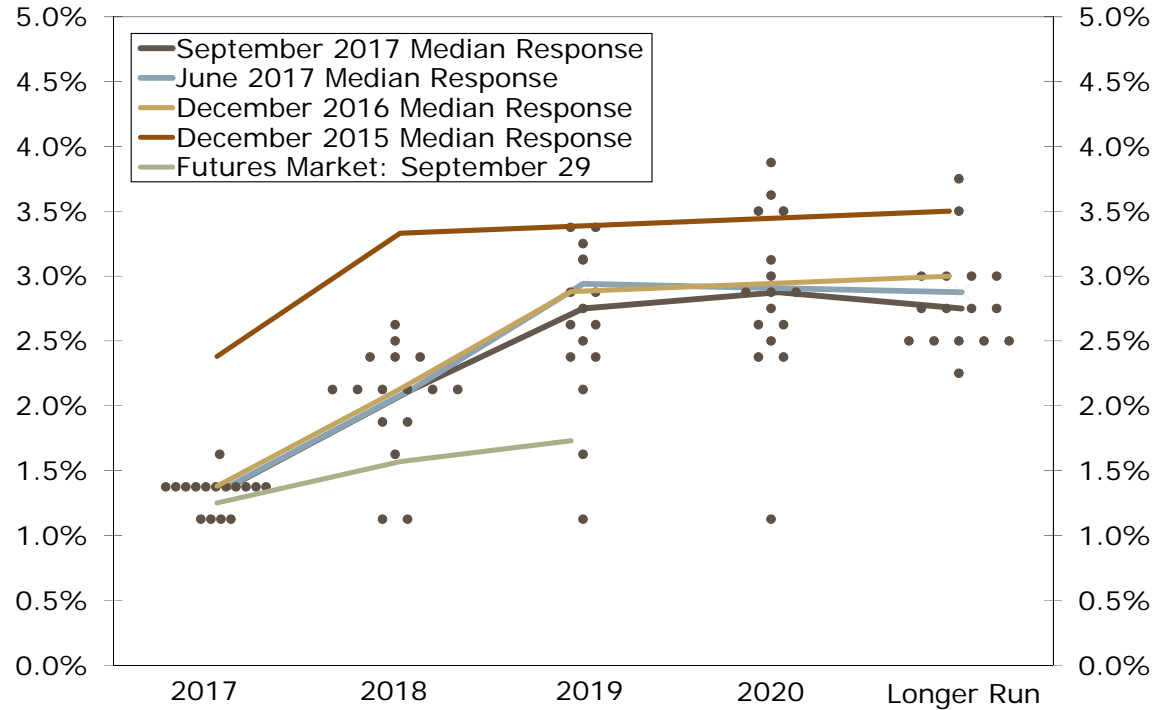
Interest Rate Path

Pace of Policy Firming: We Say Three Hikes in 2017

FOMC members' target for the Fed funds rate continues to overshoot market expectations

Appropriate Pace of Policy Firming

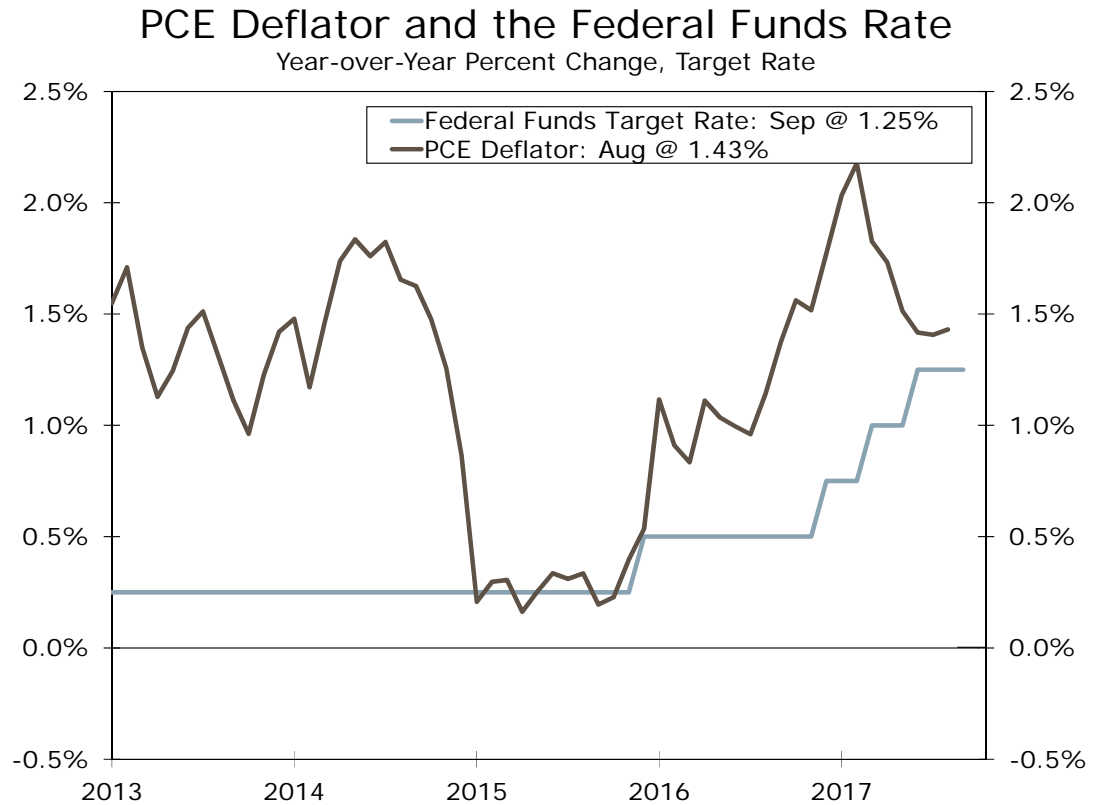
Target Federal Funds Rate at Year-End



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

Inflation and the Fed Funds Rate

Inflation has lost momentum.
Will the Fed adjust its policy path?



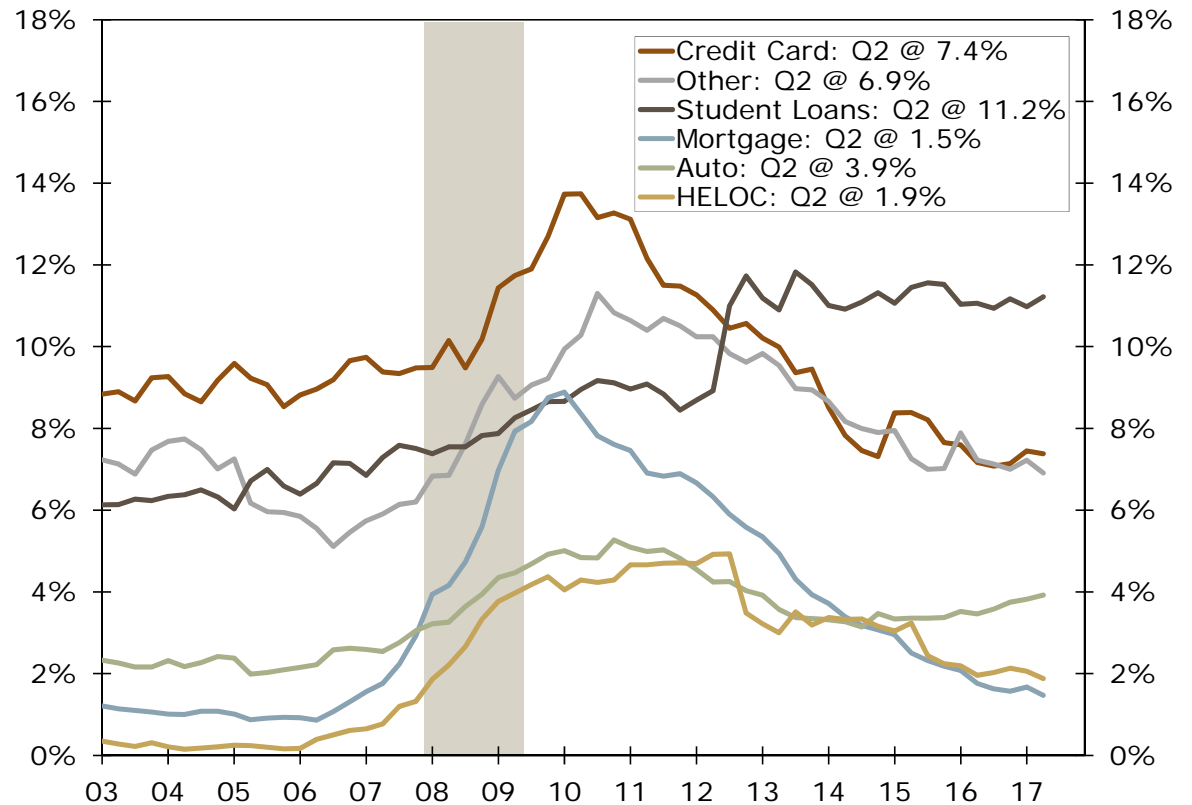
Source: Federal Reserve Board, U.S. Department of Labor and Wells Fargo Securities

Household Debt Delinquencies: Student Loans the Exception

Tighter credit standards and a strengthening economy have helped to improve the credit position of households over the past few years—with the exception of student debt.

Household Debt Delinquencies

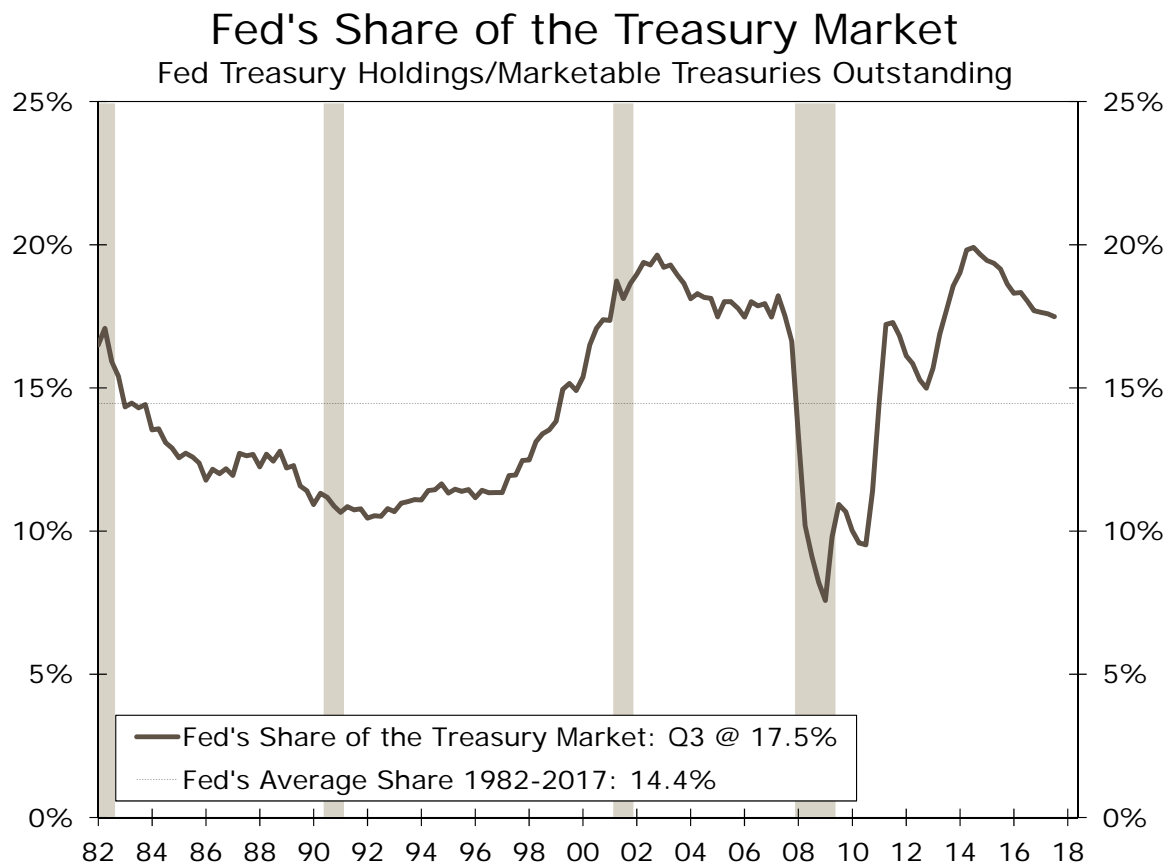
Percent of Balance 90+ Days Past Due



Source: FRBNY and Wells Fargo Securities

The Fed and the Treasury Market

The Fed holds a historically high share of the Treasury market— but perhaps not as high as one might think

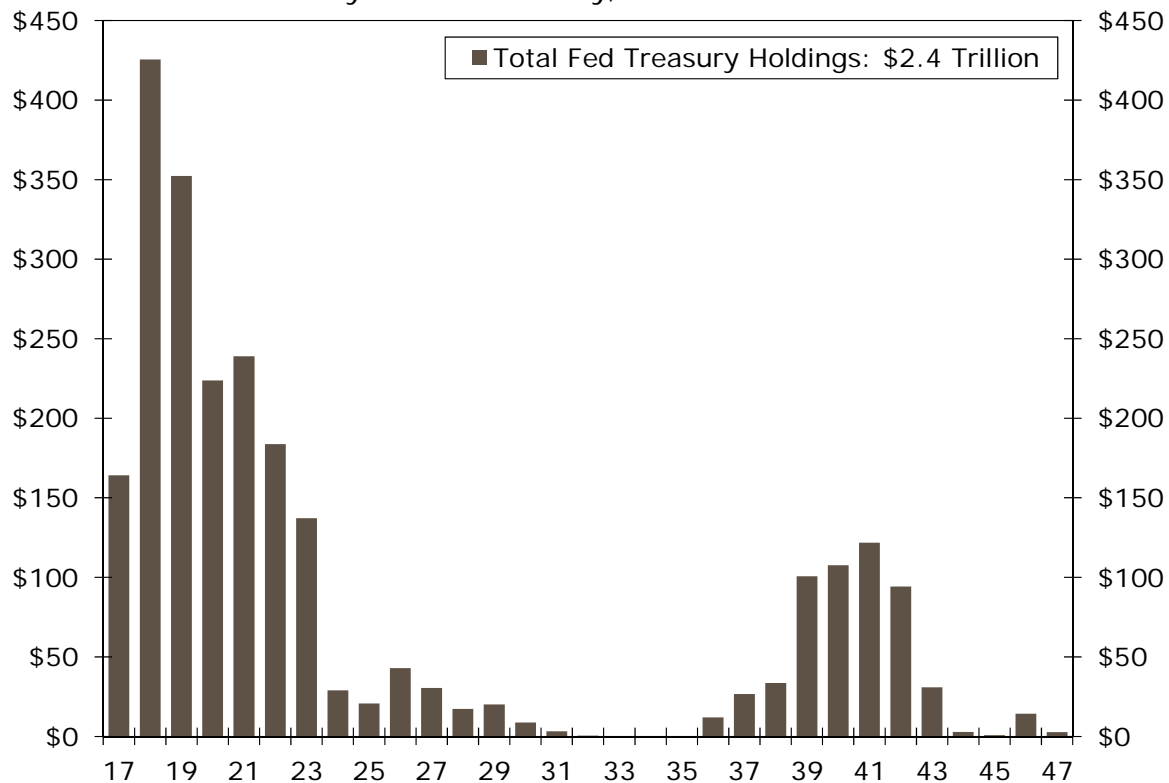


Source: U.S. Department of the Treasury, Federal Reserve Board and Wells Fargo Securities

The Fed and the Treasury Market

Nearly one-half of the Fed's \$2.4 trillion in Treasury holdings come due between now and 2020

Maturity Schedule of Fed Treasury Holdings By Year of Maturity, Billions of USD



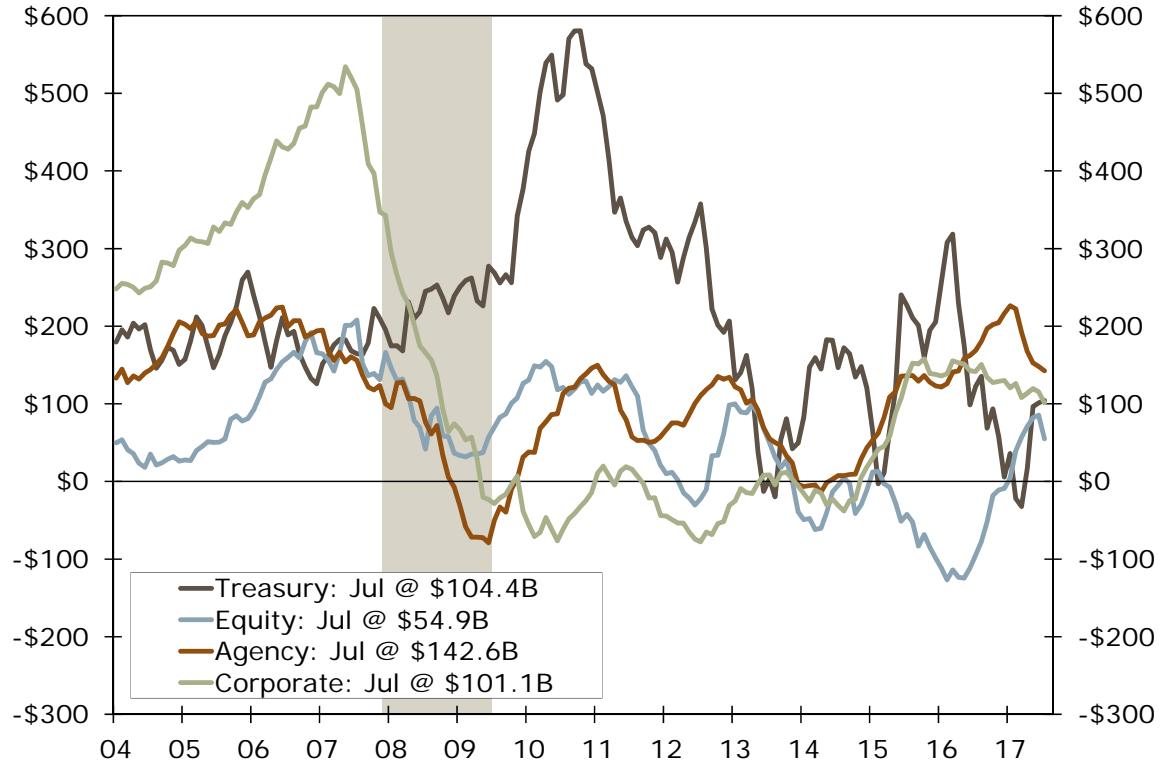
Source: Federal Reserve Bank of New York and Wells Fargo Securities

Foreign Purchases of U.S. Securities: Still Solid

Capital flows and asset allocation by global investors play a strong role in rate determinations

Foreign Private Purchases of U.S. Securities

12-Month Moving Sum, Billions of Dollars

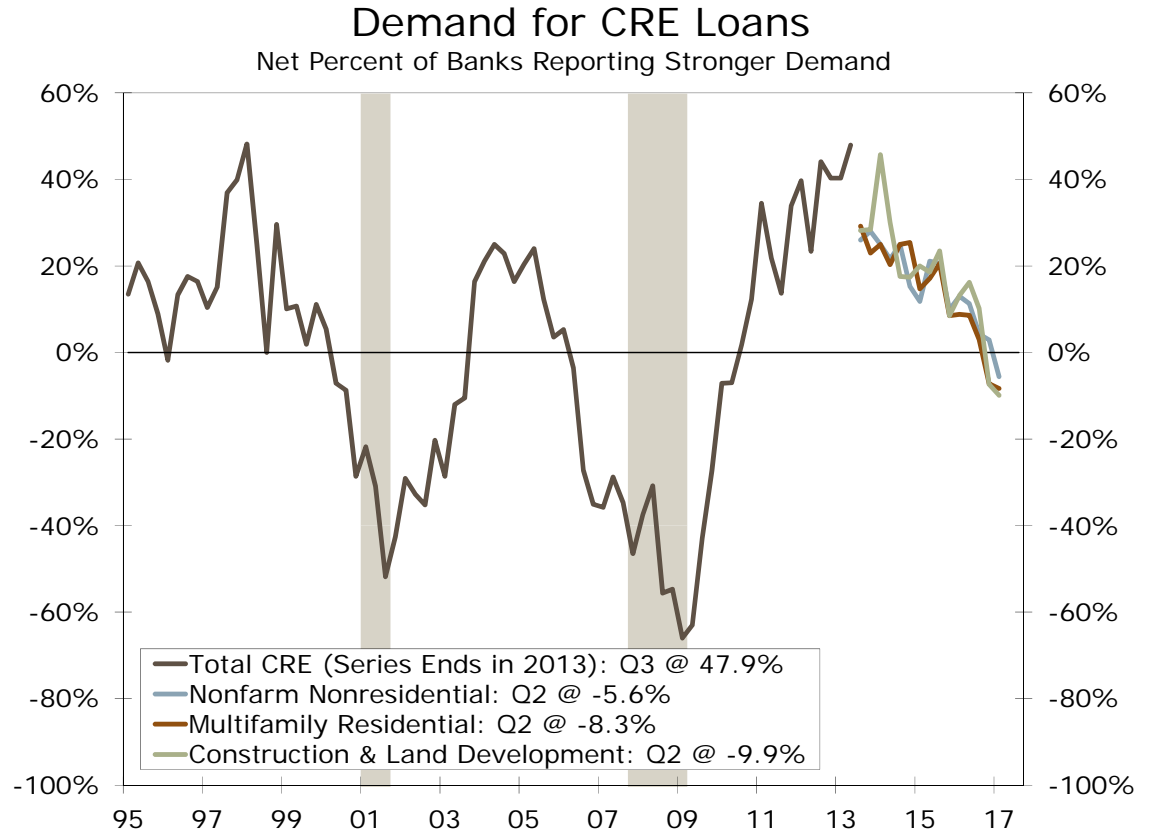


Source: U.S. Department of the Treasury and Wells Fargo Securities

Business Lending

Cracks in Bank Lending Market?

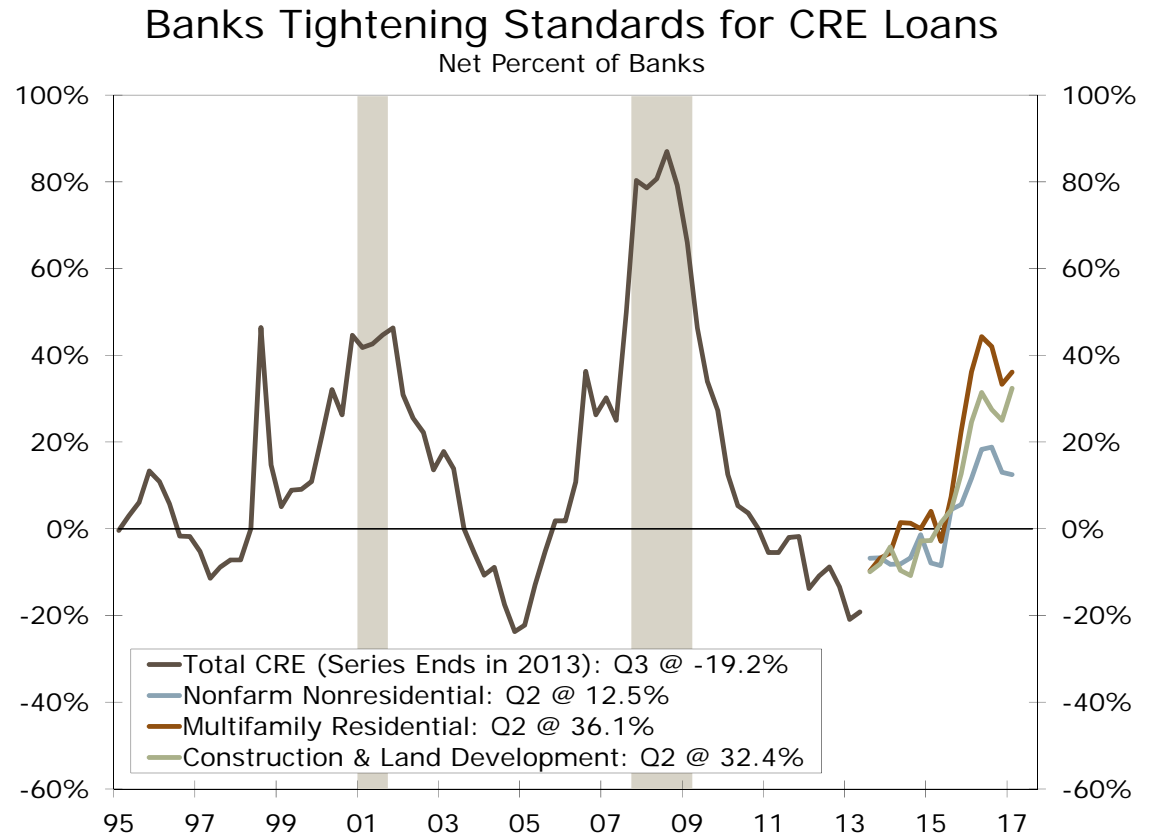
Demand for commercial real estate loans has eased from its peak



Source: Federal Reserve Board and Wells Fargo Securities

Cracks in Bank Lending Market?

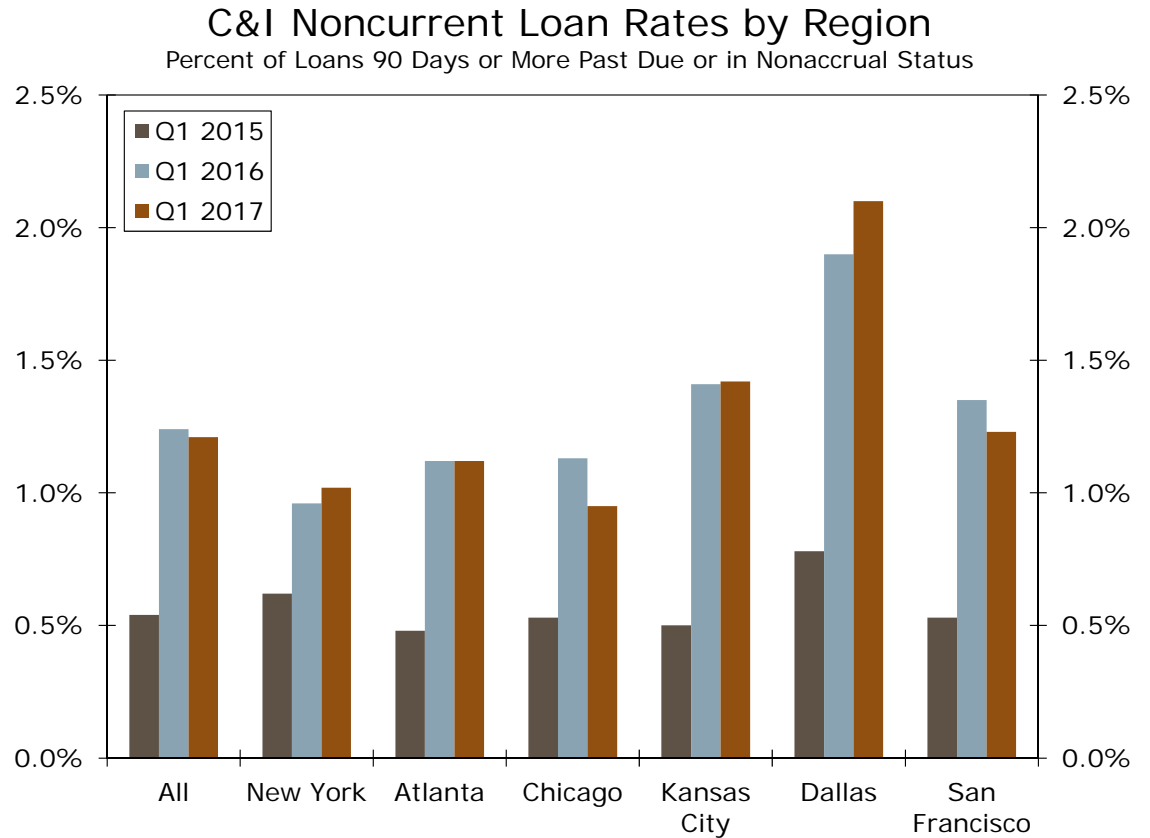
Lending standards for these types of loans have tightened



Source: Federal Reserve Board and Wells Fargo Securities

Cracks in Bank Lending Market?

Delinquencies are up across the nation, but particularly in energy-centric districts



Source: FDIC and Wells Fargo Securities

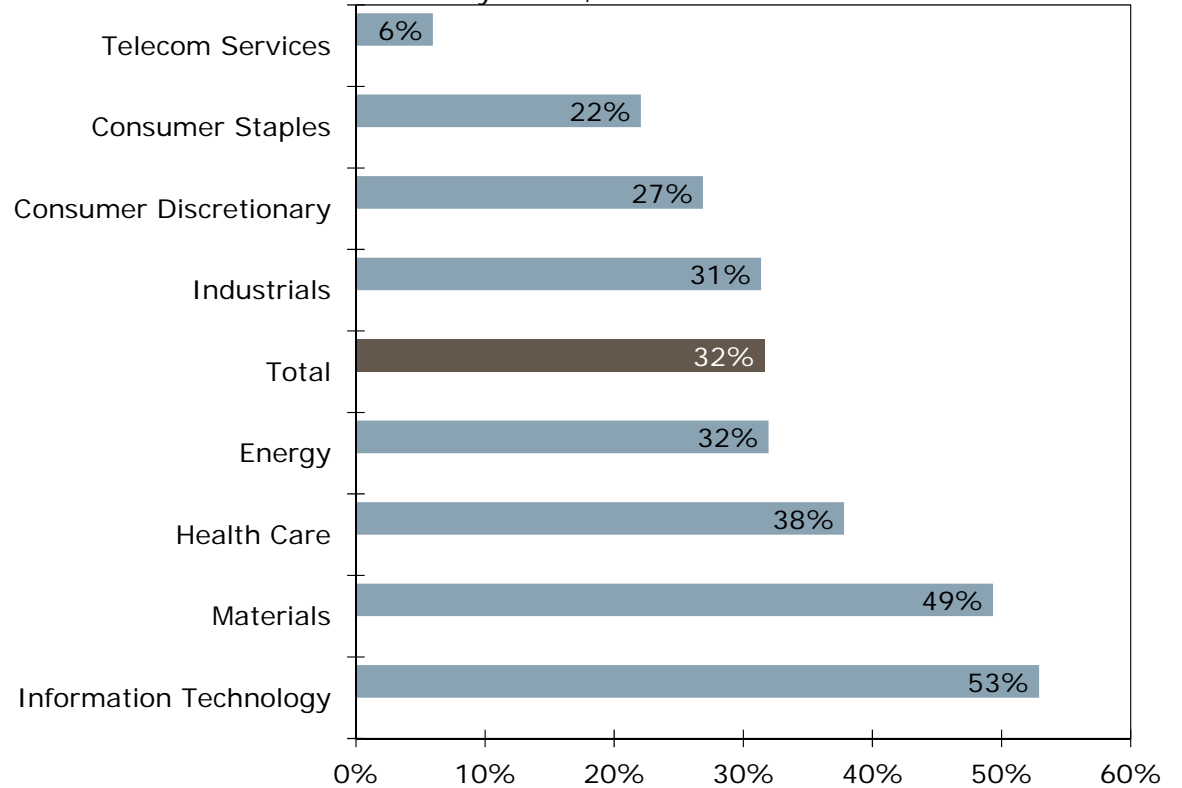
Global Profits and Shrinking Profit Margins

S&P Revenues Earned Abroad

IT and Materials earn the highest share of their revenues abroad, making those industries positioned to benefit the most from a weaker dollar

Percent of S&P Revenues Earned Abroad

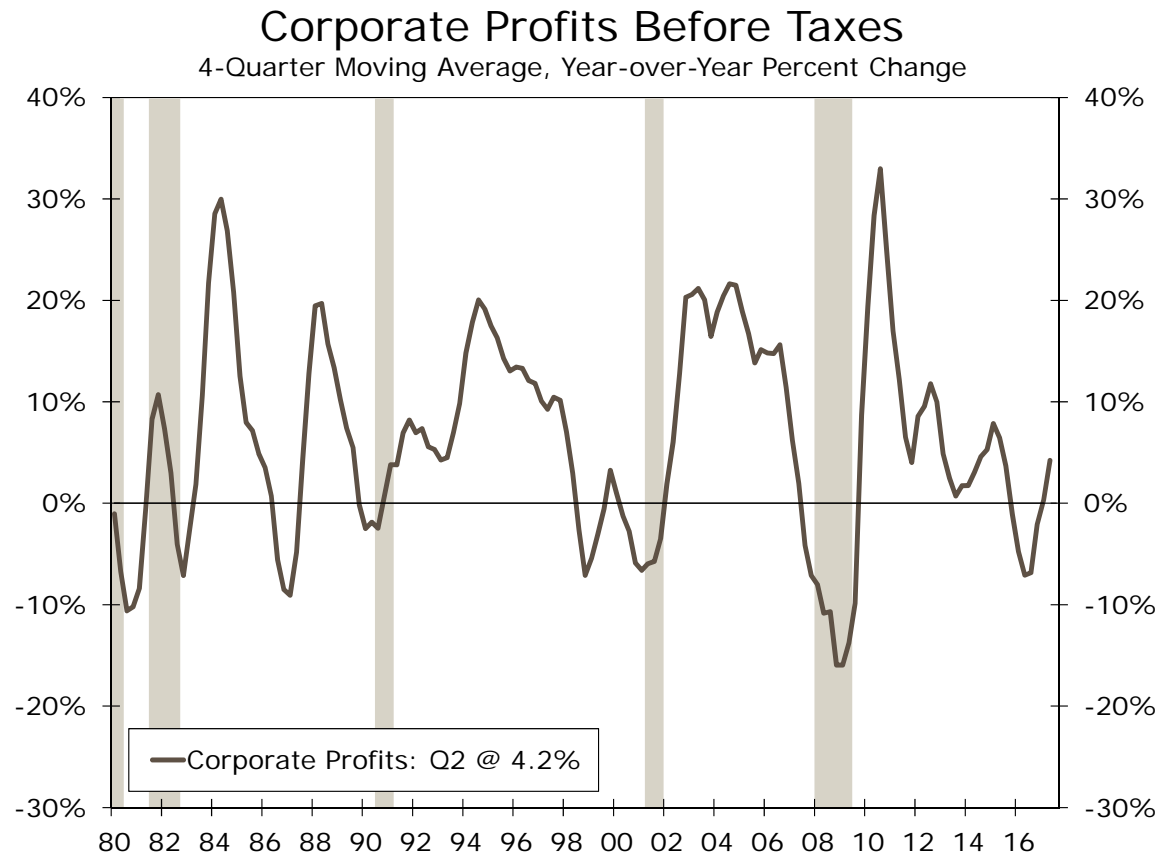
By Sector, Q1 2017



Source: Bloomberg LP and Wells Fargo Securities

Corporate Profit Growth

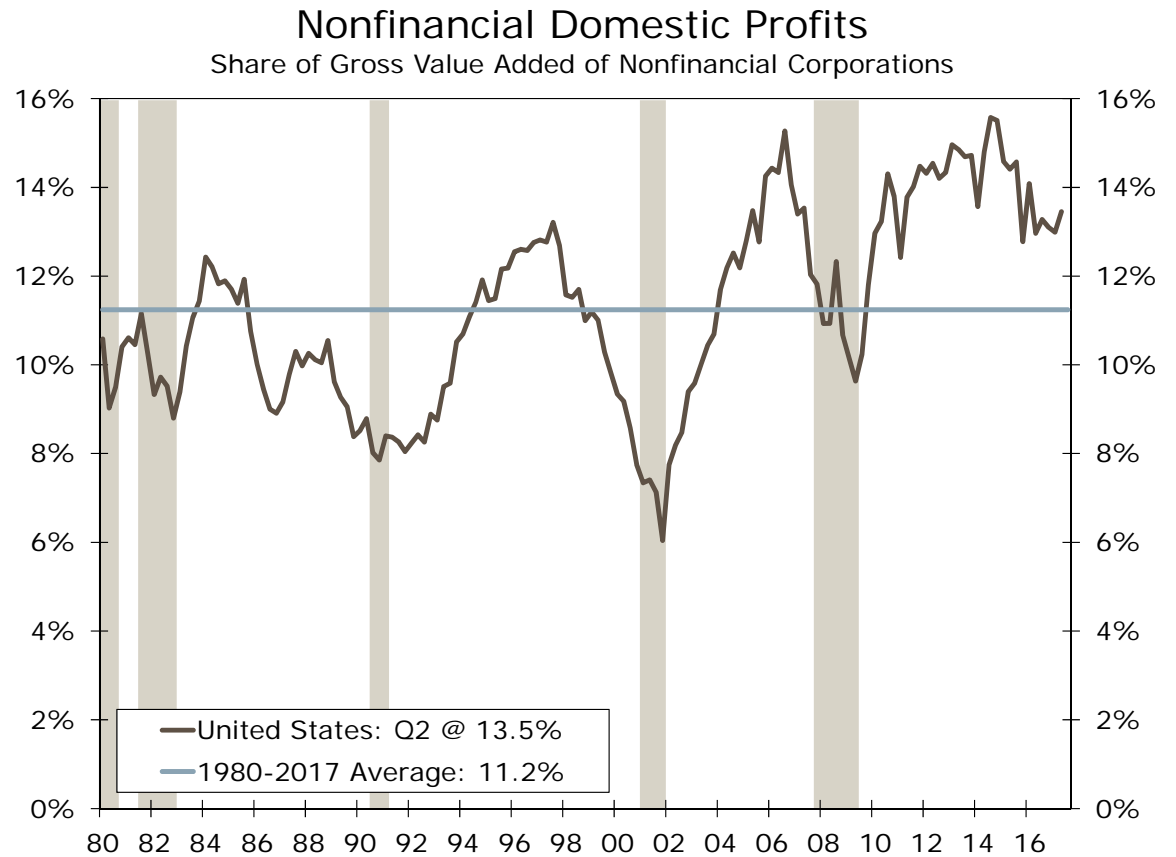
Corporate profit growth has slowed recently—typical mid- to late-cycle slowdown



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

Corporate Profit Margins

Corporate profits as a share of gross value added remains historically high but is now past its peak

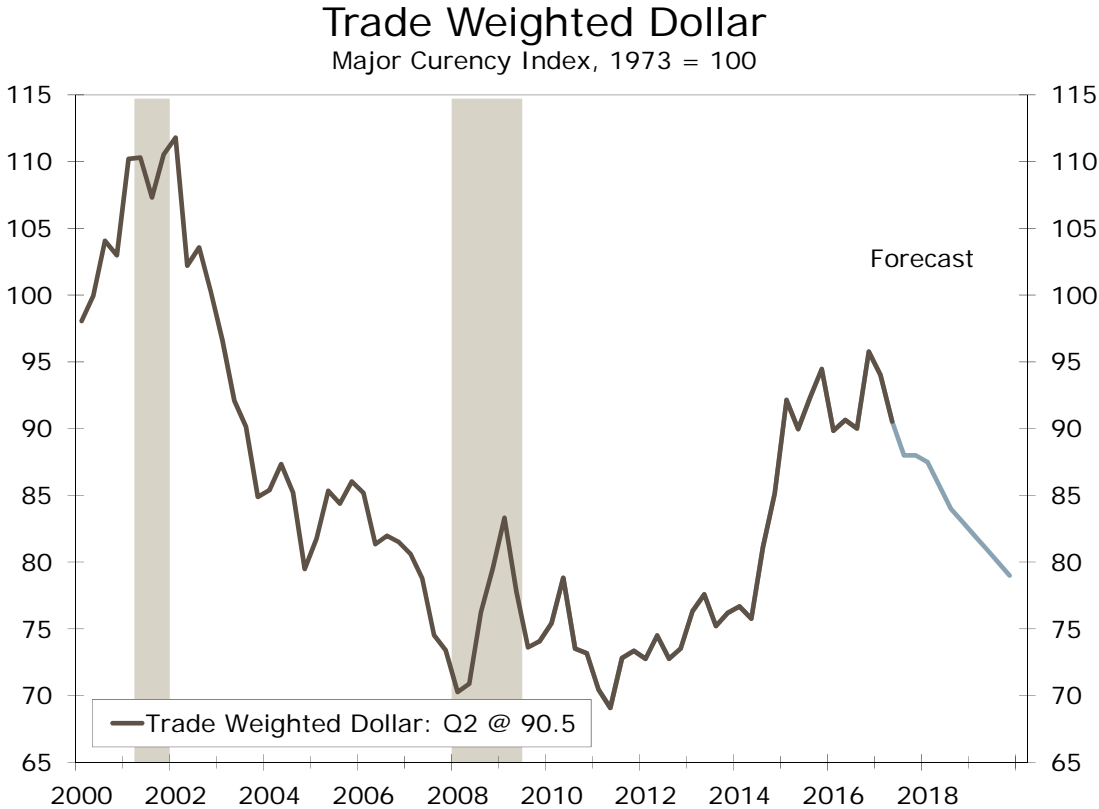


Source: U.S. Department of Commerce and Wells Fargo Securities

Dollar Appreciation and Trade Deficit

Dollar Appreciation: Bias Upward

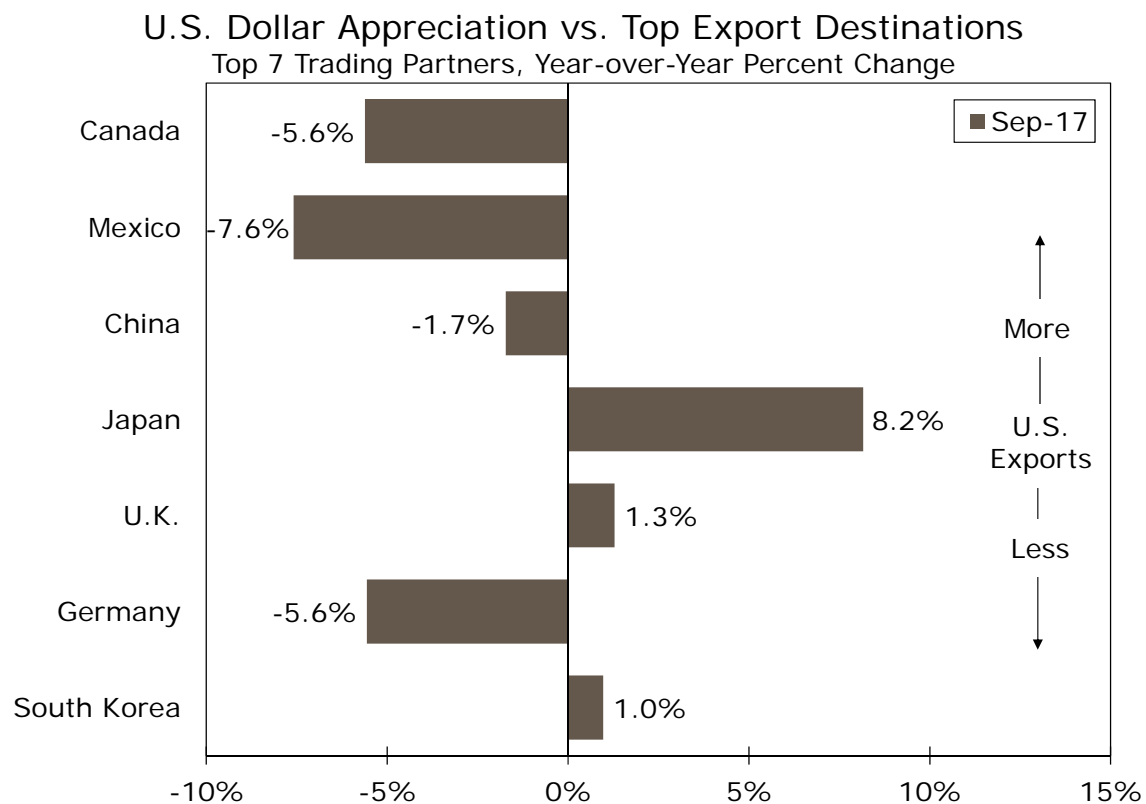
We expect the dollar to depreciate as central bank policy convergence replaces policy divergence.



Source: Federal Reserve Board and Wells Fargo Securities

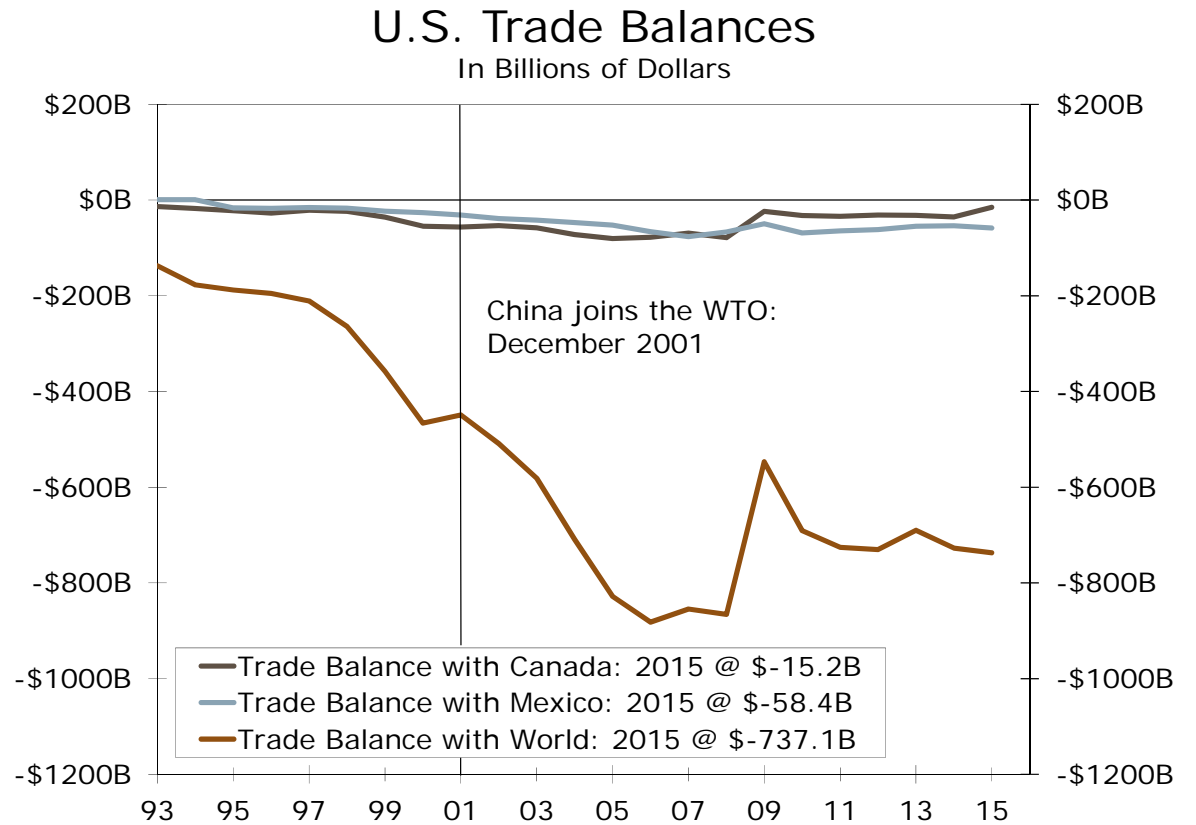
Dollar Appreciation: Bias Upward

The dollar has appreciated against most of our large trading partners over the past year, but movements have varied significantly



Source: Federal Reserve Board and Wells Fargo Securities

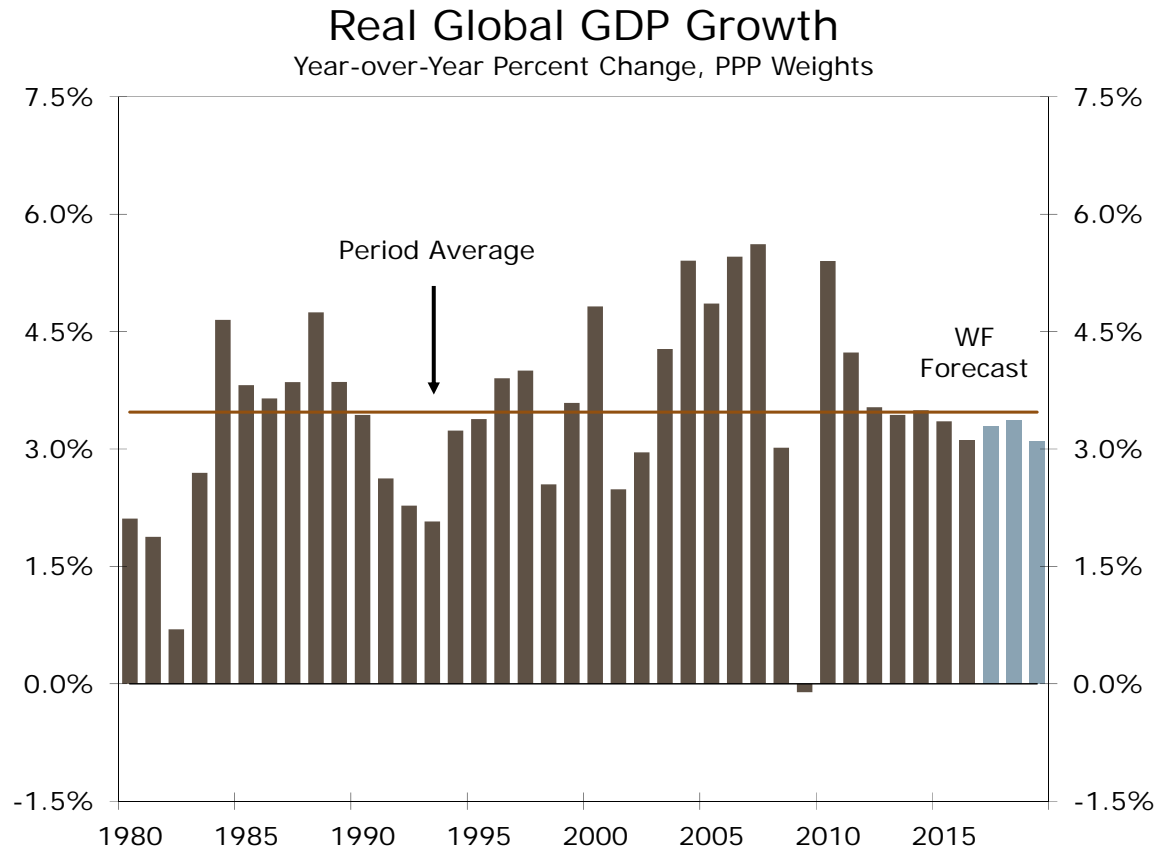
The U.S. trade balance with Canada and Mexico is modest compared to the rest of the world—particularly China



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

International Outlook: Subpar for How Long?

We expect global economic growth will remain a bit below its long-run trend



Source: International Monetary Fund and Wells Fargo Securities

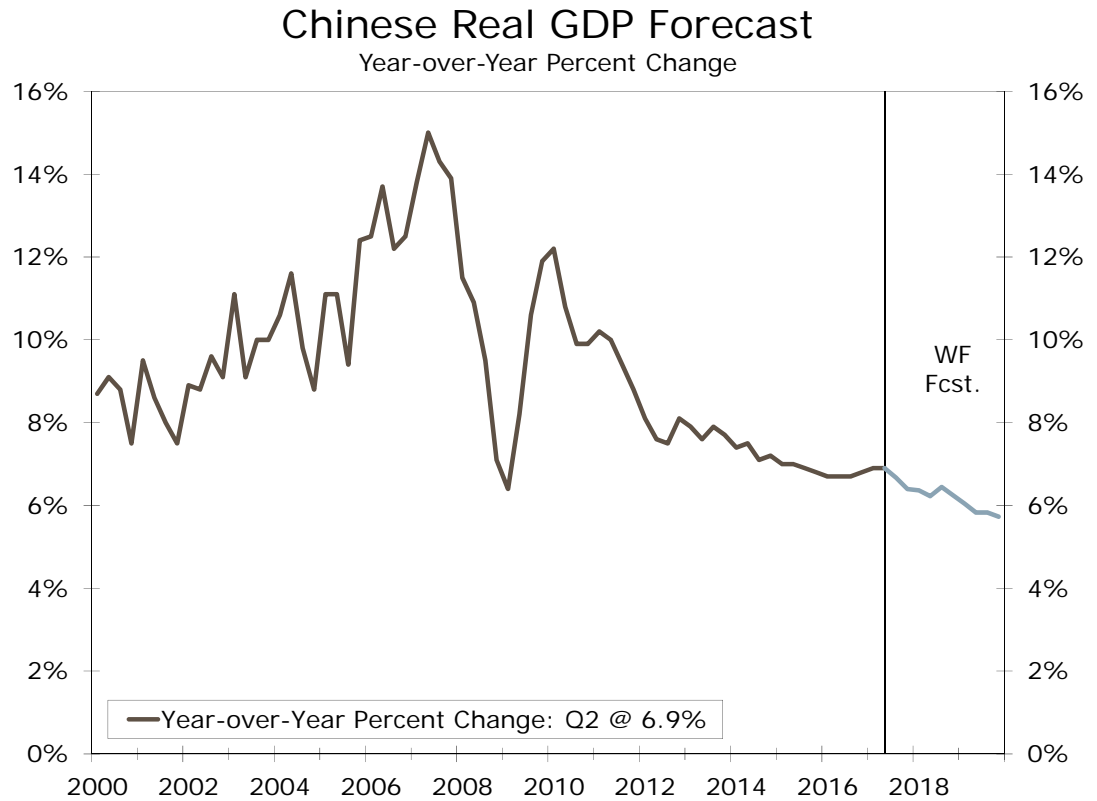
Global Exports: Downshift

Global trade has clearly downshifted compared to past expansions



Source: IHS Global Insight and Wells Fargo Securities

Growth in China will likely continue to downshift to a more sustainable pace



Source: Bloomberg LP and Wells Fargo Securities

Five Takeaways

Growth

- **Continued moderate growth led by domestic consumer**
-

Inflation

- **Moving sideways. Will this influence the Fed's policy path?**
-

Interest Rates

- **Rising short rates, but relatively flat long rates as capital flows favor the U.S.**
-

Dollar

- **Central bank policy convergence will limit dollar gains**
-

Profits

- **A late cycle slowdown**

U.S. Forecast

Wells Fargo U.S. Economic Forecast

	Actual		Forecast												Actual		Forecast		
	2017				2018				2019				2015	2016	2017	2018	2019		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q							
Real Gross Domestic Product ¹	1.2	3.1	2.0	2.5	2.3	2.5	2.6	2.6	2.4	2.6	2.5	2.7	2.9	1.5	2.1	2.4	2.5		
Personal Consumption	1.9	3.3	1.8	2.5	2.5	2.6	2.6	2.6	2.3	2.5	2.4	2.4	3.6	2.7	2.6	2.5	2.5		
Business Fixed Investment	7.1	6.7	5.2	6.2	4.8	4.1	4.0	3.7	3.6	3.5	3.5	3.6	2.3	-0.6	4.7	4.9	3.7		
Equipment	4.4	8.8	6.9	8.7	5.4	4.3	4.2	3.7	3.7	3.3	3.5	3.7	3.5	-3.4	4.1	5.9	3.7		
Intellectual Property Products	5.8	3.7	4.5	5.0	5.2	4.8	4.7	4.5	4.6	4.6	4.6	4.6	3.8	6.3	4.1	4.8	4.6		
Structures	14.8	7.0	3.0	2.5	3.0	2.4	2.4	2.2	2.0	1.9	1.9	1.9	-1.8	-4.1	6.7	2.9	2.1		
Residential Construction	11.1	-7.3	-6.0	-2.0	5.0	8.0	7.5	7.0	5.0	4.5	4.5	4.0	10.2	5.5	0.7	2.4	5.6		
Government Purchases	-0.6	-0.2	-0.5	0.4	0.2	0.8	0.8	0.8	0.7	0.7	0.7	0.7	1.4	0.8	-0.2	0.3	0.7		
Net Exports ²	0.2	0.2	0.2	-0.3	-0.2	-0.2	-0.1	0.0	0.1	0.1	0.2	0.2	-0.7	-0.2	-0.2	-0.1	0.0		
Inventories ²	-1.5	0.1	0.8	0.2	0.0	0.0	0.0	-0.1	0.0	0.0	-0.1	0.0	0.2	-0.4	-0.1	0.1	0.0		
Nonfarm Payroll Change ³	166	187	148	153	170	160	160	155	150	150	145	145	226	187	164	161	148		
Unemployment Rate	4.7	4.4	4.4	4.3	4.2	4.1	4.0	4.0	3.9	3.8	3.9	3.8	5.3	4.9	4.4	4.1	3.9		
Consumer Price Index ⁴	2.6	1.9	2.0	2.0	1.7	2.3	2.3	1.9	2.0	2.1	2.2	2.2	0.1	1.3	2.1	2.1	2.1		
Quarter-End Interest Rates ⁵																			
Federal Funds Target Rate	1.00	1.25	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.25	2.25	2.50	0.27	0.52	1.25	1.75	2.25		
Conventional Mortgage Rate	4.20	3.90	4.03	4.20	4.28	4.36	4.40	4.46	4.49	4.55	4.57	4.65	3.85	3.65	4.08	4.38	4.56		
2 Year Note	1.27	1.38	1.46	1.72	1.83	1.93	2.00	2.15	2.23	2.33	2.38	2.50	0.69	0.83	1.46	1.98	2.36		
10 Year Note	2.40	2.31	2.30	2.49	2.57	2.66	2.71	2.78	2.82	2.88	2.91	3.00	2.14	1.84	2.38	2.68	2.90		

Forecast as of: September 29, 2017

¹ Compound Annual Growth Rate Quarter-over-Quarter

² Percentage Point Contribution to GDP

³ Average Monthly Change

⁴ Year-over-Year Percentage Change

⁵ Annual Numbers Represent Averages

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

International Forecast

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2017	2018	2019	2017	2018	2019
Global (PPP Weights)	3.4%	3.4%	3.1%	3.2%	3.3%	3.1%
Global (Market Exchange Rates)	3.2%	3.3%	2.8%	3.2%	3.3%	3.1%
Advanced Economies ¹	2.3%	2.3%	1.8%	1.7%	1.9%	1.4%
United States	2.2%	2.6%	2.5%	1.9%	1.7%	2.2%
Eurozone	2.1%	2.0%	1.7%	1.5%	1.7%	1.9%
United Kingdom	1.6%	1.7%	1.6%	2.6%	2.1%	2.0%
Japan	1.9%	1.1%	0.7%	0.3%	0.7%	0.3%
Korea	2.9%	2.8%	3.0%	2.1%	2.0%	2.4%
Canada	3.0%	2.0%	1.9%	1.6%	1.9%	2.0%
Developing Economies ¹	4.5%	4.5%	4.3%	4.8%	4.8%	4.8%
China	6.6%	6.3%	5.9%	1.5%	2.0%	1.9%
India ²	7.1%	6.4%	7.2%	3.1%	4.1%	4.3%
Mexico	2.1%	2.3%	2.4%	6.0%	5.0%	5.2%
Brazil	0.6%	2.0%	2.2%	3.5%	3.5%	3.8%
Russia	1.7%	2.0%	2.2%	4.2%	4.3%	4.5%

Forecast as of: September 7, 2017

¹Aggregated Using PPP Weights

Source: International Monetary Fund and Wells Fargo Securities

Appendix

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<http://www.wellsfargo.com/economics>

Recent Special Commentary

Date	Title	Authors
U.S. Macro		
September-20	FOMC: Gauging Normality for Investors: Real Rates Positive	Silvia
September-19	Inflation Slowdown: Transitional or Persistent?	House & Vaisey
September-18	Is the Yield Curve Enough to Predict Recessions?	Silvia, Iqbal & Pershing
September-13	Our Fiscal Policy Assumptions: An Update	Brown & Pugliese
September-08	Do We Need to Wait for a Yield Curve Inversion to Predict a Recession? No.	Silvia, Iqbal & Pershing
U.S. Regional		
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