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Economics Group

Special Commentary

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An Economic Framework for Financial Services*

For the financial services sector, the economic and regulatory changes have been momentous over the past four years. These changes have altered the framework for decision makers in both the private and public sectors, but especially so for the financial services sector. Here, we focus on economic changes with particular emphasis on those that suggest a structural challenge to decision making as it was done in the past.

Here we focus on economic changes with particular emphasis on those that suggest a structural challenge to decision making as it was done in the past.

Our economic framework is built on the five fundamentals that we traditionally review: growth, inflation, interest rates, corporate profits and the dollar (Figure 1). For each of these, we can recognize a familiar cyclical pattern to the data, but there are also hints of a more ominous altering of select long-term trends that would suggest decision makers must alter their view on how the economy works.

Figure 1

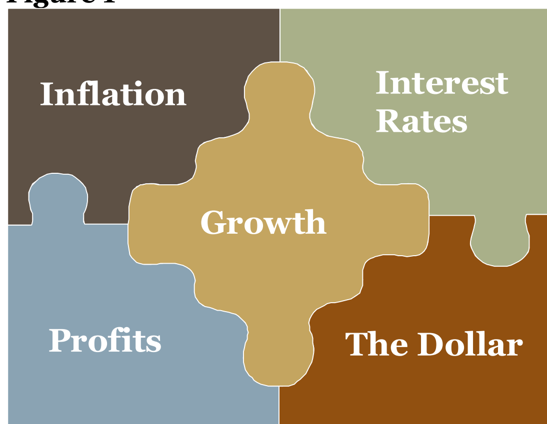
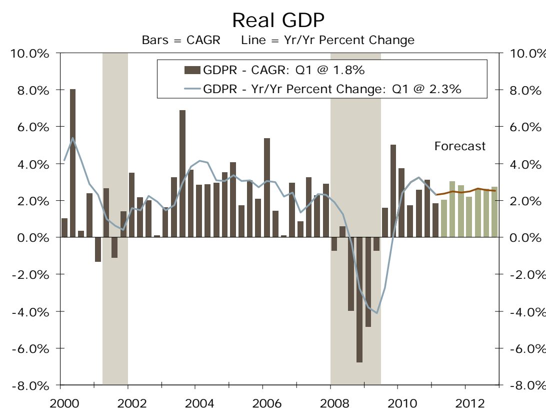


Figure 2



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

Growth: Size Does Matter

We expect growth to be sustained at a moderate pace of 2.5 percent for 2011 and 2012 (Figure 2). This pace is slightly below the Blue Chip consensus estimate. While sustained growth, this pace is also below the pace associated with an economic expansion in the post-WWII period, which has averaged 4.6 percent. Therefore, slower growth alone forces financial service firms to reevaluate their top-line growth expectations.

* **Notes from our presentation at the Financial Services Conference, June 7, 2011**

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During this economic expansion, we have seen improvement in both small business and large firm assessments of the economy, but greater improvement has been at larger firms that are better able to participate in the global recovery.

During this economic expansion, we have seen improvement in both small business and large firm assessments of the economy, but greater improvement has been at larger firms that are better able to participate in the global recovery. Expected revenue gains recorded in our Wells Fargo Small Business Index (Figure 3) have improved off the low in early 2009, but the extent of improvement remains below the level of revenue expectations recorded during the 2004–2007 period. The gains in this index are consistent with the NFIB Small Business Optimism Index, which has risen from record lows reached in early 2009 but remains well below its historic trend.

There has been improvement in other key economic indicators, including a downward trend in initial jobless claims along with a rising S&P 500 index as can be seen in Figure 3. These indicators signal more substantial growth among larger firms. We also note the robustness of the Institute for Supply Management (Figure 4) survey during the recovery, which reflects the inclusion of larger firms in the survey sample and firms that are more connected to the global economy and influenced by stronger growth rates abroad. Within the ISM index, the recent subcomponents of this indicator—such as production and new orders—have also been very strong. The recent moderation in this indicator is consistent with continued economic growth, but at a more measured pace.

Figure 3

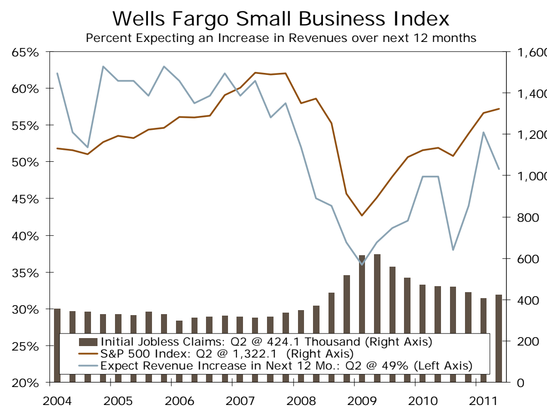
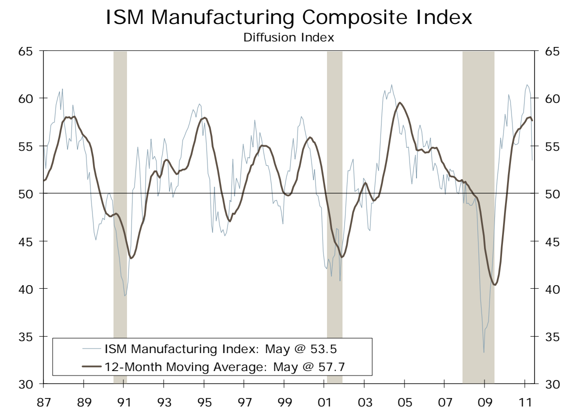


Figure 4



Source: U.S. Department of Labor, IHS Global Insight, Gallup, Wells Fargo & Co., Institute for Supply Management and Wells Fargo Securities, LLC

The pattern of the current employment cycle suggests a more significant share of structural unemployment as a share of total unemployment exists relative to that in previous cycles.

Jobless claims have exhibited a cyclical recovery in the face of structural challenges in the labor market. In Figure 5, we have a clear picture of a recovery in jobless claims as they have dropped from their peak in late 2009. Yet, in Figure 6, we can see evidence that the overall pace of job recovery during this expansion remains far below the pace in the past, thereby contributing to a higher rate of initial claims as fewer jobs are created. Meanwhile, the high unemployment rate for lower-skilled workers provides evidence that the character of the labor market has shifted in favor of better-educated, higher-skilled professional workers. The pattern of the current employment cycle suggests a more significant share of structural unemployment as a share of total unemployment exists relative to that in previous cycles.

Figure 5

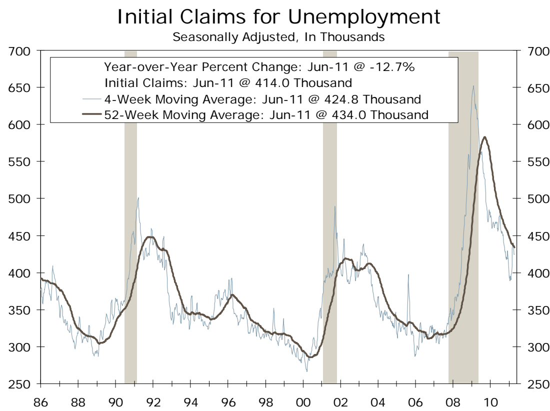
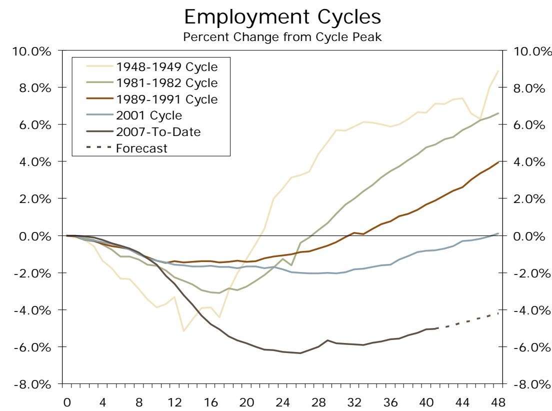


Figure 6



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

Housing: The Structural Challenge

Housing starts dropped sharply in 2007 as is typical of any economic recession, but the extent of the decline has been far more severe than in earlier cycles, as illustrated in Figure 7. Moreover, starts have not rebounded from their lows and therefore provide evidence that the housing market in this business cycle is facing a more fundamental shift in its structure. On the demand side, buyers are reassessing the idea of a home as a surefire investment and their expectations that home prices will always rise in certain areas (California, Florida) and will eventually rise nationally over time. Moreover, new home prices are far above their historical average spread over existing homes (Figure 8). This price differential between new and existing homes has become very wide with the high inventory of existing homes on the market—including numerous foreclosed homes—and therefore limits a rally in homebuilding in the United States as existing homes are relatively more affordable. On the supply side, the credit that is available to support home purchases is being constrained by tighter underwriting and higher down payment requirements.

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Figure 7

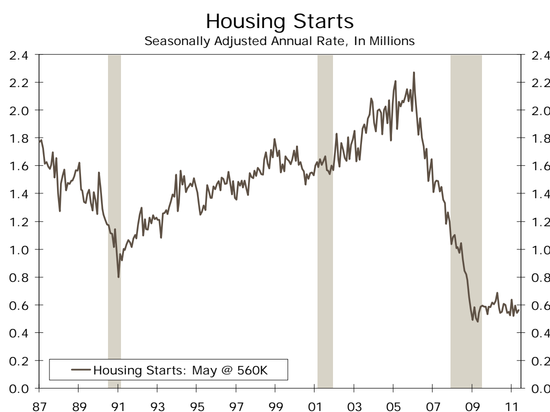
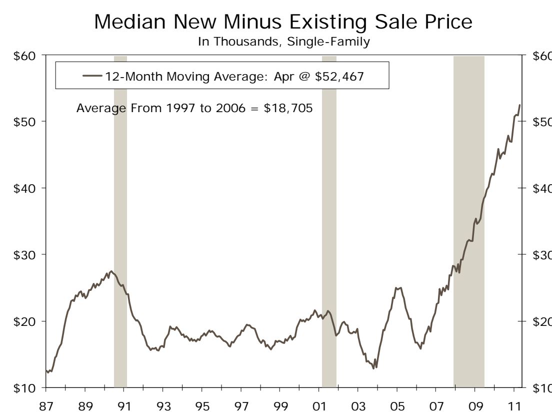


Figure 8



Source: U.S. Department of Commerce, National Association of Realtors and Wells Fargo Securities, LLC

Given the modest expectations for improvement in residential real estate, small and medium-sized financial institutions, for which the portfolio on the asset side is heavily weighted toward residential lending, must reevaluate their expectations for investment returns going forward and their interest in devoting large amounts of capital to home financing.

Inflation: Neither Deflation, Nor Jimmy Carter Inflation

TIPS provides evidence of rising inflation expectations, not just a rise in measured headline inflation.

Since the first quarter of 2011, inflation measured by both the overall and core inflation indexes has drifted up consistently with the rise in gasoline and food prices over this period (Figure 9). Meanwhile, the TIPS inflation compensation, or break-even rate, has risen steadily (Figure 10) since the third quarter of 2010, and, although this measure has dipped down lately, the inflation trend appears to be on the upside. TIPS provides evidence of rising inflation expectations, not just a rise in measured headline inflation.

Figure 9

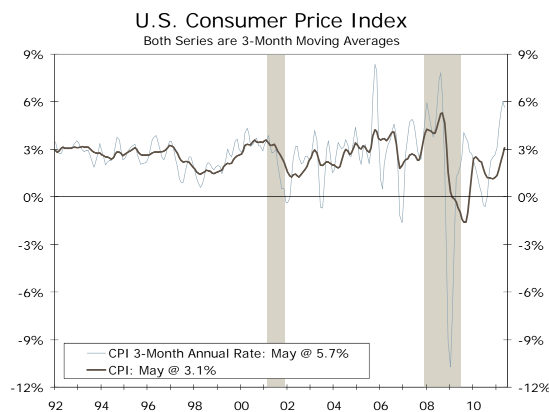
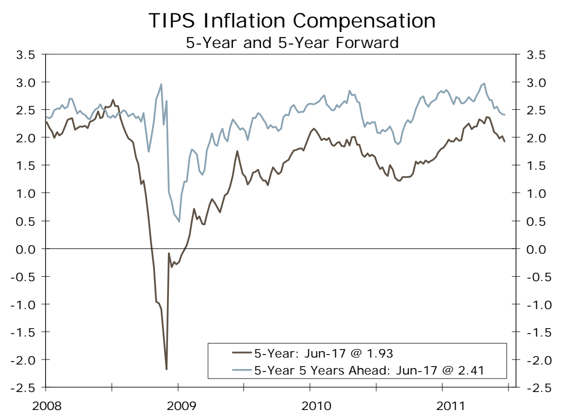


Figure 10



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

Low nominal yields do not compensate for rising modest inflation—there is no need for Jimmy Carter-era inflation to generate capital losses.

Even though the pace of inflation remains modest, inflation remains a wealth management issue as investors who bought Treasury notes several years ago to protect against the collapse of the financial system are now faced with negative real returns and a capital loss on many issues as inflation now exceeds the rate of return on these issues. Low nominal yields do not compensate for rising modest inflation—there is no need for Jimmy Carter-era inflation to generate capital losses.

Yield Curves and Quality Spreads

Modest economic growth and rising inflation from a low level sets the framework for the yield curve and quality spreads. With these economic fundamentals, the Federal Reserve is unlikely to raise the Federal Funds rate any time soon, so short-term interest rates are likely to stay low and anchor the yield curve. Meanwhile, modest inflation will suggest higher long-term interest rates in the future. As a result, the yield curve remains fairly steep from three-month to the 10-year term even though the level of rates overall remains fairly low (Figure 11).

Figure 11

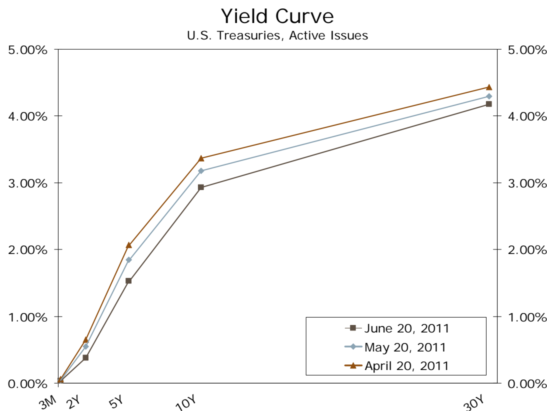
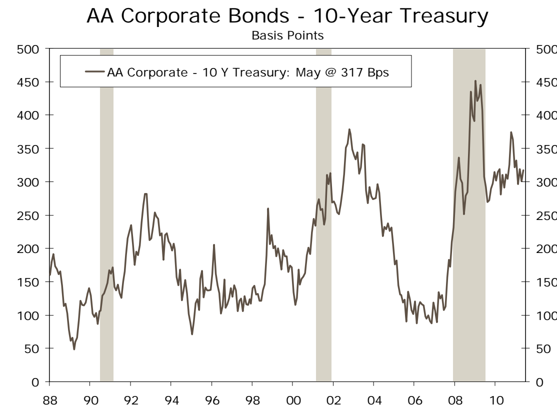


Figure 12



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

In addition, quality spreads have improved from the high peaks associated with the recession, yet there remains some additional skepticism in the marketplace on credit. The quality spread today (Figure 12) remains wider than what the spread was at the most optimistic point in 2006–2007 which is probably a good development. The corporate bond-to-10-year Treasury spread reflects neither extreme pessimism nor extreme optimism—a fairly accurate assessment to go along with our modest economic growth.

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Corporate Debt Issuance: High Yield and High Grade

New issuance of both high-yield (Figure 13) and high-grade (Figure 14) debt has improved sharply in 2011 compared to last year. There are three possible forces here that would support such increased issuance. First, many firms are likely engaged in restructuring their balance sheets to fit their view of a rebalancing of leverage within the enterprise. Second, some firms are no doubt engaged in opportunistic financing where they view current interest rates as very attractive relative to expected future interest rates. Finally, some firms are financing what they perceive as profitable expansion of existing facilities at very low interest rates.

Figure 13

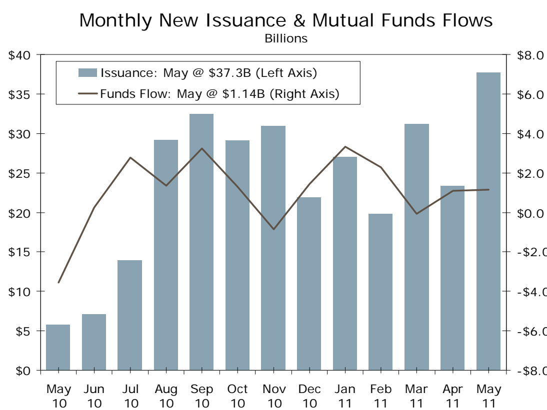
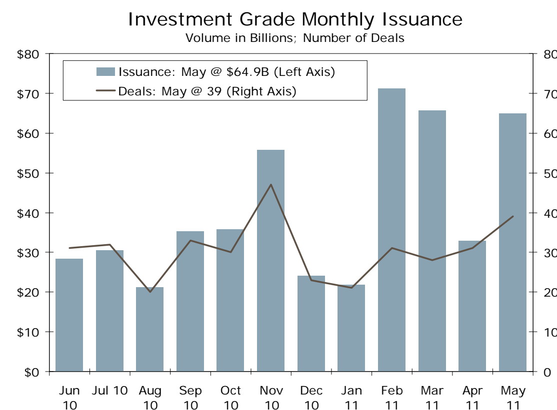


Figure 14



Source: IFR Markets, Lipper FMI and Wells Fargo Securities, LLC

Profit Growth and Equity Offerings

The strength of profit gains this cycle is linked more to the global opportunities available to many large companies and less to the subpar pace of the U.S. recovery.

Profit growth has followed its typical cyclical pattern of rapid gains at the start of the recovery and then more modest gains as the cycle continues (Figure 15). The strength of profit gains this cycle is linked more to the global opportunities available to many large companies and less to the subpar pace of the U.S. recovery. There are many opportunities abroad for those firms willing to explore the global territory. Of course, some industrial sectors (information technology and energy) and regions (coastal areas and major ports) are better able to take advantage of global growth as their economies are more international in scope (Figure 16).

Better profit growth has supported the gains in equity issuance that we have seen over the past year. Issuers find that their expectations for economic opportunities continue to outstrip the cost of equity finance today. These equity capital offerings and backlogs reflect forward-looking optimism for the companies as well as an effort at restructuring outmoded business models.

For 2010 and 2011, the capital markets are characterized by a restructuring of corporate balance sheets to finance opportunities going forward. Meanwhile, for the buyer, the expected returns on equity surpass those on cash and Treasury alternatives.

Figure 15

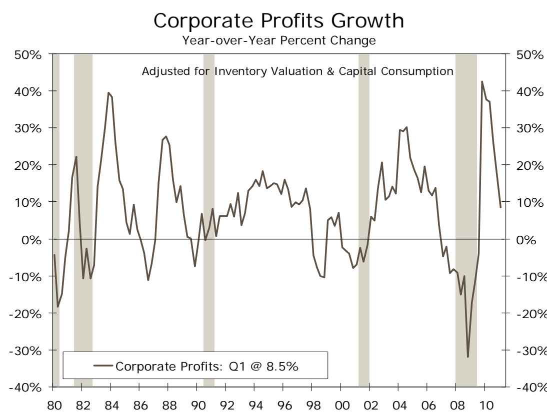


Figure 16

Globalization and Corporate Profits

Sector	Percentage of Total Sales Earned Abroad (07-09 Average)
Information Technology	56.9%
Energy	48.1%
Materials	44.9%
Industrials	36.7%
Consumer Staples	27.5%
Consumer Discretionary	24.0%
Financials	18.0%
Health Care	17.4%
Telecommunications	0.6%

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

Dollar Declines

A weaker dollar redistributes spending power in favor of exporters and away from importers, and the United States is, on balance, a nation of net importers.

A steady erosion in the value of the dollar since 2003 (Figure 17), interrupted only by the flight to safety trade associated with the Great Recession of 2008–2009, suggests an upward bias on prices paid for imported goods and an improved competitive position for U.S. exporters. The weaker dollar is perceived by some as a positive for the U.S. economy. However, a weaker dollar redistributes spending power in favor of exporters and away from importers, and the United States is, on balance, a nation of net importers. Moreover, there is no political will to offset the dollar decline despite its effect of redistributing spending power.

Figure 17

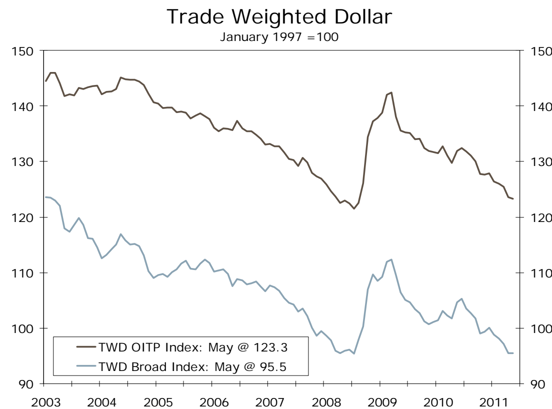
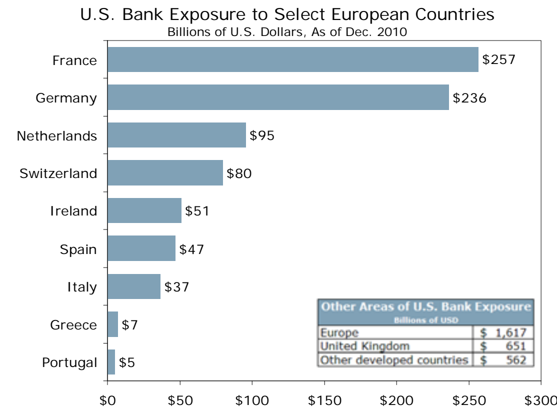


Figure 18



Source: Federal Reserve Board, Bank for International Settlements and Wells Fargo Securities, LLC

U.S. Bank Exposure to the European Sovereign Debt Crisis

Bank exposure to European peripheral country debt is relatively low for U.S. banks, as illustrated in Figure 18. This suggests that the channel of influence on U.S. economic developments will be primarily through the impact on U.S. trade with Europe and less on the financial transfer of credit losses. Of course, European difficulties have kept U.S. interest rates lower than they would be otherwise given the flight to safety toward U.S. Treasury debt and away from European debt.

Bank Assets and Economy Size: Scale of Domestic Risk?

Despite the nominal size of the largest U.S. banks, when compared to the scale of the U.S economy, illustrated in Figure 19, the major U.S. banks' assets do not appear very large at all. Further detail for related countries appears in Figure 20. The fear that problems at a major banking institution would mean a collapse of the U.S. economy appears to be a bit overdone.

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Figure 19

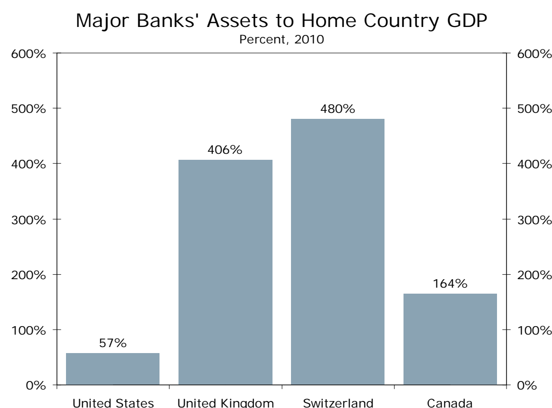


Figure 20

Institution	Total Assets (Billions)	Country	Assets to GDP, 2010
Bank of America Corporation	2,265	United States	15%
JPMorgan Chase & Co.	2,118	United States	14%
Citigroup Inc.	1,914	United States	13%
Wells Fargo & Company	1,258	United States	9%
U.S. Bancorp	308	United States	2%
PNC Financial Services Group, Inc.	264	United States	2%
Bank of New York Mellon Corporation	247	United States	2%
Royal Bank of Canada	713	Canada	45%
Toronto-Dominion Bank	608	Canada	39%
Bank of Nova Scotia	517	Canada	33%
BMO Financial Group	404	Canada	26%
Canadian Imperial Bank of Commerce	345	Canada	22%
HSBC Holdings Plc	2,455	United Kingdom	109%
Barclays Plc	2,333	United Kingdom	104%
Royal Bank of Scotland Group Plc	2,276	United Kingdom	101%
Lloyds Banking Group Plc	1,554	United Kingdom	69%
Standard Chartered Plc	517	United Kingdom	23%
UBS AG	1,411	Switzerland	269%
Credit Suisse Group AG	1,105	Switzerland	211%

Source: SNL Financial LC, IMF and Wells Fargo Securities, LLC

Federal Budget Imbalance and the Deficit Cycle

We are truly in unchartered waters as made clear by Figure 21 where the current federal budget deficit represents 10 percent of GDP, which is unprecedented for a period of economic expansion. Moreover, demographics as destiny implies that future federal spending will continue to rise with

the retirement of the baby boomers and the rise in healthcare expectations and costs. The growth of spending for entitlements will continue to outpace the gains in revenues from economic growth. The pattern of the current deficit cycle is clearly higher and more ominous than in prior cycles (Figure 22). Whereas the deficit has turned down at this point in previous cycles, the deficit is this current cycle continues to head higher even as GDP is growing.

The problem is not whether we can finance the federal deficit, but at what price we do so in terms of higher interest rates and a depreciating currency.

This leaves our society with difficult choices in order to bring the deficit and the federal debt in line with what may be sustainable in a global capital market and the position of the dollar as the global reserve currency. The problem is not whether we can finance the federal deficit, but at what price we do so in terms of higher interest rates and a depreciating currency.

Figure 21

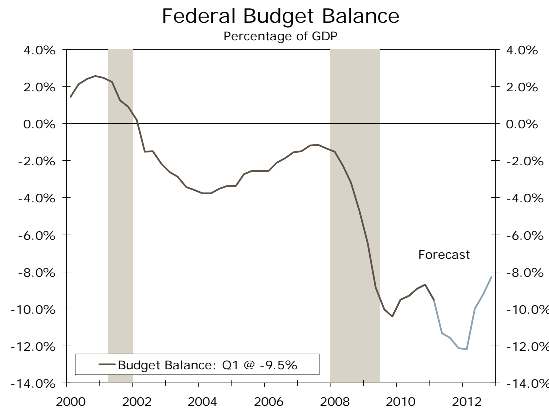
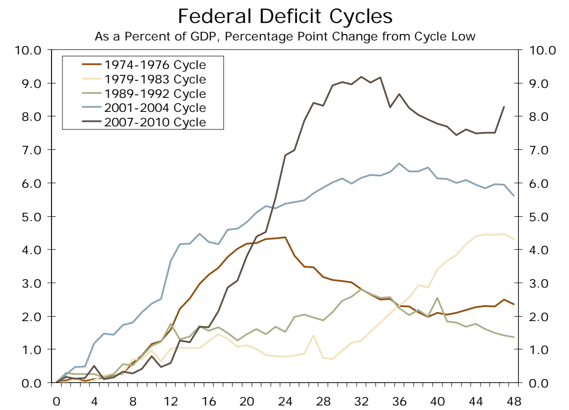


Figure 22



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

Loan Performance and the Business Cycle

Loan delinquencies exhibit a clear, counter cyclical, pattern although the depth of the recent Great Recession did not elicit the jump in commercial and industrial loan delinquencies to the level of the 2001 recession that might have been expected. This would suggest that for business firms, in contrast to homeowners with mortgages, the degree of financial stress was more muted.

Figure 23

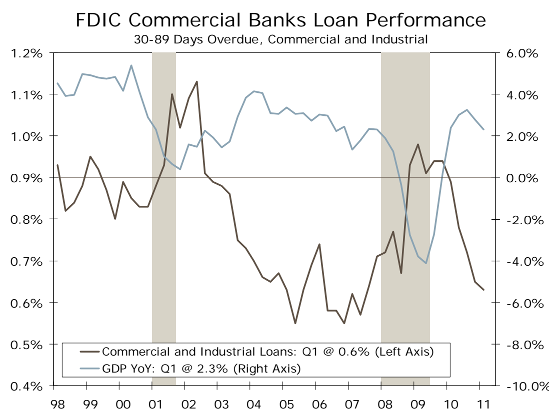
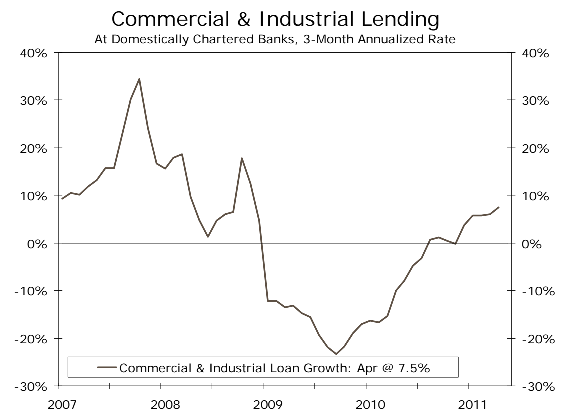


Figure 24



Source: FDIC, Federal Reserve Board and Wells Fargo Securities, LLC

Improvement in the Bank Lending Cycle

At this stage of the business cycle, bank credit to business has improved, as illustrated in Figure 24. First, the percentage of banks that have tightened their lending standards has declined below the zero percent line, suggesting that, on net, banks are actually easing their standards (Figure 25). This is true for lending standards for both small and large to medium-sized firms.

Meanwhile, the net percent of banks reporting stronger demand has risen into positive territory (Figure 26). This is a good sign that credit demand is picking up and that firms are ready to use credit to expand their operations and perhaps increase employment as well.

Figure 25

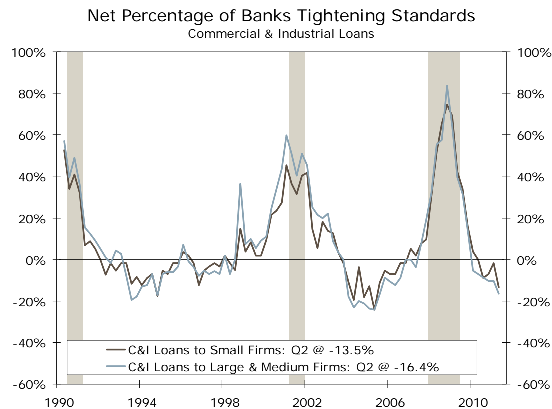
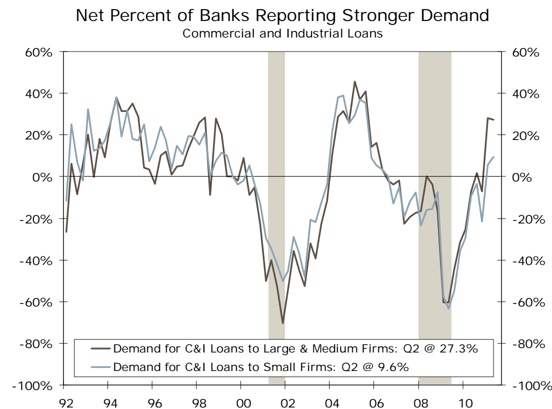


Figure 26



Source: Federal Reserve Board and Wells Fargo Securities, LLC

Summary

An analysis of the five economic fundamentals of growth, inflation, interest rates, corporate profits and the dollar indicates a structural shift in the way the economy will function in the future.

The substantial changes in the economic landscape over the past four years have significantly altered the framework of financial decision makers. An analysis of the five economic fundamentals of growth, inflation, interest rates, corporate profits and the dollar indicates a structural shift in the way the economy will function in the future. The shift in domestic economic fundamentals has led to a more globally focused corporate environment. The moderate pace of domestic economic growth combined with a rising inflationary environment has motivated firms to focus on their global customers. In addition, these firms continue to take advantage of low interest rates and slightly looser credit standards to restructure their operations and adopt more technology. The retooling of these corporations is intended to restructure their balance sheets by decreasing their leverage positions as well as to expand current operations. The net result of these actions should be good news for both domestic output and employment growth going forward, although gains will occur at a more moderate pace than in the past.

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