June 19, 2015

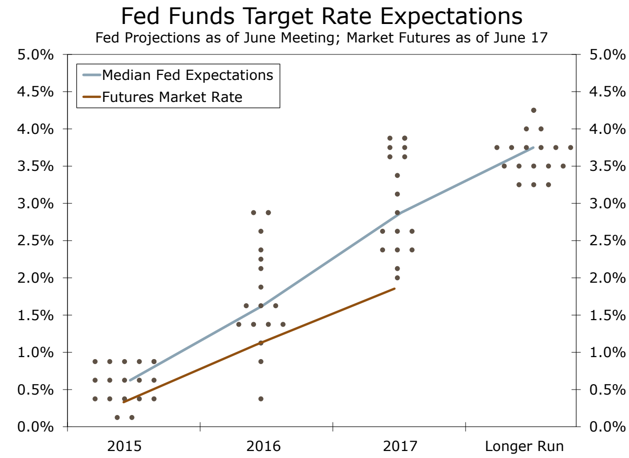
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

The Fed Gears Up for September Hike

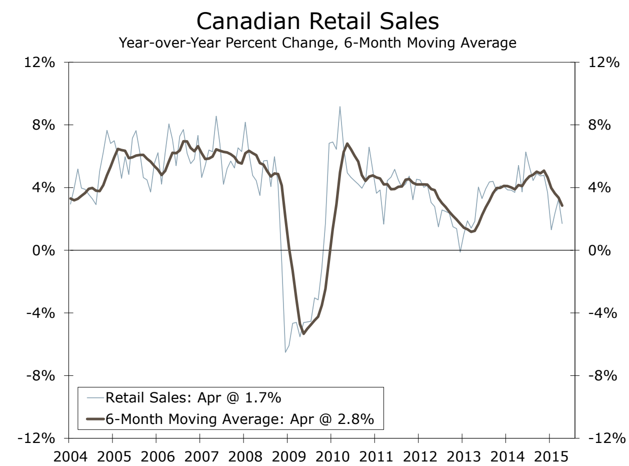
- The June Federal Open Market Committee (FOMC) meeting points to a September rate hike despite some downward revisions to its economic forecast.
- Consumer prices gained strength in May, thanks to higher energy costs, although year-ago inflation remains soft.
- The factory sector has struggled with a stronger dollar and energy cutbacks, which contributed to another decline in industrial production in May.
- Homebuilders are more confident, but residential construction growth is set to be relatively modest.



Global Review

Retail Sales Slip in Canada, Firming in United Kingdom

- After back-to-back gains in prior months, retail sales in Canada slipped 0.1 percent in April. Meanwhile, the year-over-year rate of headline CPI inflation picked up to 0.9 percent in May, as core CPI slowed to 2.2 percent.
- After a brush with deflation in the United Kingdom, prices are firming again. That is not the only thing picking up in the United Kingdom; after a soft start to the year, the U.K. economy is regaining momentum as well. In this week's Global Review on page 4, we discuss that improvement and what it means for the Bank of England and U.K. interest rates.



Wells Fargo U.S. Economic Forecast

	Actual 2014				Forecast 2015				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2012	2013	2014	2015	2016
Real Gross Domestic Product [1]	-2.1	4.6	5.0	2.2	-0.7	1.7	2.7	3.6	2.3	2.2	2.4	2.0	2.9
Personal Consumption	1.2	2.5	3.2	4.4	1.8	2.8	2.8	3.0	1.8	2.4	2.5	2.9	2.8
Inflation Indicators [2]													
PCE Deflator	1.1	1.6	1.5	1.1	0.3	0.0	0.2	0.8	1.8	1.2	1.3	0.3	1.9
Consumer Price Index	1.4	2.1	1.8	1.2	-0.1	0.0	0.3	1.0	2.1	1.5	1.6	0.3	2.2
Industrial Production [1]	3.9	5.7	4.1	4.7	-0.3	-2.1	2.5	3.1	3.8	2.9	4.2	1.7	3.0
Corporate Profits Before Taxes [2]	-4.8	0.1	1.4	-0.2	3.7	3.2	3.9	4.8	11.4	4.2	-0.8	3.9	5.3
Trade Weighted Dollar Index [3]	76.9	75.9	81.3	85.1	92.1	90.5	91.5	92.8	73.5	75.9	78.5	91.7	95.9
Unemployment Rate	6.6	6.2	6.1	5.7	5.6	5.4	5.3	5.2	8.1	7.4	6.2	5.4	5.0
Housing Starts [4]	0.93	0.98	1.03	1.06	0.98	1.12	1.21	1.24	0.78	0.92	1.00	1.13	1.22
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	0.25	0.25	0.25	0.44	1.56
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.77	4.05	4.15	4.23	3.66	3.98	4.17	4.05	4.51
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.25	2.35	2.41	1.80	2.35	2.54	2.24	2.66

Forecast as of: June 19, 2015

[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: U.S. Department of Commerce, U.S. Department of Labor, Federal Reserve Board, IHS Global Insight and Wells Fargo Securities, LLC

Inside

U.S. Review

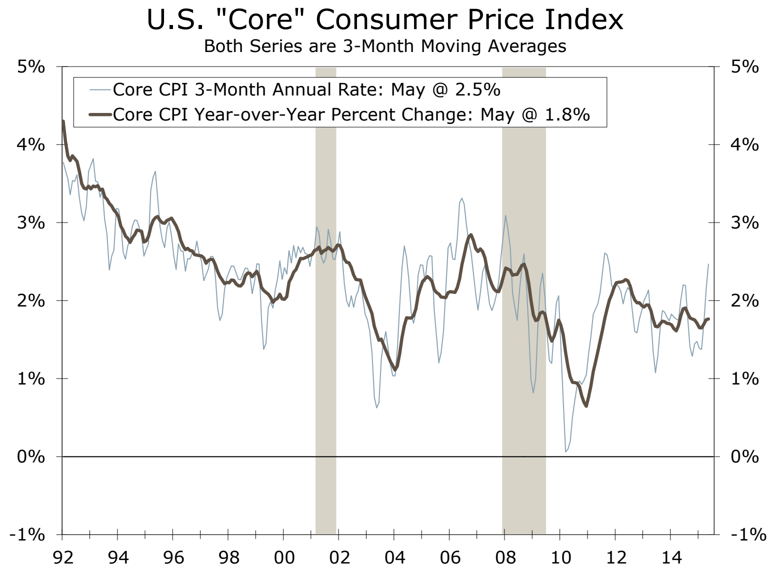
Inflation Builds, but Factories Struggle

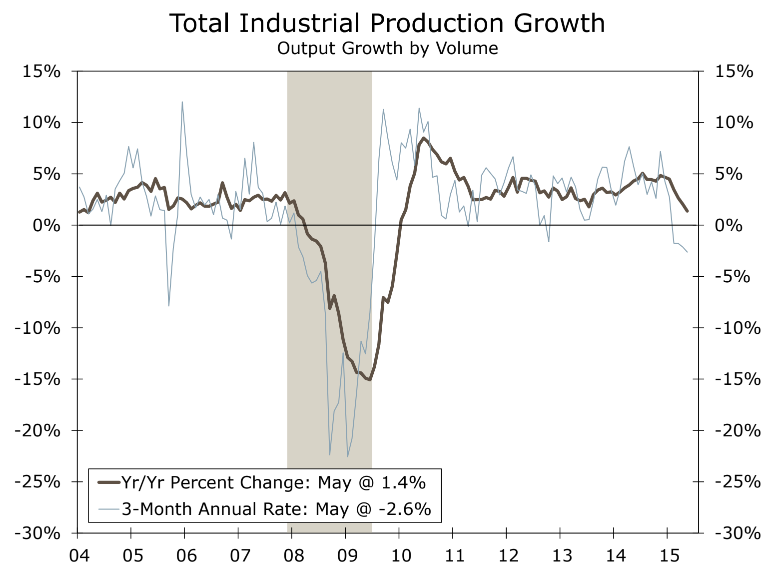
After the June FOMC meeting, the Fed still looks set to raise the fed funds rate this year. Forward guidance was left unchanged, while the current assessment of the U.S. economy improved. Although the Fed lowered its GDP forecast for 2015, it left its 2016 and 2017 forecasts largely the same. The Fed's own projections for the fed funds rate imply 50 bps of tightening by the end of the year, but there is still some uncertainty for a September rate hike. The Fed will need to see more improvement in the labor market and be "reasonably confident" that inflation will move toward to its 2 percent target. We expect that the Fed will see both of these trends and raise rates twice this year, with 25 basis points moves in September and December.

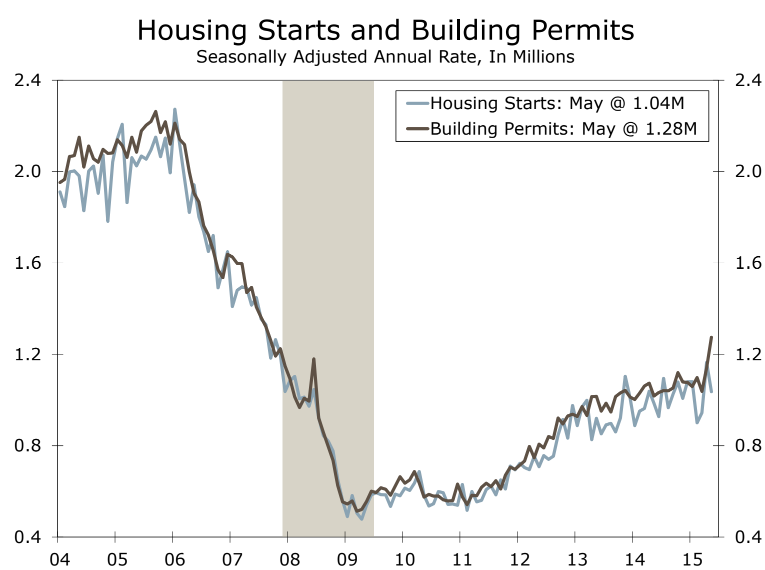
While the Fed acknowledged that inflation is running below its target, the consumer price index (CPI) accelerated in May, thanks to much stronger energy prices. Although core prices, which exclude the volatile food and energy components, slowed some in the month, they are up 2.5 percent on a three-month annualized basis. Oil prices have finally stabilized in recent months while appreciation of the greenback has slowed, but oil prices are drastically lower than a year ago, while the dollar is considerably stronger than it was this time last year, leaving year-over-year inflation weak. Nevertheless, a stronger labor market should fuel more price appreciation moving forward.

The Fed also took note of the slow pace of business fixed investment, which has been reflected in the sluggish factory sector data out this week. Headwinds to the sector have had more lingering effects than the weather and port shutdowns. A stronger dollar and cutbacks in the energy industry continue to plague manufacturers and miners. Industrial production fell 0.2 percent in May after a 0.5 percent decline in April. Mining has been predictably weak all year, while manufacturing has been more volatile. On a year-ago basis, though, manufacturing remains 1.8 percent higher than a year earlier, thanks in large part to the auto industry, where production is up 7.6 percent year over year. A June rebound for manufacturing is unlikely to be a strong one as the Empire State Manufacturing Index fell back into contraction territory.

Housing market data out recently suggest a modest expansion. On the positive side, homebuilders are feeling more confident and have reported stronger sales. They also anticipate better sales in the future, thanks in part to rising prospective buyer traffic. However, residential construction has been more subdued. Neither the sizable drop in housing starts in May nor the comparable rise in building permits in the same month should be taken at face value. Housing starts are notably volatile and the recent up and downs can largely be blamed on the lingering effects of severe winter weather earlier this year. Meanwhile, the surge in multifamily building permits is not a sign of the housing market roaring back, but rather a consequence of expiring tax credits, which encouraged builders to obtain permits as a qualifying measure for those tax breaks.







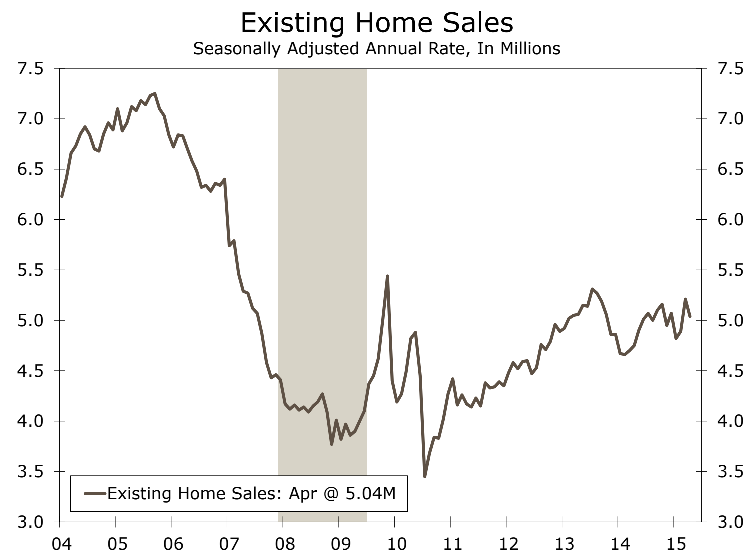
Source: U.S. Department of Labor, Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities, LLC

Existing Home Sales • Monday

Existing home sales fell 3.3 percent in April to a 5.04 million unit pace. The primary issue remains the tight supply of inventory which continues to hold back the pace of sales activity. Inventories are still 0.9 percent below their level the same time last year. Meanwhile, median home prices continued to rise, 8.9 percent on a year-over-year basis, marking the 38th month of year-ago price increases. We expect that existing home sales rose 4.0 percent to a 5.24 million-unit pace in May as more inventory likely came online during the month. We continue to expect the housing market to improve with firm prices and a gradual pick up in new and existing home sales in the months ahead. The overall pace of improvement, however, is likely to remain below historical trends given some of the structural and demographic issues that we have highlighted.

Previous: 5.04M **Wells Fargo: 5.24M**

Consensus: 5.28M

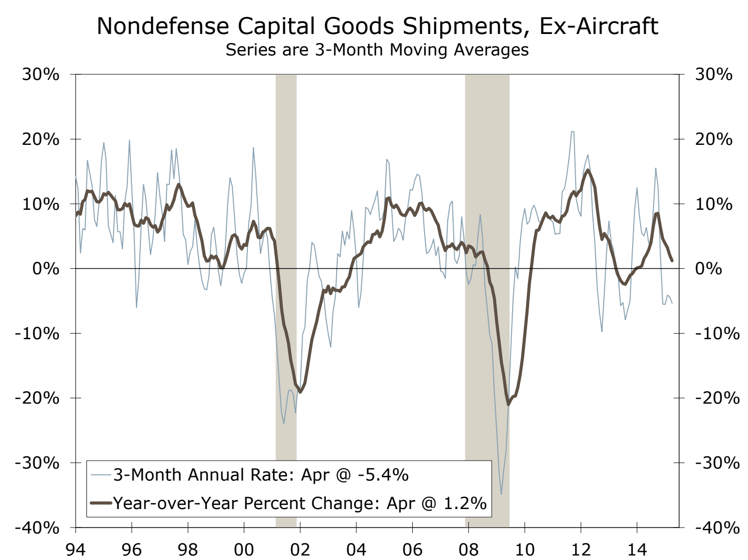


Durable Goods Orders • Tuesday

April's new orders for durable goods fell 1 percent with the volatile transportation component pulling the headline index lower. Excluding transportation orders, durables orders declined 0.2 percent. Given the influence in calculating the equipment component of GDP, we focus on core capital goods shipments, which rose 0.5 percent. Thus, even with the disappointing headline readings from the April report, we expect equipment spending within GDP will still be positive in Q2. Durables orders are likely to decline again in May but excluding transportation, orders are expected to rise 0.5 percent. We continue to expect the manufacturing sector to face several headwinds including the stronger U.S. dollar and slow global demand. That said, the negative effect on headline GDP growth should not be all that dramatic.

Previous: -1.0% **Wells Fargo: -2.8%**

Consensus: -0.6% (Month-over-Month)

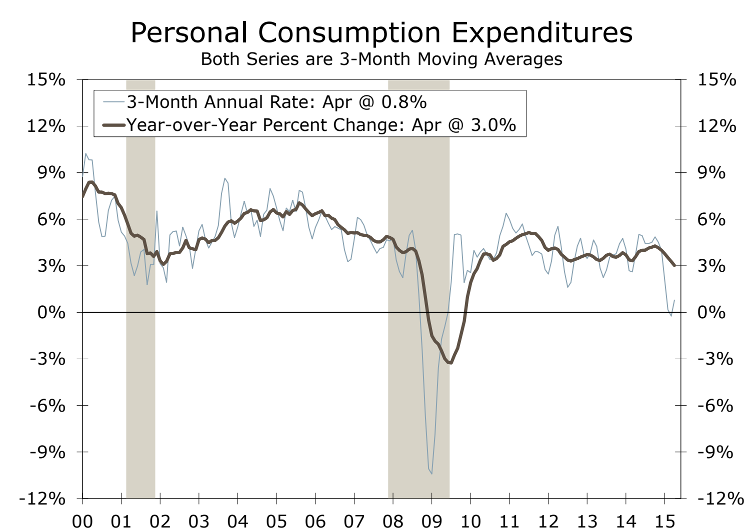


Personal Spending • Thursday

Personal income rose 0.4 percent in April with real disposable income increasing 0.3 percent for the month. The rise in real disposable income comes on the heels of a 0.2 percent decline in March. The saving rate rose to 5.6 percent for the month. On the personal spending front, consumers remained cautious with their spending behavior. Consumer spending was flat in April. We expect that personal spending activity accelerated in May, rising 0.6 percent as personal income rose 0.4 percent. The continued rise in income growth still gives us optimism that consumer spending activity will be stronger as the year progresses. We maintain the view that real consumer spending should be stronger this year (2.8 percent) from last year's 2.5 percent. Thus, consumer spending should continue to provide solid support to economic growth for the reminder of the year.

Previous: 0.0% **Wells Fargo: 0.6%**

Consensus: 0.7% (Month-over-Month)



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

Global Review

Firming in U.K. Economic Activity

Economic growth in the United Kingdom slowed in Q1 of 2015. With full year GDP growth of 2.8 percent in 2014, the 1.2 percent annualized growth rate in Q1 was a marked slowdown from the pace of the prior year and delayed the timing of eventual rate increases from the Bank of England's rate setting group, the Monetary Policy Committee.

More recently, the U.K. economy has found its footing and developments there are in keeping with our expectation for headline growth there to return to a pace of between 2.0 percent and 2.5 percent over the next several quarters. Manufacturing PMIs have remained in expansion territory and after a soft patch around the turn of the year, industrial production has climbed for three straight months.

This week, inflation figures in the United Kingdom for consumer and producer prices were roughly in-line with expectations. Headline CPI moved from mild deflation to mild inflation as the year-over-year rate picked up from -0.1 percent to +0.1 percent. As is the case in most parts of the world, depressed oil and commodity prices are largely to blame for soft headline price growth; core inflation has been more buoyant.

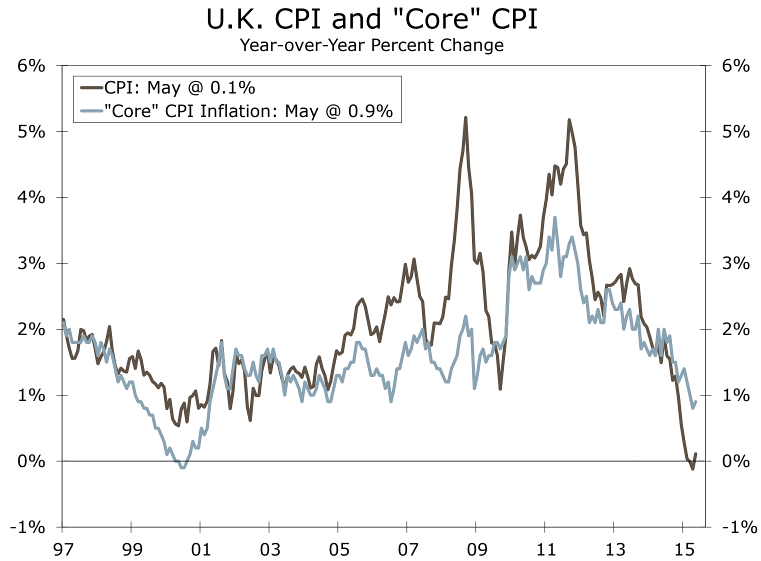
Core CPI in the United Kingdom picked up from 0.8 percent to 0.9 percent. The next monthly CPI report will be for the month of June which is the month in 2014 when oil prices peaked. This means that upcoming year-over-year inflation figures will be calculated off a smaller base which will likely mean that headline inflation will trend higher in the second half of the year.

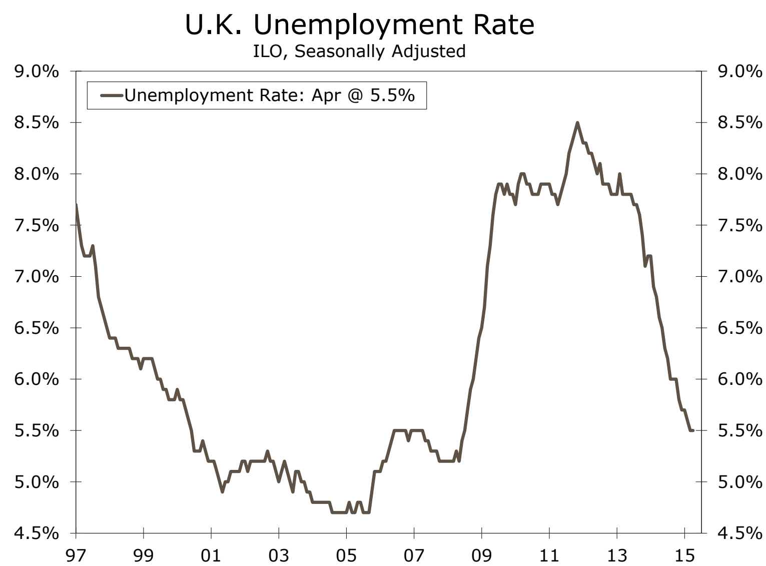
While we expect prices to firm in the second half, we do not anticipate that price gains will be sufficient to warrant rate increases this year. Bank of England Governor Mark Carney has suggested that rate hikes could still be on the table for 2015—only a slightly different message from what is being signaled by policy makers at the Federal Reserve. Yet, there appears to be some hand-wringing at the Bank of England about the Fed's plan to lift rates later this year. The minutes from the latest MPC meeting cautiously observed that "these policies could have international spillovers." The MPC also noted that its monetary policy path would be determined by prospects for domestic inflation not by the rate determinations of foreign central banks.

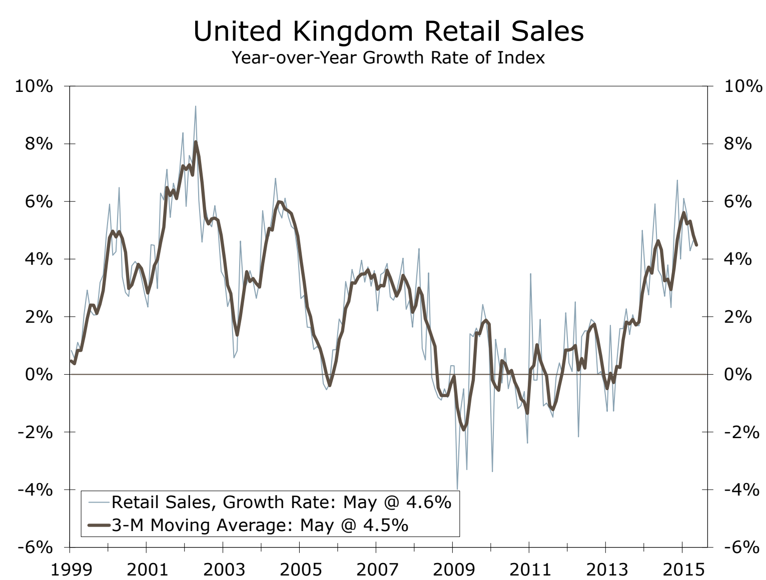
We also learned this week that the U.K. unemployment rate remained at its lowest level in seven years. While job growth was less than the consensus was expecting, average weekly earnings climbed more than what was expected.

Our expectation is that consumer spending will be the largest positive contributor to GDP growth in Q2 and developments this week increased our confidence in that view.

On balance the U.K. job market has sufficient momentum to underpin economic activity, which was evident in this week's better-than-expected outturn for retail sales. Despite expectations for a decline in May sales after a large gain in April, core retail sales increased 0.2 percent putting the year-over-year growth rate at 4.4 percent.







Source: IHS Global Insight and Wells Fargo Securities, LLC

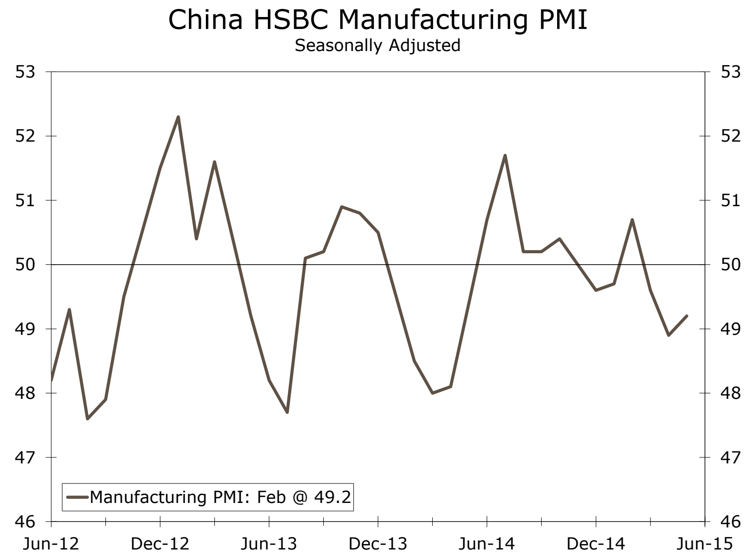
China Manufacturing PMI • Monday

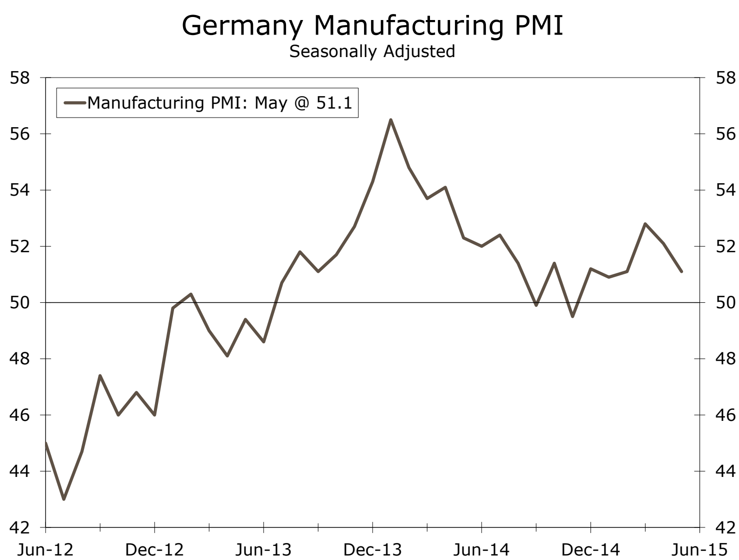
On Monday we will get the release of the Markit manufacturing PMI for China with consensus expecting the number to remain below the 50 demarcation point, at 49.5 compared to a 49.2 reading for May. Not much has changed in terms of economic indicators for the Chinese economy lately so this release will probably not add to the disappointing releases we have become used to getting from China. The biggest disappointment lately has been the performance of the external sector with exports falling 8.0 percent in May on a three-month-moving average, year over year.

Perhaps the biggest positive for trade was that imports fell even more, by 17.6 percent, which means that the trade surplus improved further during the month. Thus, net exports may be able to contribute a bit more to GDP growth in Q2 than what they have contributed in the recent past.

Previous: 49.2

Consensus: 49.5





Germany Manufacturing PMI • Tuesday

Germany's manufacturing PMI will probably show no substantial change in June with consensus expecting the number to be slightly higher, at 51.2, versus 51.1 in May. If consensus is correct then it will mean that the sector's performance during Q2 of the year will be very similar to the first quarter, which doesn't bode well for a better performance by the German economy in Q2 of the year. However, the Eurozone manufacturing PMI, which is also going to be released on Tuesday points to a slight decline, which means that other regions of the Eurozone manufacturing sector have deteriorated.

On Wednesday, we will get the IFO business climate, current assessment and expectation's indices for June with consensus expecting slight declines for all of them compared to May's readings.

Previous: 51.1

Consensus: 51.2

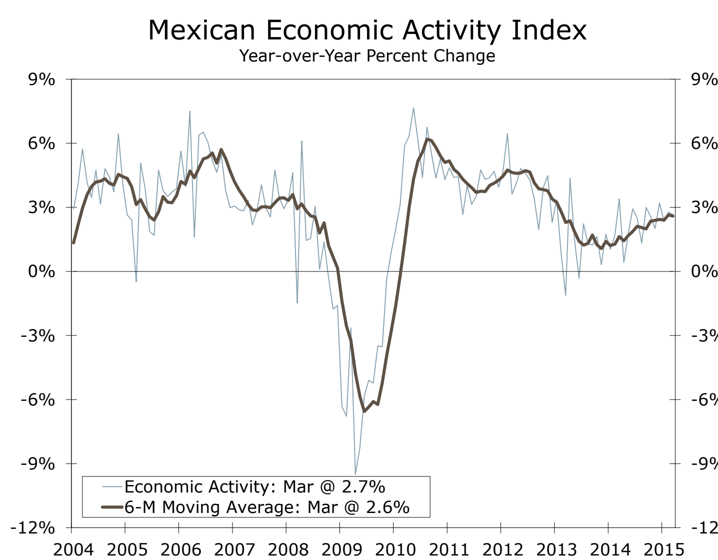
Mexico Economic Activity Index • Wed

Recent results for Mexican economic activity have been highly disappointing as the mining sector continues to plunge due to the weak performance of petroleum and natural gas production. However, the important auto manufacturing sector continues to lead the way supported by the impressive performance of U.S. automobile demand.

Thus, the result for April's economic activity index, which will be the first view into Q2 GDP performance, will probably be important for markets. Our expectation is for the index to remain relatively close to Q1 growth rate of 2.5 percent. However, a better performance by the manufacturing sector and potentially less of a drag from the petroleum and natural gas sector may help push April's index above the number recorded in Q1.

Previous: 2.7%

Consensus: 2.3% (Year-over-Year)



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

The Game Is Afoot!

So the chase begins with the FOMC now on the path to raising the federal funds rate and the financial markets assessing the effect of any rate rise.

As illustrated in our top graph, the Fed's assessment of the path of funds rate increases has steadily declined over the past three published sets of expectations. In contrast to much of the media commentary, it is the Fed, not the market that misinterpreted the path of interest rates this year. The Fed has moved toward the market—not vice-versa.

No Battle Plan Survives Contact with the Enemy

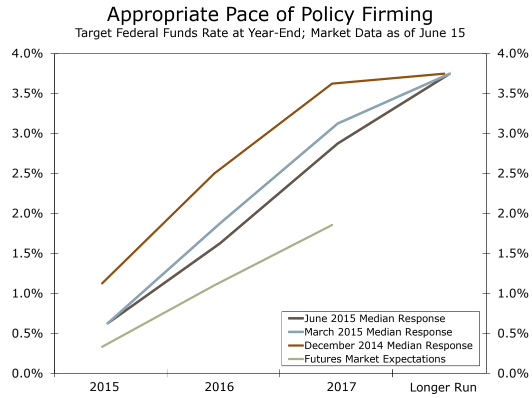
The one-percenters on bonds did not even survive the weakness of Q1 GDP, nor the continued concerns about Greece. This leaves us concerned about capital markets and the Fed's inflation projection for the year ahead (middle graph). How will the fixed-income markets deal with the projected rise of inflation by the Fed.

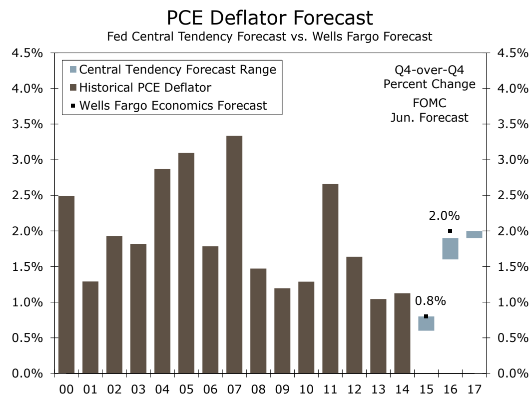
Since the markets are thought to be forward looking, this week's report that the CPI is up an annualized 3.2 percent over the past three months should give us pause. Meanwhile, core CPI is increasing at a 2.5 percent three-month annualized rate—so higher gas prices are not the only culprit.

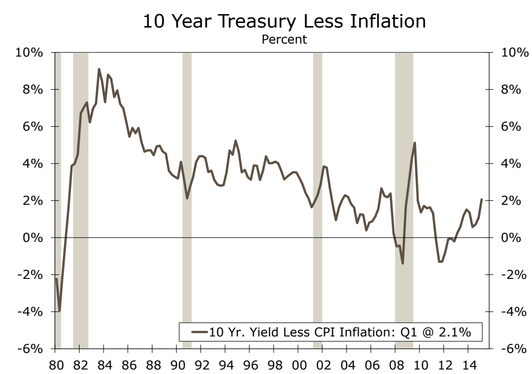
We take no comfort in the number of analysts who project no Fed action this year. For us, this suggests that the Fed will fall behind the inflation curve and that financial markets will react to higher inflation and witness negative total returns. Year-to-date, the total return for Treasury debt has been negative and the 10-year Treasury note yield is up 15 bps.

The Dog That Didn't Bark

One interesting note is that there was no dissent at the latest FOMC meeting. We interpret this as a signal that policy hawks, such as President Lacker, feel comfortable with the tone of policy and, therefore, the bias is for the Fed to raise rates in September. Already we can see in the bottom graph that the benchmark 10-year Treasury yield has moved upward. Is this a turn in the secular bull market for bonds? We await the evidence.







Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities, LLC

Credit Market Insights

Boomerang Buyers Make Comeback

In a recent report, TransUnion showed that roughly 700,000 "boomerang buyers," or home buyers who were previously unable to qualify for a mortgage due to a foreclosure, short sale, delinquency or other similar event during the housing crisis could re-enter the mortgage market again this year. Over the next five years, the report estimates some 2.2 million of these buyers could return to the market.

These buyers had previously been unable to qualify for a mortgage due to federally-mandated (Fannie Mae, Freddie Mac and FHFA) lockout periods. For example, buyers who previously had a short sale must wait four years before they can qualify again, while seven years must pass for a buyer whose house was foreclosed on. The hope is that these periods will allow buyers to rebuild their credit and eventually be able to meet agency credit underwriting guidelines. However, the study found that as of December 2014, only 18 percent of these "boomerang buyers" had recovered to meet these guidelines and thus were unable to qualify for a mortgage.

Moreover, even if some of these buyers rebuild credit and work to meet agency guidelines, there is no guarantee that they would be willing to apply for another mortgage. Many of these buyers may be scarred from the effects of the crisis, or simply may be unaware that they are able to qualify again. Thus, we may only see a small subset of this group return to the market in the next few years.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.00%	4.04%	3.87%	4.17%
15-Yr Fixed	3.23%	3.25%	3.11%	3.30%
5/1 ARM	3.00%	3.01%	2.90%	3.00%
1-Yr ARM	2.53%	2.53%	2.50%	2.41%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,876.5	-7.31%	12.21%	12.47%
Revolving Home Equity	$449.6	-8.48%	-6.53%	-3.45%
Residential Mortgages	$1,604.2	-5.07%	7.39%	1.83%
Commerical Real Estate	$1,669.2	7.36%	12.31%	7.96%
Consumer	$1,219.0	0.02%	3.30%	4.36%

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

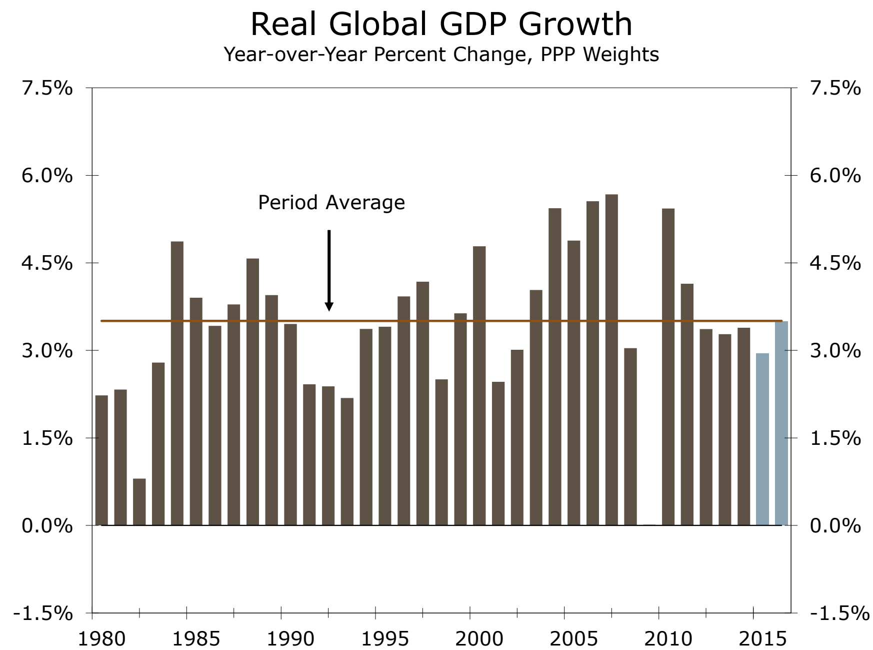
Topic of the Week

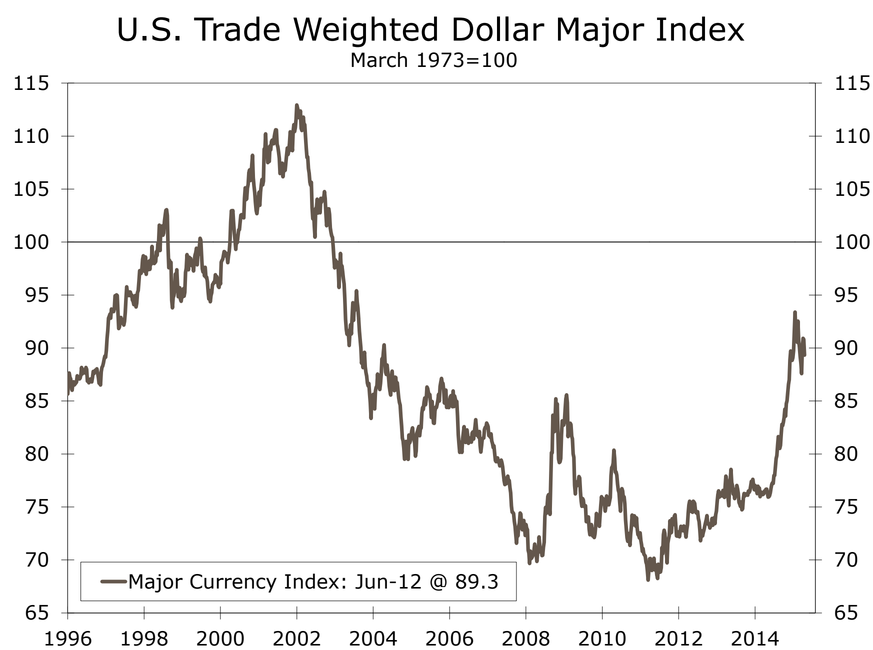
Global Growth Outlook: Where to Now?

Global GDP looks set to grow at its slowest rate since the global recession this year. After rising 3.4 percent in 2014, we expect global real GDP will grow only 2.9 percent this year before returning to its long-run average of 3.5 percent next year. Weakness looks fairly broad-based, as growth in advanced and developing economies has generally slowed this year. In particular, the U.S. economy was vexed by another weak Q1, but does not look poised to snap back as much as it did last year. Among developing economies, China is generally leading the slowdown in growth. Much of this is due to the country's continued shift away from debt-fueled, investment-led growth, a development that is not entirely unwelcome by the government. As growth in China has continued to slow, growth in much of the commodity export-dependent world has slowed as well.

However, there has been one standout developing economy whose growth performance has stood out recently: India. The decline in oil prices has helped fuel strong consumer-led growth, and we expect India will continue to enjoy robust growth in the coming years. Among advanced economies, the Eurozone has been another source of upside surprises recently. The Eurozone economy looks to be enjoying the start of a cyclical upswing, helped by the central bank's quantitative easing program. That said, the ongoing situation in Greece remains a key obstacle to a full recovery in the region. If no deal is reached between Greece and its creditors, the country will likely be unable to repay a €1.5 billion loan to the IMF due at the end of this month. Fortunately, there are some backstops now that did not exist a few years ago that should limit the contagion effects on other European economies of potential Greek default and Grexit. However, even with these backstops in place, the knock-on effects in financial markets are impossible to predict. Thus, in our view, readers should keep a close eye on this situation.

For further reading, see our special report, *Global Chartbook: June 2015*, available on our website.





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Thursday 6/18/2015	1 Week Ago	1 Year Ago
3-Month T-Bill	0.00	0.01	0.02
3-Month LIBOR	0.29	0.29	0.23
1-Year Treasury	0.26	0.30	0.17
2-Year Treasury	0.65	0.71	0.44
5-Year Treasury	1.65	1.73	1.67
10-Year Treasury	2.35	2.38	2.58
30-Year Treasury	3.14	3.10	3.40
Bond Buyer Index	3.87	3.81	4.37

Foreign Exchange Rates

	Thursday 6/18/2015	1 Week Ago	1 Year Ago
Euro ($/€)	1.140	1.126	1.360
British Pound ($/£)	1.588	1.552	1.699
British Pound (£/€)	0.718	0.725	0.800
Japanese Yen (¥/$)	123.060	123.420	101.930
Canadian Dollar (C$/$)	1.219	1.229	1.084
Swiss Franc (CHF/$)	0.918	0.933	0.896
Australian Dollar (US$/A$)	0.782	0.776	0.941
Mexican Peso (MXN/$)	15.253	15.349	12.979
Chinese Yuan (CNY/$)	6.208	6.207	6.231
Indian Rupee (INR/$)	63.733	63.975	60.404
Brazilian Real (BRL/$)	3.058	3.090	2.228
U.S. Dollar Index	93.830	94.976	80.584

Foreign Interest Rates

	Thursday 6/18/2015	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.01	-0.01	0.19
3-Month Sterling LIBOR	0.57	0.57	0.56
3-Month Canada Banker's Acceptance	1.00	1.00	1.27
3-Month Yen LIBOR	0.10	0.10	0.13
2-Year German	-0.20	-0.17	0.04
2-Year U.K.	0.58	0.53	0.88
2-Year Canadian	0.62	0.65	1.09
2-Year Japanese	0.02	0.01	0.09
10-Year German	0.81	0.88	1.38
10-Year U.K.	2.04	2.05	2.74
10-Year Canadian	1.82	1.81	2.26
10-Year Japanese	0.45	0.54	0.60

Commodity Prices

	Thursday 6/18/2015	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	60.19	60.77	105.97
Gold ($/Ounce)	1202.03	1181.96	1277.68
Hot-Rolled Steel ($/S.Ton)	464.00	464.00	668.00
Copper (¢/Pound)	260.50	266.90	306.00
Soybeans ($/Bushel)	9.65	9.46	14.05
Natural Gas ($/MMBTU)	2.84	2.83	4.66
Nickel ($/Metric Ton)	12,715	13,564	19,036
CRB Spot Inds.	465.89	471.34	529.44

Source: Bloomberg LP and Wells Fargo Securities, LLC

Next Week's Economic Calendar

	Monday 22	Tuesday 23	Wednesday 24	Thursday 25	Friday 26
U.S. Data	**Existing Home Sales** April 5.04M May 5.24M (W)	**Durable Goods** April -1.0% May -2.8% (W) **New Home Sales** April 517K May 520K (W)	**GDP 3rd Revision (QoQ)** Q1 (2nd) -0.7% Q1 (3rd) -0.3% (W)	**Personal Income & Spending** April 0.4% & 0.0% May 0.4% & 0.6% (W)	
Global Data	**Eurozone** **Manufacturing PMI** Previous (May) 52.2 **China** **Manufacturing PMI** Previous (May) 49.2	**Germany** **Manufacturing PMI** Previous (May) 51.1	**Mexico** **Economic Activity Index (YoY)** Previous (Mar) 2.7%	**Japan** **CPI (YoY)** Apr 0.6% May 0.4% (W)	

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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