

**WELLS
FARGO**

SECURITIES

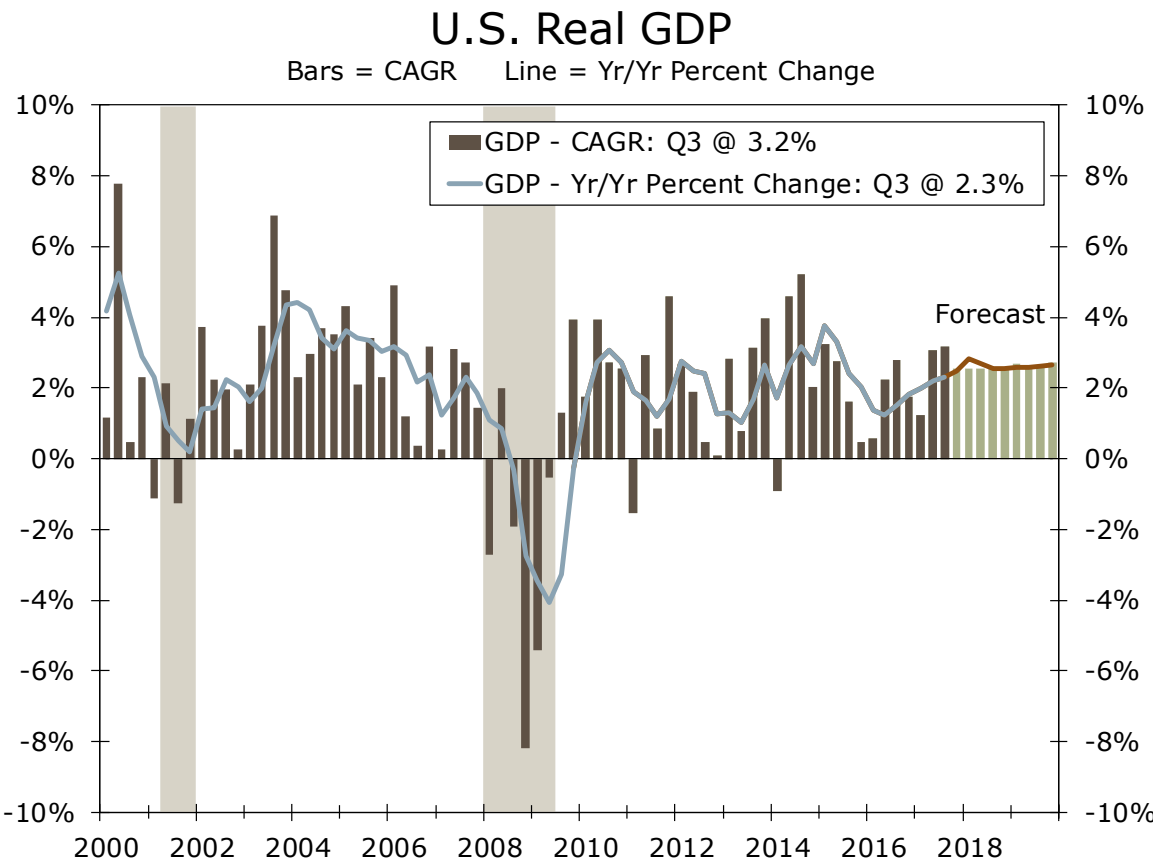
Economic Outlook

Tim Quinlan, Senior Economist
January, 2018

Together we'll go far



Near-term outlook is for trend-like growth to continue



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

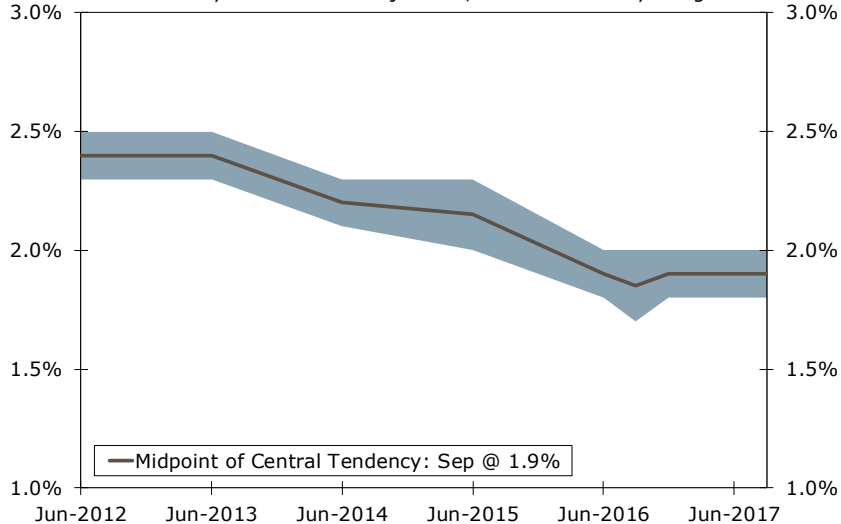
GDP and Fed Funds “Long-Run” Expectations from the Fed

Over the past several years, the Fed has dialed-back its own estimates of potential GDP growth as have private-sector economists and the Congressional Budget Office

GDP

Long-Run GDP Projections

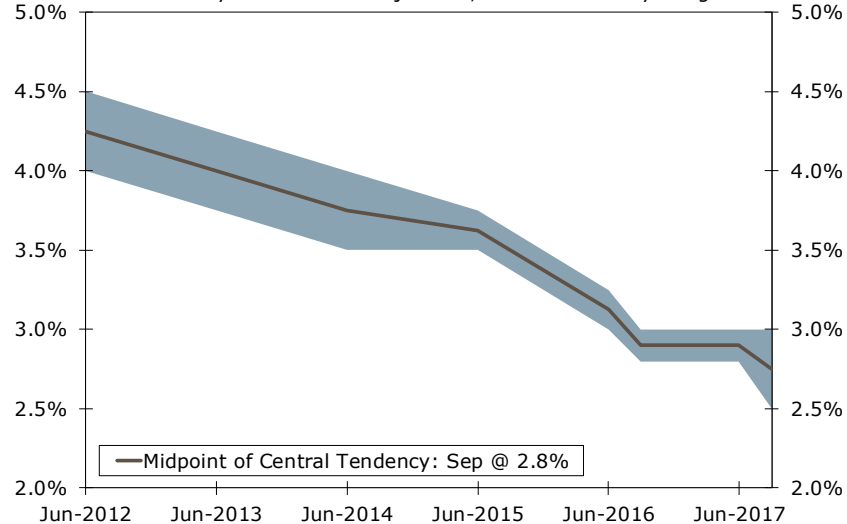
Summary of Economic Projections, Central Tendency Range



Fed Funds Rate

Long-Run Fed Funds Projections

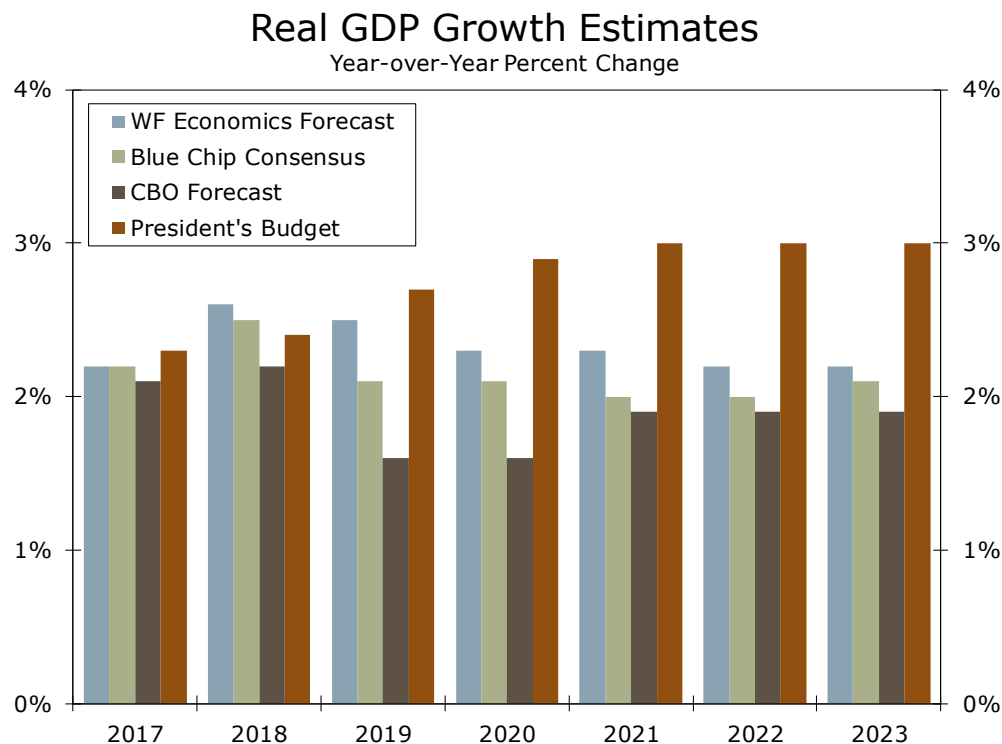
Summary of Economic Projections, Central Tendency Range



Source: Federal Reserve and Wells Fargo Securities

Forecasting Outside the Consensus

- The Trump administration has repeatedly stated its goal of achieving real economic growth of 3-4 percent.
- In the president's FY 2018 budget, the administration assumed real GDP growth of 3 percent over the long-run.
- This is well above that of other forecasters. Why?

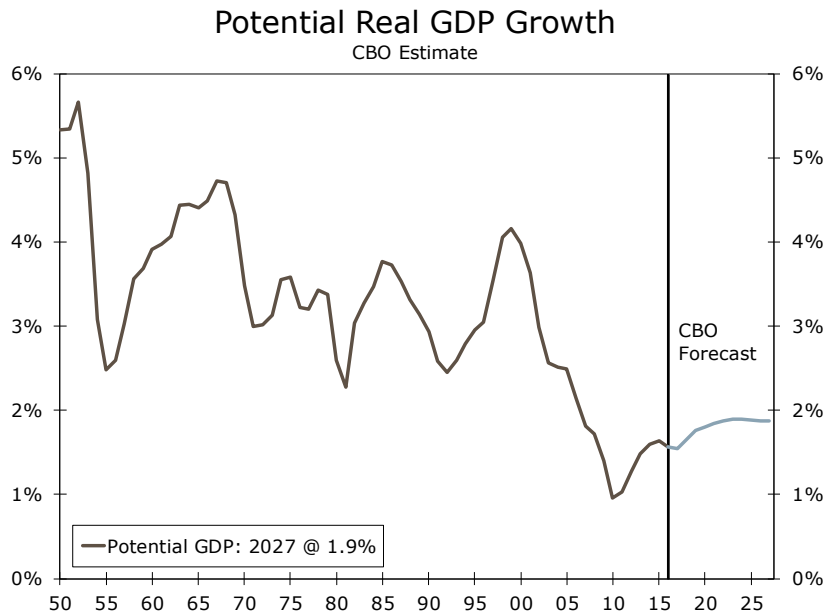


Source: Congressional Budget Office, Blue Chip, Office of Management and Budget and Wells Fargo Securities

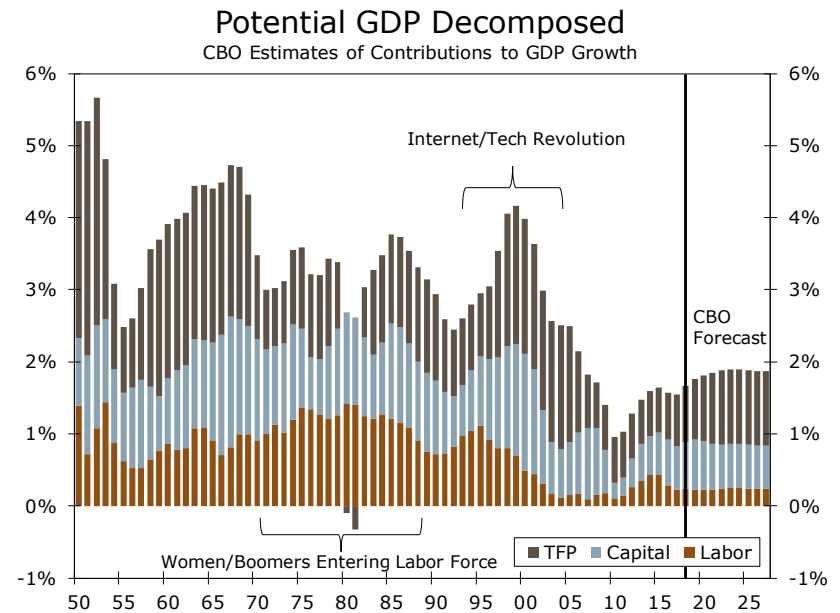
Why Is Potential Growth So Slow?

- The Congressional Budget Office produces the gold standard for potential GDP estimates.
- By its projections, the sustainable pace of growth is a bit shy of 2 percent.
- Why? Primarily because of slower growth in the working-age population, but also because of somewhat slower capital and productivity growth.

Potential GDP Growth Has Fallen



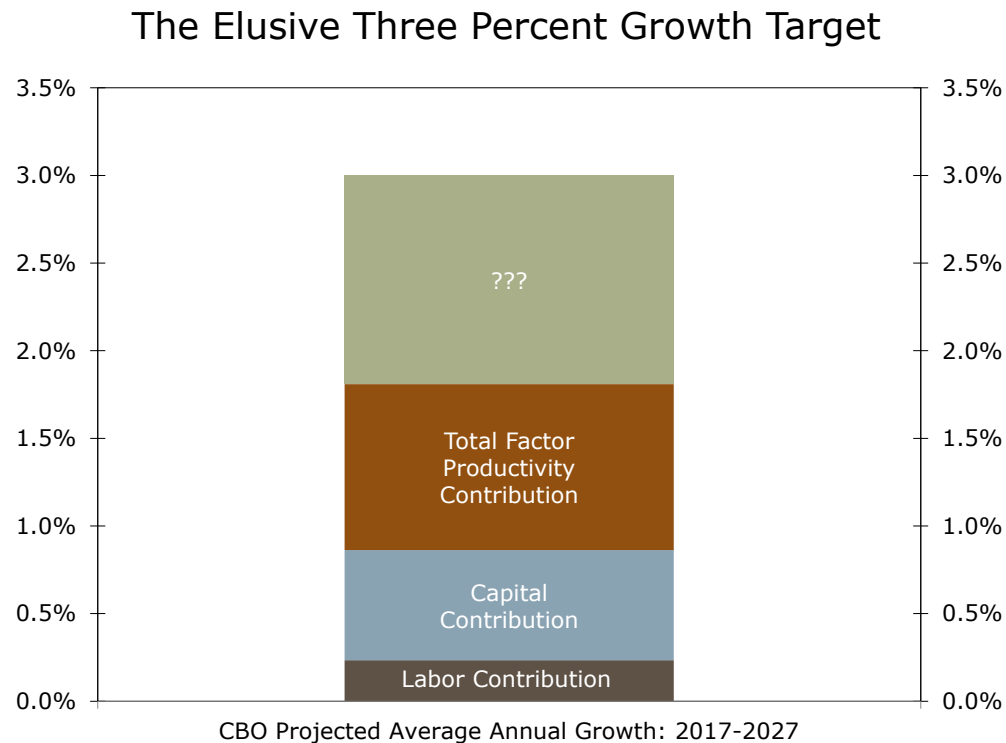
Both Aging and Productivity to Blame



Source: Congressional Budget Office and Wells Fargo Securities

What Would It Take to Get to 3 Percent Growth?

- Let's say the CBO baseline proves to be too pessimistic.
- Given a potential GDP estimate of about 1.9 percent, how much faster would growth need to be in the three key inputs (labor, capital and total factor productivity) to reach 3 percent plus?



Source: Congressional Budget Office and Wells Fargo Securities

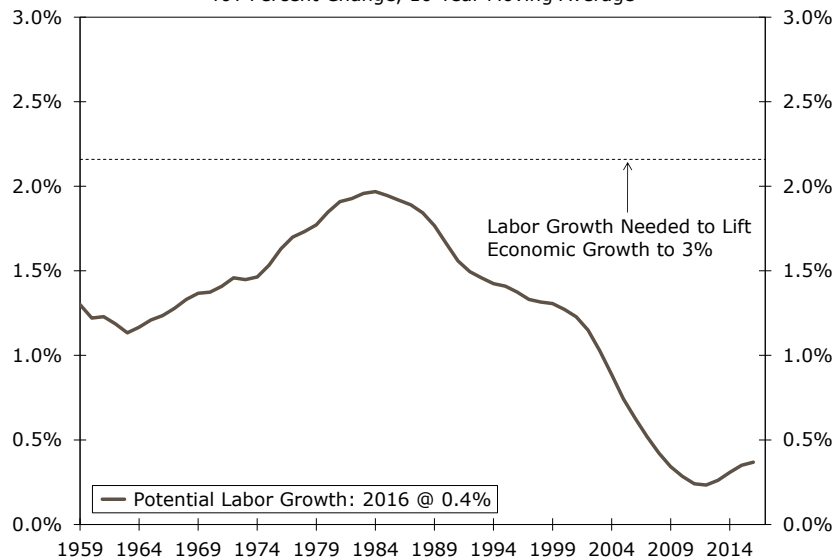
Battling the Demographic Headwinds

- To achieve sustained economic growth of 3 percent solely through faster labor growth, potential labor hours would need to expand at about 2.2 percent per year, holding the CBO's capital and TFP projections constant.
- This would require potential labor growth similar to the period when boomers/women entered the labor force in large numbers.
- Yet, the labor force is aging, with few signs of a reversal anytime soon.

Labor Growth Has Seen a Secular Decline

Drivers of Real GDP: Potential Labor Hours

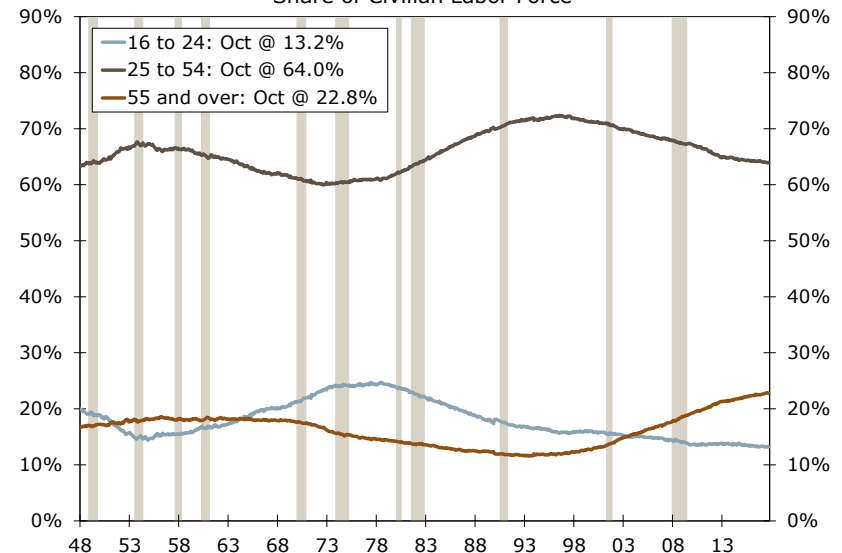
YoY Percent Change, 10-Year Moving Average



An Increasingly Aged Workforce

Civilian Labor Force: Aging

Share of Civilian Labor Force



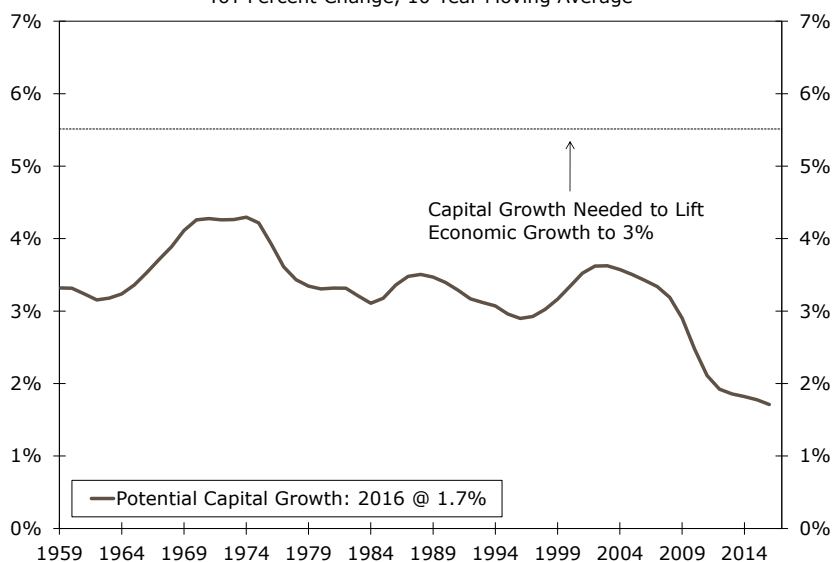
Source: Congressional Budget Office, U.S. Department of Labor and Wells Fargo Securities

Doing More with Less

- To achieve sustained potential GDP growth of 3 percent over the next decade through capital alone, potential capital growth would need to average about 5.5 percent, well above even the fastest historical potential growth rates.
- Capital spending in this cycle has been weak, though we expect some modest improvement. Sentiment, core orders have been better of late.
- Still big gap between where we are now and where we would need to be.

Potential Capital Growth: Low Base

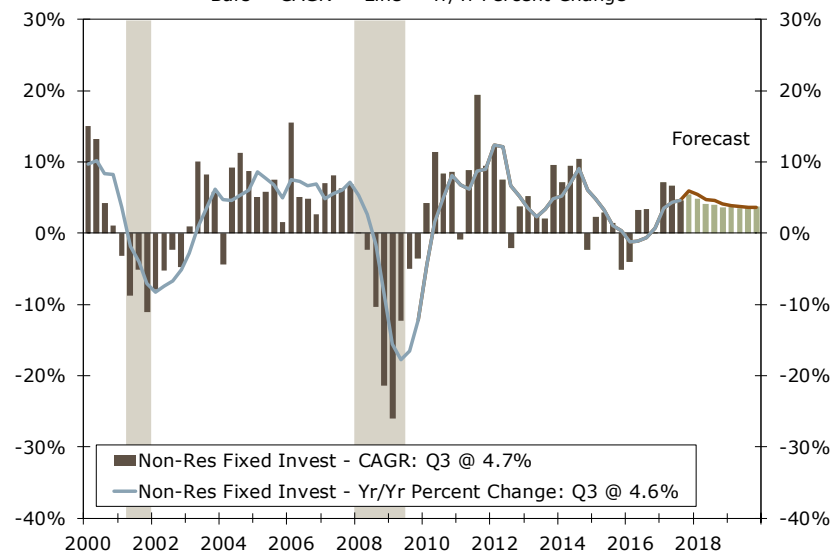
Drivers of Real GDP: Potential Capital Growth
YoY Percent Change, 10-Year Moving Average



Modest Business Investment Outlook

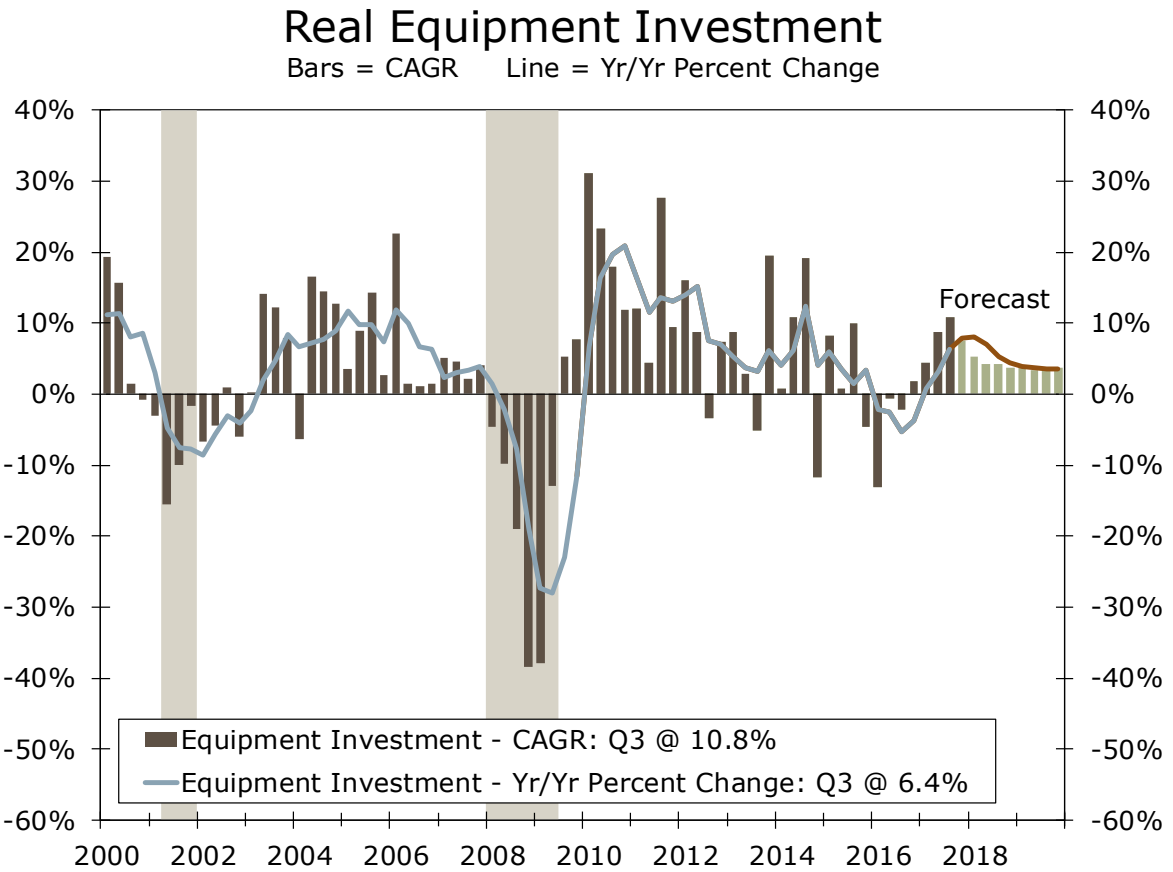
Real Business Fixed Investment

Bars = CAGR Line = Yr/Yr Percent Change



Source: Congressional Budget Office, U.S. Department of Commerce and Wells Fargo Securities

Cap-ex has been surprising on the upside, but as “bounce effect” fades, will the pace of growth moderate?



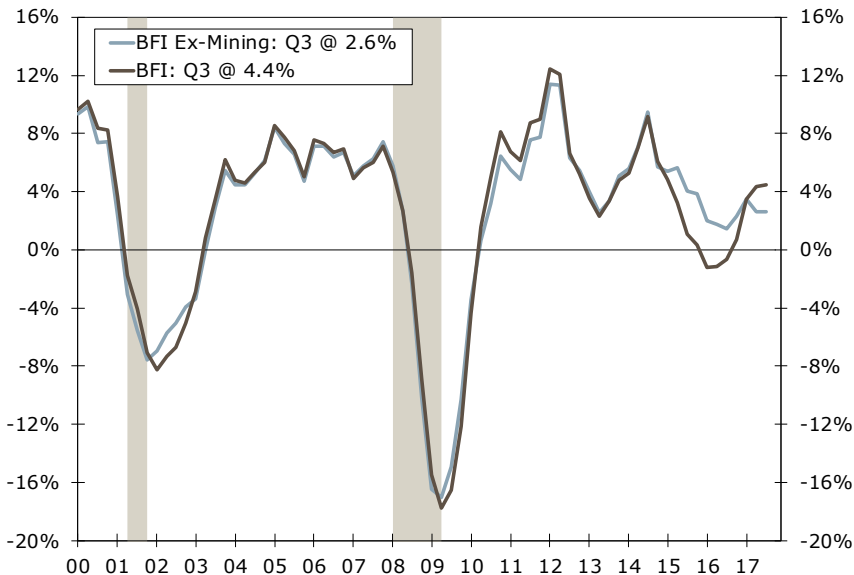
Source: U.S. Department of Commerce and Wells Fargo Securities

The rebound in energy prices and more specifically oil prices is starting to boost business investment.

Business Investment Ex-Mining

Real Business Fixed Investment

Year-over-Year Percent Change

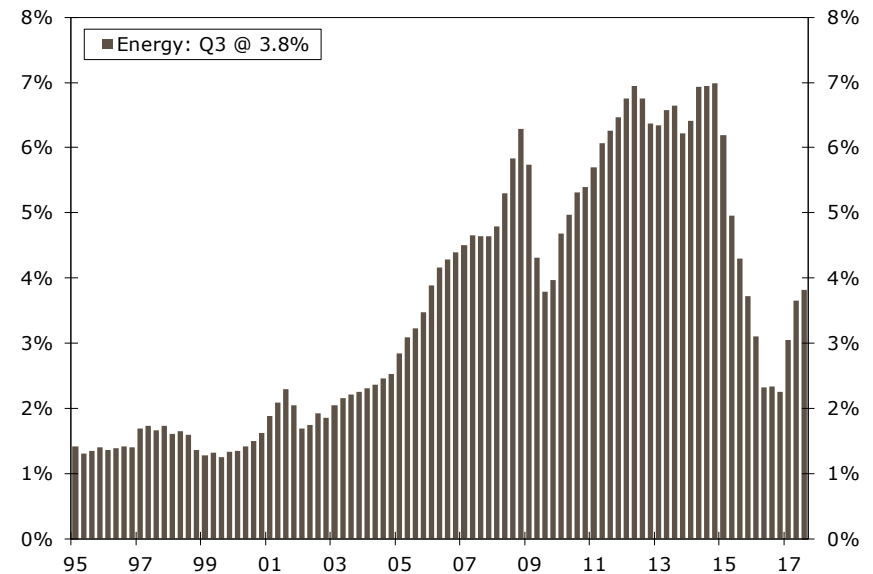


Source: U.S. Department of Commerce and Wells Fargo Securities

Energy Share of Investment

Fixed Investment Spending on Energy

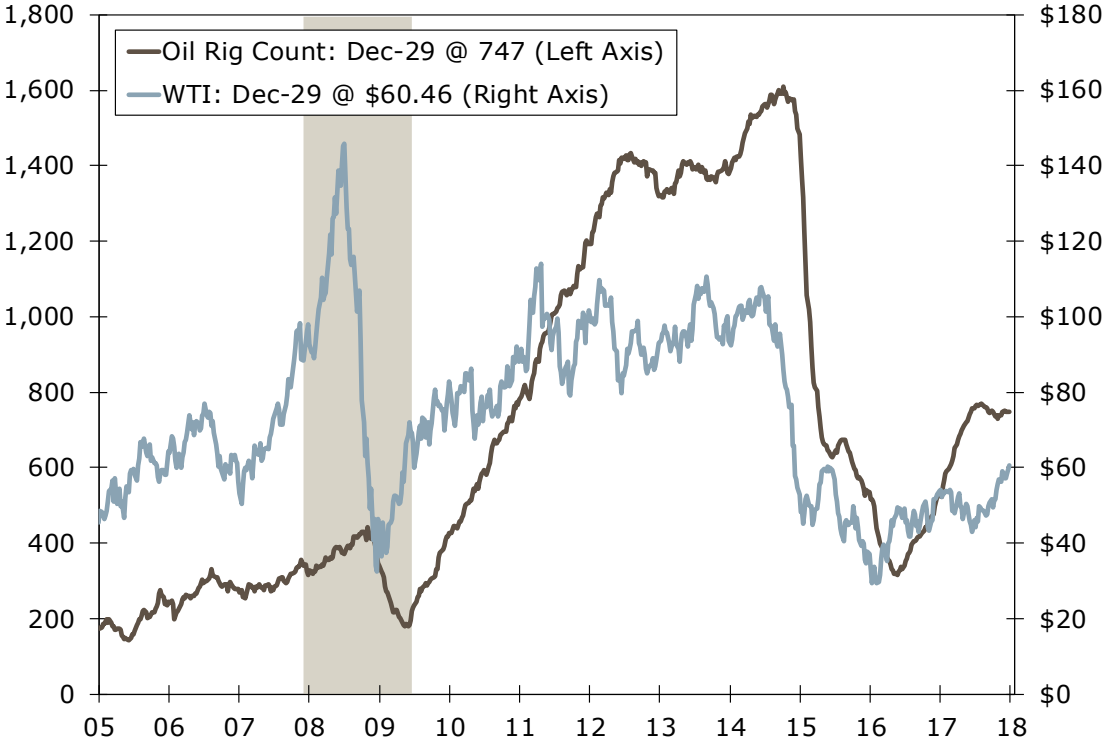
As Percent of Total BFI



Even modest rebound in price has been supportive of improvement in rig count

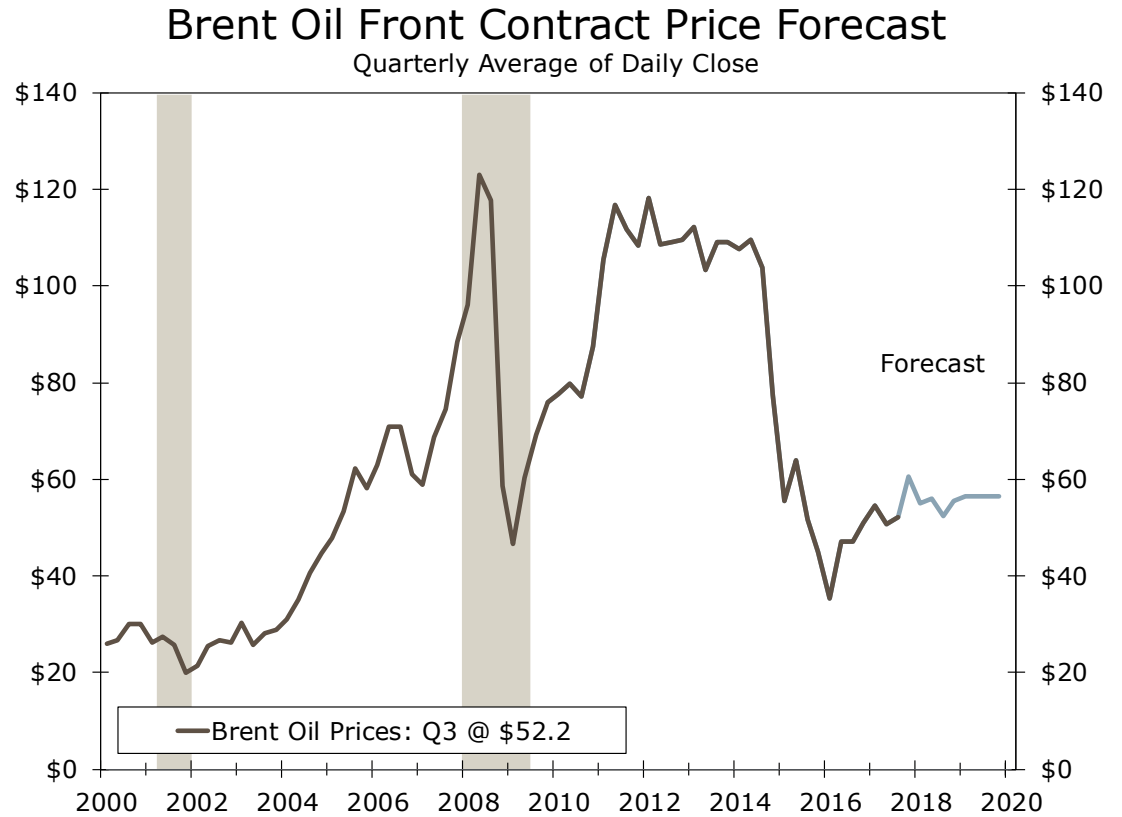
Baker-Hughes Rig Count vs. Oil Prices

Oil Rotary Rigs; USD per Barrel



Source: Baker Hughes Inc., Bloomberg LP and Wells Fargo Securities

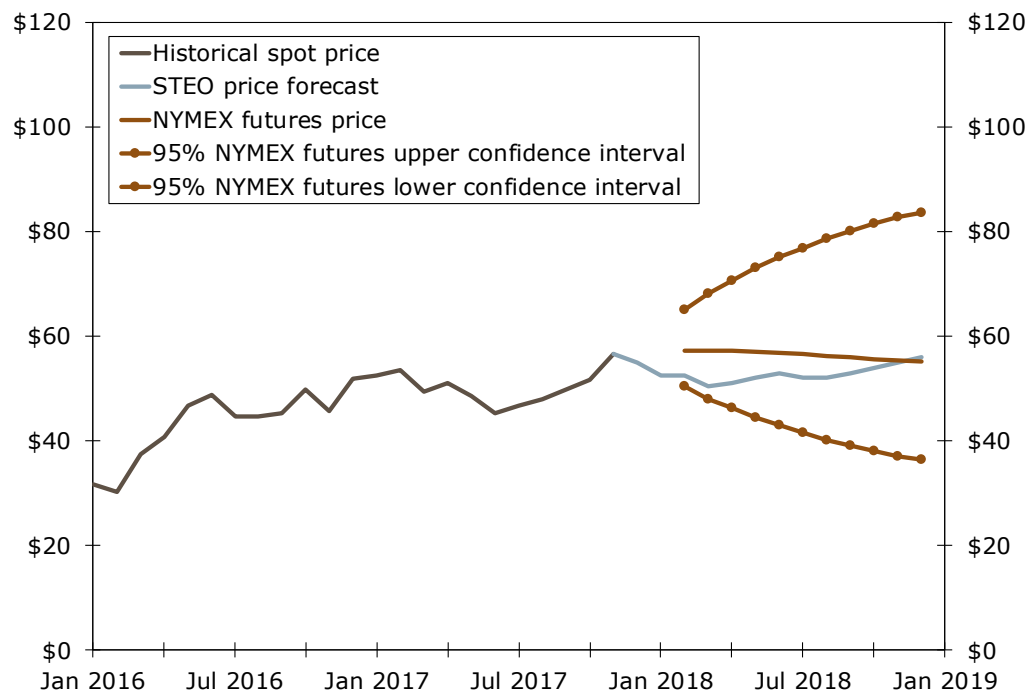
Now we see prices range-bound



Source: IHS Global Insight and Wells Fargo Securities

Confidence intervals have tightened as well

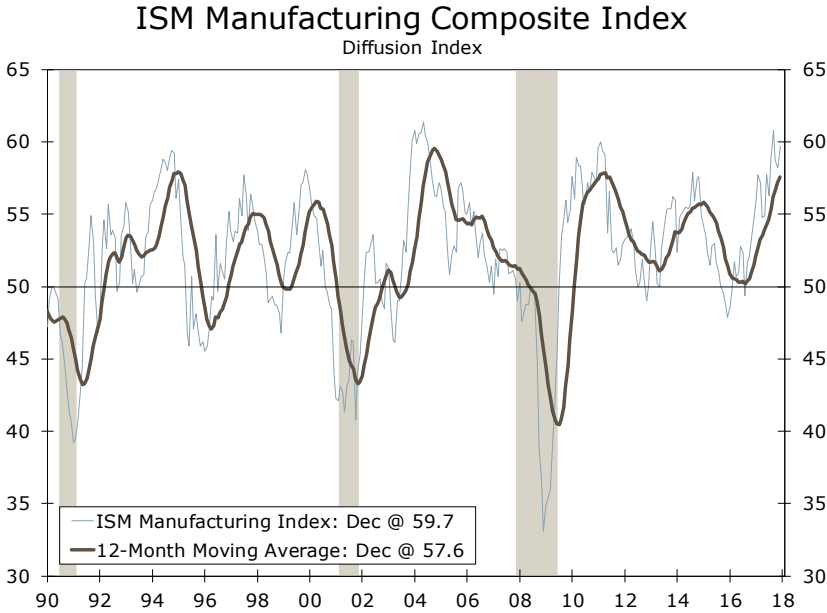
West Texas Intermediate (WTI) Crude Oil Price dollars per barrel



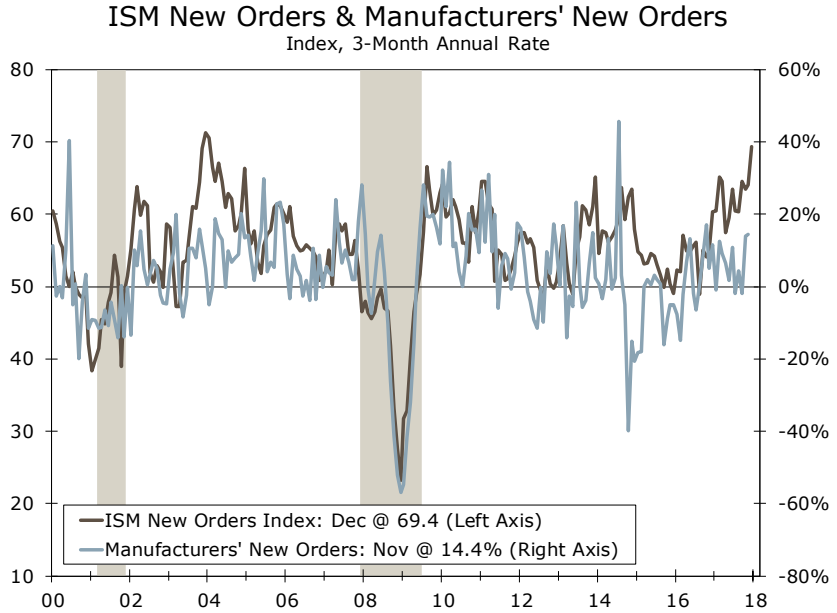
Source: Energy Information Administration and Wells Fargo Securities

We are seeing acceleration in soft data, as the ISM new orders index has registered fastest pace of expansion since 2004

ISM is Riding High



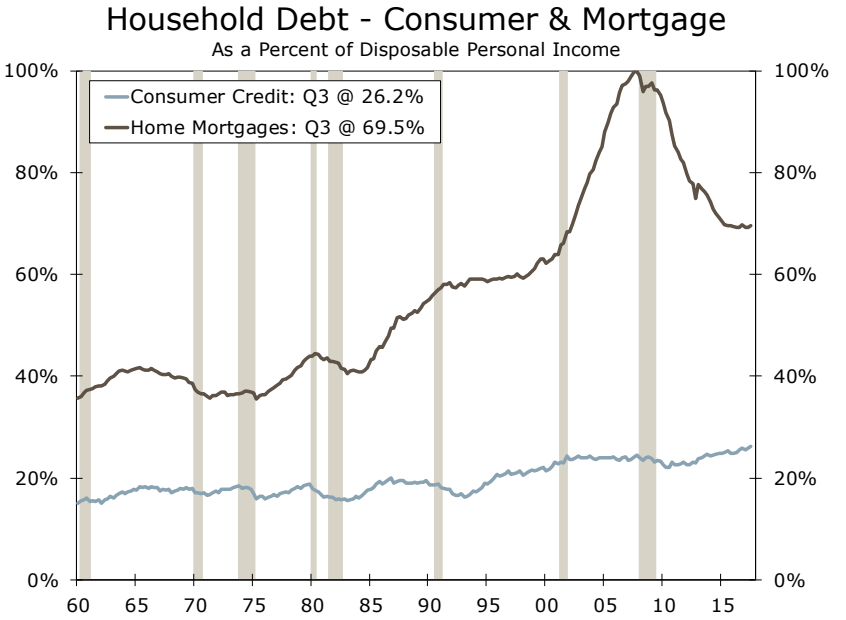
But Why the Gap With Hard Data?



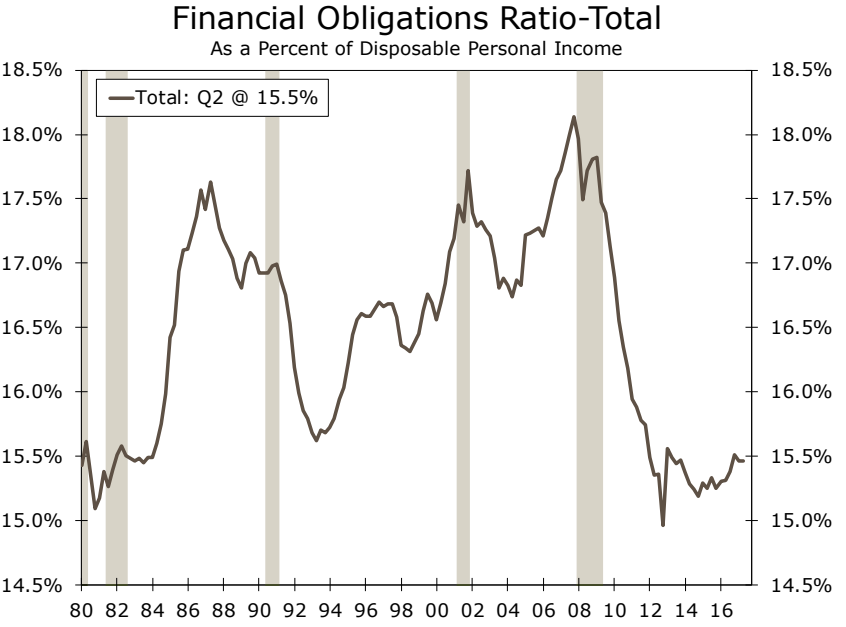
Source: U.S. Dept. of Commerce, ISM and Wells Fargo Securities

Consumer deleveraging may be nearing an end, but monthly debt and other financial obligation payments remain near historic lows

Household Debt



Financial Obligations Ratio

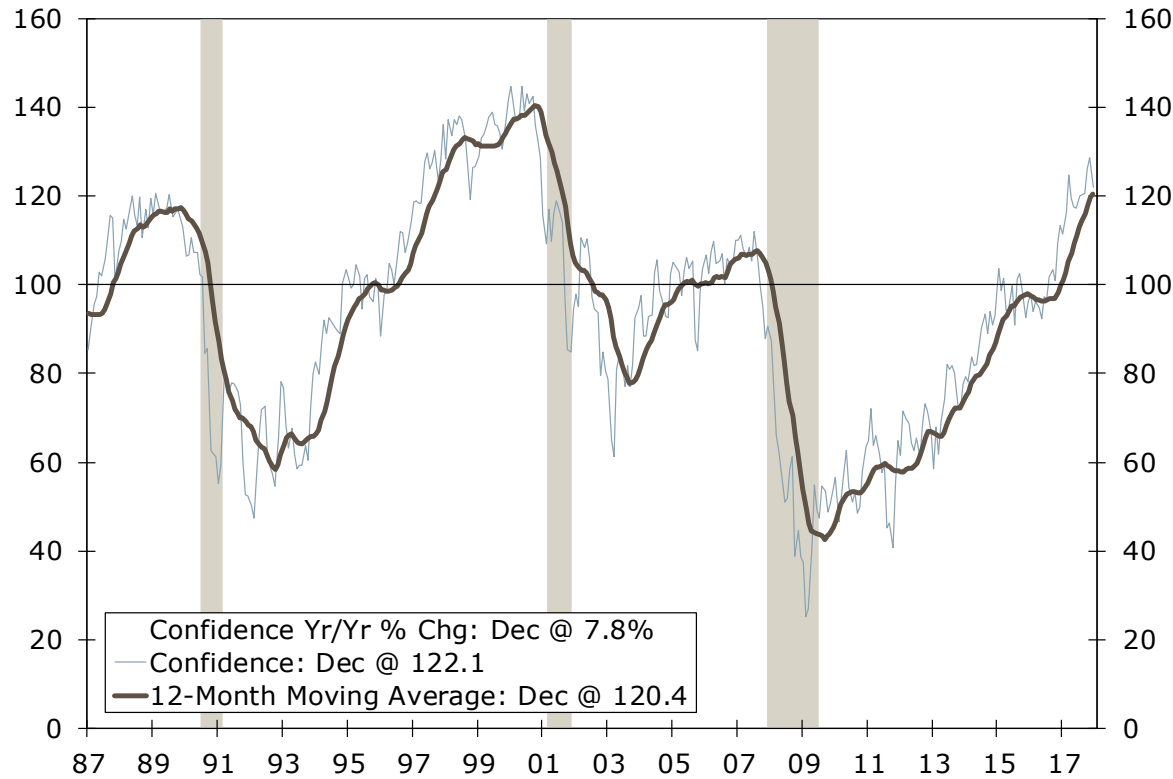


Source: Federal Reserve Board and Wells Fargo Securities

Consumer confidence has jumped post-election. Will more upbeat sentiment translate into an acceleration in personal consumption?

Consumer Confidence Index

Conference Board

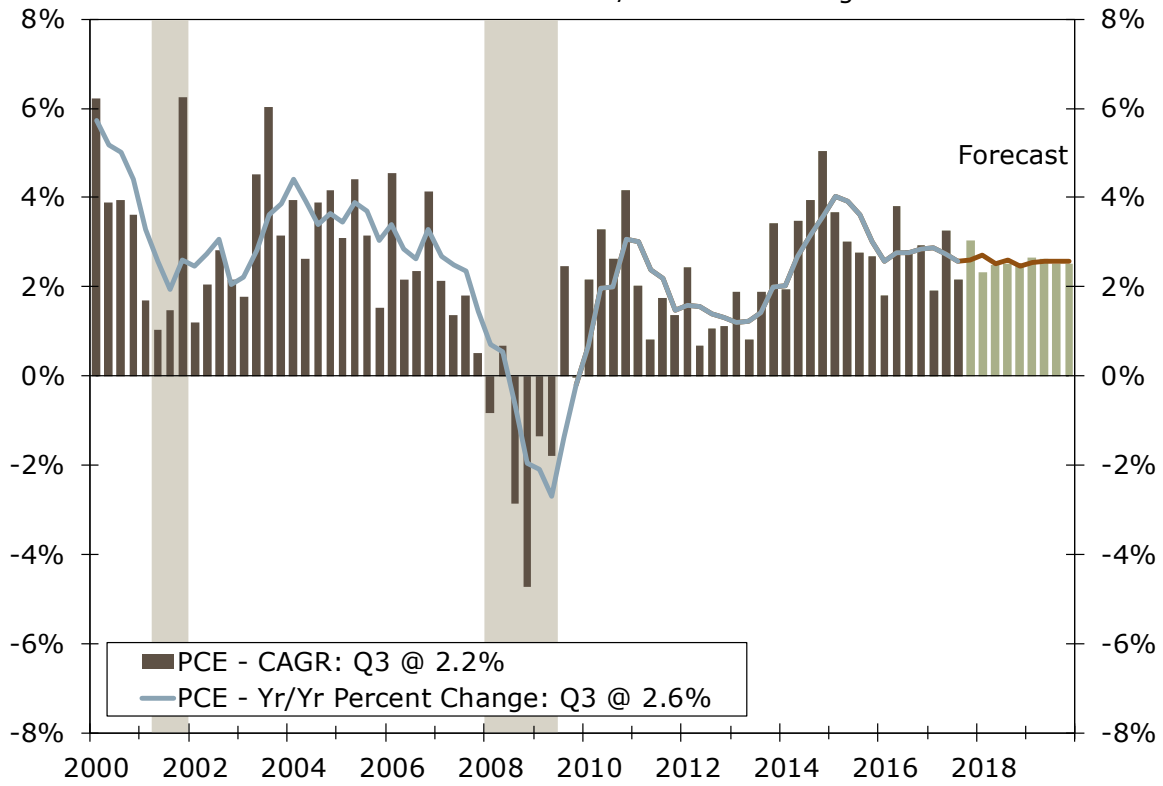


Source: The Conference Board and Wells Fargo Securities

Consumer spending growth is set to moderate but remain positive throughout the forecast horizon

Real Personal Consumption Expenditures

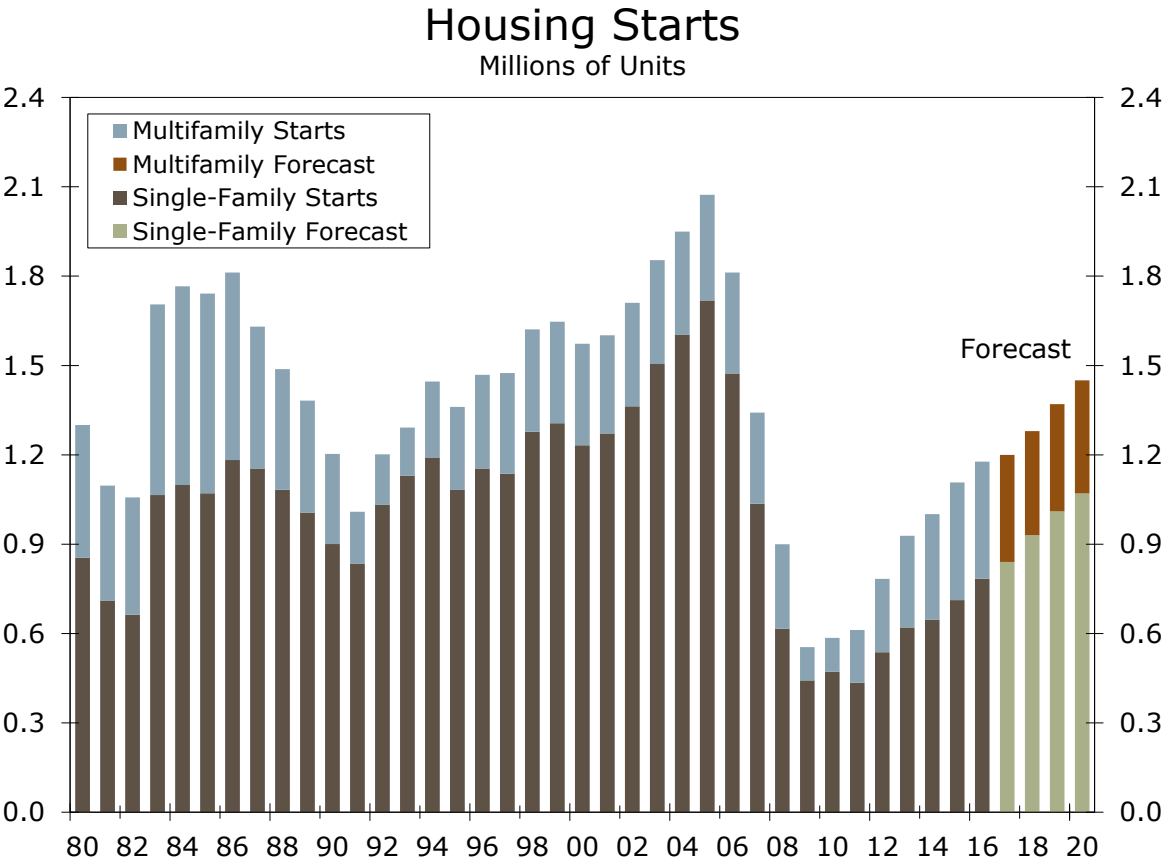
Bars = CAGR Line = Yr/Yr Percent Change



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

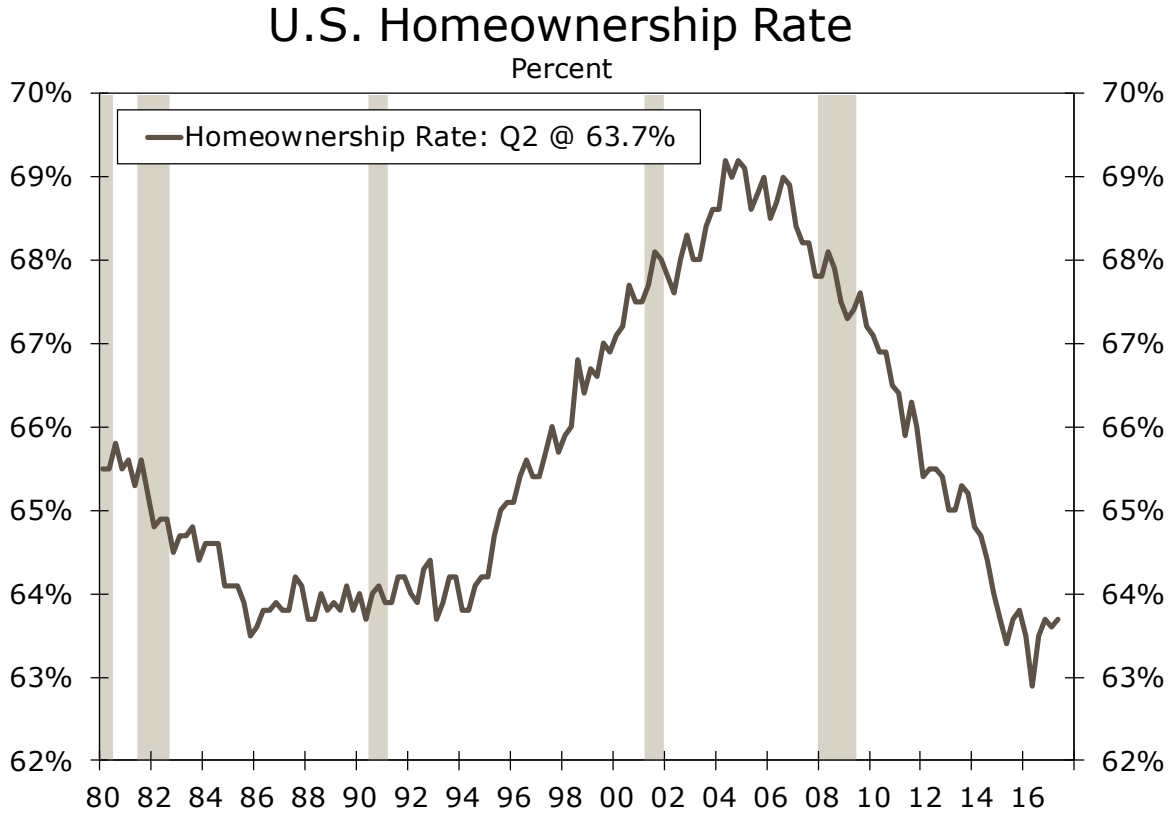
After a very slow start, we see single-family homebuilding steadily gaining momentum over the next few years

Apartment construction is showing signs of topping out but should remain near recent levels



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

The long slide in the homeownership rate may have finally ended. The recovery in homeownership is likely to be protracted due to a combination of cyclical and structural factors.



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

Fiscal Policy

Key Tax Law Changes

Individual Tax Code Changes

The bill reduces the top income tax rate to 37 percent

Eliminates the state and local tax (SALT) deduction but allows income and property tax deductions of up to \$10K

Pass-throughs would be allowed to deduct income up to 20 percent

Increases the standard deduction and the child tax credit

Caps mortgage interest deduction at \$750,000

Keeps the estate tax but doubles the exemption

Keeps the Alternative Minimum Tax (AMT) but lifts the threshold to \$500K

Maintains several deductions including medical expenses, student loans and private activity bonds (PABs)

Repeals the Obamacare individual mandate

Individual cuts will expire on December 31, 2025

Business Tax Code Changes

Permanently reduces the corporate tax rate to 21% from the current 35% federal rate starting in 2018

The corporate AMT would be repealed

The business interest expense deductions are capped at 30 percent of EBITDA for 4 years and 30 percent of EBIT thereafter

The bill would allow for full and immediate expensing of business capital investments for a 5-year period

Ends the current worldwide corporate tax system. Existing profits held abroad can be repatriated at 15.5 percent for cash and cash equivalents, 8 percent for reinvested foreign earnings

The fiscal policy checklist

Key Issues to Watch in the Second Session of the 115th Congress

Infrastructure Spending

- There is currently no political appetite nor a funding mechanism to pass another infrastructure plan

Immigration Reform

- Expect a fix for DACA early in the year which will likely be paired with border security measures
- Attempts to restrict immigration have faced court challenges

Trade Policy Changes

- Congress has delegated many powers to the executive branch related to trade policy
- NAFTA is currently being renegotiated but we expect very few major changes to the agreement
- Tariffs or backing out of existing trade deals without replacements likely represents the greatest downside fiscal policy risk

We expect some marginal changes to the regulatory environment

Potential Regulatory Changes

General Regulatory Changes

- Many pending actions/regulations have already been halted through an executive order
- Changes to existing regulations will take time

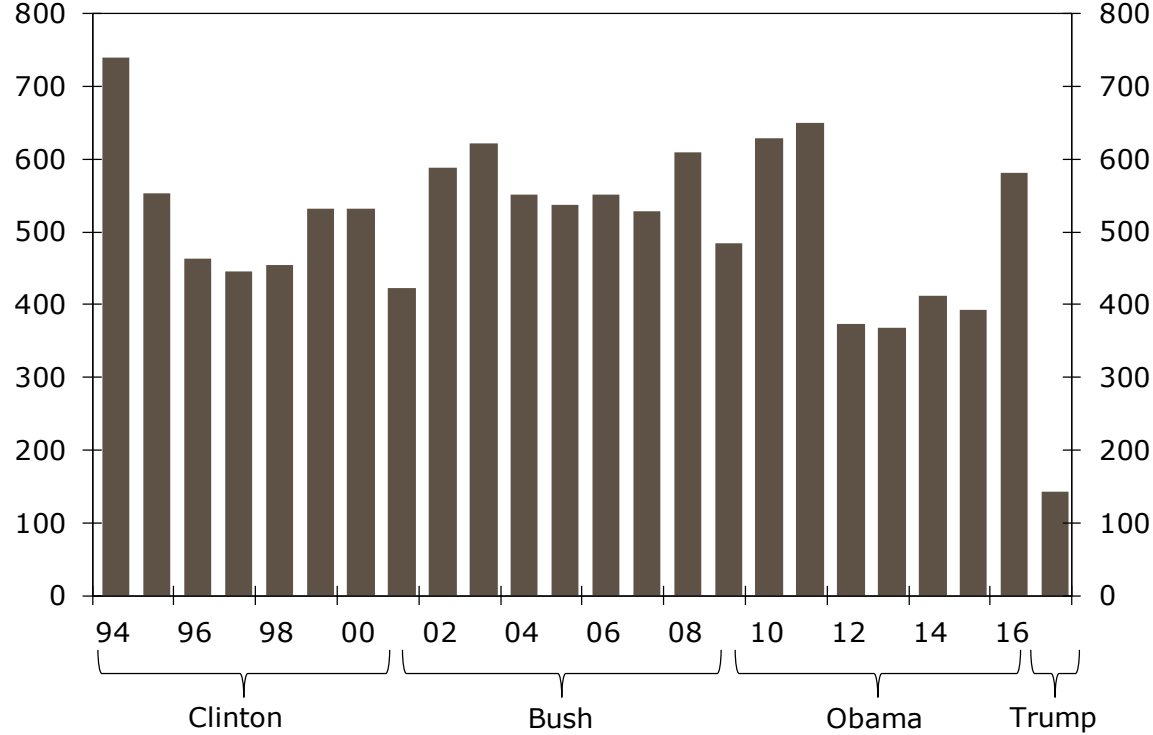
Financial Regulatory Changes

- With new Federal Reserve Board members next year, look for more changes to financial regulations.
- Liquidity Coverage Ratio (LCR) changes are a likely place for regulatory modifications
 - Allow U.S. Municipal Bonds to be counted towards fulfilling LCR requirements which would reduce demand for 10-year U.S. Treasuries
 - Would change the profitability profile of lending channels, likely extending the credit cycle

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

Major New Regulatory Changes

Number of Rules Reviewed By the OIRA Each Year



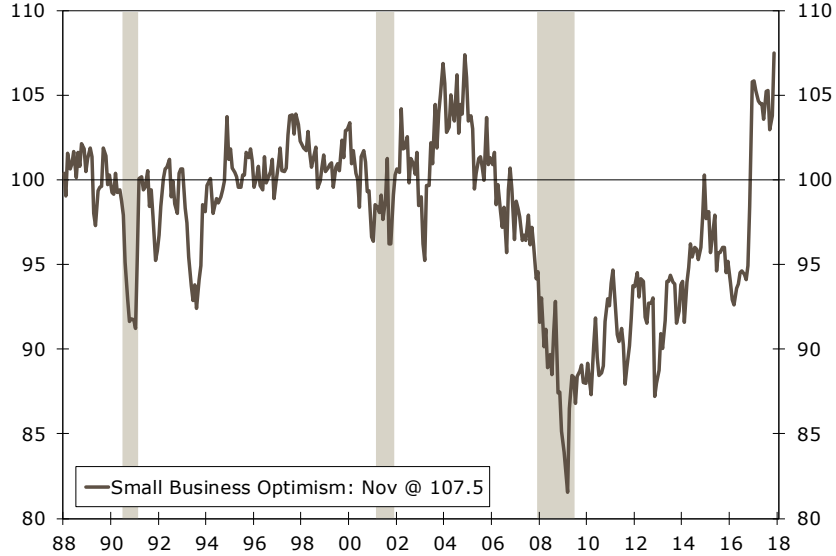
Source: Office of Information and Regulatory Affairs and Wells Fargo Securities

Small business confidence is surging after the tax-cuts and business owners have become less worried about the regulatory environment

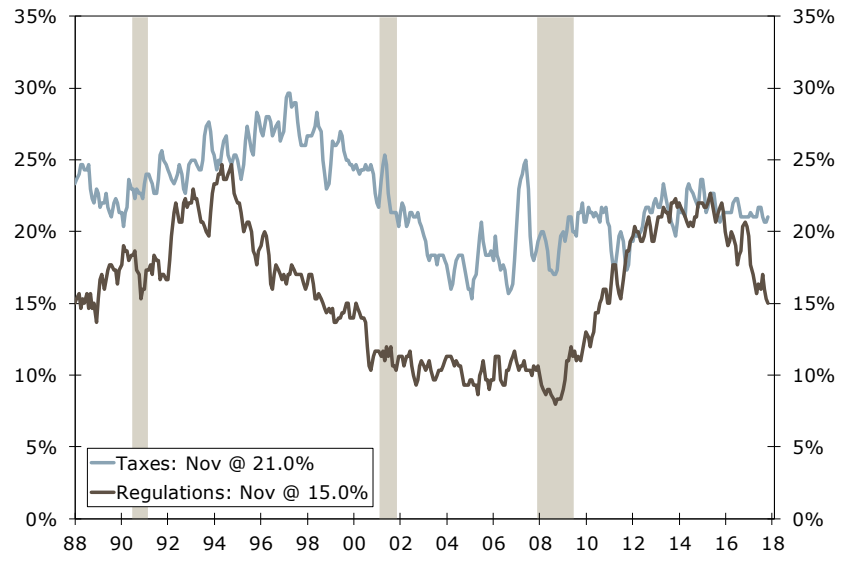
Small Business Optimism

Small Business Concerns

NFIB Small Business Optimism
Overall Index 1986 = 100



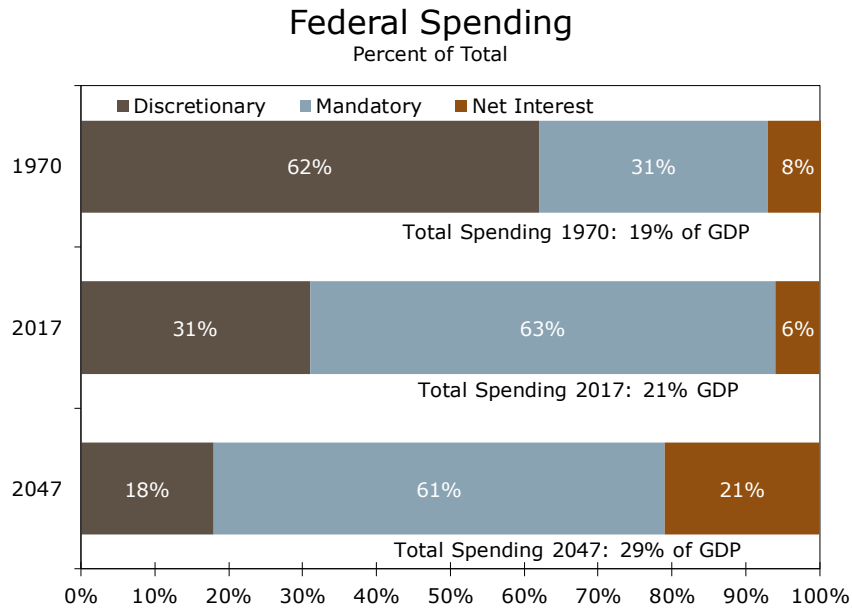
Small Business Most Important Problems
Single Most Important Problem Facing Firms, SA 3-MMA



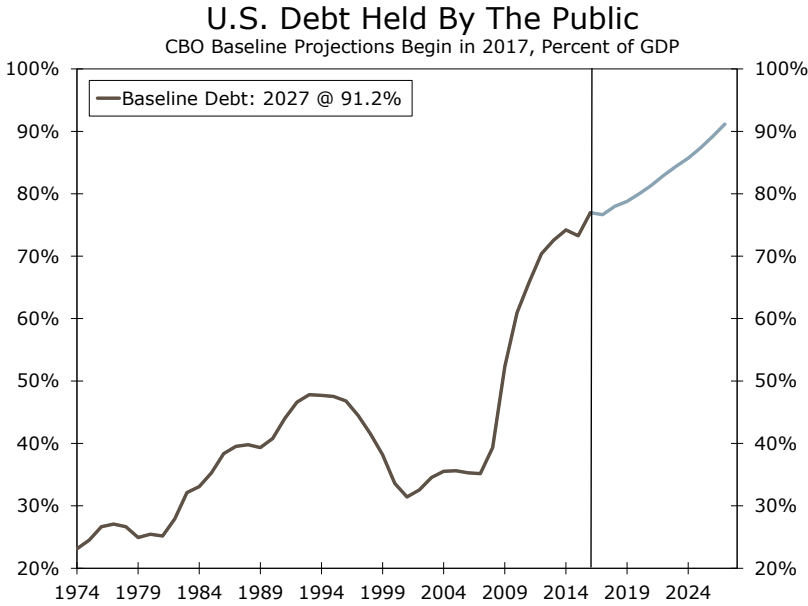
Source: National Federation of Independent Business (NFIB) and Wells Fargo Securities

The composition of federal spending has shifted dramatically. The CBO projects that the debt-to-GDP ratio will surpass 91.2 percent by 2027.

Composition of Federal Spending



Federal Debt Continues to Rise



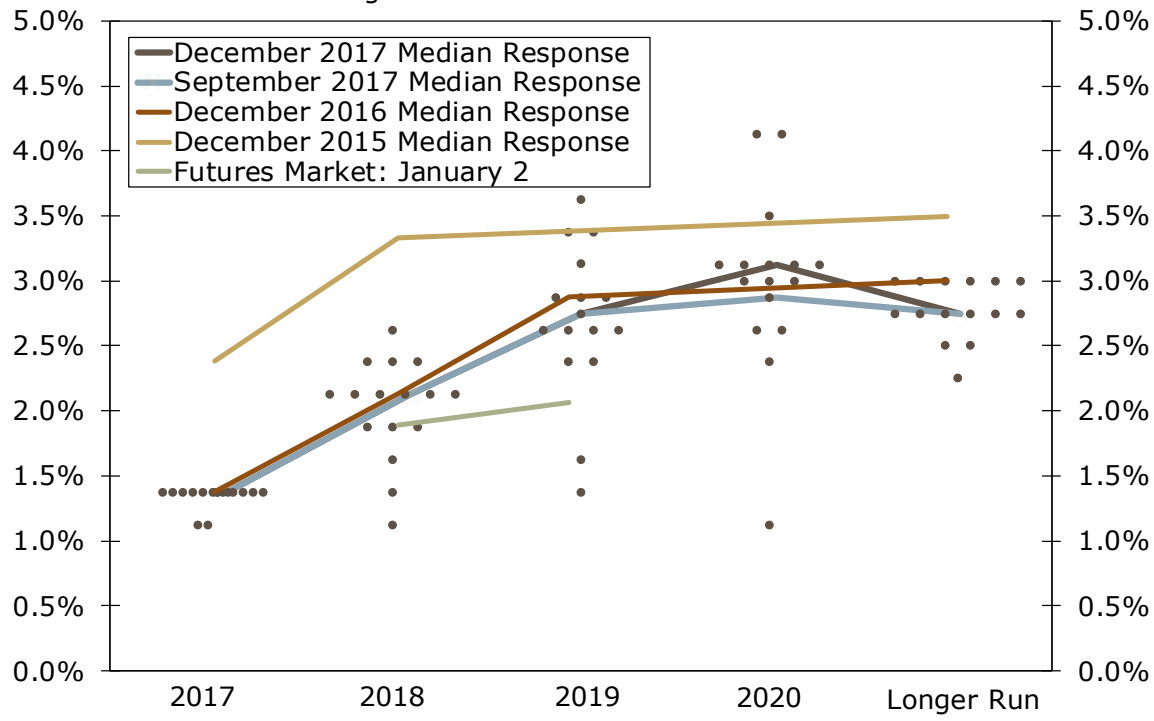
Source: Congressional Budget Office and Wells Fargo Securities

Monetary Policy

Normalization is underway

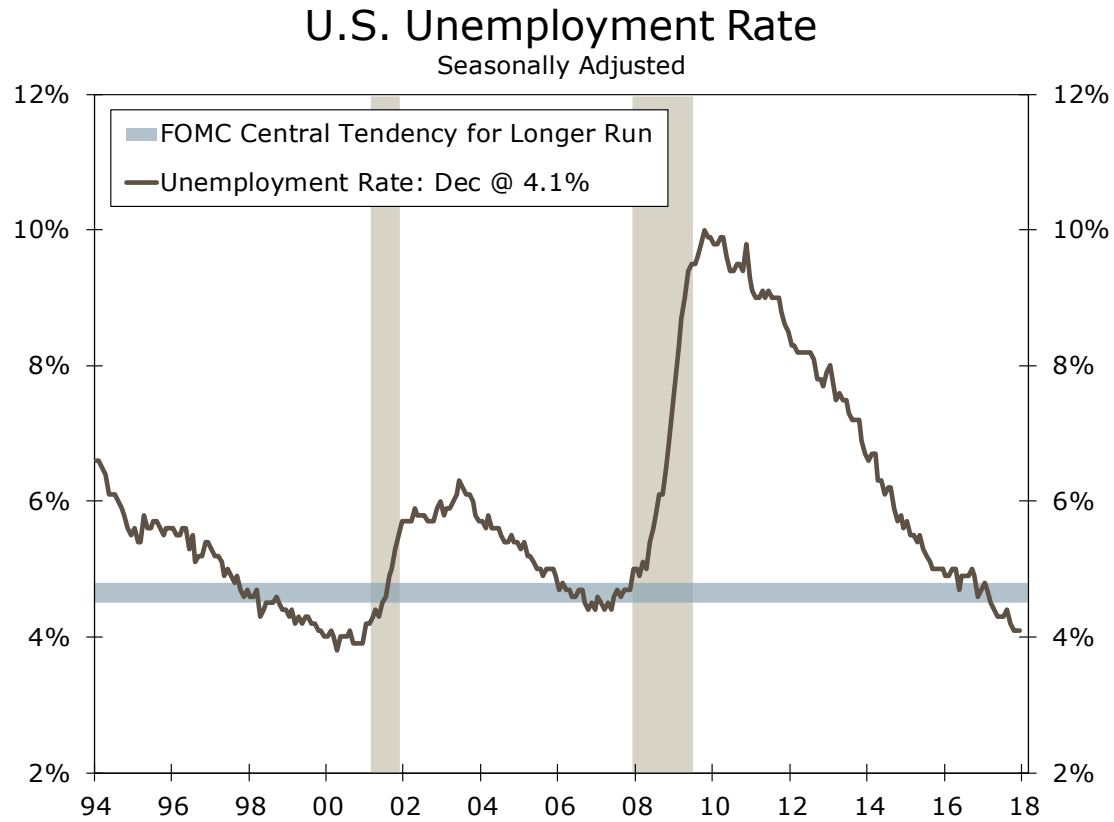
Appropriate Pace of Policy Firming

Target Federal Funds Rate at Year-End



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

The labor market is steadily firming, the unemployment rate is well-below the FOMC's central tendency target

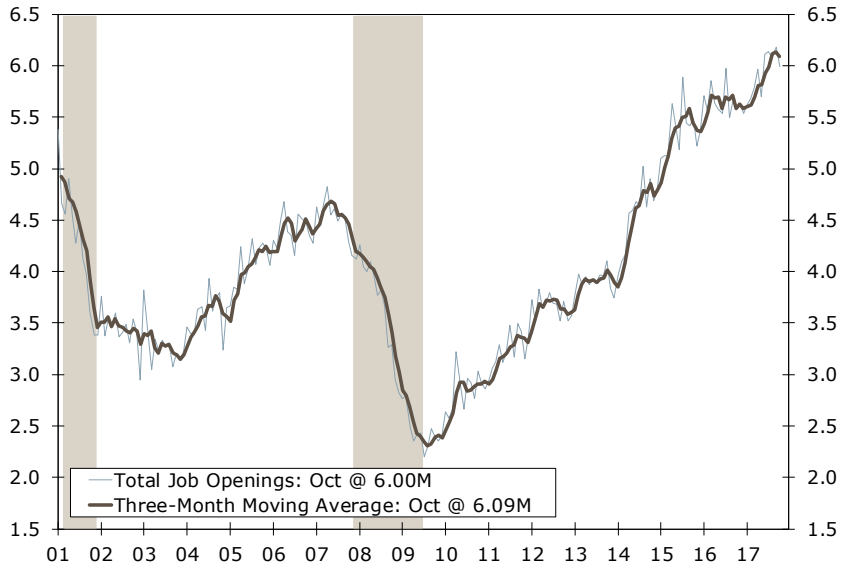


Source: U.S. Department of Labor, Federal Reserve Board and Wells Fargo Securities

Job openings also near a record high, while quits approach levels last seen in 2001

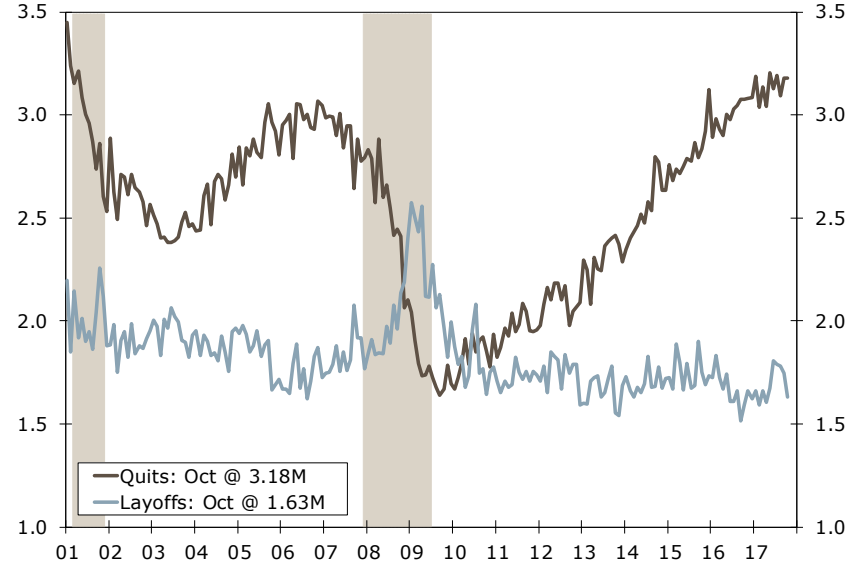
Openings

Job Openings
Millions of Openings, Seasonally Adjusted



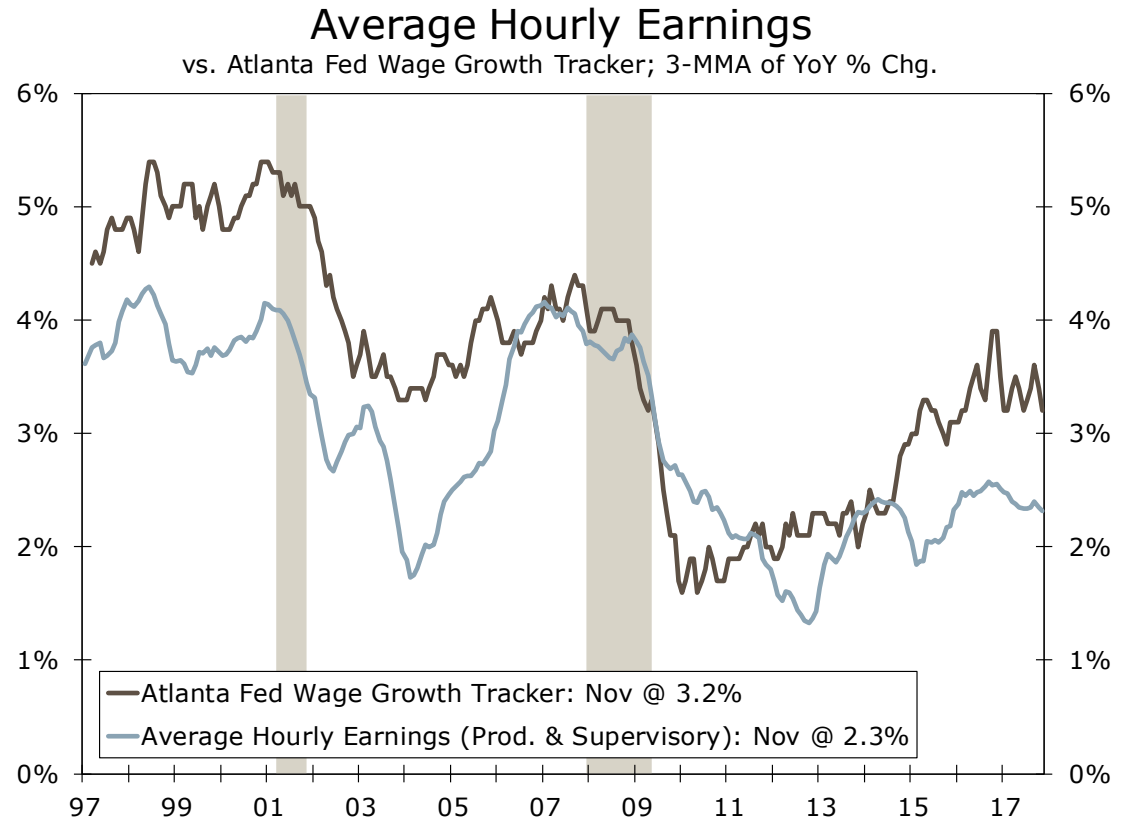
Separations

Quits vs. Layoffs
Millions of Workers, SA



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

Wage growth has picked up modestly but remains limited by lower-skilled workers entering the workforce and Baby Boomers beginning to retire

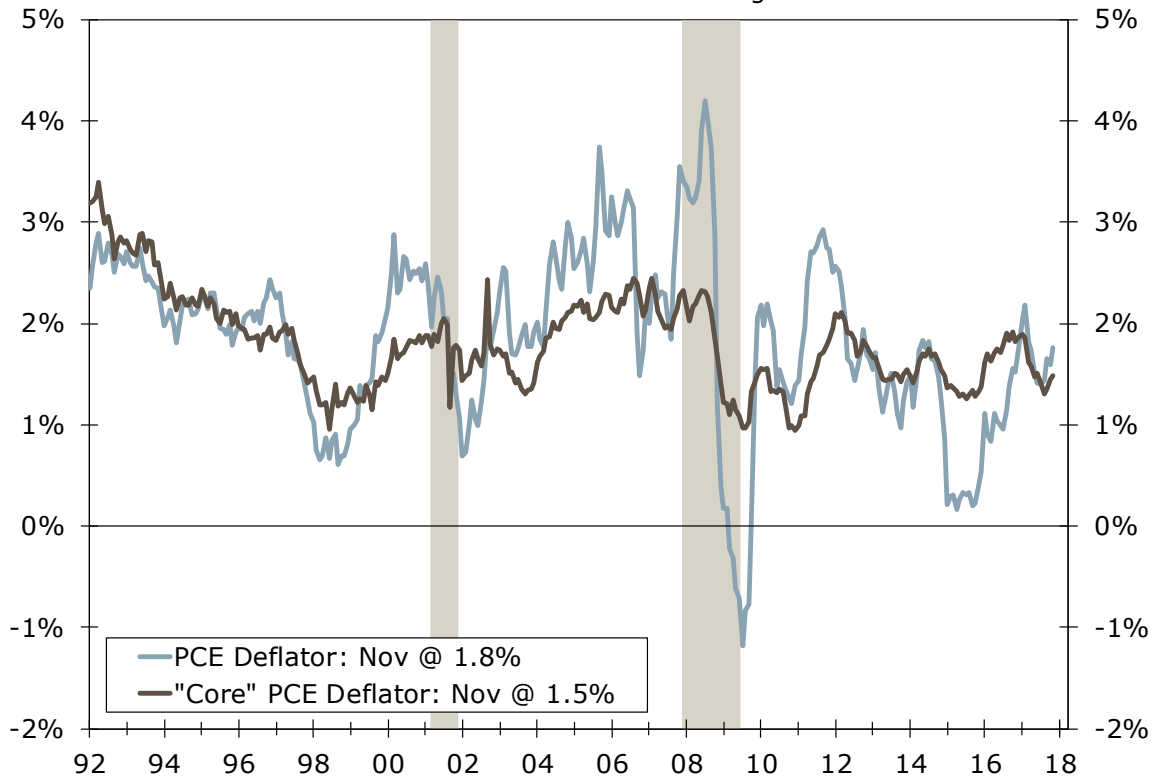


Source: Federal Reserve Bank of Atlanta, U.S. Department of Labor and Wells Fargo Securities

Inflation has moved higher but remains below the Fed's 2 percent target

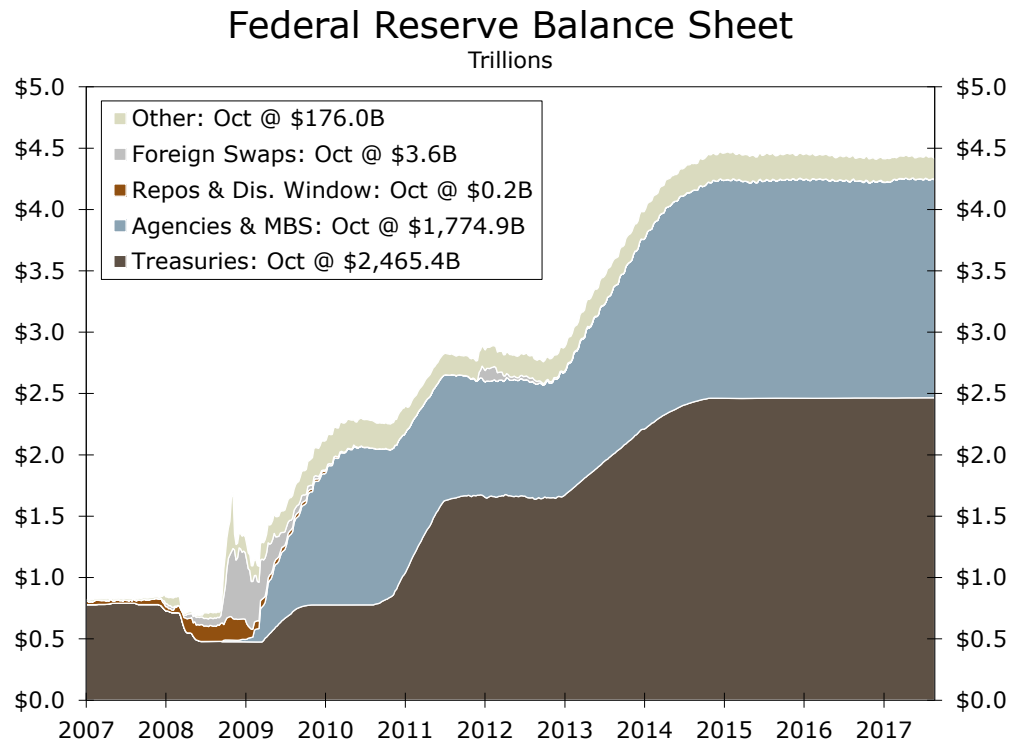
PCE Deflator vs. Core PCE Deflator

Year-over-Year Percent Change



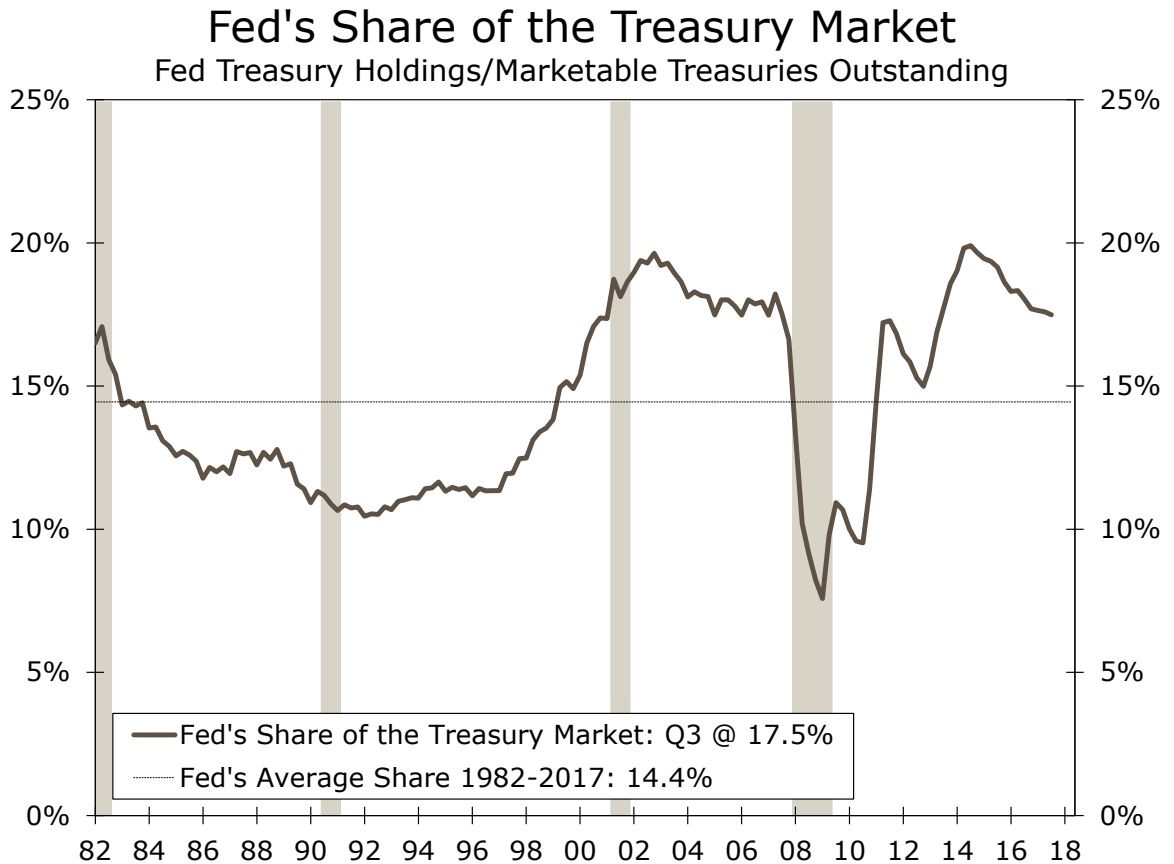
Source: U.S. Department of Commerce and Wells Fargo Securities

- Prior to the 2008, Fed’s holdings were about \$900 of mostly Treasuries.
- Balance sheet briefly held a diverse selection of financial instruments, such as commercial paper and currency swaps, to help mitigate the liquidity challenges in the financial system.
- Current size is roughly \$4.5 trillion, comprised mostly of Treasuries and mortgage-backed securities (MBS).



Source: Federal Reserve System and Wells Fargo Securities

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

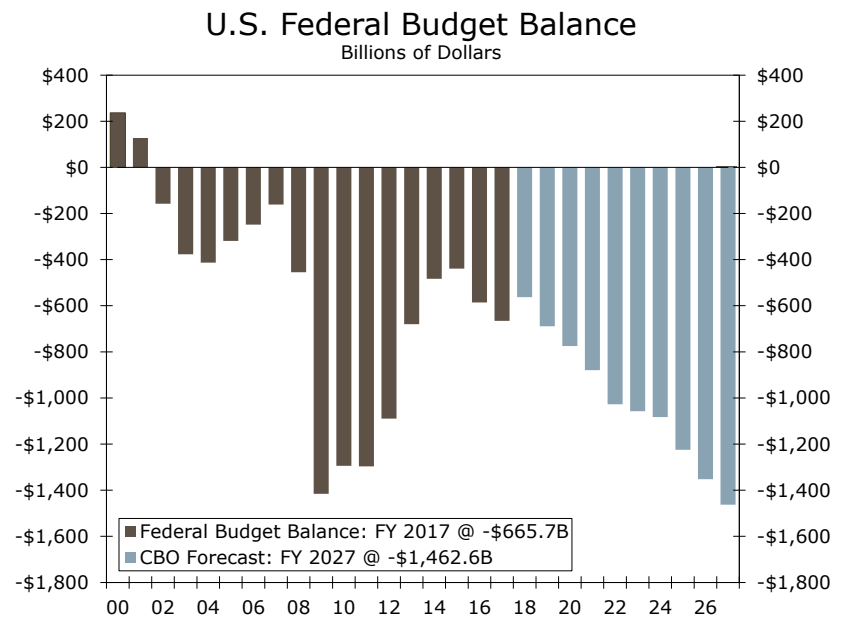


Source: U.S. Department of the Treasury, Federal Reserve Board and Wells Fargo Securities

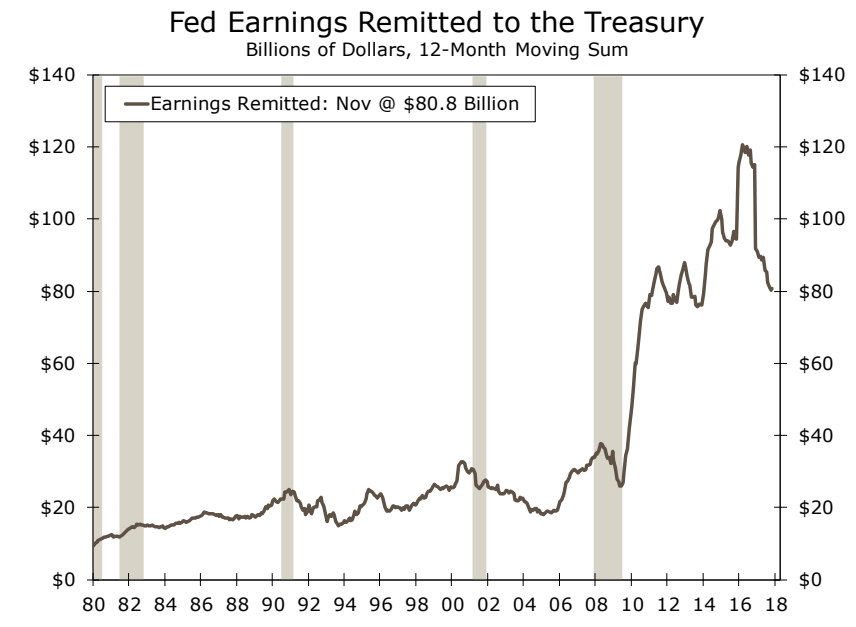
Where Fiscal and Monetary Policy Are Intertwined

- Like it or not, Fed’s large holdings currently help reduce the budget deficit.
- With rising deficits and trouble finding the funding for policy proposals, reduced remittances to the Treasury cannot be ignored.
- Fed earnings remitted to the Treasury in the past year add up to roughly \$80 billion.
- Without it, last year’s fiscal budget deficit would have been 16 percent larger.

U.S. Federal Budget



Fed Earnings Remitted



Source: U.S. Department of the Treasury, Congressional Budget Office and Wells Fargo Securities

Wells Fargo U.S. Economic Forecast

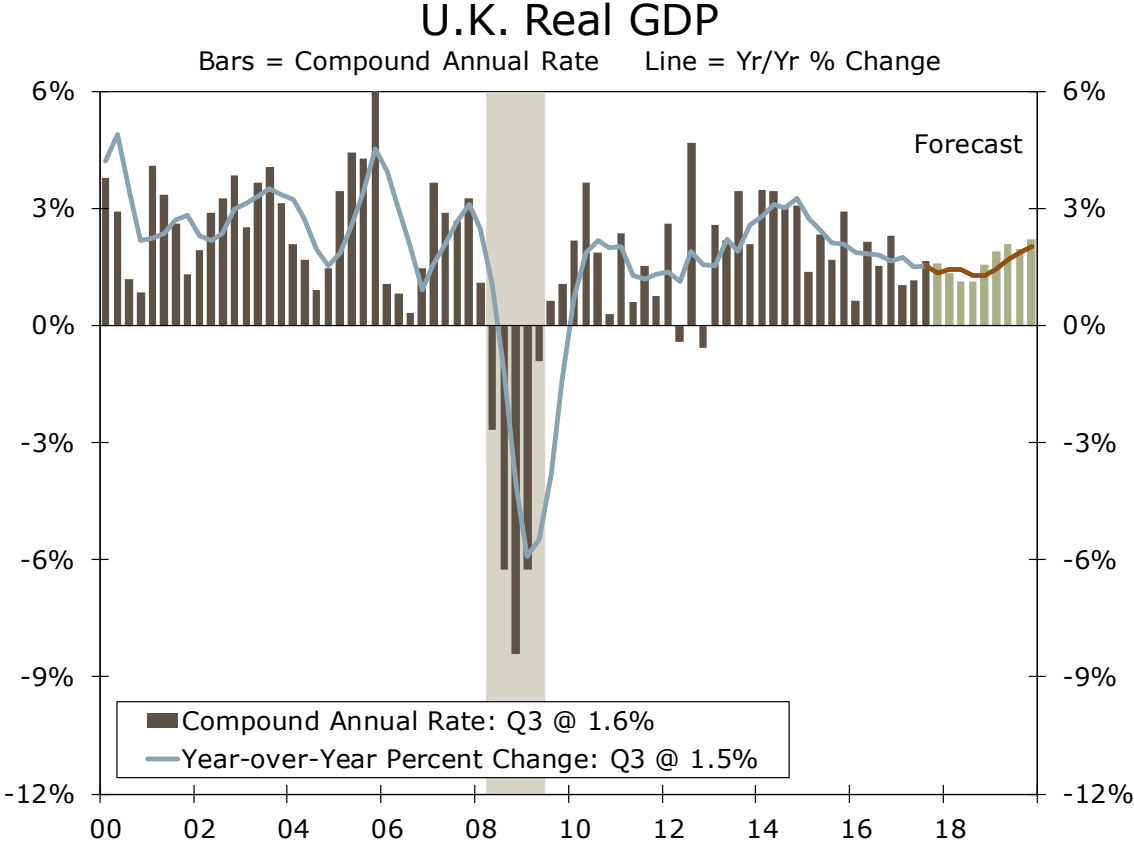
	Actual				Forecast				Actual		Forecast		
	2017				2018				2015	2016	2017	2018	2019
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product ¹	1.2	3.1	3.2	2.5	2.6	2.5	2.6	2.5	2.9	1.5	2.3	2.7	2.6
Personal Consumption	1.9	3.3	2.2	3.0	2.3	2.5	2.5	2.5	3.6	2.7	2.7	2.6	2.6
Inflation Indicators ²													
PCE Deflator	2.0	1.6	1.5	1.6	1.7	2.1	2.3	2.0	0.3	1.2	1.7	2.0	2.1
Consumer Price Index	2.6	1.9	2.0	2.1	2.0	2.6	2.7	2.1	0.1	1.3	2.1	2.3	2.1
Industrial Production ¹	1.5	5.6	-0.9	5.8	2.4	2.2	2.3	2.1	-0.7	-1.2	1.9	2.8	2.3
Corporate Profits Before Taxes ²	3.3	6.3	5.3	3.8	3.4	3.3	3.1	3.1	-1.1	-2.1	4.7	3.2	2.9
Trade Weighted Dollar Index ³	94.0	90.5	88.1	89.3	88.5	87.5	86.3	84.8	91.1	91.6	90.5	86.8	81.6
Unemployment Rate	4.7	4.4	4.3	4.1	4.1	4.0	3.9	3.8	5.3	4.9	4.4	4.0	3.8
Housing Starts ⁴	1.24	1.17	1.17	1.27	1.27	1.28	1.28	1.29	1.11	1.17	1.20	1.28	1.37
Quarter-End Interest Rates ⁵													
Federal Funds Target Rate	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	0.27	0.52	1.25	2.06	2.63
Conventional Mortgage Rate	4.20	3.90	3.81	3.89	4.06	4.20	4.30	4.35	3.85	3.65	3.95	4.23	4.56
10 Year Note	2.40	2.31	2.33	2.49	2.66	2.80	2.90	2.95	2.14	1.84	2.38	2.83	3.16

Forecast as of: December 21, 2017

¹ Compound Annual Growth Rate Quarter-over-Quarter² Year-over-Year Percentage Change³ Federal Reserve Major Currency Index, 1973=100 - Quarter End⁴ Millions of Units⁵ Annual Numbers Represent Averages

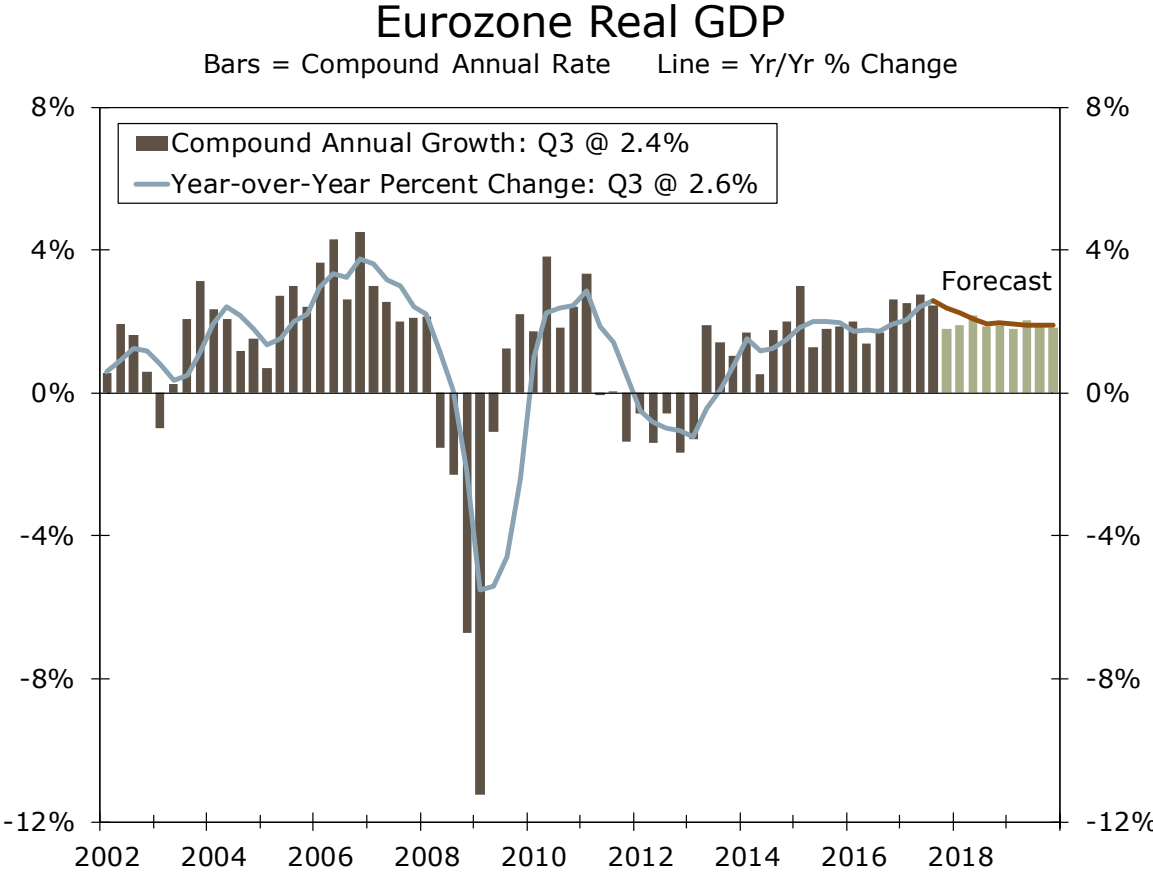
International Developments

Implications of Brexit have not been as bad as feared



Source: IHS Global Insight and Wells Fargo Securities

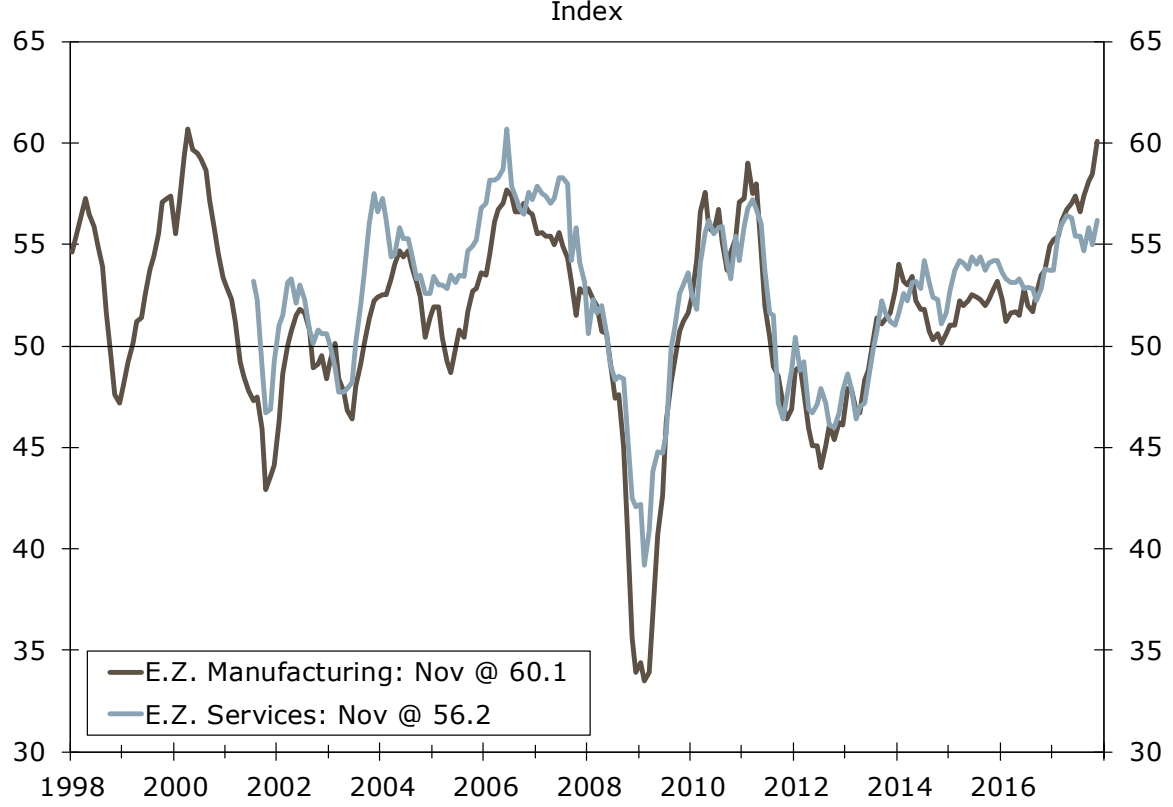
3+ Years of Uninterrupted Growth



Source: IHS Global Insight and Wells Fargo Securities

The Eurozone purchasing managers' indices are pointing to continued recovery

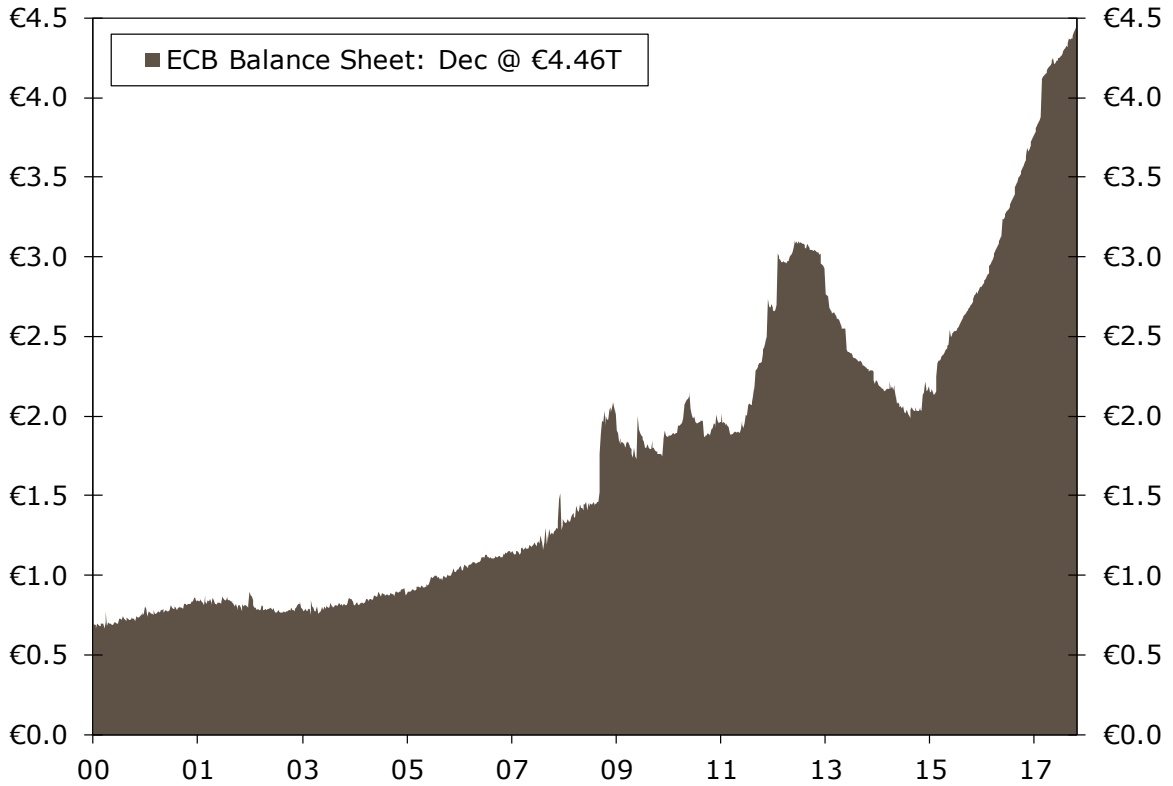
Eurozone Purchasing Managers' Indices



Source: Bloomberg LP and Wells Fargo Securities

The ECB's QE program should remain operational

ECB Balance Sheet
Trillions of Euros

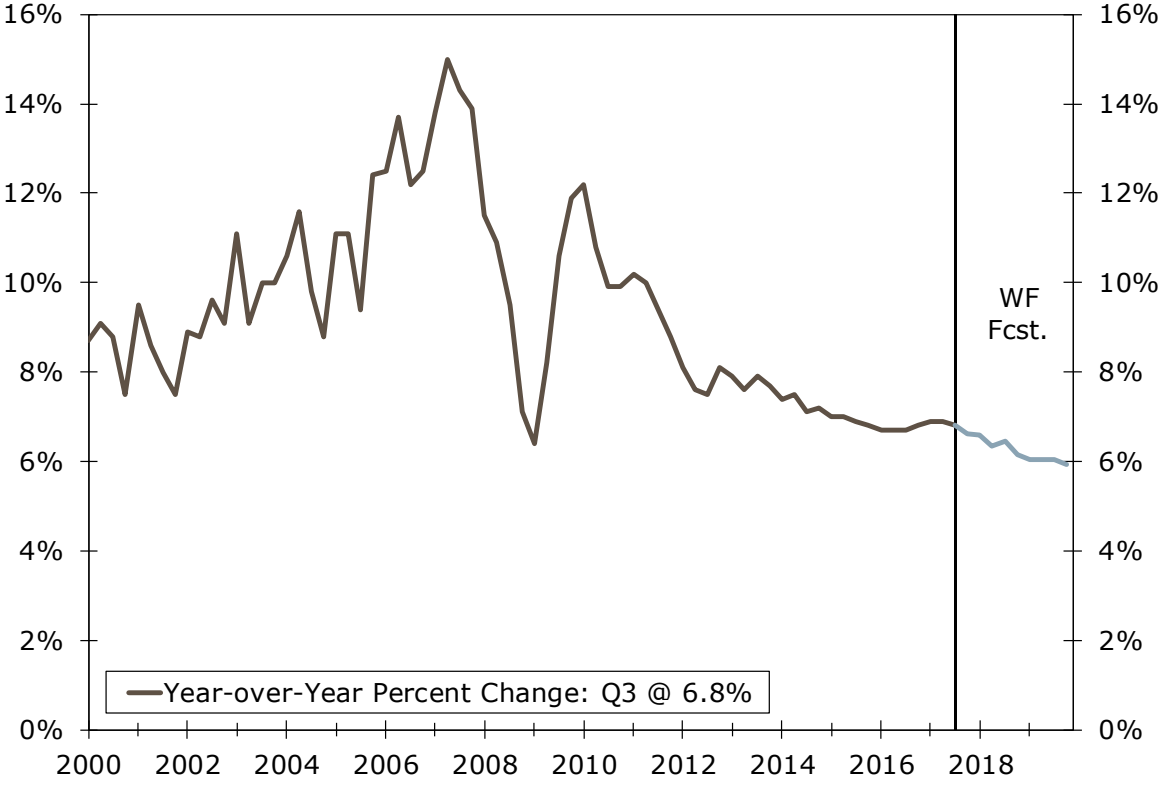


Source: IHS Global Insight and Wells Fargo Securities

Growth in China has stabilized, but we do not expect it to return to the double-digit growth rates seen in the past

Chinese Real GDP Forecast

Year-over-Year Percent Change

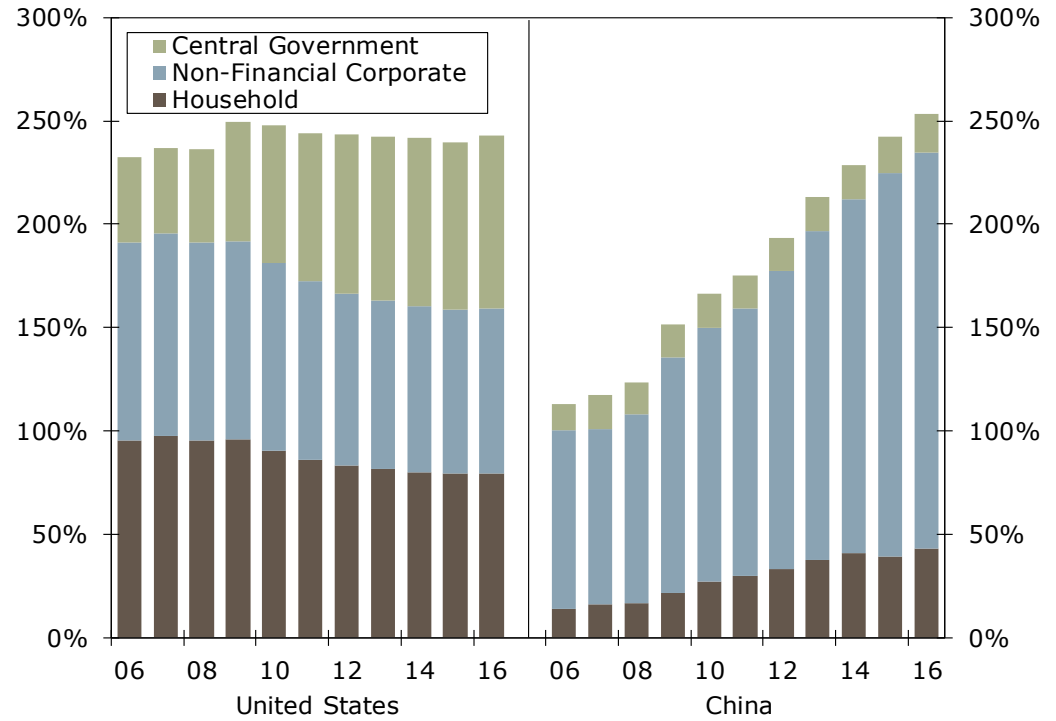


Source: Bloomberg LP and Wells Fargo Securities

Debt problems in China are concentrated in the business sector

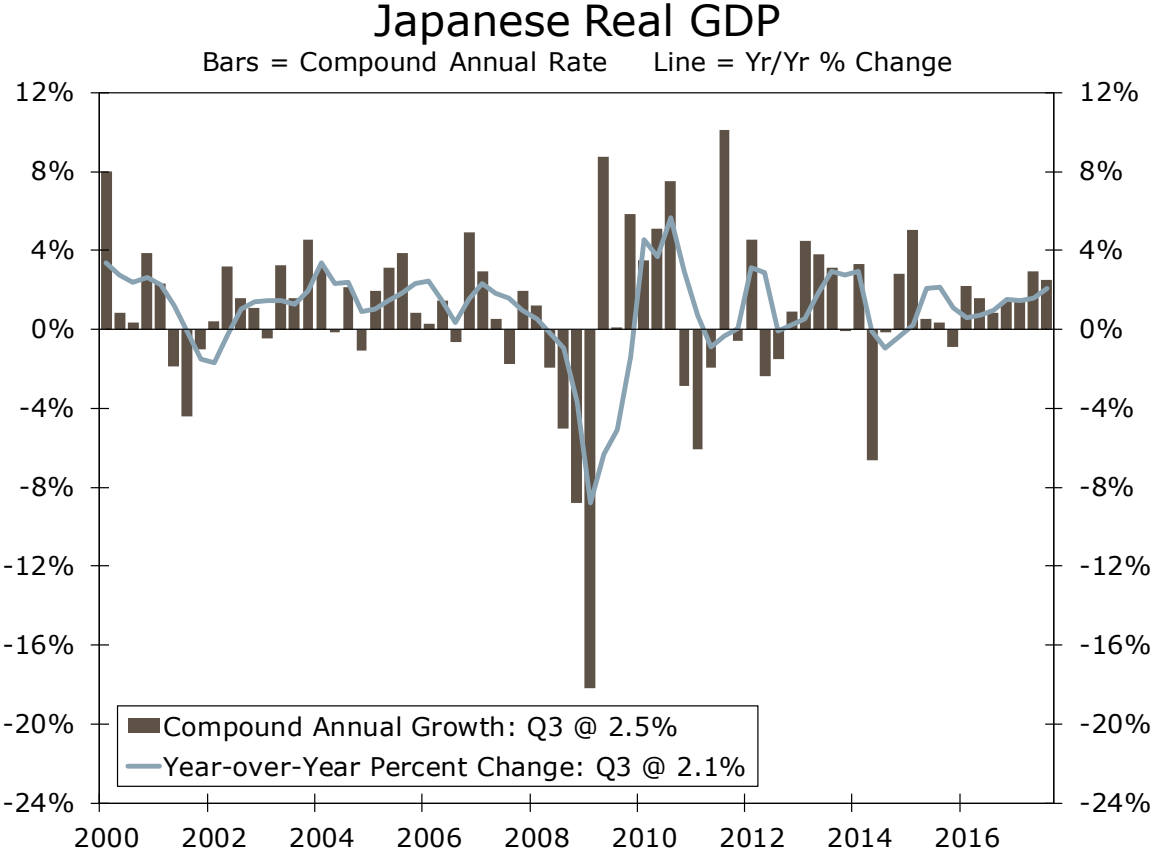
U.S. vs. China Debt Outstanding by Sector

Percent of GDP



Source: Bloomberg LP and Wells Fargo Securities

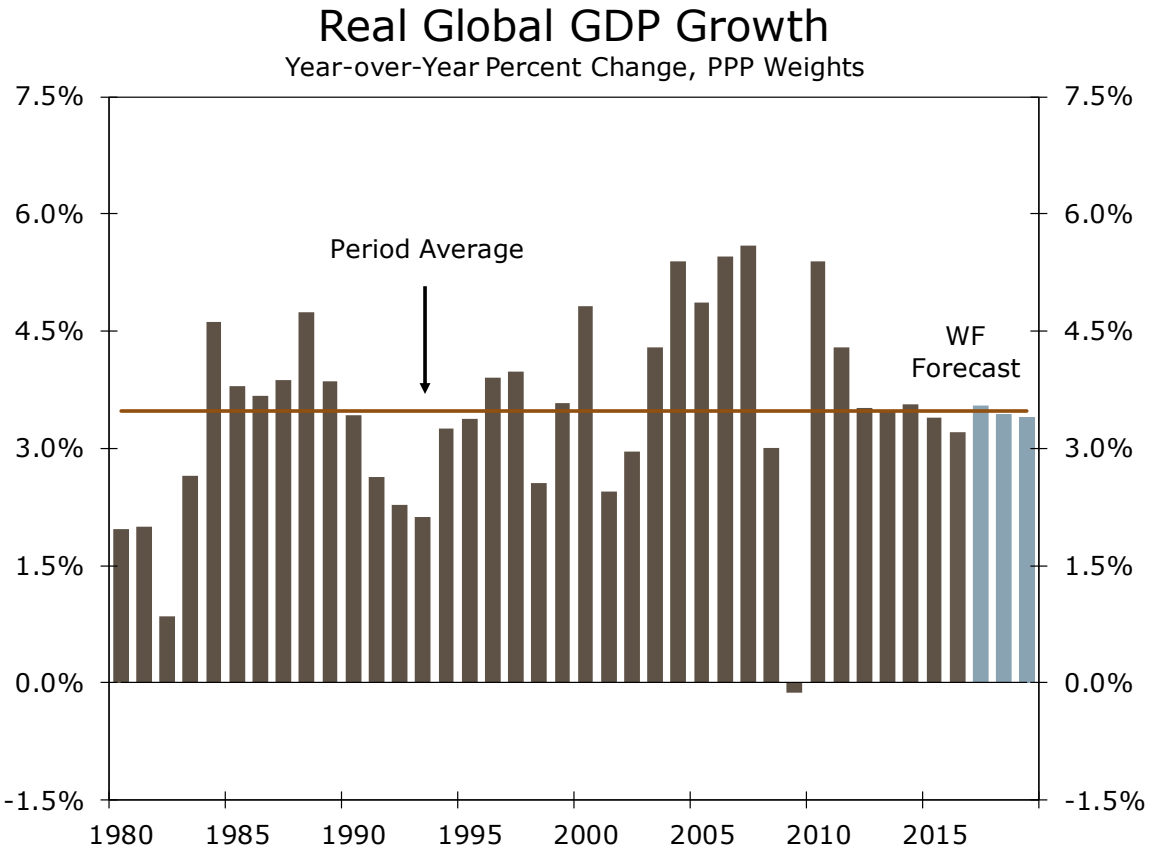
Mixed track record for Abenomics



Source: Bank of Japan, IHS Global Insight and Wells Fargo Securities

2016 will likely mark the weakest year for global economy since 2009, but we see gradual improvement in coming years

OECD's updated forecast:
3.5% in 2017
3.7% in 2018

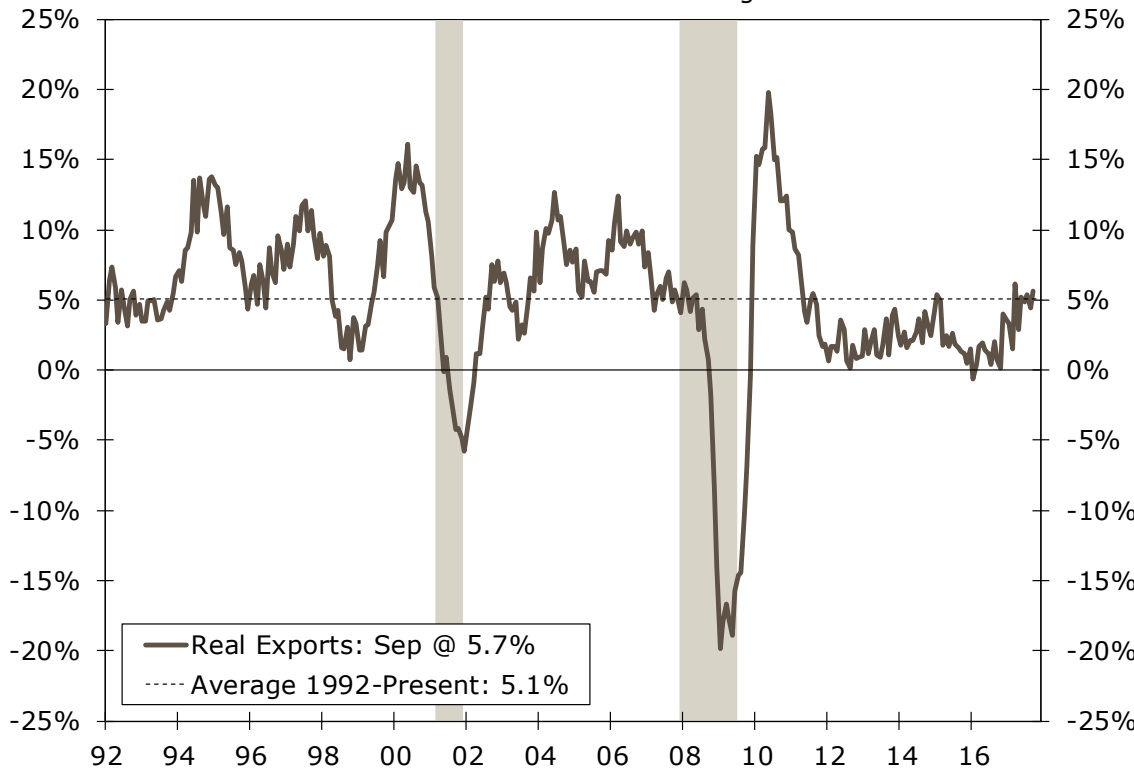


Source: International Monetary Fund and Wells Fargo Securities

Global trade has slowed over the past year

Global Export Volumes

Year-over-Year Percent Change



Source: IHS Global Insight and Wells Fargo Securities

Growth in the global economy likely will grind closer to long term trend

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2017	2018	2019	2017	2018	2019
Global (PPP Weights)	3.5%	3.4%	3.4%	3.1%	3.5%	3.5%
Global (Market Exchange Rates)	3.3%	3.3%	3.2%	3.1%	3.5%	3.5%
Advanced Economies ¹	2.4%	2.4%	2.2%	1.8%	1.9%	2.0%
United States	2.3%	2.7%	2.5%	2.1%	2.2%	2.1%
Eurozone	2.4%	2.1%	1.9%	1.5%	1.6%	1.8%
United Kingdom	1.5%	1.4%	1.8%	2.7%	2.3%	2.0%
Japan	1.5%	1.1%	1.0%	0.4%	0.9%	1.1%
Korea	3.3%	3.0%	2.6%	2.0%	1.8%	2.1%
Canada	2.9%	2.0%	1.7%	1.6%	2.0%	2.0%
Developing Economies ¹	4.7%	4.5%	4.5%	4.4%	5.0%	5.1%
China	6.6%	6.4%	6.0%	1.6%	2.2%	2.2%
India ²	7.1%	6.7%	7.1%	3.3%	5.0%	4.7%
Mexico	2.0%	1.9%	2.9%	5.9%	5.0%	5.1%
Brazil	1.0%	2.6%	3.0%	3.5%	3.8%	4.4%
Russia	1.8%	2.1%	2.2%	3.7%	3.4%	4.5%

Forecast as of: December 14, 2017

¹Aggregated Using PPP Weights

²Forecast Refers to Fiscal Year

Source: International Monetary Fund and Wells Fargo Securities

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