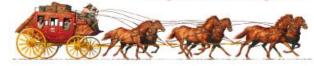


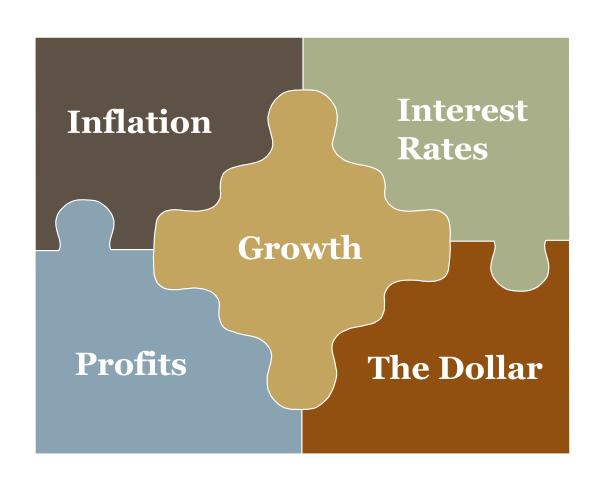
#### Economic Outlook: Cyclical Recovery, Structural Challenges Detroit NABE

John E. Silvia, Chief Economist May 13, 2014

Together we'll go far



Five benchmarks for good decision making

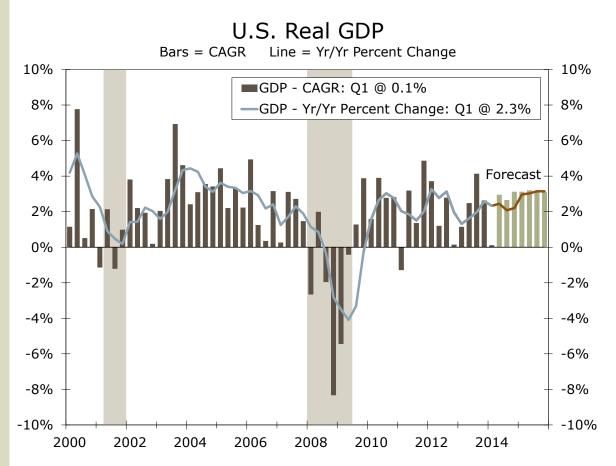


### How do we differ from consensus?

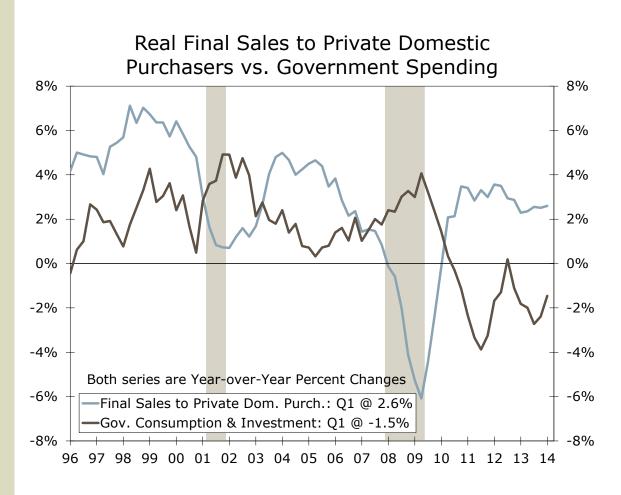
#### **Expectations for the Future**

- Sustained-trend plus growth
- Employment—cyclical and structural change
- Still cautious on consumer segments
- Housing improving—multifamily especially
- State and local governments—still restructuring
- Unsustainable long-run fiscal policy
- Europe exits recession
- China growth stable at 7 percent plus

Sustained recovery in 2014 at 2.8 percent, but near historical experience benchmark 2.75 percent is trend from 1982-2012

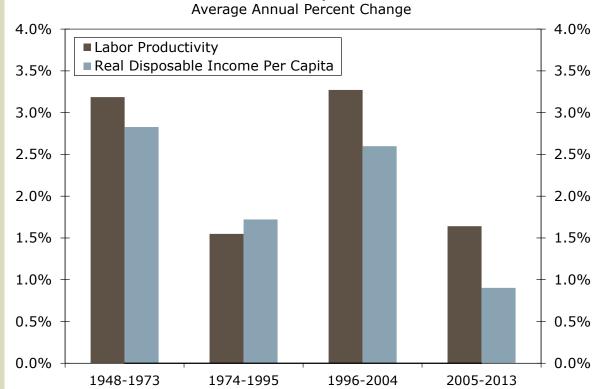


The economy is rebalancing with steady private sector demand



If labor productivity growth remains weak, the paltry pace of real income growth that the country has experienced in recent years seems set to continue

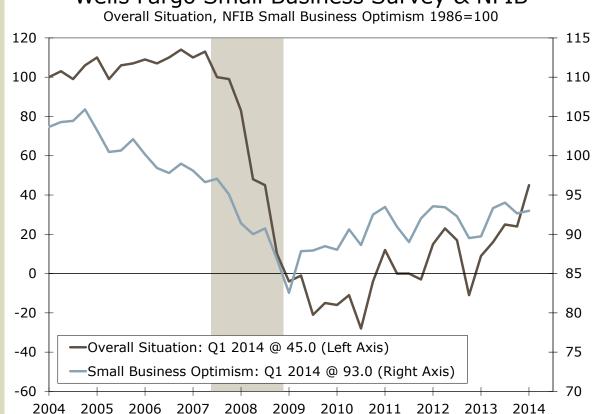
#### Labor Productivity and Income



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

Small Businesses:
A full recovery in small business optimism is still distant, taxes and regulation the two big issues

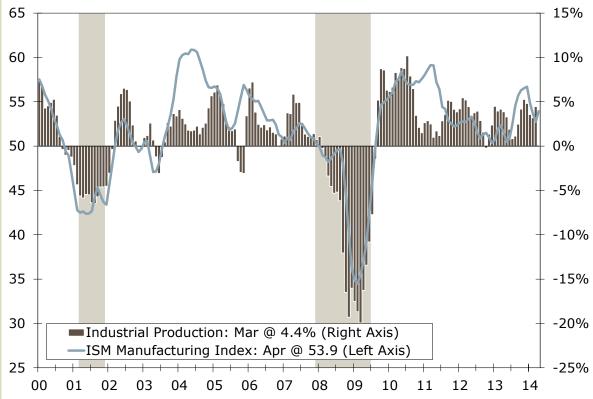
#### Wells Fargo Small Business Survey & NFIB



Source: National Federation of Independent Businesses, Gallup, Wells Fargo Bank and Wells Fargo Securities, LLC

Gains in ISM a plus for manufacturing

# ISM Manufacturing Composite & Industrial Production Index, 3-Month Moving Average, 3-Month Annual Rate

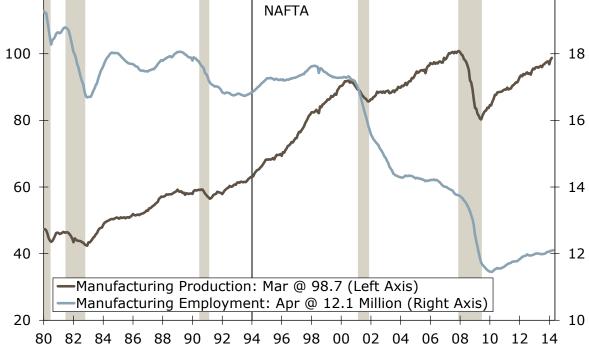


Source: Institute for Supply Management and Wells Fargo Securities, LLC

120

The gap between jobs and production in the manufacturing sector has become massive

# Production & Jobs in Manufacturing Sector Index, 2007=100 on Left Axis, Right Axis in Millions NAFTA

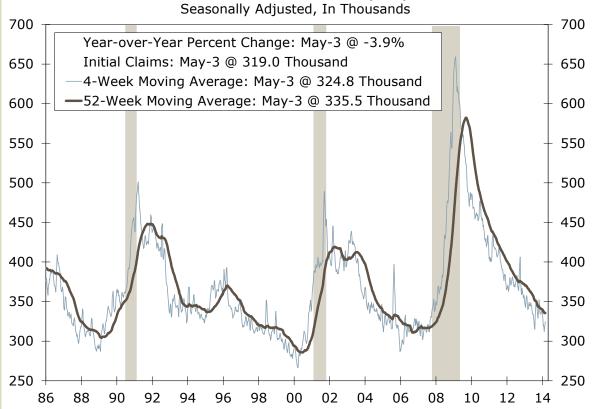


Source: Institute for Supply Management and Wells Fargo Securities, LLC

20

Signaling continued, moderate job gains ahead

#### Initial Claims for Unemployment

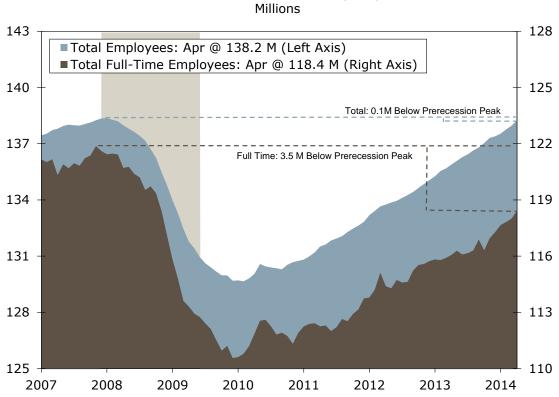


Structural Change:
A much lower base to support growth and spending, especially for entitlements

#### Unemployment vs. Employment-Population Ratio 16 Years and Over, Seasonally Adjusted 11% 57% -Unemployment Rate: Apr @ 6.3% (Left Axis) Employment-Population: Apr @ 58.9% (Right Axis - Inverted) 10% 58% 9% 59% 8% 60% 7% 61% 6% 62% 5% 63% 4% 64% 3% 65% 88 90 92 94 96 98 00 02 04 06 08 10 12 14 86

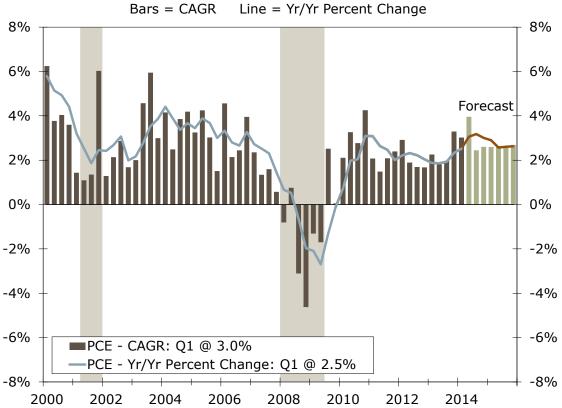
We still have a ways to go before recovering all of the jobs lost in the most recent recession

#### Full-Time vs. Total Employment

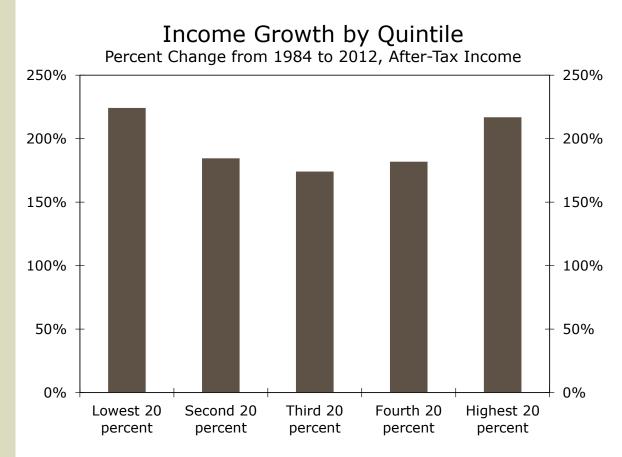


Subpar recovery suggests slower consumer spending and lower state sales tax revenues compared to the past

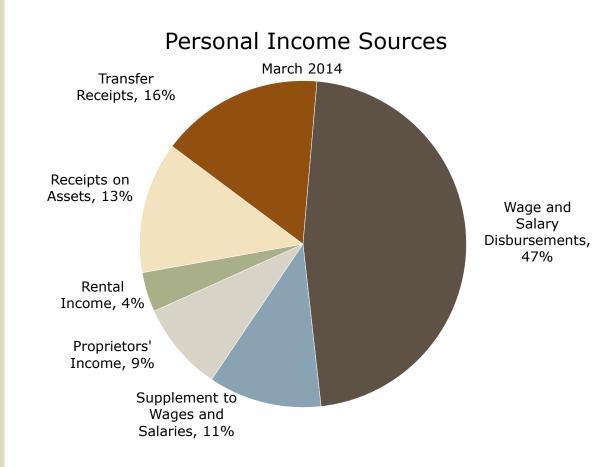
#### Real Personal Consumption Expenditures



After-tax income has increased the most for the lowest and highest income households since the mid-1980s

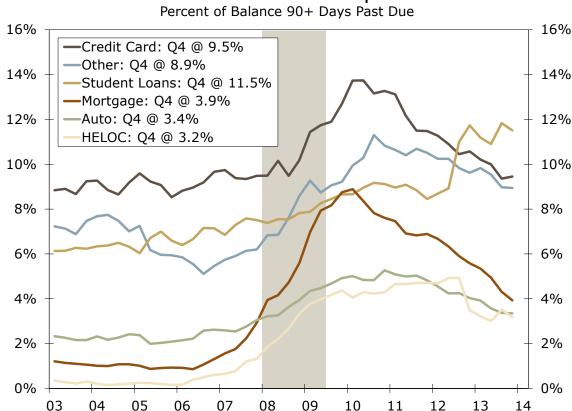


Wages and salaries make up less than half of personal income as transfer payments make up a greater share of income over time



Tighter credit standards and a strengthening economy have helped to improve the credit position of households over the past 3 years

#### Household Debt Delinquencies



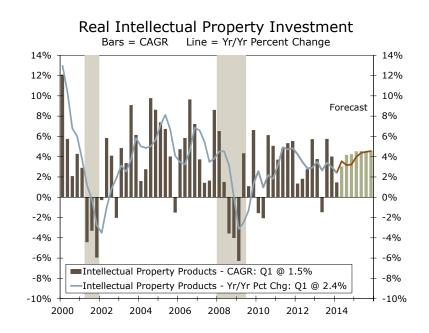
Source: Federal Reserve Bank of New York and Wells Fargo Securities, LLC

On an improving global demand outlook and diminishing fiscal policy headwinds, business leaders are becoming more comfortable with capex plans.

#### **Large-Ticket Spending Outlook Improves**

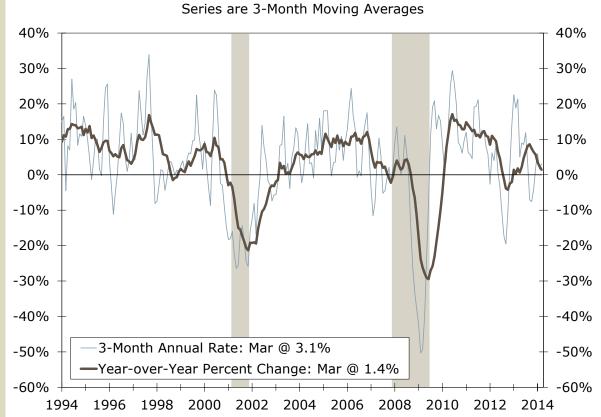
#### Real Equipment Investment Bars = CAGR Line = Yr/Yr Percent Change 40% 40% 30% 30% 20% 20% Forecast 10% 10% 0% 0% -10% -10% -20% -20% -30% -30% -40% -40% Equipment Investment - CAGR: Q1 @ -5.5% -50% -50% -Equipment Investment - Yr/Yr Percent Change: Q1 @ 2.0% -60% -60% 2000 2002 2004 2006 2008 2010 2012 2014

#### **Intellectual Investment Has Been Stable**



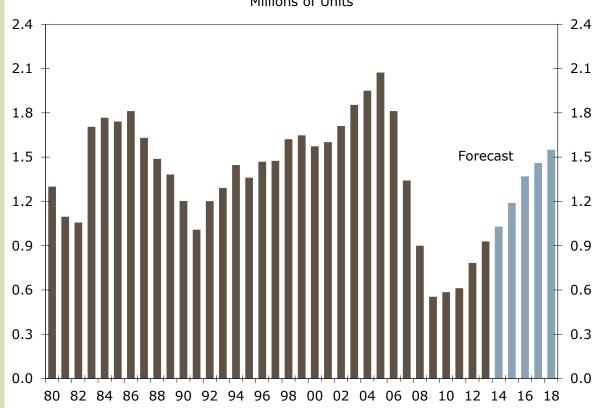
Signs of life appeared early in this recovery in capital goods orders—now the slowdown fiscal cliff?

#### Nondefense Capital Goods Orders, Ex-Aircraft





U.S. Housing Starts
Millions of Units



The number of renters has been accelerating steadily since 2007, while homeowners have been declining

# U.S. Homeowners vs. Renters Annual Change in Occupied Units, In Thousands 2,500 Renters: 2013 @ 525.5 Thousand Homeowners: 2013 @ -76.5 Thousand 2,000 1,500 1,000 1,000

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

78

Series

Break 1981

82

86

90

94

98

02

06

10

500

-500

-1,000

-1,500

66

70

74

500

0

-500

-1,000

-1,500

#### Housing: Overcoming the Rise in Rates

What is the housing environment looking like now?

#### Overview

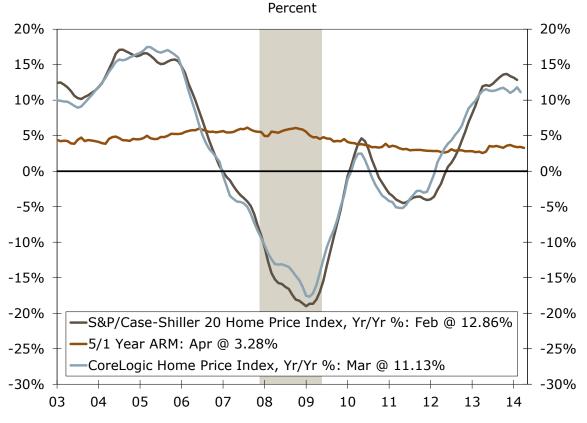
- Mortgage demand is up and lending standards have eased (Senior Loan Officers Survey)
- Housing Affordability: High
- Rental costs rise faster than cost of ownership
- Consumer confidence/ jobs rising
- Negative equity decline

Secular Shift?
Households were living in smaller homes with more people following the recession, but longer-term trends have returned

#### Median Home Size vs. Average Household Size Square Feet; Number of Persons 2,600 2.80 2,400 2.75 2,200 2.70 2,000 2.65 1,800 2.60 1,600 2.55 1,400 -Median Square Footage: 2013 @ 2,384 (Left Axis) -Number of Persons per Household: 2013 @ 2.54 (Right Axis) 1,200 2.50 84 96 80 12 80 88 92 00 04

Home prices are rising faster than mortgage interest rates

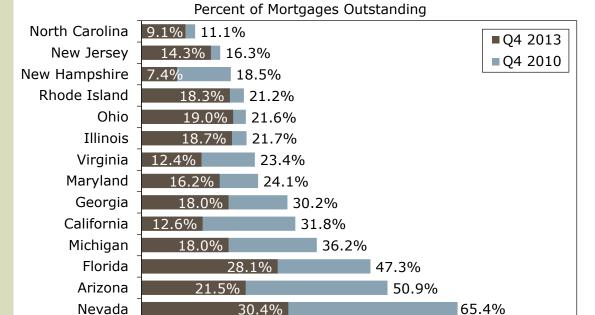
#### Home Price Growth vs. Mortgage Rates



Source: S&P/Case-Shiller, CoreLogic, Bloomberg LP and Wells Fargo Securities, LLC

Negative equity in homes has contributed to foreclosures and reduced labor mobility, but much improvement has been seen since 3 years ago

#### Negative Equity by State



23.1%

30%

40%

50%

60%

70%

80%

90%

Source: CoreLogic and Wells Fargo Securities, LLC  $\,$ 

US

0%

10%

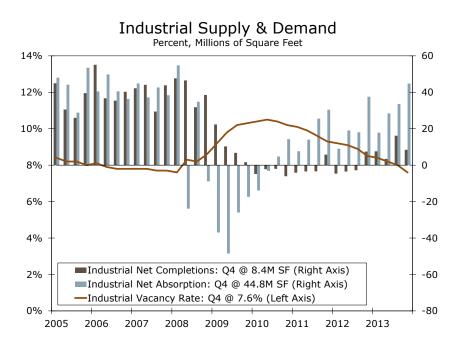
20%

Apartments have seen the greatest improvement in operating fundamentals but are also seeing intense new development. The industrial market has also improved quite significantly.

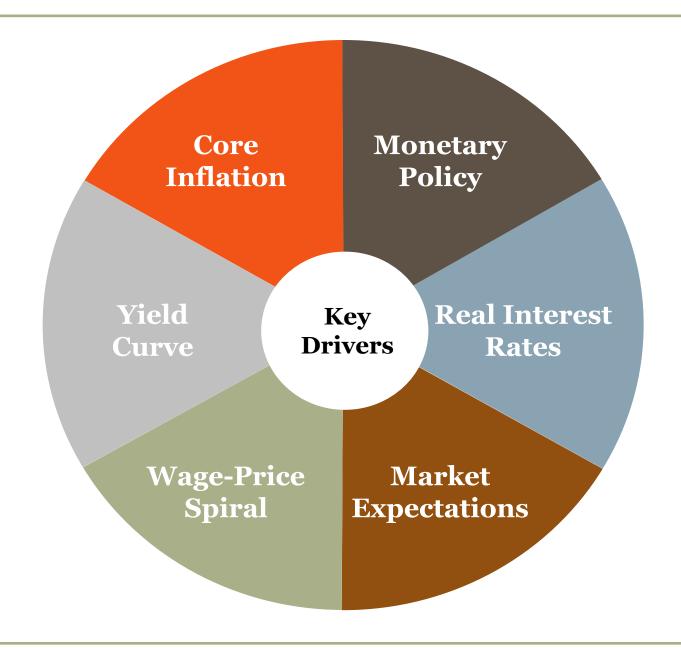
#### **Apartment Supply & Demand**

#### Apartment Supply & Demand Percent, Thousands of Units 9% 100 8% 75 7% 6% -25 4% ■ Apartment Net Completions: Q4 @ 41,651 Units (Right Axis) 3% -50 Apartment Net Absorption: Q4 @ 50,627 Units (Right Axis) Apartment Vacancy Rate: Q4 @ 4.1% (Left Axis) 2% -75 2005 2006 2007 2008 2009 2010 2011 2012 2013

#### **Industrial Supply & Demand**

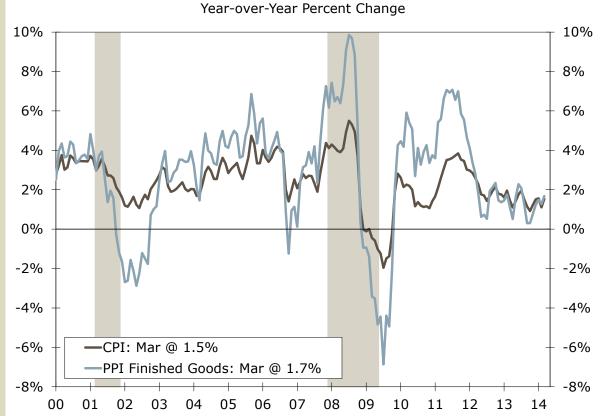


Source: Reis, Inc., PPR, U.S. Department of Commerce and Wells Fargo Securities, LLC

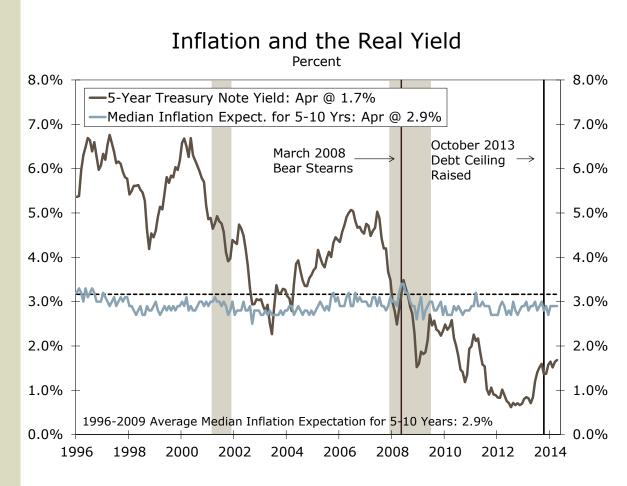


Overall price growth should not pose a barrier to continued easy monetary policy. CPI does not include sales or federal excise taxes.

#### Consumer Price Index vs. Producer Price Index

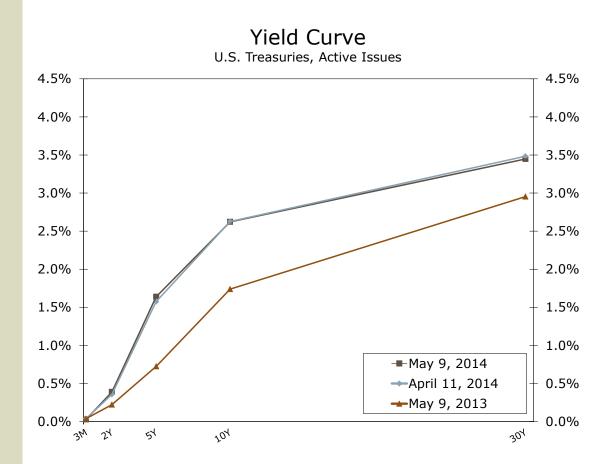


Inflation expectations exceed nominal returns, suppressed interest rates, not free market



Source: Federal Reserve Board, University of Michigan and Wells Fargo Securities, LLC

The Fed will continue easy policy in 2014, but the yield curve is steepening as the Fed tapers asset purchases



Source: Bloomberg LP and Wells Fargo Securities, LLC

The Fed will continue easy policy in 2014. No change at short end of the curve, long rates rise modestly with Fed taper.

#### Wells Fargo Rates Forecast Through 2015 5.0% 5.0% 4.5% 4.5% 4.0% 4.0% 3.5% 3.5% 3.0% 3.0% 2.5% 2.5% 2.0% 2.0% 1.5% + 1.5% 1.0% 1.0% **-**Q4 2015 **Q**4 2014 0.5% 0.5% **Q**4 2013 0.0% 0.0% 3/2 2/ 5 50, 304

Source: Bloomberg LP and Wells Fargo Securities, LLC

Spreads have returned to a more normal level; bond issuance is strong

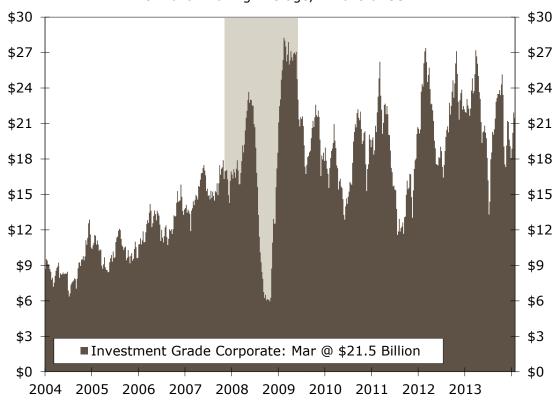
#### Aaa and Baa Corporate Bond Spreads Over 10-Year Treasury, Basis Points -Baa Spread: Mar @ 234 Bps -Aaa Spread: Mar @ 166 Bps Bear Stearns March 2008

Source: Federal Reserve Board and Wells Fargo Securities, LLC

Businesses are taking advantage of low interest rates

#### Investment Grade Corporate Issuance



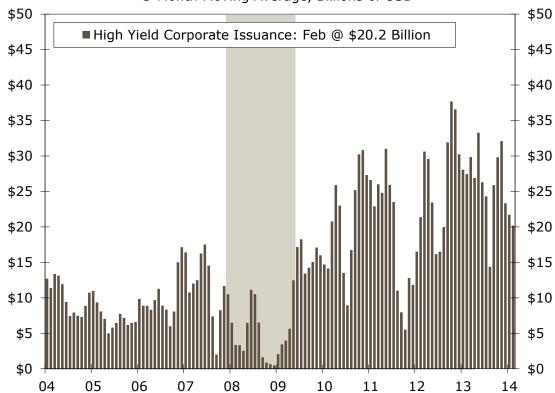


Source: IFR Markets and Wells Fargo Securities, LLC  $\,$ 

As investors search for yield among exceptionally low interest rates, bond issuance has gained momentum

#### High Yield Corporate Issuance

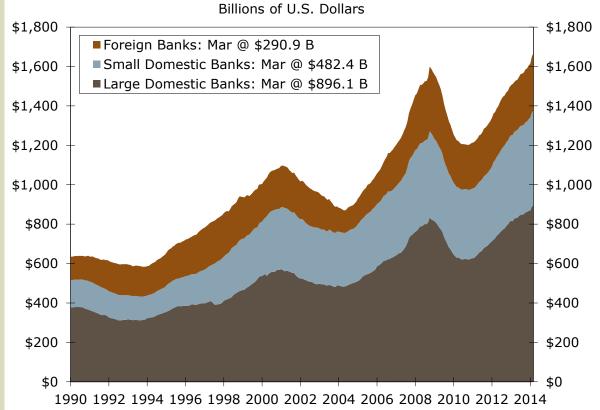
3-Month Moving Average, Billions of USD



Source: IFR Markets and Wells Fargo Securities, LLC

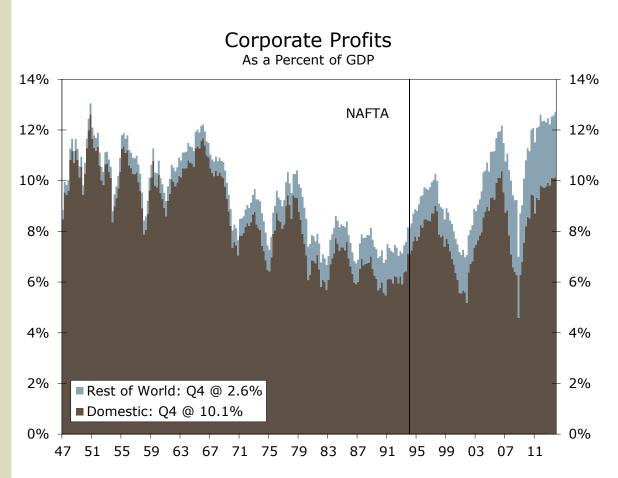
Banks of all types are contributing to business lending

#### Commercial & Industrial Loans by Bank Type



Source: Federal Reserve Board and Wells Fargo Securities, LLC

Profits as a percentage of GDP are historically high and are being boosted by profits earned abroad



Many U.S. companies rely on the health of international economies

## U.S. Companies listed in the S&P 500 with Greater Than 50 Percent of Sales Abroad (A Sample)

- Goodyear Tire
- BorgWarner
- Priceline.com
- Nike
- Coca-Cola
- Heinz
- Proctor & Gamble
- Avon
- Exxon Mobil
- AFLAC
- Intel
- Applied Materials
- Oracle
- Johnson & Johnson

- Merck
- Boeing
- Eaton Corp.
- Emerson Electric
- Fluor
- GE
- 3M
- Caterpillar
- Cisco
- Qualcomm
- Apple
- eBay
- IBM
- Symantec

Corporate interest expenses remain low amid the low-rate environment

# Non-fin. Corporate Business: Corporate Interest As a Percentage of Pre-Tax Profits 120% 120% -Corporate Interest: Q4 @ 23.9% 100% 100% 80% 80% 60% 60% 40% 40% 20% 20%

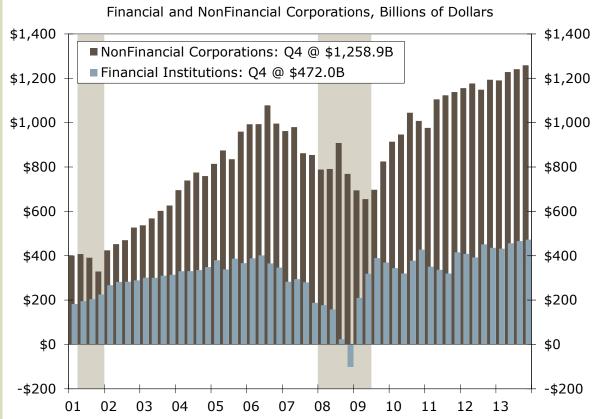
80 82 84 86 88 90 92 94 96 98 00 02 04 06 08 10 12 14

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

0%

Big gains in profits have been from nonfinancial corporations

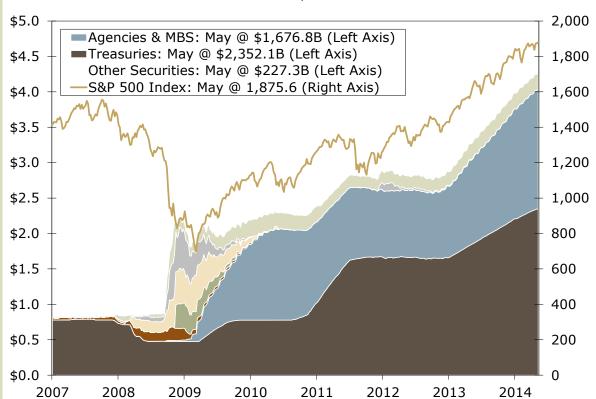
# Domestic Profits



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

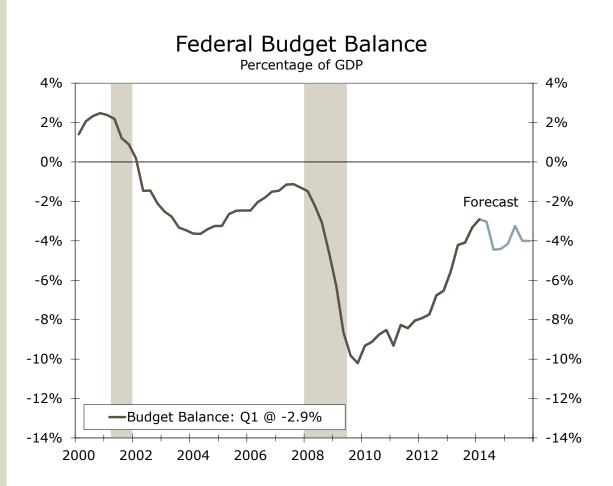
We have seen a strong correlation in the expansion of the Fed's balance sheet and the rise in the S&P 500

# Federal Reserve Balance Sheet vs. S&P 500 Index Trillions, Index



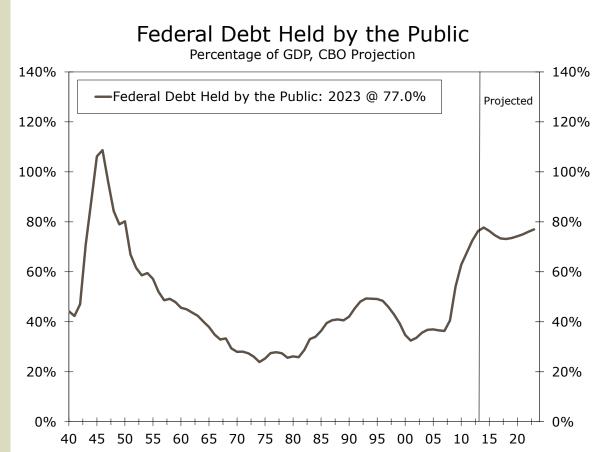
Source: Federal Reserve Board and Wells Fargo Securities, LLC

The nation has entered uncharted waters in fiscal policy—no balance at 2.75 percent GDP growth



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

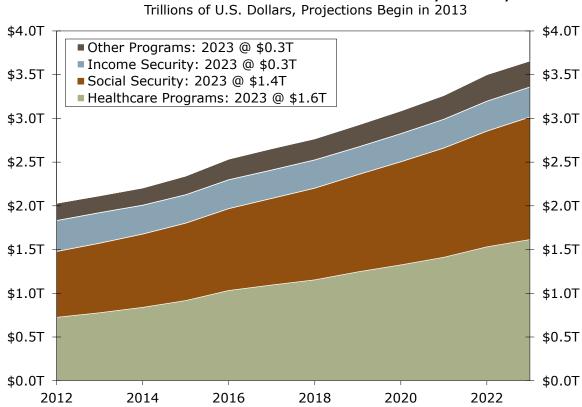
Federal debt held by the public will likely remain near 80 percent



Source: Congressional Budget Office and Wells Fargo Securities, LLC

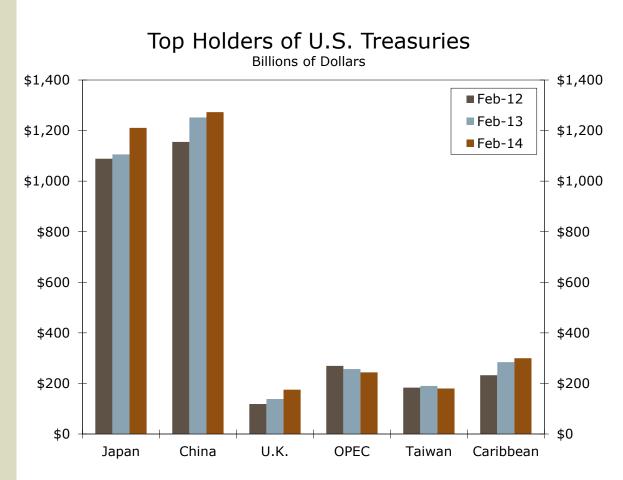
The unfunded liabilities of the entitlement programs reflect a commitment to spend in the future

# U.S. Federal Government Mandatory Outlays



Source: Congressional Budget Office and Wells Fargo Securities, LLC

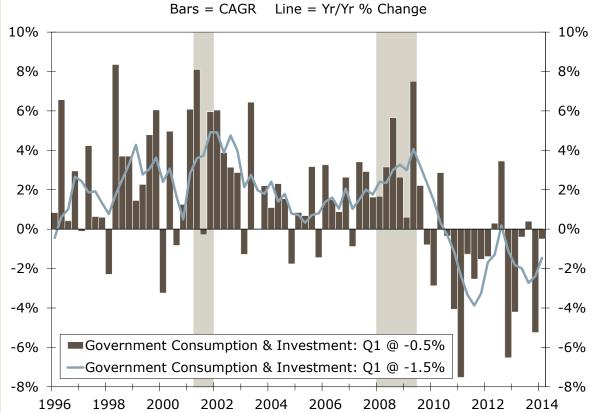
Japan and China hold an unprecedented amount of U.S. debt



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

The government sector continues to be a drag on GDP as state and local governments restructure

# Real Government Consumption & Investment

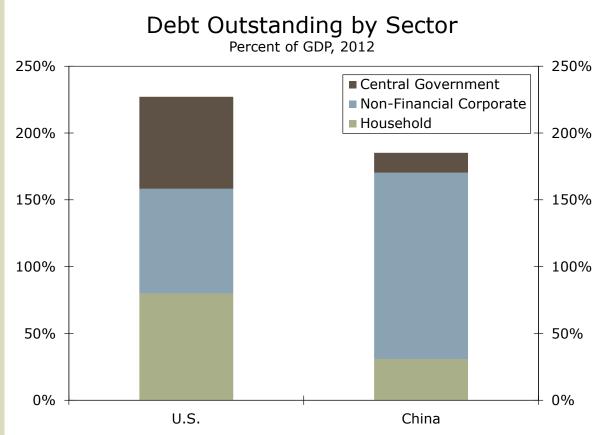


Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

		20		2013	
	Global (year-over-year unless otherwise s	Wells Fargo Economics specified)	Blue Chip Consensus		<u> Historical</u>
	Global Real GDP	3.50%	3.70%*		3.00%
	Eurozone Real GDP	1.30%	1.00%	•	-0.40%
The global recovery is being	United Kingdom Real GDP	2.60%	2.50%	•	1.80%
driven by emerging markets,	China Real GDP	7.50%	7.50%	•	7.70%
downshift ahead	Japan Real GDP	1.40%	1.70%	•	1.50%
	Canada Real GDP	2.10%	2.30%		2.00%
	Mexican Real GDP	2.70%	3.40%	•	1.10%
	* IMF Estimate				

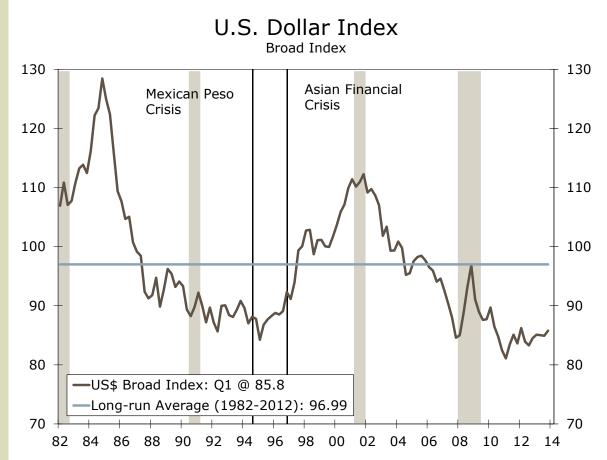
Source: International Monetary Fund and Wells Fargo Securities, LLC

Chinese debt outstanding is notably lower than in the United States and is concentrated in the non-financial corporate sector



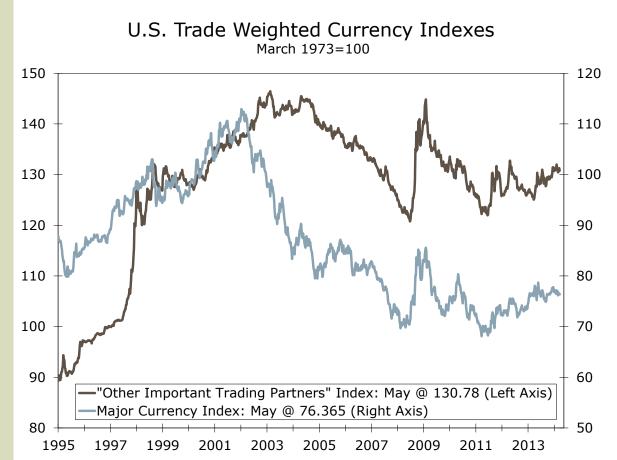
Source: CEIC, BIS, U.S. Department of Commerce and Wells Fargo Securities, LLC

Economic fundamentals and risks abroad will drive the dollar



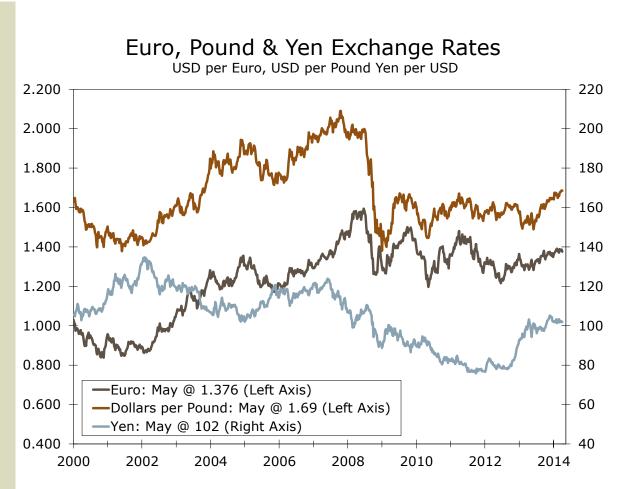
Source: Federal Reserve Board and Wells Fargo Securities, LLC

The dollar has experienced recent strength against both major and emerging currencies



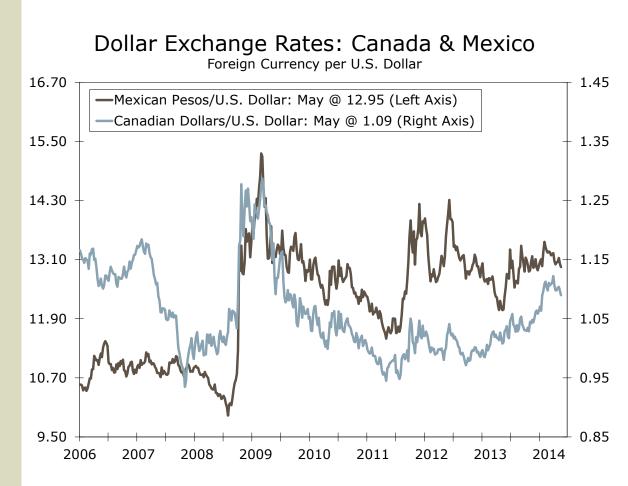
Source: Federal Reserve Board and Wells Fargo Securities, LLC

The euro and the pound have appreciated recently as the yen continues to decline



Source: Bloomberg LP and Wells Fargo Securities, LLC

The Canadian dollar and Mexican peso have both seen recent depreciation



Source: Bloomberg LP and Wells Fargo Securities, LLC

## **Outlook Risks**

What are the primary risks to the outlook?

### **Potential Challenges to the Outlook**

- Tighter monetary policy brings questions for the dollar, inflation and interest rate outlook
- Fiscal policy: tax increases and/or spending cuts face unsustainable long-run outlook
- Housing: unable to sustain growth on its own if rates rise?
- European debt crisis weighs on global growth and global credit allocation over the long-run
- Weak employment growth means less-than-expected real income and spending growth for some consumer segments

Wells Fargo U.S. Economic Outlook													
	Actual 2013				Forecast		Actual			Forecast			
					2014			2011	2012	2013	2014	2015	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product <sup>1</sup>	1.1	2.5	4.1	2.6	0.1	3.0	2.7	3.1	1.8	2.8	1.9	2.3	3.1
Personal Consumption	2.3	1.8	2.0	3.3	3.0	4.0	2.4	2.6	2.5	2.2	2.0	2.9	2.7
Inflation Indicators <sup>2</sup>													
PCE Deflator	1.4	1.1	1.1	1.0	1.1	1.6	1.6	1.8	2.4	1.8	1.1	1.5	2.0
Consumer Price Index	1.7	1.4	1.5	1.2	1.4	1.9	1.9	2.1	3.1	2.1	1.5	1.8	2.2
Industrial Production <sup>1</sup>	4.2	1.9	2.5	4.8	4.4	8.5	5.1	4.3	3.3	3.8	2.9	4.9	5.1
Corporate Profits Before Taxes <sup>2</sup>	2.1	4.5	5.7	6.2	3.5	3.6	3.8	4.0	7.9	7.0	4.6	3.7	4.3
Trade Weighted Dollar Index <sup>3</sup>	76.2	77.5	75.2	76.4	76.9	76.5	76.5	76.5	70.9	73.5	75.9	76.6	78.1
Unemployment Rate	7.7	7.5	7.2	7.0	6.7	6.3	6.2	6.1	8.9	8.1	7.4	6.3	5.9
Housing Starts <sup>4</sup>	0.96	0.87	0.88	1.01	0.92	1.06	1.12	1.17	0.61	0.78	0.92	1.06	1.22
Quarter-End Interest Rates <sup>5</sup>													
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.44
Conventional Mortgage Rate	3.57	4.07	4.49	4.46	4.34	4.53	4.72	4.96	4.46	3.66	3.98	4.64	5.42
10 Year Note	1.87	2.52	2.64	3.04	2.73	2.88	3.07	3.31	2.78	1.80	2.35	3.00	3.77

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

Forecast as of: May 2, 2014

¹ Compound Annual Growth Rate Quarter-over-Quarter

<sup>&</sup>lt;sup>2</sup> Year-over-Year Percentage Change

<sup>&</sup>lt;sup>3</sup> Federal Reserve Major Currency Index, 1973=100 - Quarter End

<sup>&</sup>lt;sup>4</sup> Millions of Units

<sup>&</sup>lt;sup>5</sup> Annual Numbers Represent Averages

# Appendix

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#### **Recent Special Commentary** April-24 Export Surge Lifts First Quarter GDP in Korea Quinlan April-18 Strong Payroll Growth for the Tar Heel State Vitner & Wolf April-18 Employment Gains in California Modest for March Vitner & Wolf April-18 Vitner & Wolf Texas Payroll Gains Moderate in March April-18 Florida's Payroll Gain the Largest in the Nation Vitner & Wolf April-17 Different Times for the U.S. Consumer Alemán & Griffiths April-17 "Ex-" Marks the Spot: A Focused Outlook for the Transportation Sector Quinlan & House April-16 Has the Chinese Economy Pulled Off a "Soft Landing?" Bryson April-16 Brazilian Economy Strengthens in February Alemán April-14 Vitner & Wolf Nevada Economic Outlook: April 2014 April-14 Singaporean Real GDP Growth Weakens a Bit in Q1 Bryson April-11 No Respite for Mexican Industrial Production Alemán April-10 Stronger Aussie Jobs Report and Implications for RBA Quinlan April-09 Silvia & House Labor Force Participation: Where to Now? April-09 Housing Chartbook: March 2014 Vitner & Khan April-08 Bryson & Quinlan Can Japan Stabilize Its Debt Dynamics? April-07 2014 Federal Fiscal Policy Outlook Part I Silvia & Brown April-03 Casting Doubt on Industrial Metal Prices Brown & House April-03 North Carolina Economic Outlook: April 2014 Vitner, Wolf & Miller April-02 Bryson & Miller Will the Russian Economy Continue to Limp Along? March-31 Patterns at the Mid-Cycle of the Expansion Silvia, House & Brown March-28 Industrial Fundamentals Move Ahead Khan March-28 Texas Employment Still in the Driver's Seat Vitner & Wolf March-28 Vitner & Wolf Big Bump Up in Florida's Labor Market March-24 Bet Your Bottom Dollar? Ouinlan & Griffiths March-21 The Changing Profile of the American Workforce and Its Effect on Consumption Alemán, Brown & Zachary March-21 California Job Growth Ramps Back Up in February Vitner & Wolf March-19 Chile: Growth in a Weaker World Environment Alemán March-18 Global Chartbook: March 2014 March-17 Labor Market Dynamics: Three Peaks Behind the Curtain Silvia & House March-17 Florida's Economy Continues to Outpace the U.S. Vitner & Wolf March-17 Easier Credit Conditions Support Economic Growth Silvia & Miller March-17 Bank Credit and Money in the Post-Great Recession Era Silvia & Griffiths March-17 FDIC Loan Performance: An Improvement in Quality Silvia & Zachary

## Wells Fargo Securities, LLC Economics Group

### **Global Head of Research and Economics**

Diane Schumaker-Krieg <u>diane.schumaker@wellsfargo.com</u>

Global Head of Research & Economics

### **Chief Economist**

John E. Silvia john.silvia@wellsfargo.com

### **Senior Economists**

Mark Vitner, Senior Economist mark.vitner@wellsfargo.com

Jay H. Bryson, Global Economist jay.bryson@wellsfargo.com

Sam Bullard, Senior Economist <a href="mailto:sam.bullard@wellsfargo.com">sam.bullard@wellsfargo.com</a>

Nick Bennenbroek, Currency Strategist nicholas.bennenbroek@wellsfargo.com

Eugenio J. Alemán, Senior Economist eugenio.j.aleman@wellsfargo.com

Anika R. Khan, Senior Economist anika.khan@wellsfargo.com

### **Economists**

Azhar Iqbal, Econometrician

Tim Quinlan, Economist

Eric J. Viloria, Currency Strategist

Sarah Watt House, Economist

Michael A. Brown, Economist

Michael T. Wolf, Economist

azhar.iqbal@wellsfargo.com

tim.quinlan@wellsfargo.com

eric.viloria@wellsfargo.com

sarah.house@wellsfargo.com

michael.a.brown@wellsfargo.com

michael.t.wolf@wellsfargo.com

### **Economic Analysts**

Zachary Griffiths, Economic Analyst

Mackenzie Miller, Economic Analyst

Blaire Zachary, Economic Analyst

Mackenzie Miller, Economic Analyst

Blaire Zachary, Economic Analyst

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### **Administrative Assistants**

Peg Gavin, Executive Assistant

Cyndi Burris, Senior Administrative Assistant

cyndi.burris@wellsfargo.com

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