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The Economic and Financial-Market Outlook Through 2017:
A Slow Transition From The Post-"Meltdown" Economy

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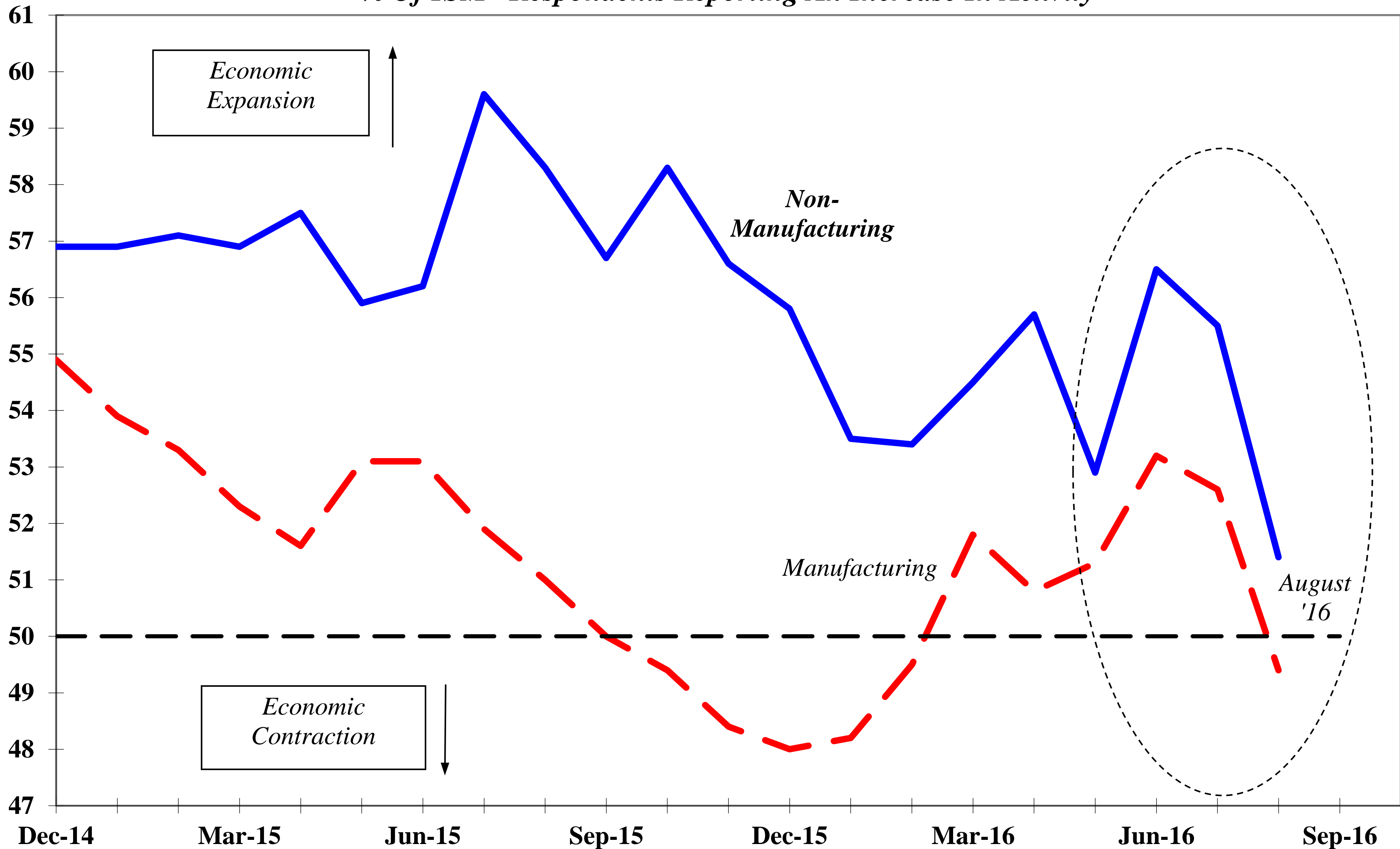
Wells Fargo Asset Management is a trade name used by the asset management businesses of Wells Fargo & Company.

Forecast Highlights

- Adequate 2%-2½% Economic Growth Through 2017
- Below (2%) Target Inflation Through Early 2017?
  - *Counting On Weak Oil Prices And Imported "Deflation"*
- Gradual Interest-Rate "Normalization" Beginning Late 2016 Or Early Next Year
- A Typical Interest-Rate "Up Cycle," With A Few Twists
  - *A Low-Inflation "Tightening" Cycle?*
  - *Foreign Investment Still A U.S. Market Mover?*
  - *A Polarized Election, Financial Distortions And The Threat Of Interest-Rate Volatility*
- A Strong Dollar's Debilitating Effect On Global Growth

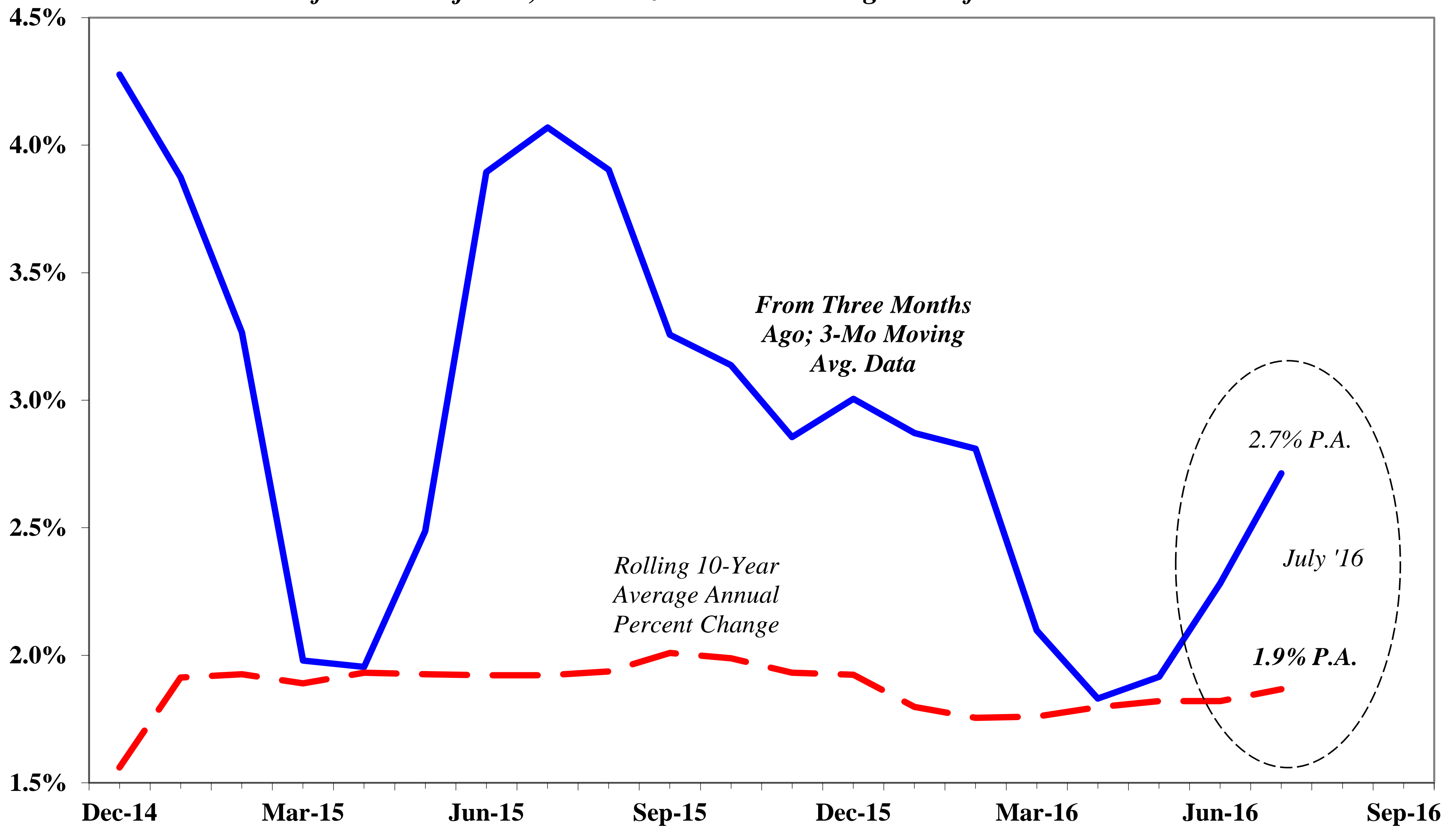
TACTICAL ECONOMIC AND FINANCIAL-MARKET THEMES

- A ”Split Personality” Economy
  - *Manufacturing Vs. Non-Manufacturing Growth And Inflation*
- A Dwindling “Mini-Locomotive” Role For The U.S. In The Global Economy
- A More Interest-Sensitive Economy And Financial Market
- A More “Globalized” Federal Reserve
- Central Banks’ Growing Interdependence With The Financial Market
- Toward More Balanced Economic Stimulus At Home And Abroad
- Non-Traditional Recession Risks In An Unusual Late-Cycle Economy
  - *Still An Asset-Driven Economic Cycle?*



Economic growth showed signs of losing momentum midway through the third quarter, judging from declines in purchasing-managers' activity indexes during August that included manufacturing's first dip into recession since February. Spending's "drivers" (including income growth, mortgage rates and housing "affordability," inventory levels and factory operating rates) still largely are intact, making it more likely that this latest in a series of growth slowdowns is a shift to more sustainable growth after a July rebound from first-half weakness rather than the start of an enduring slide toward a recession.

Source: Institute Of Supply Management



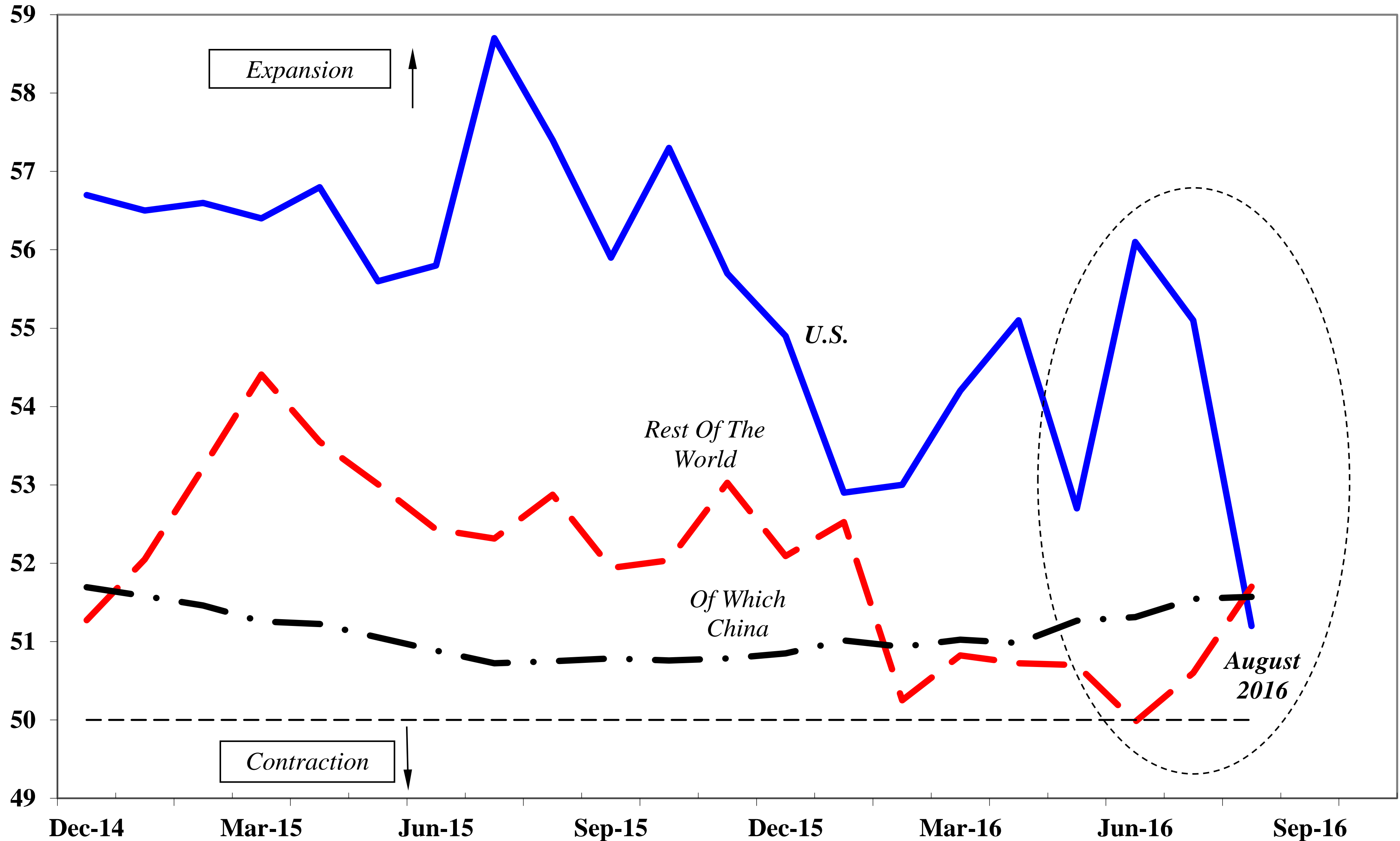
** Inflation as measured by the PCE deflator.*

Economic growth is expected to recover from its latest "soft patch," despite the growth cycle's advanced age, because spending's "drivers" remain intact. Among the most important of these is inflation-adjusted income, or "purchasing power," whose accelerated growth since April has put it nearly a percentage point above its long-term average. Support has come both from firming wage increases and from inflation subdued by lower fuel costs. Solid income growth goes a long way toward explaining the economy's consumer-led growth, critical to countering the economy's manufacturing and investment-led weakness.

Sources: U.S. Commerce Department

IS THE GLOBAL ECONOMY LOSING A U.S. GROWTH "ENGINE?"

% Of Respondents Reporting Increased Manufacturing & Non-Manufacturing Activity



Slowing U.S. economic growth risks undercutting the country's role as a mini-"locomotive" for the global economy, already constrained by historically modest growth and by our reduced importance in the global economy from just a few decades ago. In fact, the latest purchasing-manager reports show economic momentum here falling behind the pace abroad for the first time in three years. That risks a further slowdown in already tepid global growth, if exports to the U.S. are constrained both by more modest market expansion and by a loss of export competitiveness by foreign firms against U.S. companies from associated dollar weakness.

Sources: JP Morgan Chase, Inc.; Bloomberg Financial News, Inc.

AN UNUSUAL INTEREST-RATE CYCLE IN 2015?

- A Cautious “Sea Change” In Monetary Policy

  --A More “Internationalist” Federal Reserve

- An Eroding, But Still-”Friendly” Backdrop For Long-Term Rates

  --A Cautious Nod Toward Subdued Inflation…

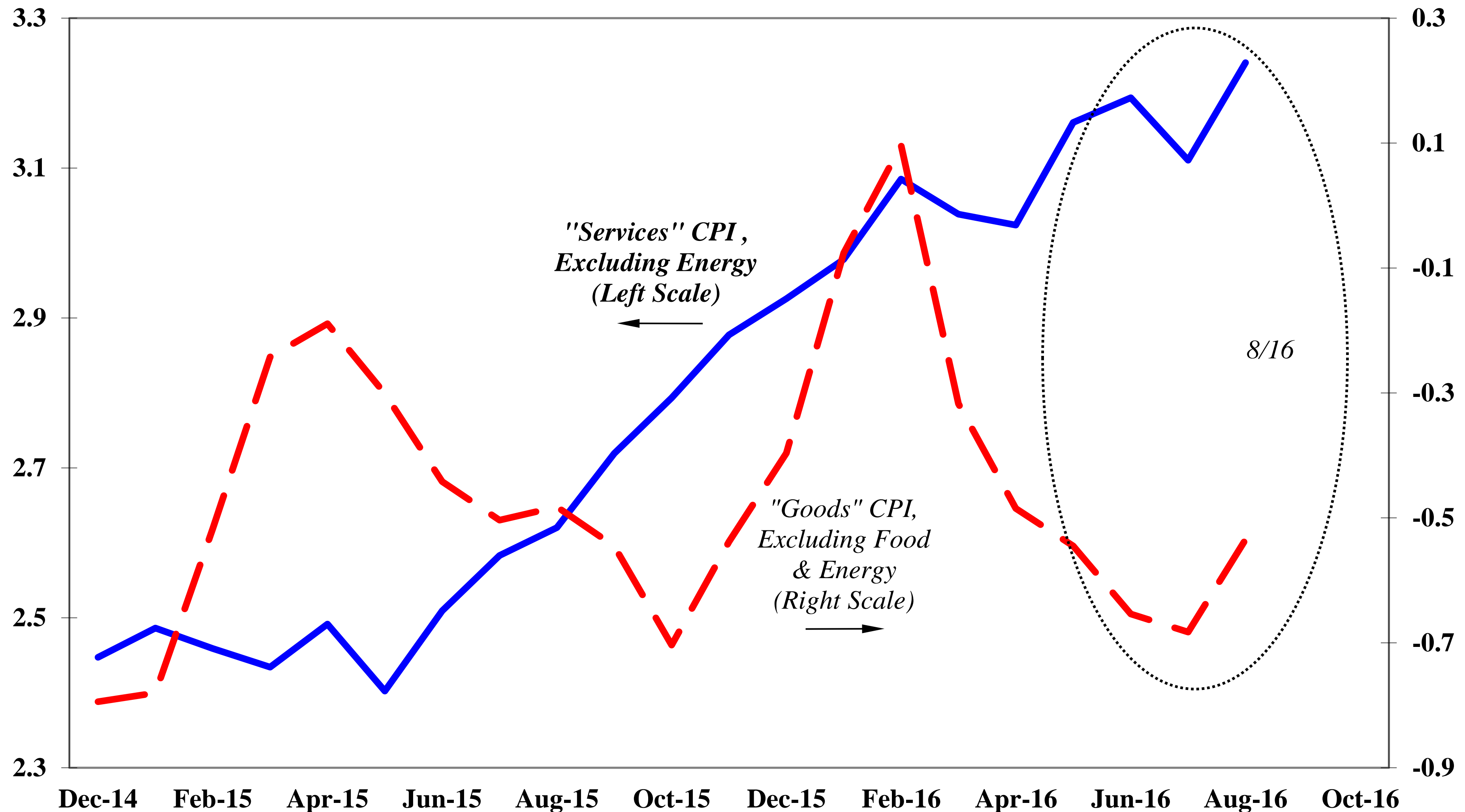
  --…And Toward Foreign, Yield-Driven Demand For U.S. Debt

- A “Bumpy” Ride Higher?

  --Bracing For A Potentially Unsettling Election-Year Cycle

  --An Unwinding Of Financial-Market Distortions

  --Sorting Out Money-Fund Reform’s After-Effects

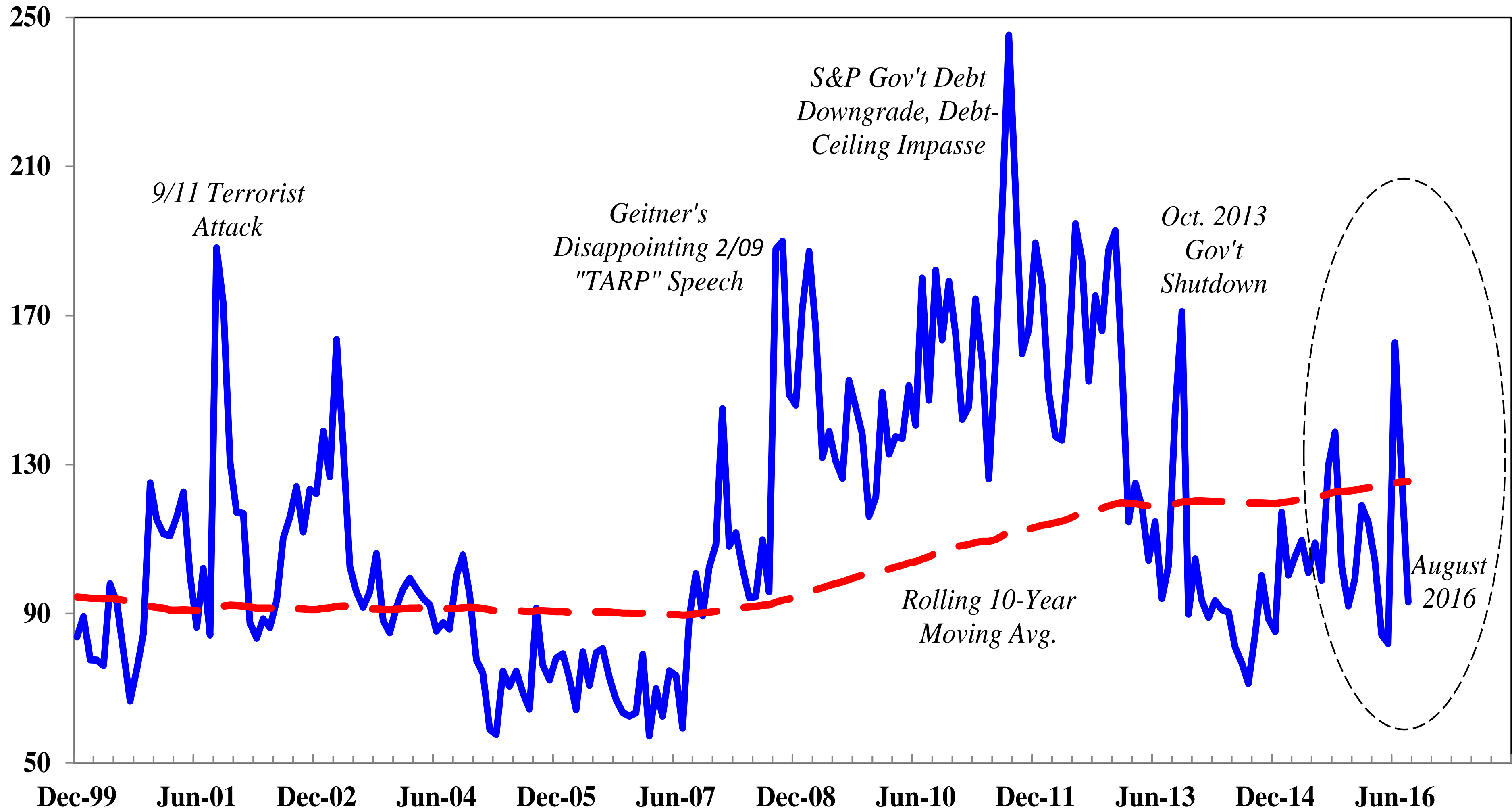


Overall CPI inflation remains subdued, slowing to little more than 1% in the twelve months to August. Dominating changes in that rate have been the decline of energy costs. Those declines have masked a buildup of pressure on the "core" rate (i.e., the CPI less food and energy), which has been running above the Fed's 2% target (set for the PCE deflator, a close cousin of the CPI) since last November. Within that underlying inflation rate is a noticeable split between "deflation" (or declining prices) for trade-sensitive goods, suppressed by overseas weakness and by a strong dollar, and an accelerated rise in domestic-driven, labor-intensive services prices to an eight-year high of nearly 3¼%. That pattern leaves overall CPI inflation vulnerable to a noticeable increase, once energy prices stabilize and the dollar steadies enough to lift manufactured-goods import and consumer-goods prices.

Source: U.S. Dep't Of Labor

WILL ECONOMIC-POLICY UNCERTAINTIES LEAVE THE FINANCIAL MARKET EXPOSED TO HEIGHTENED VOLATILITY AHEAD OF THE ELECTION?

Sum Of Twelve Uncertainty Components



A composite index of twelve policy-related components, touching on monetary, fiscal, entitlements and an array of other policy issues, moved above its long-term average in June for the time since last September and remained above average despite slippage in July. The latest increase reflected uncertainties over the Fed's response to "Brexit"-related turbulence in the global economy and international financial market plus widely differing policy views by the two political parties--and, particularly, their presidential candidates--in the run-up to the election campaign. Recent and prospective increases in the index serve as a useful guide to potential financial volatility during, what could be, a turbulent period for the asset markets.

Source: Scott R. Baker, Nicholas Bloom and Stephen J. Davis, "Measuring Economic Policy Uncertainty, NBER

A REPLAY OF LAST DECADE'S "BOOM-BUST" CYCLE?

- The Good News…

  --No Nationwide Housing "Bubble"

  --Less Leveraged, Better Capitalized Banks

  --More Manageable Household Debt Burdens

  --Fewer Sub-Prime Mortgages

- …And The Bad

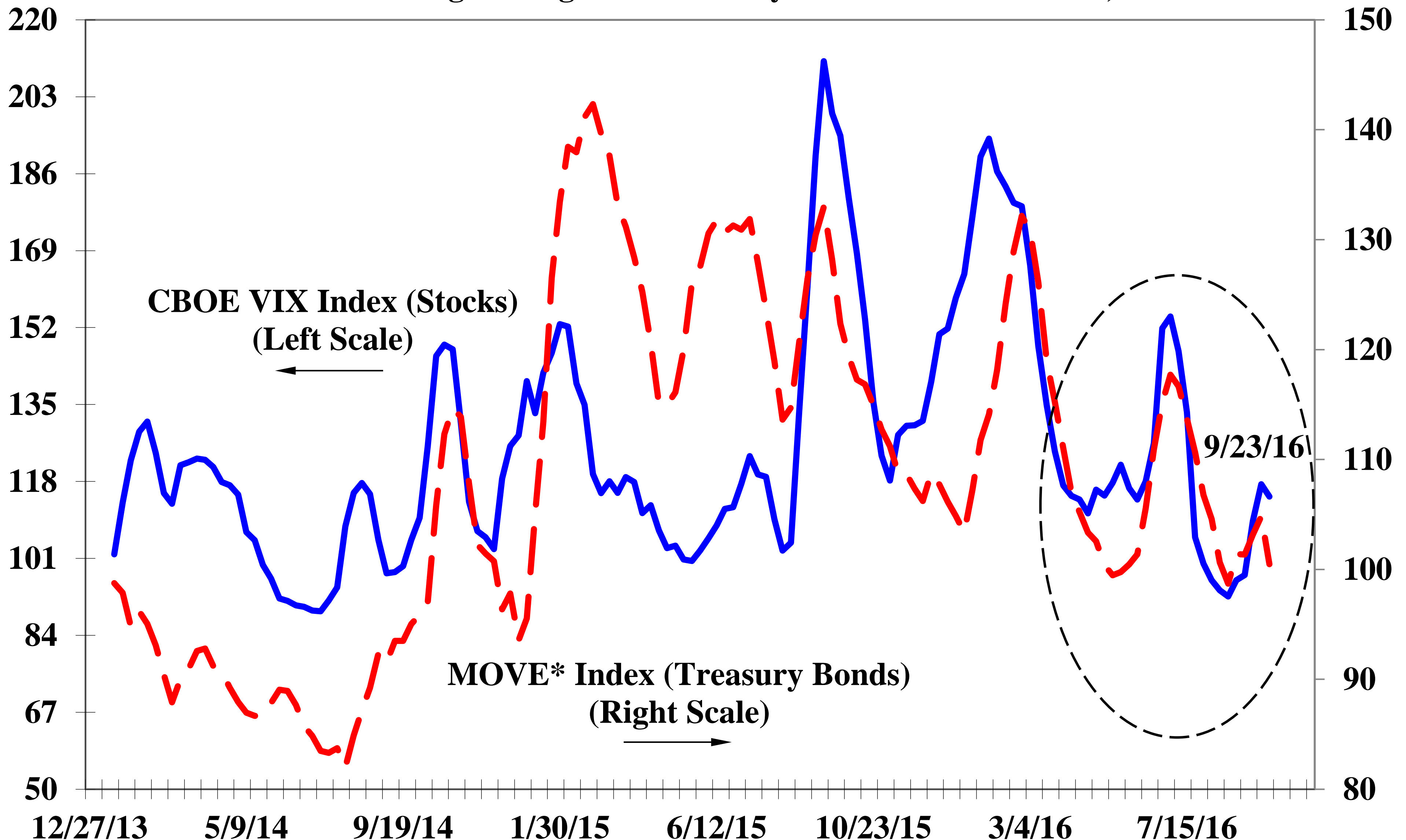
  --"Shadow Banking" Fills The Traditional-Banking Vacuum

  --"Illiquidity" Risk Amid Ample "Liquidity"

  --Weakening Underwriting Standards

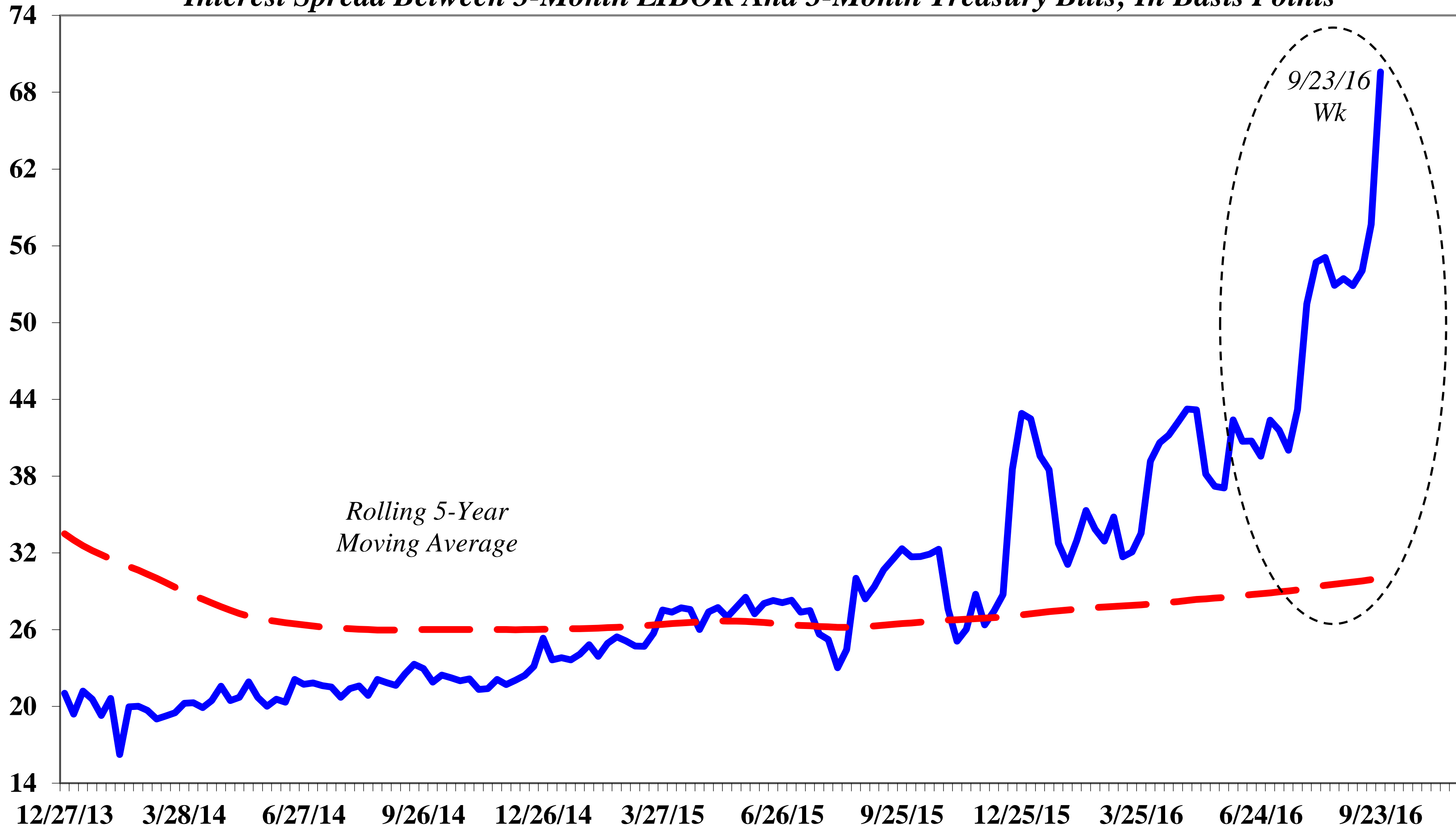
  --Increased Portfolio Leveraging

  --Inflated Asset Values



* Merrill Lynch Option Volatility Estimate, a weighted average index of 2, 5, 10 and 30-year Treasury implied volatilities.

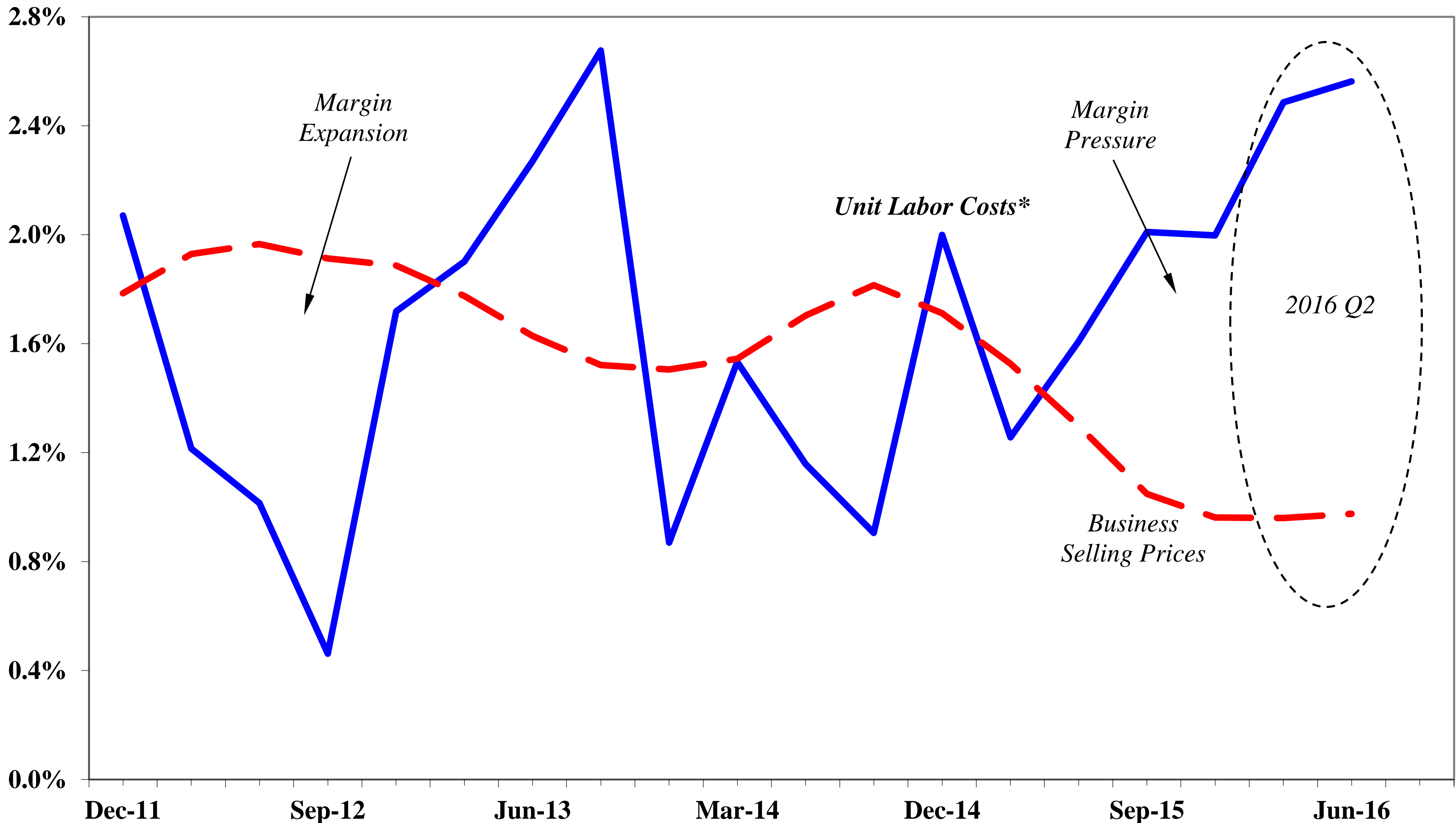
Sources: BofA Merrill Lynch, Inc.; CBOE; JPMorgan Chase, Inc.



The gap between 3-month LIBOR and "risk-free" Treasury bills with the same maturity has been propelled to a May 2009 high, ahead of mid-October's implementation of money-fund reform by the SEC for "prime" funds (i.e., those not confined to investment in government securities). The new law imposes a floating structure for net asset values (NAVs) and optional fees and restrictions on fund redemptions. A precautionary liquidity buildup by prime funds, through shorter-term investments, and a rotation into government money funds keyed to Treasury bills, has been responsible for at least a temporary widening of interest-rate differences until investors can get a clear view of market behavior in the months after reform. For some banks and individuals, the higher money-market rates could at least temporarily add to funding costs at a time when returns on lending and other investments are at historic lows.
Source: Bloomberg Financial News, Inc.

NEW AND NOT-SO-NEW U.S. RECESSION RISKS IN 2016-17

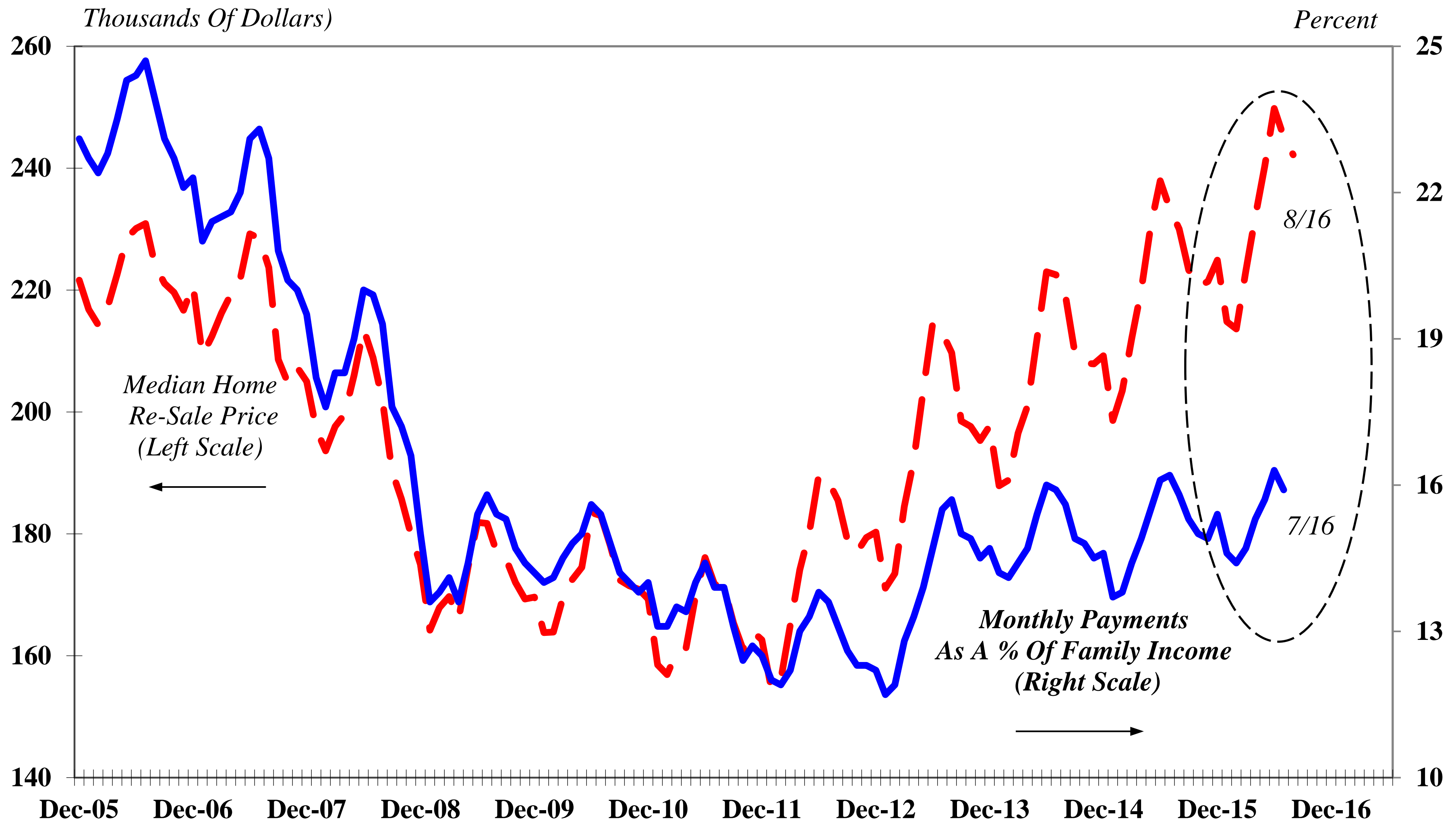
- Waning Traditional Catalysts
  - Rising Inflation, Higher Interest Rates, A Typical Inventory Cycle
- Rising Corporate Debt
- A Cost-Driven Pull Back In Hiring And In Wage Increases
  - Weak “Pricing Power”
  - Rising Wages/ Weak Productivity Growth
- Another Asset-Driven Economic Cycle
- The Economy’s More Interest-Sensitive Debt Profile



** Wages, salaries and benefits, adjusted for changes in labor productivity.*

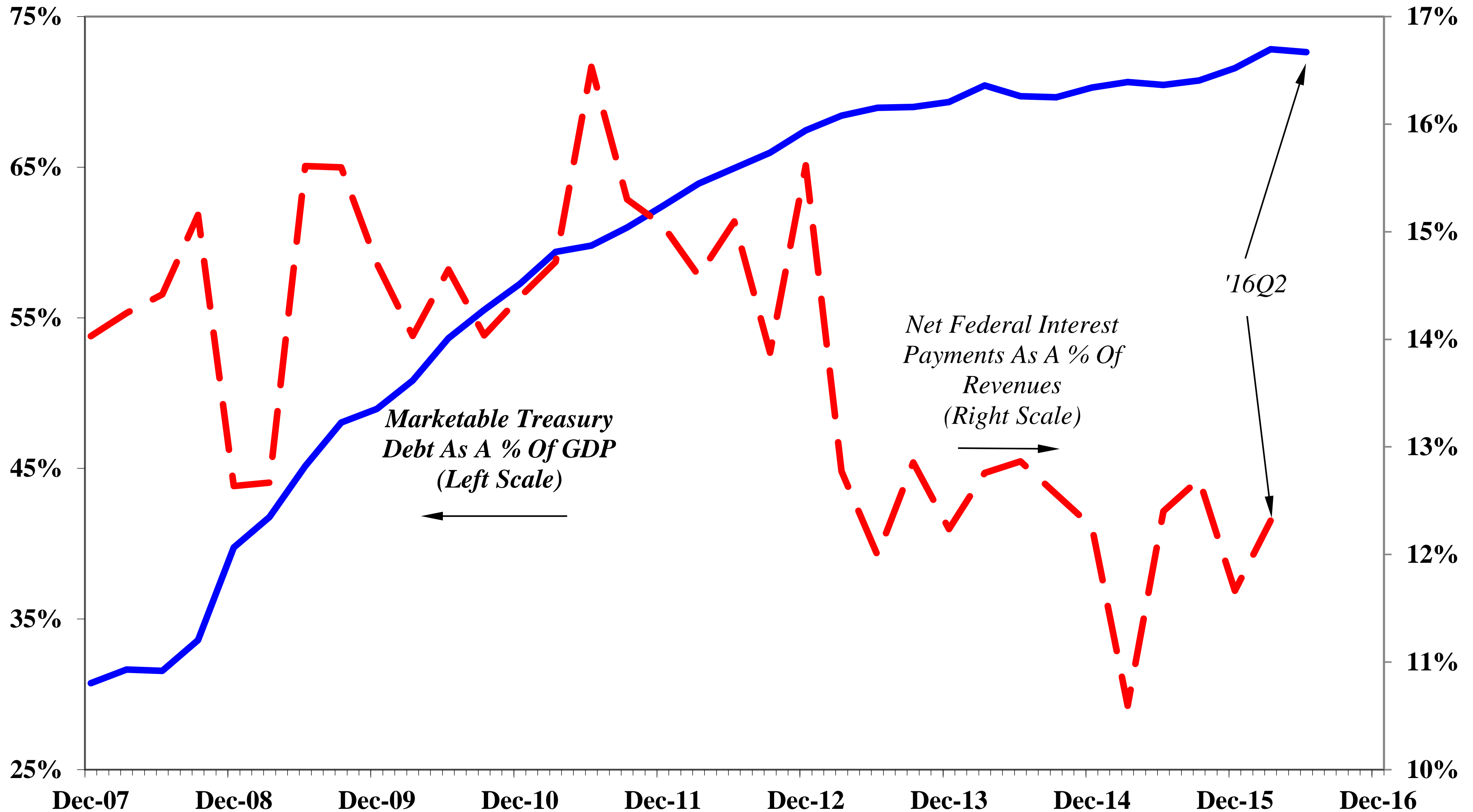
Weak productivity growth has combined with moderate gains in labor wages and benefits to lift unit labor costs well past weaker increases in selling prices. The result has been pressure on profit margins, whose expansion was the main engine behind the early and middle stages of the recovery of corporate profits after the recession. The risk is that margin pressure, combined with weak gains in unit sales, will trigger more intense cost cutting threatening jobs, wages and consumer-led economic growth.

Source: U.S. Department Of Labor



Housing nearly has enjoyed the best of both worlds as a result of historically low mortgage rates. Home-price increases exceeding inflation during much of this growth cycle have propelled household wealth, an important engine of consumer-led growth. And despite rising home values to nearly 5% above their July 2006 peak during the last housing "boom," the mortgage repayment burden--defined as annual mortgage payments on the median priced existing home as a percent of median family income--is less than 16% compared to the near-25% peak back then. One problem for housing in the here-and-now is that first-time home buyers are having trouble raising the down payment for homes at these prices, despite a still-manageable repayment burden. Another is that housing activity effectively is being inflated by artificially low interest rates fuelling the rise in home values, leaving the sector that much more vulnerable to a sustained rise in borrowing costs during the next interest-rate "up cycle."

Sources: National Home Builders' Association; National Association Of Realtors



Government debt as a share of GDP has more than doubled since mid-2008, the eve of the financial "meltdown." Unlike the last election, however, deficit control is off the table as a campaign issue this year because the budget deficit--and its financing burden--have returned to more manageable levels. The deficit has been contained by the usual late-cycle improvement, reinforced by the lingering effects of recent budget agreements and subdued increase, viewed by many as temporary, in health-care costs. Perhaps most importantly, historically low interest rates have kept the financing burden low by historic standards, despite the debt buildup. Good news now could leave government finances vulnerable later, however, given the prospective acceleration of entitlements spending for retiring "baby boomers," and the budget's vulnerability to a return to more "normal" interest rates.

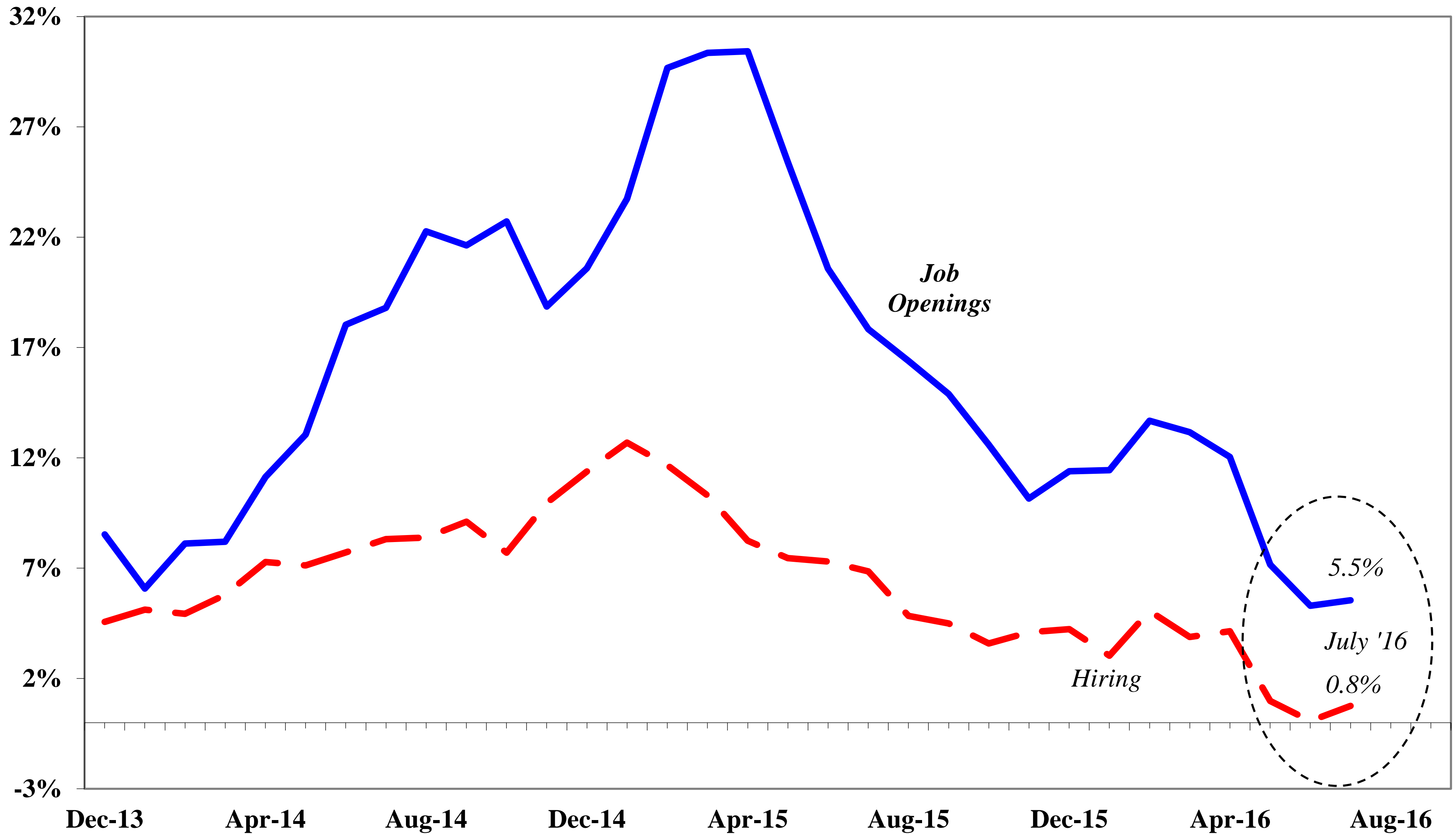
Source: U.S. Treasury Department

A "NEW NORMAL" FOR THE U.S. ECONOMY?

- Lingering Fall-Out From The 2008-09 Financial "Meltdown"
- Policy-Related Distortions In The Financial Market
- The Great Productivity Puzzle
- An Aging, Slower-Growing Workforce
- A Jobs Mismatch Between Skilled And Less Skilled Workers

A LABOR "MISMATCH" LEAVING THE JOB MARKET "TIGHTER" THAN IT APPEARS

Year-Ago Percent Change; Three-Month Moving Average Data



The Labor Department's July release on Job Openings and Labor Turnover (also known as the "JOLTS" report) showed a still-sizable gap between subdued--but still respectable--growth of job openings and a tepid, sub-1% rise in hiring. The difference is viewed by some as one indication of a significant mismatch between a shortage of workers with specific skill sets in high tech, manufacturing, transportation and other industries, amid a diminishing, but still sizable pool of less skilled unemployed. These results, consistent with a small-business survey showing a still-elevated percent of firms reporting difficulty filling at least one position, ultimately should contribute to a more noticeable buildup of wage pressures.

Source: U.S. Bureau of Labor Statistics

GLOBAL ECONOMIC OUTLOOK ISSUES

- Rekindling Economic And World Trade Growth

  --Tax And Regulatory Relief, Reduced Public-Sector Spending

  --Restoring The Drive Toward Free Trade

- The Outlook For Oil And Other Commodity Prices

- A Strong Dollar's Impact On The Global Economy

- The Future Of The Euro—And The Euro-Zone

- Which Way For China's Economic Growth And Development?

- Gauging The Geo-Political Threats To Global Economic And Financial Stability

WEIGHING A STRENGTHENING DOLLAR’S THREAT TO THE GLOBAL AND U.S. ECONOMIES

- Commodity-Price “Deflation”
- More Burdensome Cost Of Dollar-Debt Payments Abroad
- Higher Overseas Interest Rates To Contain “Flight” Capital
- ”Translation” Losses On Foreign Income Of U.S. Multinationals, Foreign Investors
- A Loss Of U.S. International Competitiveness
- “Bad Deflation,” Via Weakening Business “Pricing Power”

WFAM– Disclosure

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