

Weekly — June 17, 2022

Weekly Economic & Financial Commentary

United States: Recession Risks Rise

- Last week's stronger-than-expected CPI print laid the groundwork for this week, sending markets into a churn and raising the risks of recession. We now look for the U.S. economy to experience a mild contraction in mid-2023. Economic data released this week add to evidence that the chances of a soft landing are fading.
- [Next week](#): Existing Home Sales (Tues), New Home Sales (Fri)

International: Bank of England Raises Rates by 25 bps as Growth Unexpectedly Contracts

- The outlook for the U.K. economy may be starting to cloud, as the economy saw an unexpected contraction, with GDP falling 0.3% month-over-month in April. Against a backdrop of slowing growth and high inflation, the BoE delivered a 25 bps rate hike at its June monetary policy meeting, bringing the Bank Rate to 1.25%.
- [Next week](#): Canada CPI (Wed), U.K. CPI & PMIs (Wed/Thurs), Eurozone PMIs (Thurs)

Interest Rate Watch: Treasuries Tumble as Yields React to CPI, Fed

- New economic data and aggressive Federal Reserve actions sent Treasury yields up sharply this week. Monday, in particular, was one of the most volatile days of the year for bond markets as yields spiked roughly 30 bps across most parts of the Treasury curve.

Topic of the Week: So What's Happening with Our Old Friend Supply Chains?

- There is still ample backlog to be chipping away at, but overall things tend to be gradually improving on the supply front. That doesn't mean we are out of the woods yet, as there are still mentions of supply chain disruptions among many industries, particularly in reference to lockdowns in China.

Wells Fargo U.S. Economic Forecast

	Actual				Forecast				Actual		Forecast	
	2021				2022				2020	2021	2022	2023
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q				
Real Gross Domestic Product ¹	6.3	6.7	2.3	6.9	-1.5	3.5	1.7	0.8	-3.4	5.7	2.5	0.0
Personal Consumption	11.4	12.0	2.0	2.5	3.1	3.8	1.4	0.6	-3.8	7.9	3.1	0.1
Consumer Price Index ²	1.9	4.8	5.3	6.7	8.0	8.6	9.2	8.5	1.2	4.7	8.6	4.0
"Core" Consumer Price Index ²	1.4	3.7	4.1	5.0	6.3	6.0	6.2	6.1	1.7	3.6	6.2	4.0
Quarter-End Interest Rates ³												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.50	1.75	3.00	4.00	0.50	0.25	2.31	4.38
Conventional Mortgage Rate	3.17	3.02	2.88	3.11	4.42	5.70	5.85	5.90	3.12	2.95	5.47	5.46
10 Year Note	1.74	1.45	1.52	1.52	2.32	3.55	3.70	3.80	0.89	1.45	3.34	3.44

Forecast as of: June 15, 2022

¹ Compound Annual Growth Rate Quarter-over-Quarter

² Year-over-Year Percentage Change

³ Annual Numbers Represent Average

Source: U.S. Dept. of Commerce, U.S. Dept. of Labor, Federal Reserve Board and Wells Fargo Economics

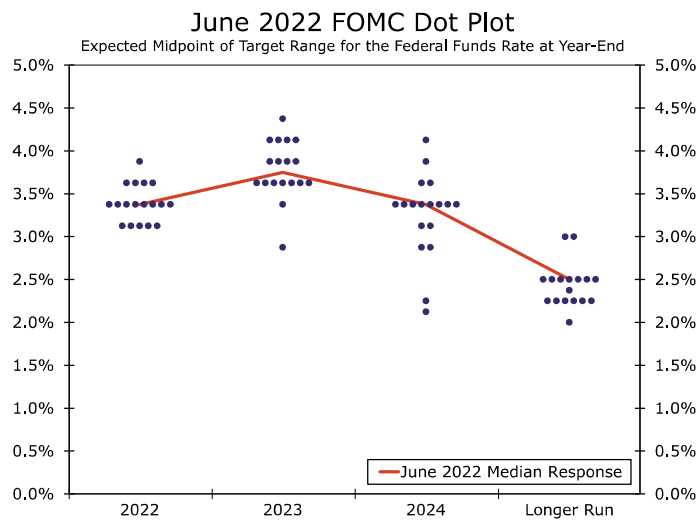
Please see our full [U.S. Economic Forecast](#) and our updated [Consumer Dashboard](#) and [Pressure Gauge](#).

U.S. Review

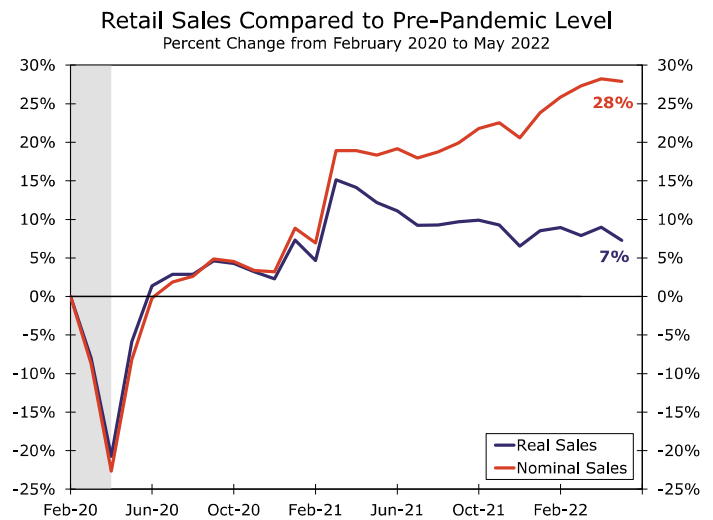
Recession Risks Rise

Last week's stronger-than-expected CPI print laid the groundwork for this week, sending markets into a churn and raising the risks of recession. As we detailed in a recent [update](#), we now look for the U.S. economy to experience a mild contraction in mid-2023. Inflation has become entrenched and a sharp moderation in demand, if not an outright contraction, would need to occur to bring price growth to more sustainable rates, in our view. Economic data released this week add to evidence that the chances of a soft landing are fading.

In response to the inflation alarm bells, the Federal Open Market Committee (FOMC) has turned more hawkish in recent days. The FOMC raised its target range for the fed funds rate by 75 bps on Wednesday, the largest rate increase in 27 years. The Committee also signaled that an aggressive pace of tightening lies ahead. The dot plot, which visualizes each member's projection for the year-end target of the fed funds rate, showed the median Fed policymaker anticipates 175 bps of additional tightening by the end of this year. In combination with the shrinking of the Fed's balance sheet, financial conditions are set to tighten significantly in the coming months.



Source: Federal Reserve Board and Wells Fargo Economics



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

Higher prices and interest rates have weighed on consumption. Retail sales came in lower than expected in May, declining 0.3% from April. After accounting for higher prices, we estimate real retail sales fell 1.6% last month. Weaker sales were broad based with notable decreases in motor vehicles and parts (-3.5%), electronics (-1.3%) and non-store retailers (-1.0%). Looking ahead, we expect spending on goods to contract with sustained growth in services.

Mortgage rates have propelled higher, which has dented new home demand. According to Freddie Mac, the average 30-year fixed-rate mortgage rose to 5.78% the week ended June 16, the highest since late 2008. In response, builders have tapped the brakes on construction. Housing starts tumbled 14.4% month-over-month in May, while building permits slipped 7.0%. Demand has slowed just as building material pricing and availability was starting to show signs of improvement. The construction PPI for final demand increased 0.4% in May, a moderation from the ripping 3.7% rise in April.

Softening demand amid the high-cost environment will likely compress profit margins. To that end, signs of shakier earnings have crept up. The proportion of small business owners reporting increased earnings in the past three months tumbled seven points in May to a net -24%. The share of owners who cited increased costs as the primary driver of lower earnings has more than tripled over the past two years to 20%. Sales volume (11%) was the second-most cited reason, down from 20% two years ago. Declining profits are a recipe for cutbacks in capital expenditure and production, although we do not expect that to materialize until the back half of this year. Industrial production rose weaker than expected in May, rising 0.2% over the month. ([Return to Summary](#))

U.S. Outlook

Weekly Domestic Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
21-Jun	Existing Home Sales (SAAR)	May	5.40M	5.49M	5.61M
24-Jun	New Home Sales (SAAR)	May	595K	703K	591K

Forecast as of June 17, 2022

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Existing Home Sales • Tuesday

Now that mortgage rates have hit 5.78% this week, existing home sales are cooling down, and we expect them to cool further in coming months. However, the reference period for next week's existing home sales release closed before the most recent run-up in mortgage rates in June.

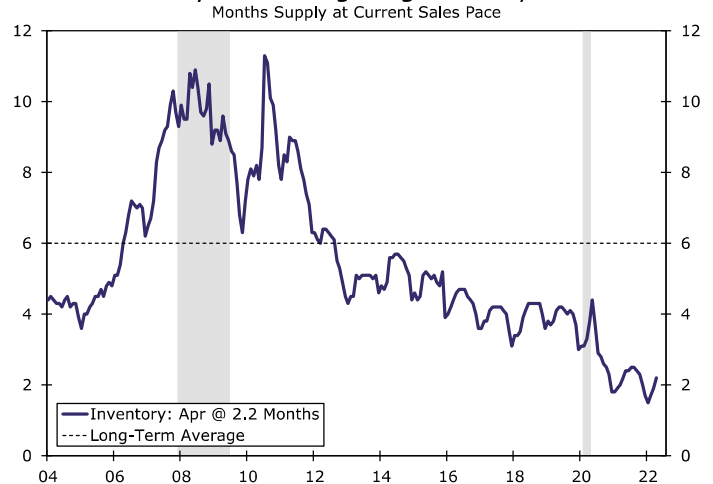
Even if buyers have jumped ahead of the mortgage rate, they still have to contend with high prices and extremely low home inventory. Though inventories have ticked up since the lows at the very start of the year, there is still a major pressure on the supply and on the demand side reducing sales. Unaffordability is growing and the strength in housing demand is weakening. We forecast existing home sales to fall to a 5.49M annual unit pace from the 5.61M pace in April.

New Home Sales • Friday

As interest rates continue to rise, the costs for purchasing a home continues to rise. Those currently looking to purchase a new home could be facing a mortgage rate of over 300 bps higher than a comparable mortgage originated two years ago. For many, this could reach into several hundred dollars a month and further hurt affordability, compounded by the run-up in home prices, up 21.1% year-over-year as estimated by the S&P CoreLogic Case-Shiller HPI in March.

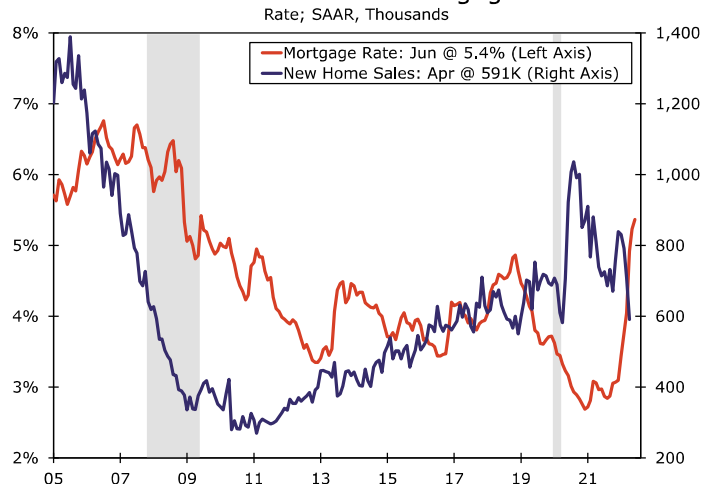
However, we have noted that completions have surged and believe that home buyers may push up their buying now to beat additional rate hikes. Demand for homes remains strong, and growth in inventories of homes should help to ease some supply constraints reducing current purchases. In May, we suspect new home sales rose to a 703K annual unit pace, up from 591K in April. ([Return to Summary](#))

Inventory of Existing Single-Family Homes



Source: NAR and Wells Fargo Economics

New Home Sales vs. Mortgage Rate



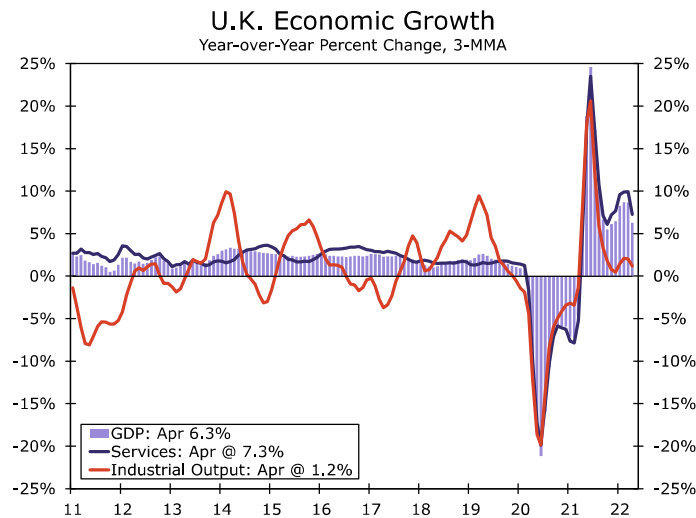
Source: U.S. Department of Commerce, Freddie Mac and Wells Fargo Economics

International Review

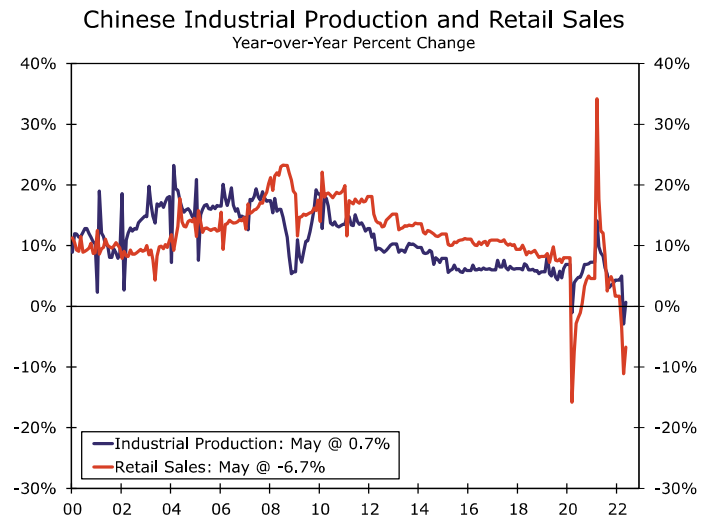
Bank of England Raises Rates by 25 bps as Growth Unexpectedly Contracts

The outlook for the U.K. economy may be starting to cloud, as the economy saw an unexpected contraction in April. GDP fell 0.3% month-over-month, following a 0.1% decline in March; although even with the drop, GDP is still 0.9% above its pre-pandemic level. Within the details of the report, the main economic sectors (services, production and construction) all experienced declines in April, with the main driver being a 0.3% decline in services spending. The fall in the services sector reflected a significant drop in health and social work activity as the government reduced its COVID testing presence. On the other hand, production and construction activity fell in April, likely due to supply chain issues and higher costs. The GDP release highlighted the increased costs of production, including higher prices for oil, gas and electricity, as well as other inputs, which is affecting industries across the board. With a negative GDP reading for April, there is now some additional risk that second quarter growth will be negative. Indeed, the Bank of England's (BoE) June forecast now expects GDP to fall by 0.3% in Q2, a bigger decline than it projected in May.

Against a backdrop of slowing growth and high inflation, the BoE delivered a 25 bps rate hike at its June monetary policy meeting, bringing the Bank Rate to 1.25%. The committee voted 6-3 in favor of a 25 bps hike, while the minority voted for a 50 bps hike. Notably, the BoE signaled it is willing to go for larger magnitude hikes and "act forcefully" if inflation continues its upward trend. The U.K. is experiencing some of the highest inflation among major developed economies, and headline CPI is currently running at a 9.0% year-over-year rate. The BoE believes price pressures will intensify even more, especially given an increase in the energy price cap scheduled for October. As a result, the central bank raised its inflation forecast peak to slightly above 11%. Overall, the BoE emphasized that it would "take the actions necessary to return inflation to the 2% target sustainably in the medium term," and noted that the magnitude and timing will reflect the Committee's evaluation of the economic outlook and inflation.



Source: Datastream and Wells Fargo Economics



Source: Bloomberg Finance L.P. and Wells Fargo Economics

China Sees Mixed Recovery, Australian Labor Market Remains Resilient

In the emerging markets, China's post-lockdown recovery has been mixed, although we may be seeing tentative signs that the worst of the economic slowdown is in the past. Sentiment via the manufacturing and services PMIs showed improvement in May, while industrial output experienced a surprise gain in May, increasing 0.7% year-over-year. We also saw tentative signs consumer spending is improving as retail sales contracted less than expected. May retail sales fell 6.7%, an improvement from an 11.1% drop in April, as COVID restrictions are gradually being lifted. Tentative signals of recovery do not mean China is completely out of the woods just yet. Shanghai recently announced it will conduct weekly mass testing, and enforce temporary lockdowns if positive cases are detected. In our view, mass testing will have a less significant impact on economic activity compared to the restrictive lockdowns that were recently lifted. Thus, we believe the worst of the COVID-related

lockdowns could be behind us. As of now, we forecast GDP growth of just 4.2% in 2022, although risks around that forecast are now balanced.

Meanwhile, Australia saw May employment data released this week. The economy added more than double consensus estimates and gained 60,600 new jobs. This upside surprise came on top of strong employment growth, indicating that the labor market remains tight. The gain was driven by full-time employment (+69,400), as part-time employment declined (-8,700). The unemployment rate remained at a 48-year low, and labor force participation rose to a record high. These resilient labor market trends should be supportive of further Reserve Bank of Australia (RBA) rate hikes. The central bank surprised market participants at its June monetary policy meeting, raising the Cash Rate by 50 bps. Given a tight labor market and resilient growth, we expect the RBA to deliver another 50 bps rate hike in July to help tame inflation, before reverting to the more typical 25 bps increments in August, November and December, which would bring the Cash Rate to 2.10% at the end of 2022. However, given a reasonably resilient economy and elevated inflation, a more extended series of 50 bps rate hikes, which would include another in August, remains a distinct possibility. ([Return to Summary](#))

International Outlook

Weekly International Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
22-Jun	Canada CPI NSA (YoY)	May	7.3%	7.5%	6.8%
22-Jun	U.K. CPI (YoY)	May	9.2%	9.1%	9.0%
23-Jun	U.K. Manufacturing PMI	Jun	53.7	--	54.6
23-Jun	U.K. Services PMI	Jun	53.0	--	53.4
23-Jun	Eurozone Manufacturing PMI	Jun	53.8	--	54.6
23-Jun	Eurozone Services PMI	Jun	55.5	--	56.1

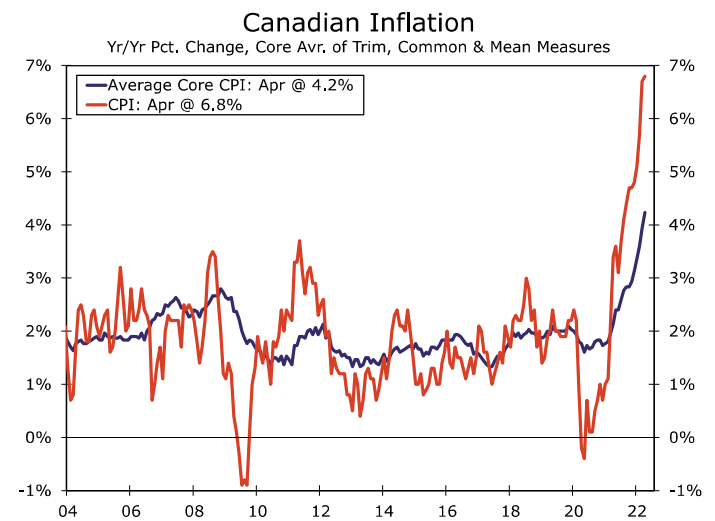
Forecast as of June 17, 2022

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Canada CPI • Wednesday

Canada's CPI data released next week will likely show that inflation accelerated further in May, as gas and energy prices saw another spike. We expect the headline rate quickened 1.2% month-over-month, bringing the year-over-year rate to 7.5%. Inflation ticked higher to 6.8% year-over-year in April, the fastest pace since 1991. Like past months, the gain has been driven by rising prices for transportation, food, energy and shelter. Underlying price pressures have also increased, with the average of the three core inflation measures accelerating to 4.2% year-over-year from 3.9% in March.

Intensifying price pressures have motivated the Bank of Canada (BoC) to become more hawkish in order to bring inflation back to its 2% target. At the BoC's June monetary policy meeting, the central bank delivered a 50 bps rate increase for the second meeting in a row, taking its policy rate to 1.50%. The central bank noted that the "risk of elevated inflation becoming entrenched has risen," and the economy is "clearly operating in excess demand." As a result, we expect the BoC to deliver more forceful tightening and expect 50 bps rate increases at the July, September and October announcements. As inflation potentially peaks and begins to slow, we expect the Bank of Canada to revert to a 25 bps hike in December, bringing its policy rate to 3.25% by the end of 2022.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

U.K. CPI & PMIs • Wednesday & Thursday

The U.K. has been experiencing some of the highest inflation among major developed economies, and market participants will be watching closely on Wednesday to see how the pace of inflation has developed. We expect headline CPI to have quickened to 9.1% year-over-year in May.

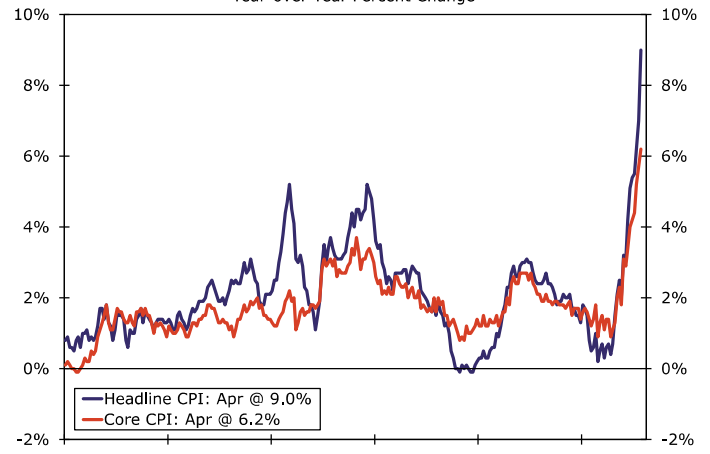
In April, U.K. inflation surged to 9.0% year-over-year from 7.0% in March, driven by higher food and energy prices. We forecast that U.K. inflation is on track to average 8.2% this year and expect that persistently elevated inflation will constrain purchasing power as well as weigh on economic activity and growth. Following a surprise 0.3% month-over-month drop in April GDP, we anticipate that this slowing in growth will also be reflected in the June PMI survey data released next Thursday. Industrial production and the services index both contracted in April, and we expect that in June sentiment continued to soften for the services and manufacturing sectors. Consensus expectations are for the June manufacturing and services PMIs to decline to 53.7 and 53.0, respectively.

Eurozone PMIs • Thursday

PMI readings for the Eurozone will be released next Thursday and will provide an initial glimpse into recent sentiment trends for the manufacturing and services sectors for Europe's key economies. Consensus estimates expect the June manufacturing PMI to slow to 53.8, while the June services PMI is expected to decline to 55.5.

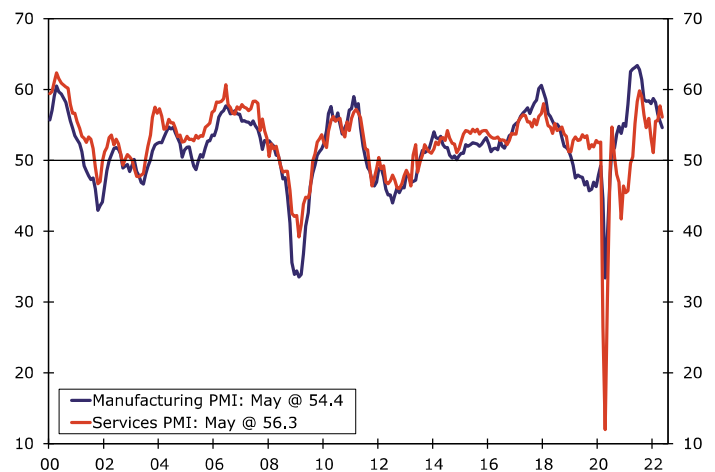
In May, both the manufacturing and services PMIs lost some momentum against a backdrop of high inflation, although they remained in expansionary territory (above 50). Services, which compose a larger proportion of the economy, saw a decline in sentiment, with the overall Eurozone May services PMI falling to 56.3. Notably, the largest Eurozone economies, Germany and France, both saw a deterioration in sentiment. As for the manufacturing sector, the overall Eurozone PMI fell to 54.4, with a decline in France's manufacturing PMI but with Germany's manufacturing PMI holding broadly steady. The PMI surveys also reflected still-elevated input and output price pressures. With Eurozone CPI inflation quickening to 8.1% year-over-year in May and expected to remain elevated, we anticipate that price pressures will continue to weigh on economic activity, growth and ultimately sentiment. ([Return to Summary](#))

U.K. Consumer Prices
Year-over-Year Percent Change



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Eurozone PMIs



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Interest Rate Watch

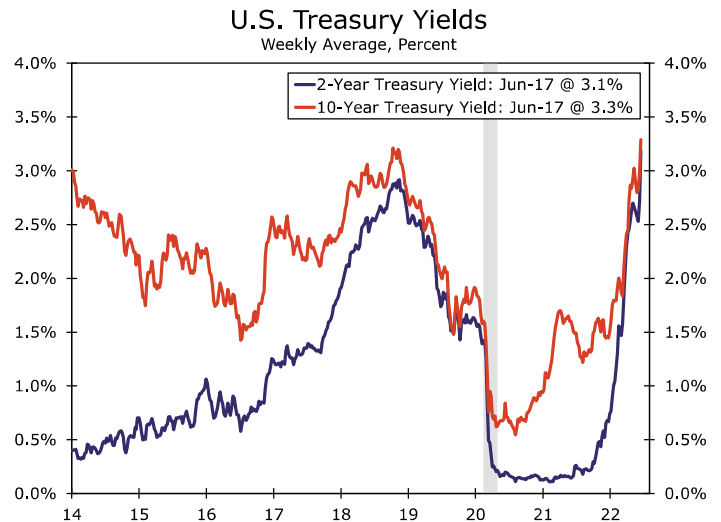
Treasuries Tumble as Yields React to CPI, Fed

This has been a very tumultuous week for interest rates, as new economic data and aggressive Federal Reserve actions sent Treasury yields up sharply. Monday, in particular, was one of the most volatile days of the year for bond markets as yields spiked roughly 30 bps across most parts of the Treasury curve.

The initial catalyst occurred last Friday with the release of a consensus-beating 8.6% year-over-year CPI print for May. The stunning headline rates are not just being held up by rising food and energy prices. Core components continue to push considerably above 2%. Shelter costs are up 5.4% year-over-year, while services ex-shelter prices are up an even higher 6.0%. The higher and more persistent inflation noticeably affected Wednesday's FOMC meeting where the Committee chose to raise the fed funds target rate by 75 basis points, 25 basis points more than financial markets and most analysts expected before the May CPI release. The newest Summary of Economic Projections from the Fed and guidance from Chair Powell revealed a more hawkish stance on monetary policy. The dot-plot showed the median FOMC participant projection for the fed funds rate at the end of 2022 is now 3.375%, which implies another 175 bps of tightening at the four remaining FOMC meetings of the year.

With high inflation and rapidly tightening monetary policy, rates have risen with a vengeance. The yields on 10 year Treasury securities are the highest they have been since 2011, while 2 year yields are the highest since 2007. Even so, despite nominal yields rising throughout 2022, shorter-term real interest rates are still in negative territory. The 2 year real yield, for example is roughly -85 bps.

The CPI and Fed news that drove rates so much this week also led to a shift in our forecast. As explained in our [forecast update](#), we now forecast a recession in 2023, as slowing growth turns into a contraction. As this occurs, we expect to see the Treasury yield curve flatten further and eventually invert. ([Return to Summary](#))



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Topic of the Week

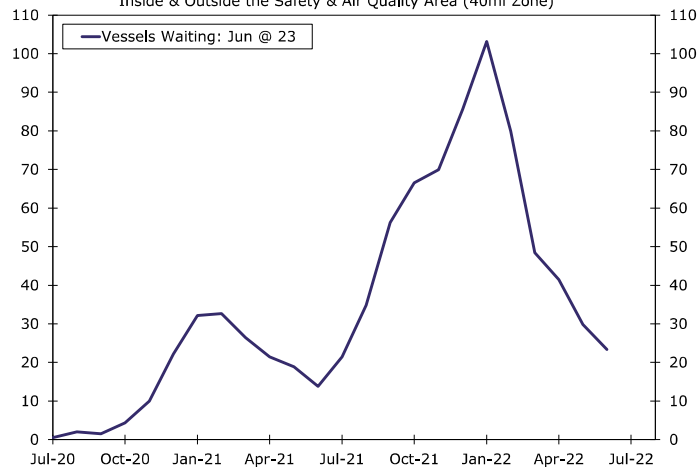
So What's Happening with Our Old Friend Supply Chains?

In what has been an incredibly volatile period for the economy, much of the focus has been on demand and its trajectory, given the moving parts of interest rate hikes, inflation and income. But inflation did not get to its blazing 8.6% year-over-year pace on demand-side factors alone. Yes, consumers' strong appetite for goods played a part, but also it was not too long ago that visions of piled-up container ships and swept-clean shelves at stores were flooding the news. No matter how much exogenous shocks the Fed can impart, these supply chain snags had to unravel themselves. So, where do supply chains stand now and are things truly getting better?

To put things into perspective, "better" should be considered in the context of where we have been rather than a complete return to normal. Ships have continued to drop quickly in recent months. Ships waiting outside the ports of Long Beach and Los Angeles hit a post-pandemic low of 20 on June 10. That is less than a fifth of the record high of 109 reached in early July. However, compared to the one to two ships that may be waiting to dock in the pre-pandemic era, ports are still incredibly busy.

Container Ships Waiting to Offload Cargo

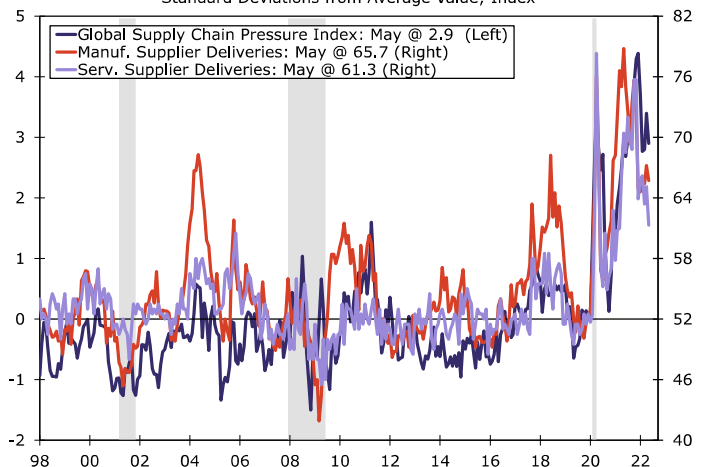
Ports of Los Angeles-Long Beach; Monthly Average
Inside & Outside the Safety & Air Quality Area (40mi Zone)



Source: Marine Exchange of Southern California and Wells Fargo Economics

GSCPI vs. ISM Supplier Deliveries

Standard Deviations from Average Value; Index



Source: Federal Reserve Board of New York, Institute for Supply Management and Wells Fargo Economics

Most other primary indicators measuring the progress of supply chains have also improved but remain high historically. The New York Federal Reserve developed the Global Supply Chain Pressure Index (GSCPI) to measure the trajectory of supply chain struggles. The index has trended down since peaking in December around the hustle and bustle of the holiday shopping season. The Institute for Supplier Management's supplier deliveries index has also come down gradually from late 2021 for both manufacturing and services. Our own measure, the [pressure gauge](#), also hints at easing, particularly when it comes to time and volume, although prices and labor remain expensive and obstacles to contend with. Sure, there is still ample backlog to be chipping away at, but overall things tend to be gradually improving on the supply front.

That does not mean we are out of the woods yet, as there are still mentions of supply chain disruptions among many industries particularly in reference to lockdowns in China. But according to Bloomberg, the use of "shortage" in the Beige Book has declined since March and have come down to around 40 mentions in the June report from around 70 last August. Perhaps this is because it is just not as top-of-mind, but another possibility could be that the current shortages are not due to widespread systematic issues; in other words, there are shortages of *some things* but not *everything* like earlier in the pandemic. Plus, some shortages have been caused by one-off factors, such as the FDA baby formula recall or inflation-driven shifts in demand preferences toward lower-priced items. Those reasons have different implications than a global tie-up at ports and overall dearth of transportation workers. Some companies have been able to completely restock and, in some cases, overstock. As consumers continue to shift from goods to services and interest-sensitive purchases begin to decline, we should see supply chains balance out even more in the near term. ([Return to Summary](#))

Market Data • Mid-Day Friday

U.S. Interest Rates			
	Friday 6/17/2022	1 Week Ago	1 Year Ago
SOFR	1.45	0.75	0.01
3-Month LIBOR	2.06	1.72	0.12
3-Month T-Bill	1.55	1.30	0.03
1-Year Treasury	2.49	2.14	0.06
2-Year Treasury	3.17	3.06	0.21
5-Year Treasury	3.34	3.26	0.88
10-Year Treasury	3.22	3.16	1.50
30-Year Treasury	3.26	3.19	2.09
Bond Buyer Index	3.57	3.16	2.09

Foreign Exchange Rates			
	Friday 6/17/2022	1 Week Ago	1 Year Ago
Euro (\$/€)	1.047	1.052	1.191
British Pound (\$/£)	1.221	1.232	1.392
British Pound (£/€)	0.858	0.854	0.855
Japanese Yen (¥/\$)	135.050	134.410	110.210
Canadian Dollar (C\$/\\$)	1.306	1.278	1.236
Swiss Franc (CHF/\\$)	0.971	0.988	0.918
Australian Dollar (US\$/A\\$)	0.692	0.706	0.755
Mexican Peso (MXN/\\$)	20.431	19.961	20.429
Chinese Yuan (CNY/\\$)	6.717	6.709	6.448
Indian Rupee (INR/\\$)	78.076	77.841	74.076
Brazilian Real (BRL/\\$)	5.134	4.988	5.008
U.S. Dollar Index	104.847	104.148	91.889

Foreign Interest Rates			
	Friday 6/17/2022	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.58	-0.59	-0.57
3-Month Sterling LIBOR	1.62	1.50	0.08
3-Month Canada Banker's Acceptance	2.42	2.28	0.44
3-Month Yen LIBOR	-0.02	-0.03	-0.09
2-Year German	1.09	0.97	-0.67
2-Year U.K.	2.20	2.05	0.12
2-Year Canadian	3.25	3.24	0.38
2-Year Japanese	-0.07	-0.08	-0.11
10-Year German	1.66	1.52	-0.20
10-Year U.K.	2.50	2.45	0.78
10-Year Canadian	3.40	3.35	1.39
10-Year Japanese	0.23	0.25	0.06

Commodity Prices			
	Friday 6/17/2022	1 Week Ago	1 Year Ago
WTI Crude (\\$/Barrel)	110.81	120.67	71.04
Brent Crude (\\$/Barrel)	114.06	122.01	73.08
Gold (\\$/Ounce)	1843.03	1871.60	1773.50
Hot-Rolled Steel (\\$/S.Ton)	985.00	1030.00	1745.00
Copper (¢/Pound)	401.40	429.45	417.80
Soybeans (\\$/Bushel)	17.57	17.81	14.79
Natural Gas (\\$/MMBTU)	7.23	8.85	3.25
Nickel (\\$/Metric Ton)	25,170	27,946	17,619
CRB Spot Inds.	646.65	659.19	606.69

Source: Bloomberg Finance L.P. and Wells Fargo Economics

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