WELLS FARGO

Weekly — July 22, 2022

Weekly Economic & Financial Commentary

United States: **Housing Slump Underscores Rising Risk of Recession**

- Higher mortgage rates continue to drag on housing activity. The NAHB Housing Market Index plunged 12 points to 55 in July. June brought a 5.6% drop in existing home sales as well as a 2.0% decline in housing starts. Initial jobless claims rose to 251K during the week of July 16. The Leading Economic Index (LEI) slipped 0.8% in June, the fourth straight monthly drop.
- Next week: Durable Goods (Wed.), Q2 U.S. GDP (Thurs.), Personal Income & Spending (Fri.)

International: **ECB Exits Negative Interest Rates**

- The ECB delivered a larger-than-expected 50 bps Deposit Rate increase, exiting its negative interest rate policy and taking the Deposit Rate to 0.00%. The other key policy interest rates were also lifted by 50 bps, taking the refinancing rate to 0.50% and the marginal lending rate to 0.75%.
- Next week: Japan (Tokyo) Inflation (Thurs.), Central Bank of Colombia (Fri.), Eurozone Q2 GDP (Fri.)

Interest Rate Watch: **The FOMC to Deliver Another Jumbo 75 bps Hike**

- The blistering June CPI report raised the chance that the FOMC could deliver a 100 bps hike at next Wednesday's meeting. However, with data since then showing the economy continues to cool and notable hawks signaling a smaller increase should be adequate, we look for the FOMC to hike a still head-turning 75 bps.

Credit Market Insights: **Stronger Dollar Spells Potential Trouble for Emerging Market Debt**

- Over the course of 2022, but particularly during the past few months, the U.S. dollar has broadly strengthened. Local currency depreciation could mean potential trouble for governments that have a sizable percentage of their sovereign debt denominated in U.S. dollars. As vulnerable countries struggle with potential repayment issues, economic growth across the emerging and developing world could slow sharply, while the probability of default could spike across the entire spectrum.

Topic of the Week: **Power Struggle: European Heat Waves Strain an Energy-Starved Continent**

- The second heat wave of this summer swept through Europe this week, extending as far north as the U.K. and causing wildfires in France, Spain, Portugal and Italy. The intensity of the heat wave, with temperatures reaching a record high of 104°F in the U.K., has upended life and further strained a continent already dealing with an energy crisis.

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	-1.6	0.2	1.6	0.7	-3.4	5.7	1.8	-0.3
Personal Consumption	11.4	12.0	2.0	2.5	1.8	1.0	2.1	-0.5	-3.8	7.9	2.3	-0.2
Consumer Price Index [2]	1.9	4.8	5.3	6.7	8.0	8.6	8.8	7.8	1.2	4.7	8.3	3.2
"Core" Consumer Price Index [2]	1.4	3.7	4.1	5.0	6.3	6.0	6.4	6.3	1.7	3.6	6.3	4.0
Quarter-End Interest Rates [3]												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.50	1.75	3.25	4.00	0.50	0.25	2.38	3.63
Conventional Mortgage Rate	3.17	3.02	2.88	3.11	4.42	5.81	5.30	5.35	3.12	2.95	5.22	4.93
10 Year Note	1.74	1.45	1.52	1.52	2.32	2.98	3.10	3.20	0.89	1.45	2.90	2.91

Forecast as of: July 22, 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 Pressure Gauge.

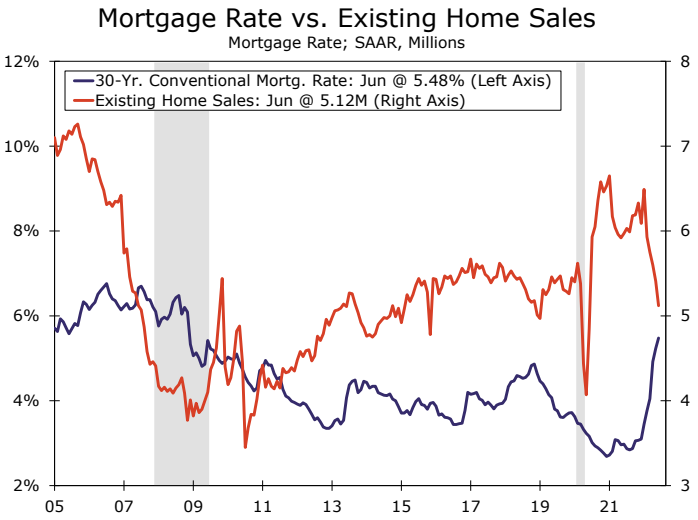
U.S. Review

Housing Slump Underscores Rising Risk of Recession

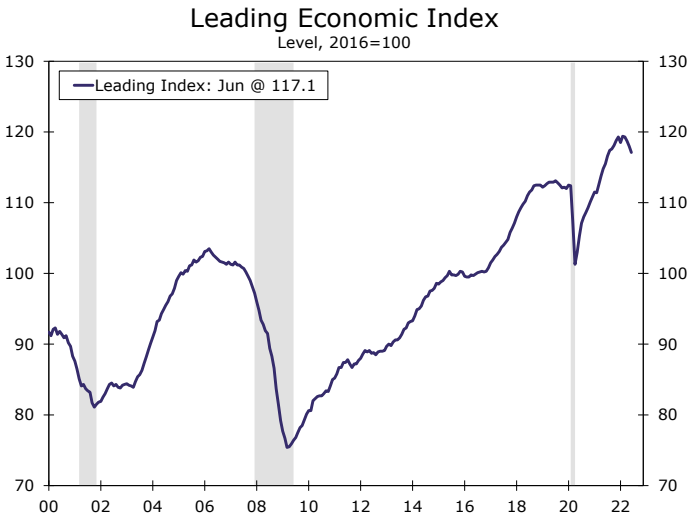
The housing market took center stage this week. The week began with an eye-catching plunge in home builder sentiment. July's NAHB Housing Market Index dropped 12 points to 55, the second largest monthly decline on record behind April 2020's pandemic-induced collapse. There was not a bright spot to be found in the underlying details, with measures of buyer traffic and single-family sales, both present and future, posting substantial declines. For most of the past two years, home builders have been navigating a rising cost environment, namely for building materials, labor and land. However, the straw that breaks the back of builder sentiment now appears to be higher financing costs. According to Freddie Mac, the average 30-year mortgage was 5.54% during the week ended July 21, a jump from the 3.22% averaged during the first week of 2022.

The downturn in home builder confidence provided an early clue that June's data for new home production would surprise to the downside. Total housing starts declined 2.0% to a 1.559 million-unit pace during June, below consensus estimates for a modest increase following May's sharp contraction. Single-family starts dropped 8.1%, the fourth consecutive monthly decline. Single-family starts are now running at a 982,000-unit pace, which is a bit higher than the sluggish pace registered for much of the decade predating the pandemic, but still the slowest since June 2020. The sharp rise in borrowing costs is clearly leading home builders to scale back production plans, with single-family permits recently taking a downward trajectory. Single-family permits dropped 8% in June, the fourth consecutive drop.

The drop in total housing starts would have been worse were it not for a solid rebound in the multifamily category. The decline in single-family affordability on account of higher mortgage rates and fast-rising home values has bolstered rental demand, which is driving multifamily construction to new heights. Over the past three months, both multifamily starts and permits have averaged a pace not seen since 1986. Another piece of trivia involving the 1980s is that one would need to go back to that period to find a time when households were devoting as large a share of their income to mortgage payments than they are currently. According to Black Knight's Mortgage Monitor, the average mortgage payment constitutes roughly 36% of the average household income, the highest level since the early 1980s, when the mortgage payment-to-income ratio surged above 50%.



Source: National Association of Realtors, Freddie Mac and Wells Fargo Economics



Source: The Conference Board and Wells Fargo Economics

The late 1970s' and early 1980s' spike in the mortgage payment to income ratio was driven almost entirely by higher interest rates, as incomes largely kept pace with appreciating home values. By contrast, the recent increase in the ratio can be traced to rising mortgage rates as well as home prices climbing ahead of income growth. Home price appreciation, however, looks to be softening as buyers retreat to the sideline as affordability further deteriorates. According to the National Association of Realtors, total existing home sales dropped 5.4% to a 5.12 million-unit pace in June. June marks the fifth consecutive monthly decline for resales, which are now down 14.2% over the past year. The

median existing single-family home price rose to a new high of $423,300 in June. The gain translates to a 13.3% year-over-year rise, which is somewhat softer than the 14.6% gain registered in May.

One silver lining to the slowdown in home buying is that it is allowing inventories to rise, which should help move the housing market back toward some semblance of balance. The inventory of unsold existing homes increased almost 10% to 1.26 million in June. Inventories are still remarkably low by historical standards but are now climbing quickly as sellers rush to put their homes on the market before the pool of buyers dries up any further. Existing home sales likely have further to fall before a bottom is reached. Mortgage applications for purchase, which dropped 7.3% during the week of July 15, have declined on a sequential basis every week so far in July.

In short, this year's steep climb in mortgage rates has slowed housing activity considerably. A cooled-off job market is likely to take even more wind out of the housing market's sails. Initial jobless claims rose 2.9% to 251,000 for the week of July 15. Jobless claims are volatile on a week-to-week basis, but the four-week moving average has steadily trended higher since April. Claims are still relatively low, especially compared to recessionary periods when they tend to rise well above 300,000. The recent increase, however, is a signal that the tight labor market is starting to loosen.

Strong job growth in recent months has buoyed hopes that the economy could avoid a downturn as the Fed seeks to tamp down mounting inflation pressures. A recent string of declines in the Leading Economic Index (LEI) is evidence to the contrary. The LEI fell 0.8% in June, the fourth straight drop. Aside from the aforementioned weakness in initial jobless claims and building permits, sinking consumer confidence was a major drag on the top-line index. Trend declines in the LEI do not always lead to a recession, but nearly every recent recession has been preceded by a trend decline in the LEI. While we do not believe that the economy is currently in a downturn, our current forecast calls for the economy to slip into a mild recession early next year. (Return to Summary)

U.S. Outlook

Weekly Domestic Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
26-Jul	Consumer Confidence	Jul	96.0	95.4	98.7
26-Jul	New Home Sales (SAAR)	Jun	667K	663K	696K
27-Jul	Durable Goods Orders (MoM)	Jun	-0.5%	-0.5%	0.8%
27-Jul	FOMC Rate Decision (Upper Bound)	27-Jul	2.50%	2.50%	1.75%
28-Jul	GDP Annualized (QoQ)	Q2	0.4%	0.2%	-1.6%
29-Jul	Employment Cost Index (QoQ)	Q2	1.1%	1.2%	1.4%
29-Jul	Personal Income (MoM)	Jun	0.5%	0.5%	0.5%
29-Jul	Personal Spending (MoM)	Jun	0.9%	0.9%	0.2%
29-Jul	PCE Deflator (YoY)	Jun	6.7%	6.6%	6.3%
29-Jul	Core PCE Deflator (YoY)	Jun	4.7%	4.6%	4.7%

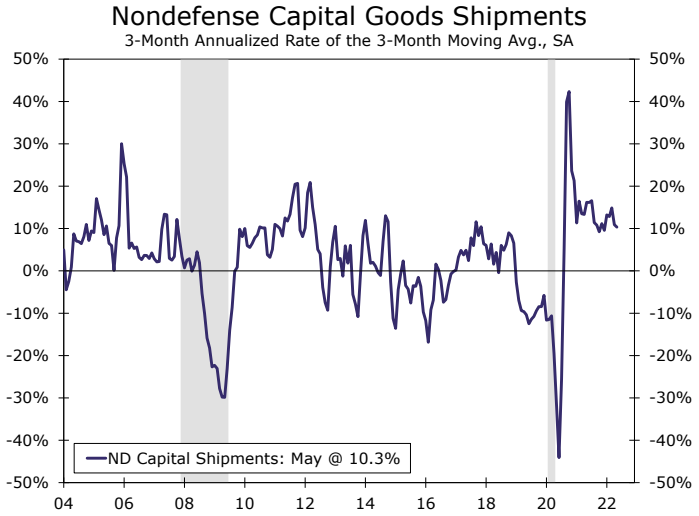
Forecast as of July 22, 2022

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

Durable Goods Orders • Wednesday

Demand for goods is slowing. That is as true for business spending as it is for personal consumption. For businesses, the growing concern the economy is about to tip into recession is weighing on activity, as well as higher borrowing costs and demand largely having been pulled forward throughout the pandemic. We forecast durable goods orders declined 0.5% in June, but we expect that to be in part due to the volatile transportation sector. According to monthly orders data from Boeing, there were 50 new gross orders for aircraft last month, 49 of which were for the 737 MAX. That's more than double the number of total orders placed in May (23), but when we adjust these order data for the price of the aircraft, it suggests a decline in the total value of orders in June. Excluding transportation, we forecast durable goods orders advanced 0.2% last month.

We've long held the view that a more sustainable growth trajectory for manufacturing may be warranted today as producers chip away at record amounts of backlogs. The recent downward revisions to data on durable goods and industrial production make that a tougher story to tell, and we'll be paying close attention to the order backlog data in next week's release for signs of increased cancellations. We'll also look to the core capital goods shipments data (including aircraft), which feeds into equipment spending, for the final indication of how equipment held up in the second quarter before GDP data are released Thursday. Core capital goods shipments were up 10.3% at a 3-month average annualized pace in May, but taken in the context of higher capital goods prices (the producer price index for capital goods was up 11.9% at a 3-month average annualized pace through June) recent data positions equipment spending to contract during the quarter.



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

FOMC Monetary Policy Decision • Wednesday

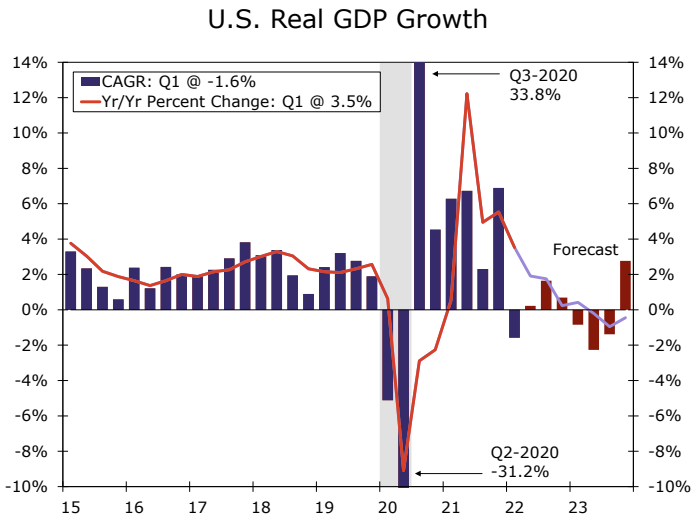
See this week's *Interest Rate Watch* for a preview of next week's FOMC Monetary Policy Decision.

Q2 U.S. GDP Growth • Thursday

The U.S. economy contracted at a 1.6% annualized pace in Q1, and we estimate U.S. GDP barely expanded in Q2 by 0.2% annualized. At that pace, it would not take much in the way of slightly weaker-than-expected spending and/or investment for GDP to register another negative print. A smaller build in inventories, a traditionally volatile component, would also be enough to pull the headline growth number negative. With the informal definition of recession being two consecutive quarters of contraction, this possibility has raised concerns that the economy is already in recession. While it's our baseline expectation for the U.S. economy to fall into a mild recession, we do not believe economic activity is broadly retrenching just yet, particularly as hiring has remained robust through June.

As far as the details go, consumer spending has been tracking to rise at around a 1% annualized pace during the quarter, and we'll get more detail on the monthly spending details for June next Friday. After demand for goods was largely pulled forward, imports started to cool, which positions Q2 net exports to boost growth for the first time in seven quarters. Equipment spending was likely modestly negative, as demand has begun to roll over amid a growing concern of a slowdown in activity and increasing financing costs. But the buckling in activity from higher interest rates is most apparent in the housing sector, where we're expecting a sizable contraction (-10.5%, annualized) in Q2 residential investment.

We believe tight monetary policy alongside still-high inflation will tip the U.S. economy into a mild recession by Q1-2023. Our latest July forecast pulled forward the timing of that downturn, and if conditions continue to deteriorate, it may warrant further reconsideration.



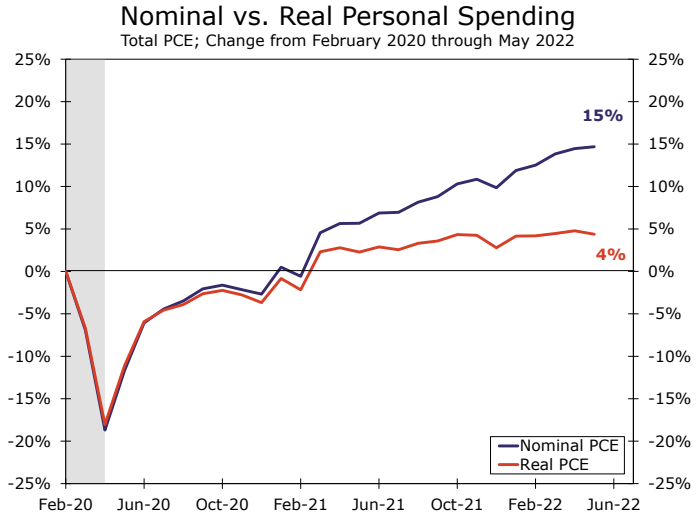
Source: U.S. Department of Commerce and Wells Fargo Economcis

Personal Income & Spending • Friday

On Friday, we'll get the full personal income and spending release for June, which we expect to show personal spending rose 0.9% last month. That gain, however, was likely mostly explained by higher prices, and if the PCE deflator is up 0.8% as we expect, that means *real* personal spending rose just 0.1% in June.

Besides the headline figures, we'll be paying close attention to how services spending held up during the month. Spending patterns continue to normalize, with services increasingly gaining wallet share. Through May, real services spending has increased for 15 consecutive months, and we believe strong services consumption will help offset weaker goods spending through the summer. Even as prices have moved higher for key service activities amid higher input costs and capacity constraints, pent-up demand for in-person activities this summer should help sustain overall spending.

Personal income likely remained under pressure last month, but that too won't be obvious from the headline print—we forecast nominal personal income rose 0.5% last month. Real disposable personal income will be more telling of consumers' purchasing power. Through May, the level of real disposable personal income was 5.4% below where it should be implied by its pre-pandemic trend. We look for real income to move even lower in the near term as consumer prices continue to outpace income growth. (Return to Summary)



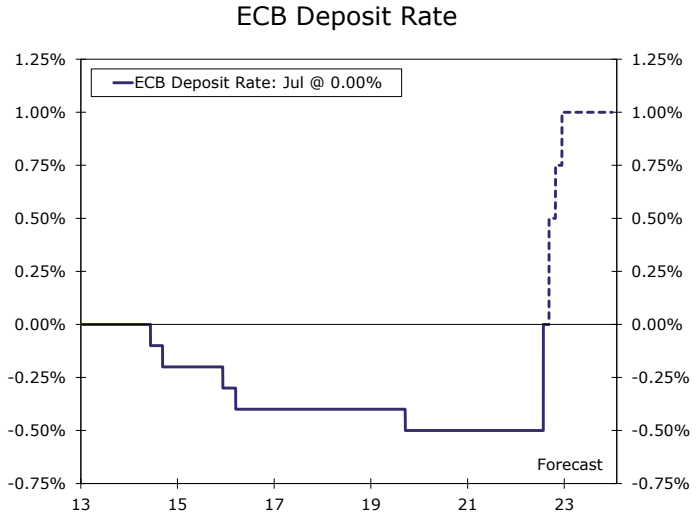
Source: U.S. Department of Commerce and Wells Fargo Economics

International Review

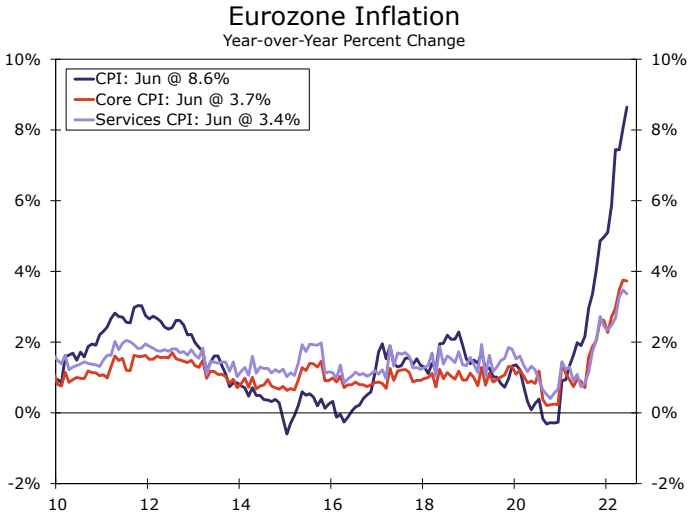
ECB Exits Negative Interest Rates

For more than a decade, the European Central Bank (ECB) has kept its main Deposit Rate in negative territory. Few central banks across Europe adopted this unorthodox monetary policy; however, the ECB led the charge on negative interest rates. This week, ECB policymakers lifted policy rates out of negative territory and toward a more orthodox stance on monetary policy. While an ECB rate hike was expected, policymakers managed to spring a few surprises on financial markets. To that point, the ECB delivered a larger-than-expected 50 bps Deposit Rate increase, thereby exiting its negative interest rate policy and taking the Deposit Rate to 0.00%. The other key policy interest rates were also lifted by 50 bps, taking the refinancing rate to 0.50% and the marginal lending rate to 0.75%. In addition to the rate hike, the ECB also approved the Transmission Protection Instrument (TPI), which is aimed at supporting orderly conditions across Eurozone government bond markets, particularly the fundamentally weaker peripheral markets such as Italy and Spain. The combination of an aggressive rate hike, as well as the announcement of a crisis-fighting tool, sparked an initial rally in the euro and narrowed Italy-Germany bond yield spreads.

In announcing the larger interest rate increase, the ECB said "further normalization of interest rates will be appropriate." The front-loading today of the exit from negative interest rates allows the Governing Council to make a transition to a meeting-by-meeting approach to interest rate decisions. The Governing Council's future policy rate path will continue to be "data-dependent and will help to deliver on its 2% inflation target over the medium term." In our view, this statement lifts any previous forward guidance the ECB provided, and the central bank's monetary policy decisions will now be more dependent on incoming economic data. On the TPI front, while all details are not yet available, the ECB said purchases using the tool are not restricted ex-ante, and that the scale of TPI purchases depends on the severity of risks facing policy transmission. While the announcement of such a tool this week was viewed as more likely than not, it was certainly not seen as a "done deal." Indeed, some reports ahead of this week's meeting hinted at a possible quid-pro-quo among ECB policymakers in that a larger 50 bps increase could shore up support for the anti-fragmentation tool. Whether such a quid-pro-quo was explicitly part of discussions, there certainly appears to be some trade off between the larger rate increase and the approval of the Transmission Protection Instrument. The ECB said that in addition to an updated assessment of inflation risks, the larger first step toward policy normalization was also reinforced by the support provided by the TPI for the effective transmission of monetary policy.



Source: Datastream and Wells Fargo Economics



Source: Datastream and Wells Fargo Economics

Of course, after Thursday's large rate increase and TPI approval, the focus now turns to what happens next from the European Central Bank. The comments in Thursday's decision about "front-loading" the exit from negative interest rates and transitioning to a "meeting-by-meeting" approach to interest rate decisions offers hints of at least some potential to shift to smaller 25 bps increments going forward. Indeed, ECB President Lagarde also said prior guidance on the September interest rate move

no longer applies. However, as the lead into the July meeting made clear, even forward guidance on interest rates does not guarantee a particular policy rate outcome. Moreover, we believe inflation remains elevated and inflation risks worrisome enough—Lagarde cited inflation risks were to the upside and have intensified in the short term—to continue with a more forceful pace of rate hikes for the time being.

As a result, our view remains that Thursday's hike will be followed up by another 50 bps Deposit Rate increase at the September meeting. In addition, while inflation remains elevated and until Eurozone economic growth slows in a much more meaningful manner, we also see a steady series of rate increases as more likely than not. In that context, we also forecast a 25 bps rate increase at the October and December meetings, which would bring the Deposit Rate to 1.00% by the end of 2022. We anticipate that will be the peak of the current cycle—as inflation begins to recede by 2023 and growth slows sharply, we see the ECB keeping interest rates steady through most, if not all, of next year. In essence, after this week's announcement, we anticipate a shorter, sharper rate hike cycle from the European Central Bank than previously. (Return to Summary)

International Outlook

Weekly International Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
28-Jul	Japan Tokyo CPI (YoY)	Jul	2.4%	--	2.3%
29-Jul	Central Bank of Colombia Rate Decision	29-Jul	9.00%	9.00%	7.50%
29-Jul	Eurozone GDP (QoQ)	Q2	0.1%	--	0.6%
29-Jul	Eurozone GDP (YoY)	Q2	3.4%	--	5.4%

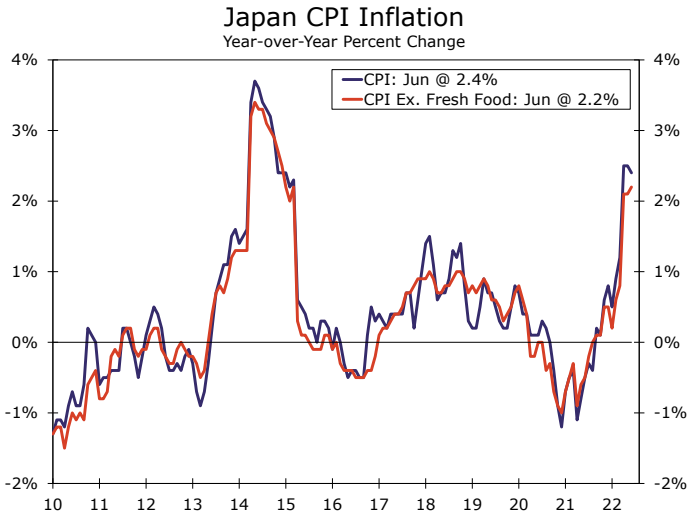
Forecast as of July 22, 2022

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

Japan (Tokyo) Inflation • Thursday

Japanese CPI has trended higher over the course of this year, with the National CPI reaching 2.4% year-over-year in June. Next week, however, July Tokyo inflation data will be released, which could give early insight into how nationwide prices are evolving. Next week, Tokyo July CPI is expected to rise. In June, Tokyo CPI hit 2.3% year-over-year. This summer has seen CPI hit highs last seen in early 2015. Similar to the rest of the world, energy and food prices have been a primary contributor to higher inflation. In addition, housing costs have come up alongside other household-related items. This suggests the inflation in Japan is broad-based and not purely driven by commodities.

Despite higher inflation, the Bank of Japan (BoJ) has not tightened monetary policy. In fact, BoJ policymakers have eased monetary policy even further as growth prospects in Japan are underwhelming and the current bout of inflation is widely expected to be temporary. As the BoJ has bucked the tighter monetary policy trend, the yen has come under pressure and is the worst performing G10 currency. In our view, the BoJ is unlikely to change course of policy, which to us, suggests the yen can continue to face depreciation pressure going forward.

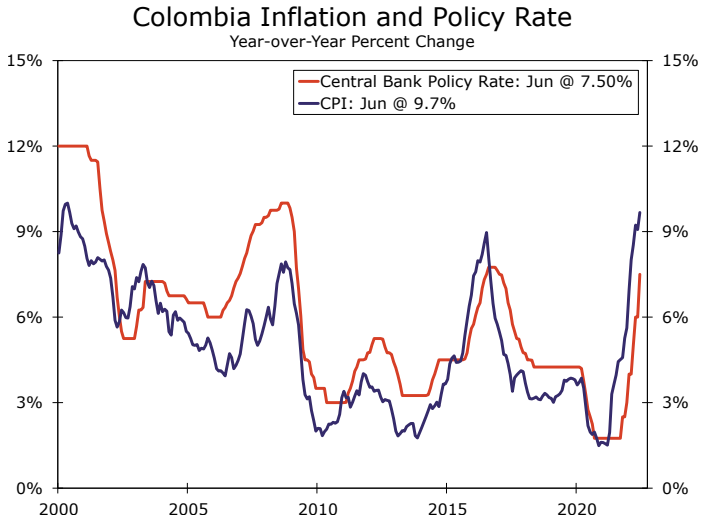


Source: Bloomberg Finance L.P. and Wells Fargo Economics

Central Bank of Colombia • Friday

Emerging market central banks, particularly in Latin America, have been some of the most hawkish institutions in the world over the past few years. Rising commodity prices and currency weakness, coupled with above-trend fiscal support, have contributed to elevated inflation across the region. Since April, Latin American currencies have come under sharp pressure, complicating the local inflation outlook and raising the likelihood of central banks intervening in FX markets to support their respective currencies. In the case of the Central Bank of Colombia, the peso has depreciated sharply amid political risk and the challenging external backdrop.

Amid a weaker currency and above-target inflation, Colombian policymakers have opted for aggressive interest rate hikes. In our view, when policymakers gather next week to assess monetary policy, we expect another 150 bps hike to contain inflationary pressures, but also provide much needed support to the peso. Central Bank of Colombia policymakers provide little forward guidance other than they will be "data dependent." In that sense, unless the peso demonstrates a recovery and inflation comes down, we expect policymakers to continue tightening policy going forward.

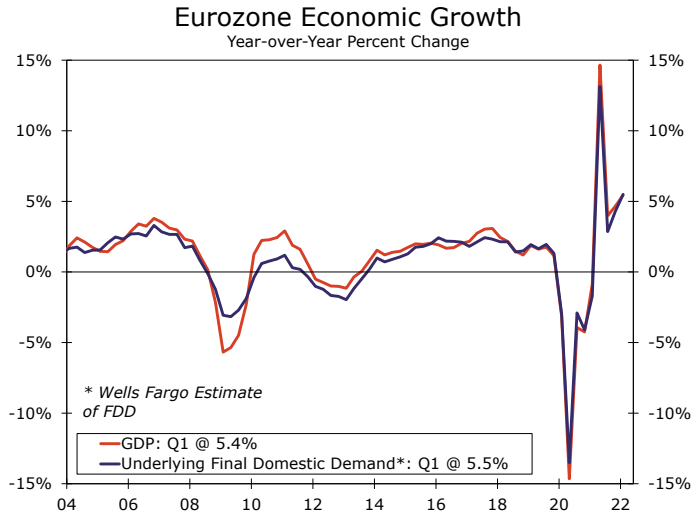


Source: Bloomberg Finance L.P. and Wells Fargo Economics

Eurozone Q2 GDP • Friday

The Eurozone economy is certainly struggling to gather momentum. Recent PMI surveys were uninspiring and indicate the Eurozone economy is in fact decelerating, possibly on the brink of recession. Other leading indicators over the past few months, especially confidence indicators, show consumers are losing faith in the health of the economy and are starting to pare back spending amid elevated inflation. The first ECB rate hike in over a decade could exacerbate the economic slowdown in the quarters to come.

Next week, Q2 GDP data will be released, which should show the Eurozone economy eking out only a small expansion. Eurozone growth was likely supported by consumer spending as household saving rates were still relatively high. However, with Europe in a bind on gas supply and potentially losing access to Russian energy, the deceleration could be more pronounced going forward. We will look at Q2 data to gauge the extent of the Eurozone slowdown; however, data may be more backward looking than usual at this point, given Europe's energy supply challenges and shift in monetary policy stance from the ECB. (Return to Summary)



Source: Datastream and Wells Fargo Economics

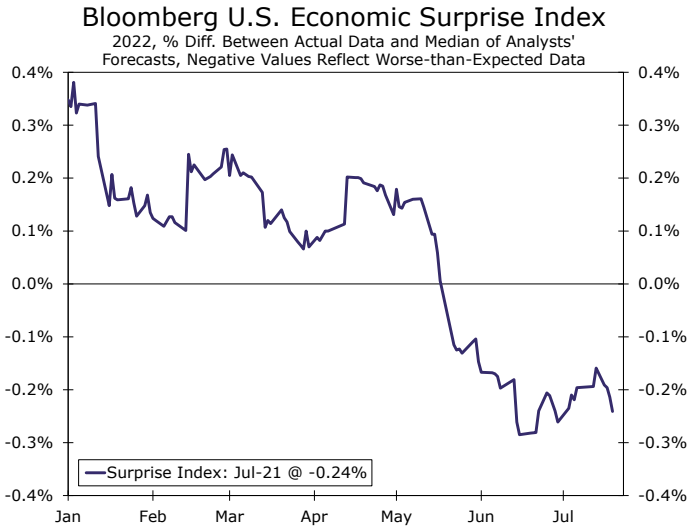
Interest Rate Watch

The FOMC to Deliver Another Jumbo 75 bps Hike

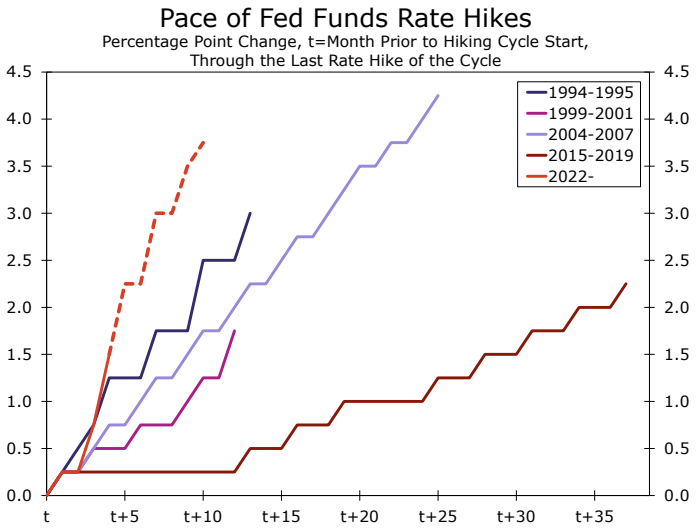
This past week has been all about the European Central Bank, as policymakers in Frankfurt lifted interest rates for the first time in more than a decade, which we discussed in detail in our International Review section. Next week, the action will move to Washington, where we now expect the FOMC to deliver a second consecutive 75 bps rate hike.

At the post-meeting press conference in June, Chair Powell said in his opening remarks, "From the perspective of today, either a 50 or 75 basis point increase seems most likely at our next meeting." However, in the immediate wake of the June CPI data, we believed the FOMC may, like at its June meeting, again hike more than initially guided. The FOMC has put reining in inflation above all other priorities and cited the need to raise rates expeditiously to restore price stability. The June CPI showed core inflation picking up compared to expectations for a moderation, heightening the risk that inflation is becoming entrenched and leading us to expect a 100 bps hike for the FOMC's upcoming meeting in our monthly forecast released the morning of July 14.

Since then, however, the case for hiking 100 bps has become less compelling. Comments squeezed in right before the blackout period started from some of the FOMC's more hawkish voters—Governor Christopher Waller and St. Louis President James Bullard— signaled that despite another scorching inflation print on top of surprisingly strong job growth in June, another 75 bps hike would likely be adequate in July. Moreover, data released over the past week show economic activity generally slowing faster than anticipated. The Bloomberg Economic Surprise Index has declined each day this week, with worse-than-expected outturns, including existing home sales, jobless claims and the bellwether Leading Economic Index.



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



Source: Federal Reserve Board and Wells Fargo Economics

We, therefore, expect the FOMC to now deliver "only" a 75 bps hike at next Wednesday's meeting. That would put the fed funds target range at 2.25%-2.50%, or around what most participants estimate to be the neutral rate of policy. But as indicated in the June dot plot and meeting minutes, FOMC members are in widespread agreement that policy will need to be restrictive later this year in order to reduce inflation. Assuming the FOMC raises rates at the remaining meetings this year by the same magnitude we expected in our July monthly U.S. Economic Outlook (75 bps in September, 50 bps in November and 25 bps in December), the fed funds target range would reach 3.75%-4.00% by year-end.

Lost somewhat in the 50/75/100 bps hike debate is that even at the lower end of the range, the FOMC in July is on course to proceed with the steepest pace of tightening since the Volker era. We expect the post-meeting statement to signal that inflation remains the paramount concern of policymakers, but we will also be closely watching for clues that the FOMC is becoming concerned about the outlook for growth and the labor market to where it believes a more gradual pace of tightening and, eventually, a pause may be warranted. (Return to Summary)

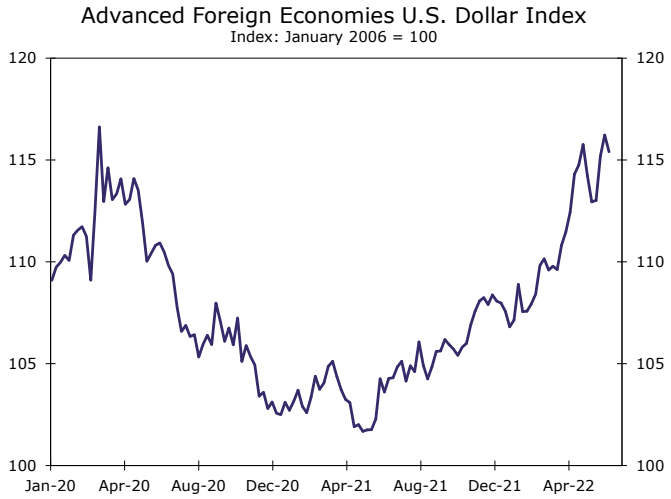
Credit Market Insights

Stronger Dollar Spells Trouble for Emerging Market Debt

Over the course of 2022, but particularly during the past few months, the U.S. dollar has broadly strengthened. At present, the U.S. Dollar Index (DXY), which measures greenback strength against G10 currencies, is up 11%, while the dollar has also exhibited strength against most emerging markets currencies. We can attribute the dollar's rally to multiple dynamics. First, the Federal Reserve's sharp shift in stance on monetary policy. FOMC policymakers have led the charge on raising interest rates and reducing balance sheet holdings, which has attracted capital flows back toward dollar-denominated assets. In addition, elevated financial market volatility due to central bank tightening and the Russia-Ukraine conflict has lured market participants toward the safe-haven characteristics of the U.S. dollar. This combination has pushed G10 currencies such as the euro and Japanese yen to selloff sharply, while multiple emerging market currencies have hit all-time lows this year. In our view, these dynamics are likely to continue through the end of 2022, and we continue to forecast broad dollar strength through the end of this year.

Dollar-Denominated Debt in Emerging Markets

There are unintended benefits and consequences of a strong dollar environment, the latter of which have become more apparent lately. In the case of emerging markets, most countries are feeling the sting of a strong dollar, both on the currency as well as the debt side. As mentioned, emerging market currencies have experienced depreciation pressure this year. This local currency depreciation could mean potential trouble for governments that have a sizable percentage of their sovereign debt denominated in U.S. dollars. Emerging markets that fit this criterion could be vulnerable to repayment capacity issues as these dollar-denominated debts become more expensive to service or repay due to exchange rate fluctuations. As far as countries with relatively high proportions of their total debt denominated in dollars, Argentina is particularly vulnerable with nearly 54% of its total government debt denominated in dollars. A high amount of dollar debt has been a common theme across Argentina's numerous sovereign defaults, including the most recent default in 2020, and even with a newly minted IMF program, has the government approaching another default. Countries such as Ukraine and Turkey also hold sizable amounts of hard currency debt, 42% and 43%, respectively, while Chile and Colombia also make the list with each having roughly one-third of their total sovereign debt in dollars. In addition to emerging market nations, frontier market countries are particularly exposed. Sri Lanka's recent default featured an elevated dollar-debt burden, while countries on the brink of default such as Pakistan also have an excess amount of hard currency debts on their respective balance sheets.



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

Foreign Participation in Emerging Market Local Currency Debt

Another potential source of vulnerability is the level of foreign investor participation in local currency government bond markets. When the dollar strengthens and local currencies weaken, foreign investors tend to divest bonds denominated in local currencies and toward other, safer assets such as U.S. Treasuries. Data from the International Institute of Finance reveal that between March 2021 and March 2022, foreign participation in local currency debt has declined in Indonesia, India, Mexico, Romania, the Czech Republic and Hungary. These examples add color to the story that foreign investors have become less interested in holding local currency denominated bonds when those local currencies are facing depreciation pressures. High dollar debts and a lack of foreign funding leaves emerging and developing nation debt sensitive in the current backdrop. A strong dollar makes emerging market vulnerabilities a more pressing risk. As vulnerable countries struggle with potential repayment issues, economic growth across the emerging and developing world could slow sharply, while the probability of default could spike across the entire spectrum. (Return to Summary)

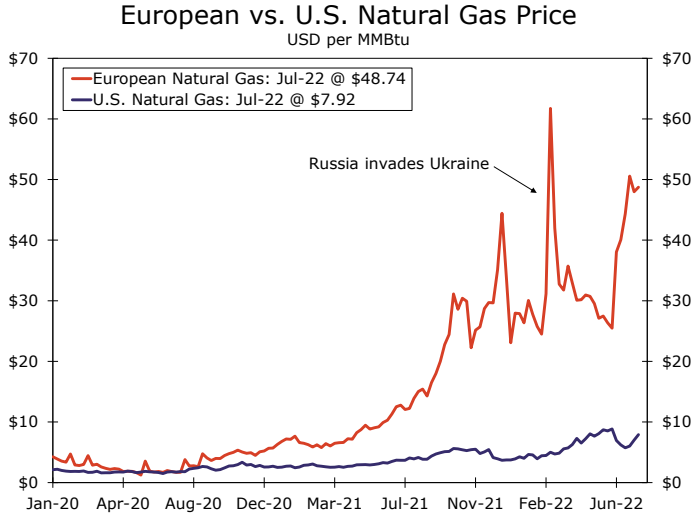
Topic of the Week

Power Struggle: European Heat Waves Strain an Energy-Starved Continent

The second heat wave of this summer swept through Europe this week, extending as far north as the U.K. and causing wildfires in France, Spain, Portugal and Italy. The intensity of the heat wave, with temperatures reaching a record high of 104°F in the U.K., has upended life and further strained a continent already dealing with an energy crisis. The economic toll will not be totalled for some time as countries struggle with loss of productivity, damage to infrastructure and reduced crop yield. Coldiretti, the Italian farmers' association, estimates that damages to cropland from wildfires amount to $25,000 per acre from extinguishing fires and later restoring the environmental condition over the course of several years. Costs to the European economy in the past have been significant, as a study published by García León et al. estimates that previous heat waves in 2003, 2010, 2015 and 2018 each reduced European GDP by 0.3-0.5 percentage points. Cost impacts are heterogeneous across the continent, with more vulnerable nations such as Croatia and Cyprus seeing GDP loss of more than one percentage point in these periods.

Outdoor productivity is the most impacted from extreme temperatures, but indoor workers are becoming increasingly affected. In London, millions of commuters have been forced to choose between braving sweltering conditions or working in torrid home offices. In a country where it's estimated less than five percent of homes have air-conditioning units installed, workers who stay home must spend an increasing amount of time keeping cool. Commuters who have braved the extreme conditions have been faced with sweltering train lines and suspended flights as infrastructure has come under increasing strain. The threat of infrastructure damage is increasingly apparent in more northern European cities like London as train lines, bridges and runways were not built with such climate conditions in mind, creating further risk to output.

What sets this heat wave apart from past ones is the extra dimension of Europe's struggle to power its economy as soaring energy prices have made cooling off an increasingly expensive endeavor. Natural gas prices in Europe have risen 77% over the past three weeks as Russian natural gas flows have been throttled as a result of the Russia-Ukraine War. Flows from Russia's Nord Stream pipeline have resumed, albeit at a significantly reduced 40% capacity. This has provided some relief to Europe but has not been enough to allay calls for gas rationing as the gas stockpiles for the winter risk falling short. The European Commission (EC) called on EU member countries this week to cut natural gas use by 15% through spring of next year in order to cope with the potential shortages. The proposal has not been put to a vote yet, but if passed, it would allow the EC to enforce gas consumption limits as the Eurozone attempts to decouple itself from its reliance on Russian gas. Risks of a complete shutdown of Russian gas are significant, and the International Monetary Fund estimates that Russia cutting off its gas supply could reduce European GDP by up to two percentage points. The impact would be greater in Central and Eastern European countries with higher gas dependence, with GDP shrinking as much as six percent for Hungary, the Czech Republic and Slovakia. (Return to Summary)



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

Market Data • Mid-Day Friday

U.S. Interest Rates

	Friday 7/22/2022	1 Week Ago	1 Year Ago
SOFR	1.53	1.53	0.05
3-Month LIBOR	2.78	2.74	0.14
3-Month T-Bill	2.39	2.29	0.04
1-Year Treasury	2.70	2.73	0.03
2-Year Treasury	2.99	3.12	0.20
5-Year Treasury	2.88	3.03	0.72
10-Year Treasury	2.80	2.92	1.28
30-Year Treasury	3.00	3.08	1.92
Bond Buyer Index	3.36	3.34	2.03

Foreign Exchange Rates

	Friday 7/22/2022	1 Week Ago	1 Year Ago
Euro ($/€)	1.022	1.008	1.177
British Pound ($/£)	1.201	1.186	1.377
British Pound (£/€)	0.851	0.850	0.855
Japanese Yen (¥/$)	136.170	138.570	110.140
Canadian Dollar (C$/$)	1.287	1.303	1.256
Swiss Franc (CHF/$)	0.962	0.977	0.919
Australian Dollar (US$/A$)	0.694	0.679	0.738
Mexican Peso (MXN/$)	20.515	20.536	20.118
Chinese Yuan (CNY/$)	6.752	6.757	6.471
Indian Rupee (INR/$)	79.854	79.880	74.468
Brazilian Real (BRL/$)	5.454	5.408	5.202
U.S. Dollar Index	106.497	108.063	92.822

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

Foreign Interest Rates

	Friday 7/22/2022	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.58	-0.59	-0.57
3-Month Sterling LIBOR	1.90	1.90	0.07
3-Month Canada Banker's Acceptance	3.43	3.32	0.44
3-Month Yen LIBOR	-0.01	-0.02	-0.08
2-Year German	0.45	0.47	-0.72
2-Year U.K.	1.85	1.92	0.07
2-Year Canadian	3.09	3.21	0.46
2-Year Japanese	-0.08	-0.06	-0.13
10-Year German	1.03	1.13	-0.43
10-Year U.K.	1.94	2.09	0.57
10-Year Canadian	2.87	3.07	1.20
10-Year Japanese	0.22	0.24	0.02

Commodity Prices

	Friday 7/22/2022	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	97.25	97.59	71.91
Brent Crude ($/Barrel)	105.22	101.16	73.79
Gold ($/Ounce)	1730.07	1708.17	1806.92
Hot-Rolled Steel ($/S.Ton)	922.00	915.00	1780.00
Copper (¢/Pound)	336.95	323.45	434.80
Soybeans ($/Bushel)	14.70	15.29	14.45
Natural Gas ($/MMBTU)	8.37	7.02	4.00
Nickel ($/Metric Ton)	21,431	19,347	18,568
CRB Spot Inds.	595.88	590.21	613.79

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