WELLS FARGO

Weekly — July 29, 2022

Weekly Economic & Financial Commentary

United States: **Busy Data Week Shows Wobbling U.S. Economy**

- Data released this week showed that U.S. economic growth modestly contracted in Q2. New home sales were yet another data release that pointed toward a cooling housing market. The FOMC continued its fight against elevated inflation with its second consecutive 75 bps increase in the federal funds rate.
- Next week: ISM Manufacturing (Mon), Trade Balance (Tue), Employment (Fri)

International: **The Global Economic Outlook Dims**

- Over the past several months, concerns about the global economic outlook have intensified, and predications of possible recessions around the world have become more widespread. As a result, we recently further downgraded our outlook and now expect global GDP growth of just 2.3% in 2022 and 1.6% in 2023.
- Next week: RBA Cash Rate (Tue), BCB Selic Rate (Wed), BoE Bank Rate (Thu)

Interest Rate Watch: **FOMC Hikes by 75 bps and Indicates More to Come**

- Not only did the FOMC raise its target range for the federal funds rate by 75 bps, which was widely expected, but it signaled that more tightening is likely. That said, the FOMC acknowledged the recent slowdown in economic activity.

Topic of the Week: **Not Yet a Recession Way Down Inside**

- Real GDP posted back-to-back declines in the first two quarters of 2022. While two consecutive quarters of negative GDP growth is one working definition of recession, it is not the official one. In a recent report, we unpacked the *right* variables to watch and introduced a new at-a-glance tool to get the next recession call right.

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	-0.9	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

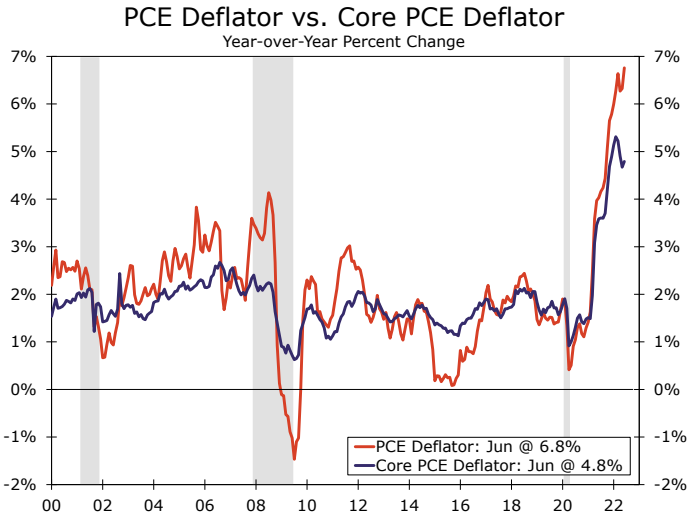
Please see our full U.S. Economic Forecast and our updated Pressure Gauge.

U.S. Review

Busy Data Week Shows Wobbling U.S. Economy

It was a busy week for U.S. economic data and events. The week started with another data point showing that output is contracting in the housing sector. New home sales for June registered a 590K annualized pace, an 8.1% decline from May and the slowest pace of new home sales since April 2020. Higher interest rates have caused many would-be home buyers to cancel contracts or delay home buying, as they can no longer afford the higher monthly mortgage payments. One side effect of slowing new home sales has been rising inventories of new homes for sale. The inventory of new homes has risen to a 9.3-month supply at the current sales pace, which is the highest it has been since May 2010. Despite the slowdown in sales, home price growth has not yet fully rolled over. S&P CoreLogic Case-Shiller home price data released on Tuesday showed that home prices in its 20-city index rose 1.32% over the month in May. For context, average monthly home price gains using this metric for 2019 were just 0.23%.

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



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

The FOMC met on Tuesday and Wednesday of this week, and the committee announced its second consecutive 75 bps rate hike. We cover the FOMC meeting in more detail in the Interest Rate Watch. The committee made clear that it is firmly committed to returning inflation to its 2% target, but the FOMC also downgraded its assessment of the current state of the economy. This gloomier outlook for economic growth was partially confirmed the following day by a disappointing GDP release. Real GDP growth in the second quarter was -0.9% quarter-over-quarter, annualized. The modest decline was the second consecutive quarterly contraction in real GDP (chart). Real personal consumption eked out a 1% annualized gain, but essentiallyflat nonresidential fixed investment growth, plunging residential investment and a drag from inventories weighed on the headline number.

As we wrote in the Topic of the Week, official recessions are determined using several economic indicators and not just GDP. Some of these other indicators, such as nonfarm payrolls, have been decisively strong in recent months. In our view, debates around the exact definition of a recession misses the forest for the trees. It appears the economy is decelerating but not collapsing at present, in line with the Federal Reserve's aim of cooling inflation. To that end, the Fed remains a long way from its goal of 2% inflation. The PCE deflator, which is the Fed's preferred measure of inflation, rose to 6.8% on a year-over-year basis in June. This marked yet another cycle high for the measure (chart). The Employment Cost Index was also released this morning and showed the cost of labor was up1.3% over the quarter in Q2. We believe wage growth and inflation more broadly will start to slow in Q3, but we think it will take time to fully revert to more sustainable levels, and as a result the road ahead for the economy looks to be a bumpy one. (Return to Summary)

U.S. Outlook

Weekly Domestic Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
1-Aug	ISM Manufacturing Index	Jul	52.1	52.0	53.0
1-Aug	Construction Spending (MoM)	Jun	0.2%	0.4%	-0.1%
3-Aug	ISM Services Index	Jul	53.9	53.2	55.3
4-Aug	Trade Balance	Jun	-$81.5B	-$79.1B	-$85.5B
5-Aug	Nonfarm Payrolls	Jul	250K	215K	372K
5-Aug	Unemployment Rate	Jul	3.6%	3.6%	3.6%
5-Aug	Average Hourly Earnings (MoM)	Jul	0.3%	0.3%	0.3%

Forecast as of July 29, 2022

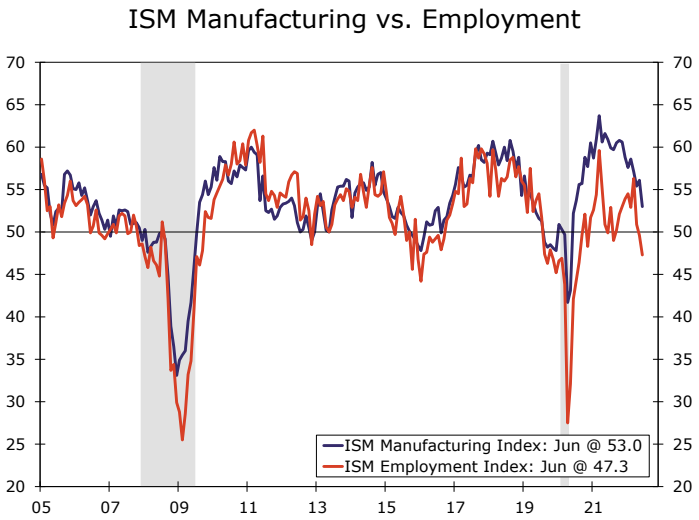
Source: Bloomberg Finance L.P. and Wells Fargo Economics

ISM Manufacturing • Monday

In June, the ISM manufacturing index only lost a bit of ground on the headline, but the underlying details were disconcerting. The overall composite edged lower to 53.0 from 56.1 the prior month. The biggest negative was that the employment component slipped further into contraction territory, falling to 47.3. New orders and prices paid were lower as well.

Elsewhere within manufacturing, the data have been indicative of deteriorating fundamentals after a strong run the past few years. Total industrial production fell 0.2% in June, and an initially reported gain of 0.2% in May was revised away to reveal a 0.0% change for the month. The wind is spilling out of the sails faster than most expected.

Monday will show the latest read from the ISM manufacturing survey. We will be particularly interested in whether employment climbs back into expansion and what happens with orders.



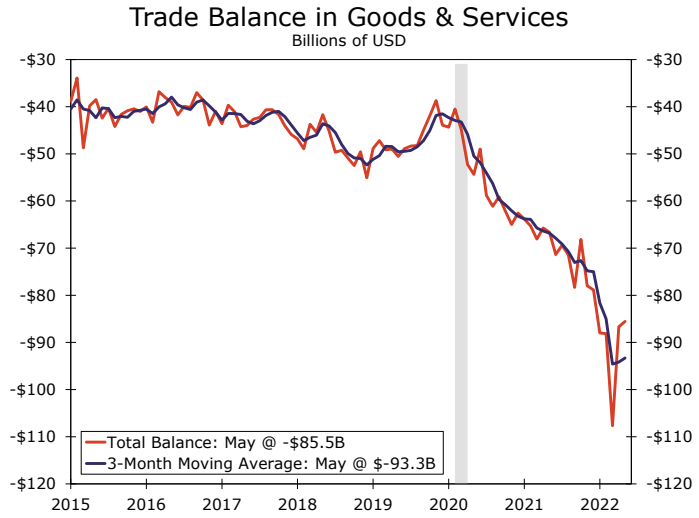
Source: Institute for Supply Management and Wells Fargo Economics

Trade Balance • Thursday

We learned in the second quarter GDP report this week that net exports boosted headline GDP growth by 1.4 percentage points, marking the first time in seven quarters trade did not weigh on growth. Next week, we will get the details for how trade fared in June.

We expect to see the trade balance narrowed for the third consecutive month to -$79.1 billion, which would mark the smallest trade deficit this year. The advanced data on merchandise goods revealed that goods exports grew 2.5% during the month, while imports slipped 0.5%. Adjusting these data for the run-up in prices last month suggests still strong export growth, up 1.7%, and a slightly larger decline from goods imports of -0.7%.

After a large widening in the trade balance throughout the pandemic as consumers stocked up on goods, the tide is finally showing signs of reversing. Weaker domestic demand should keep pressure on goods, and with exports outpacing imports, we expect the trade balance to modestly narrow. That said, the monthly trade data will likely continue to be volatile as the growth slowdown is not contained only to the United States.

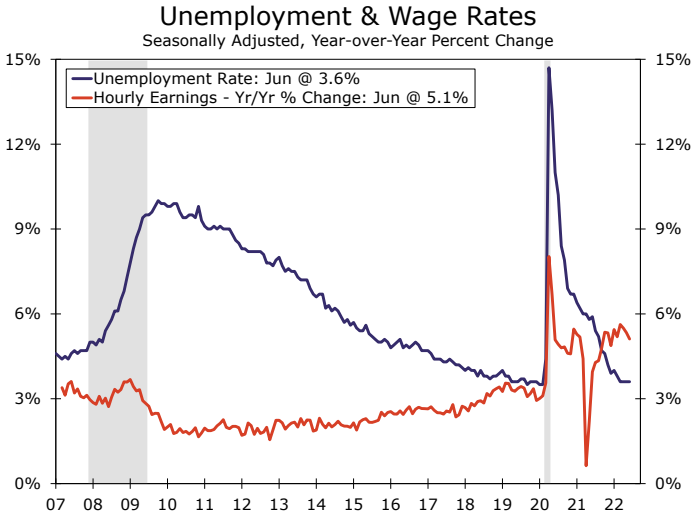


Source: U.S. Department of Commerce and Wells Fargo Economics

Employment • Friday

Insisting upon the precise definition of recession has become even trickier in light of the second consecutive drop in GDP and the unequivocal deterioration in economic activity reflected in the details of the report. Still, it is too early to call this the end of the expansion, but the hour is fast approaching. The best argument for why the economy is not yet in recession is the strength of the labor market.

Nonfarm payrolls put up another robust gain in June, increasing by 372K, and employment growth was again broad-based across industries. However, beneath the surface there are some tentative signs that the labor market is cooling. Wage growth is slowing, initial jobless claims have ticked higher throughout July and job openings appear to have peaked. With employment levels finally catching up with demand, we look for hiring to slow steadily over the second half of the year. As we look to 2023, we think an outright decline in employment will commence in late Q1/early Q2 as the economy slips into a mild recession. (Return to Summary)



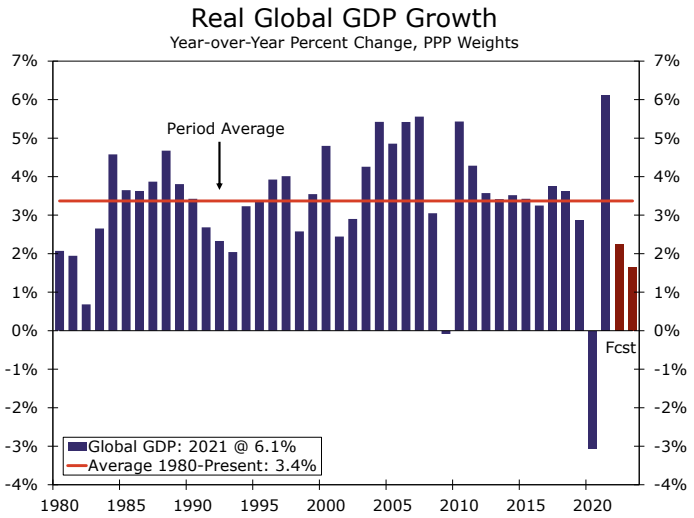
Source: U.S. Department of Labor and Wells Fargo Economics

International Review

The Global Economic Outlook Dims

Over the past several months, concerns about the global economic outlook have intensified, and predications of possible recessions around the world have become more widespread. As a result, we recently further downgraded our outlook and now expect global GDP growth of just 2.3% in 2022 and 1.6% in 2023. Despite subpar growth, elevated inflation should keep many central banks on the path of steady rate hikes through the end of 2022. That said, global CPI inflation will likely peak during the second half of this year, and expectations of global monetary tightening have potentially peaked as well. In fact, we expect some central banks to begin easing policy next year, including the Fed, Bank of Canada, Bank of England and Brazilian Central Bank. To read our most recent *International Economic Outlook*, click here.

This week, we got a slew of important inflation and growth figures from around the world. To begin, inflation data from Australia showed price pressures intensified further, with headline CPI quickening to 6.1% year-over-year in Q2 from 5.1% in Q1, driven by elevated housing and fuel prices. Goods prices continued to push inflation up higher moreso than services, reflecting strong consumer demand, supply limitations and high freight costs. Perhaps even more importantly, underlying measures of inflation also accelerated in Q2. Trimmed mean inflation rose to 4.9%, while weighted median inflation rose to 4.2%. These two measures of core inflation are significantly higher than the midpoint of the Reserve Bank of Australia's (RBA) medium-term 2%-3% inflation target band, which should keep the RBA on track for another 50 bps hike at its August meeting.



Source: International Monetary Fund and Wells Fargo Economics

In the Eurozone, CPI data released this week showed that in July, inflation accelerated to yet another all-time high, and now sits at 8.9% year-over-year. We see inflation peaking in Q3 in the Eurozone, but for now, price increases have been led by food and energy. Although overall inflation pressures in the Eurozone are not as broad-based as in other major economies (core CPI was "only" 4.0% year-over-year in July), elevated inflation is increasingly weighing on Eurozone real household disposable incomes. In addition, disruptions to energy imports from Russia have the potential to further elevate energy prices and weigh more directly on production. Both of these factors have the potential to weigh on Eurozone growth going forward.

On the growth front, however, Q2 GDP figures from the Eurozone were surprisingly strong. The economy grew 0.7% on a quarter-over-quarter basis, more than three times consensus expectations. Taking a closer look, gains from Italy, Spain and France drove the increase, with Germany's economy showing flat growth for the quarter. While Q2 GDP figures came in stronger than expected, we still forecast a mild recession for the Eurozone early next year and anticipate the economy to contract by 0.2% in 2023. While we expect a downturn, solid consumer fundamentals and household saving rates mean a Eurozone recession could potentially occur later and/or be more shallow than in the United States. Despite the downgrade to growth prospects, our outlook is for the European Central Bank (ECB) to keep tightening monetary policy in the months ahead, with another 50 bps Deposit Rate increase in September and a peak of 1.00% by the end of 2022.

Elsewhere in the G10, Canadian GDP growth was flat during the month of May, as growth in services activity was offset by a decline in goods production. Flash estimates indicate that real GDP rose by 0.1% in June, driven by output in construction, manufacturing and accommodation & food, which would imply a 1.1% quarter-over-quarter gain (not annualized) in the second quarter. We forecast annual Canadian GDP growth will average 3.5% this year, but with inflation running at almost a 40-year-high, the Bank of Canada is expected to front-load its path to higher interest rates, which will likely weigh on the economy next year. Looking ahead, we expect growth to significantly slow to just 1% in 2023 but do not expect a sustained contraction or recession. (Return to Summary)

International Outlook

Weekly International Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
2-Aug	Reserve Bank of Australia Decision	2-Aug	1.85%	1.85%	1.35%
3-Aug	Brazilian Central Bank Decision	3-Aug	13.75%	13.75%	13.25%
4-Aug	Bank of England Decision	4-Aug	1.75%	1.50%	1.25%

Forecast as of July 29, 2022

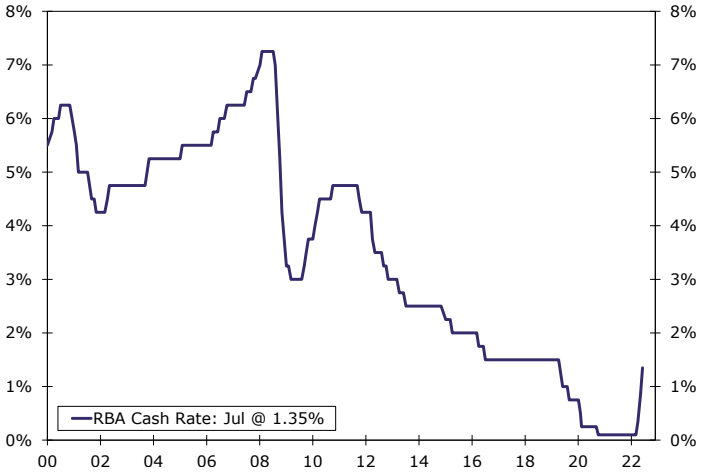
Source: Bloomberg Finance L.P. and Wells Fargo Economics

Reserve Bank of Australia Cash Rate • Tuesday

Next week will be a busy week for central banks around the world, one of them being the Reserve Bank of Australia (RBA). We expect the RBA to deliver another 50 bps rate hike to get to 1.85% at its August monetary policy meeting. In the minutes of its July meeting, the RBA highlighted that the Cash Rate is still below the lower range of estimates for the nominal neutral rate, which suggests further lifting of policy rates is necessary to return inflation to target over time. In addition, headline inflation in Australia is certainly elevated, quickening to 6.1% year-over-year in Q2, while measures of underlying inflation are well above the RBA's medium-term 2%-3% inflation target band. The RBA expects inflation to peak later in 2022 before declining toward the 2%-3% range in 2023, but for now, high inflation will likely prompt the RBA to continue with its current pace of monetary tightening in August.

We believe that the Australian economy will be resilient enough to withstand consecutive 50 bps rate hikes. In particular, the economy has seen positive labor market trends, as well as strong household and business balance sheets that can support economic growth.

Australia Policy Interest Rate



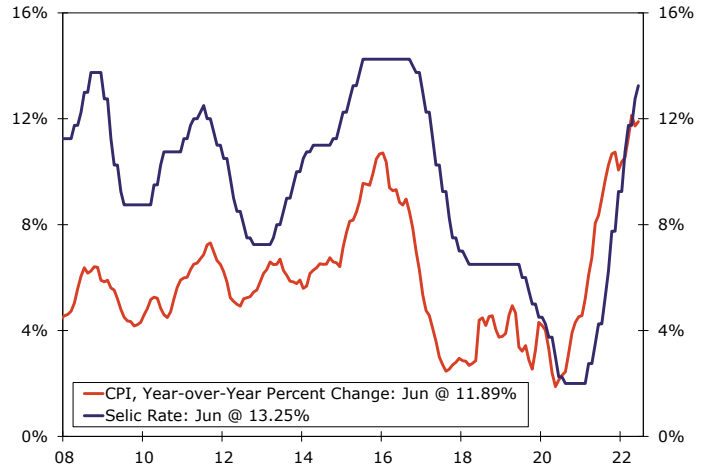
Source: Bloomberg Finance L.P. and Wells Fargo Economics

Brazilian Central Bank Selic Rate • Wednesday

Next up on the central bank roster is the Brazilian Central Bank (BCB), which will hold its August monetary policy meeting next week. The BCB has conducted one of the most aggressive monetary tightening cycles among emerging economies, and market participants will be closely watching to see if the central bank will deliver yet another sizable rate hike.

Local inflation in Brazil is elevated above 11%, and we expect the country to fall into mild recession early next year, driven by ultra-aggressive BCB tightening as well as elevated political risks. In a unanimous decision, the BCB raised rates 50 bps to 13.25% at its June meeting and signaled another rate hike to come. In August, we expect the central bank to lift the Selic Rate by 50 bps to 13.75%. We anticipate that after its August meeting, the BCB will be the first major Latin American central bank to pause rate hikes, as there are signs that inflation has peaked in the country. We then expect the BCB to change footing and begin cutting rates by 50 bps per quarter in 2023, bringing the Selic Rate down to 11.75% by the end of Q4-2023.

Brazil IPCA Inflation and Interest Rates

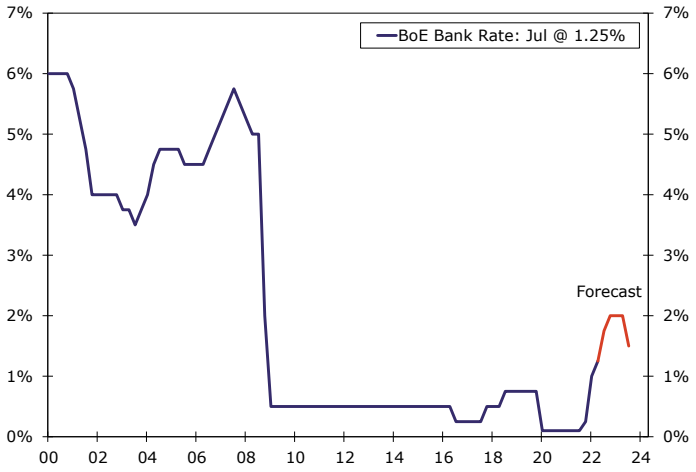


Source: Bloomberg Finance L.P. and Wells Fargo Economics

Bank of England Bank Rate • Thursday

Last but not least, the Bank of England (BoE) will hold its August monetary policy meeting next Thursday. Inflation in the U.K. is currently at a 40-year high, and there are signs that household incomes are being squeezed. While we saw some resilience in the U.K. economy at the start of 2022, warning signs are now flashing that price pressures are weighing on real incomes, consumer spending and overall growth, leading us to believe a more pronounced slowdown is approaching. We forecast that the U.K. economy will fall into recession by early next year, pushed over the edge by a U.S. recession at the start of 2023. Although we have acquired somewhat of a pessimistic outlook for the U.K. economy, we still expect the BoE to continue hiking rates to tame inflation. Specifically, we expect a steady series of 25 bps policy rate increases at upcoming meetings in August, September and November, which would lift the policy rate to 2.00% by the end of 2022. In 2023, we expect the BoE to eventually begin lowering its policy rate as inflation comes down and economic growth falters. (Return to Summary)

Bank of England Policy Rate



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

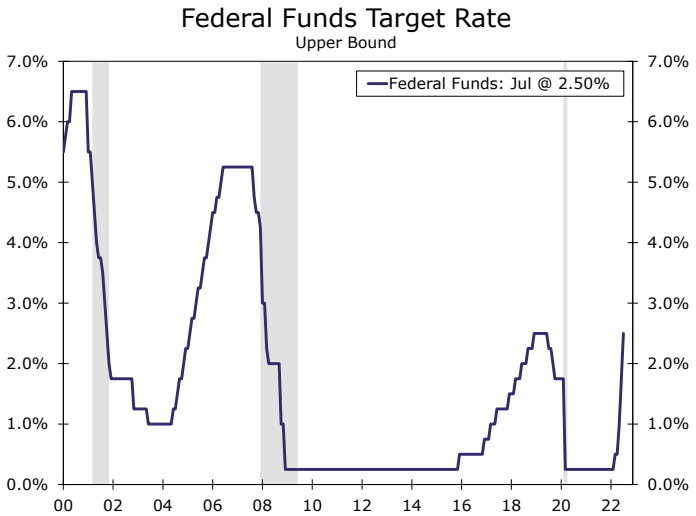
Interest Rate Watch

FOMC Hikes by 75 bps and Indicates More to Come

As widely expected, the Federal Open Market Committee (FOMC) raised its target range for the federal funds rate by 75 bps on Wednesday (chart). This move brings the range to 2.25% to 2.50%. Incredibly, the FOMC has now hiked rates by 225 bps since March, a pace of tightening that has not been experienced in more than 40 years.

In explaining its decision to tighten policy further today, the Committee again pointed to the fact that "inflation remains elevated." The statement also reiterated that "the Committee is strongly committed to returning inflation to its 2 percent objective." These references to inflation along with the unanimous vote to raise rates by another 75 bps indicates that inflation remains forefront in the minds of most FOMC members. That said, the FOMC downgraded its assessment of the current state of economic activity relative to the statement that was released following the meeting in June. The statement that was released on Wednesday noted that "recent indicators of spending and production have softened." Indeed, data released on Thursday, a day after the FOMC met, showed that the year-over-year rate of real GDP growth downshifted markedly from 3.5% in the first quarter of the year to 1.6% in Q2.

Looking forward, the Committee indicated that more tightening is likely. The statement said "ongoing increases in the target range will be appropriate," which was also used following the last meeting in June when the Committee hiked rates by 75 bps. How much tightening should we expect at the next FOMC meeting on September 21? We currently look for another 75 bps rate hike on September 21, but we readily acknowledge that the degree of tightening will depend crucially on incoming data over the intervening period. Four data releases stand out to us as vitally important. Specifically, there will be two employment reports (August 5 and September 2) and two CPI releases (August 10 and September 13) between now and the next FOMC meeting. If the labor market reports show continued strength and/or CPI inflation continues to come in hot, then the Committee may deem that another 75 bps rate hike is needed. Conversely, if the employment reports show signs of labor market weakening and/or inflation comes in lower than expected, then the FOMC likely would opt to raise rates by a smaller amount.



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

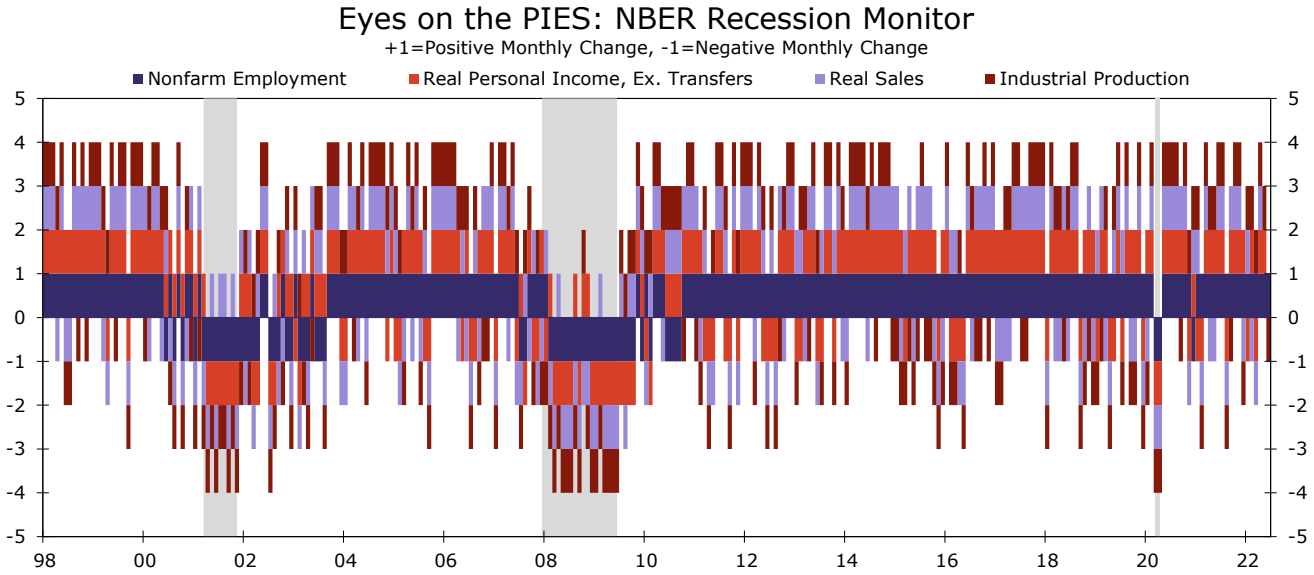
In short, the FOMC is edging into data dependency mode. That is, the Committee has wanted to raise rates as fast as possible in recent months to get the fed funds rate back to some measure of "neutral." ("Neutral" is the setting of the fed funds rate that is neither stimulating the economy nor restraining it). Although there is no precise estimate of "neutral," most FOMC members would place it somewhere in the vicinity of 2.50% based on the Summary of Economic Projections. Our inference of the onset of data dependency mode was supported by a statement by Chair Powell in his post-meeting press conference. Specifically, Powell said that the pace of further tightening "will depend on incoming data and the evolving outlook for the economy." Stay tuned. (Return to Summary)

Topic of the Week

Not Yet a Recession Way Down Inside

Real GDP posted back-to-back declines in the first two quarters of 2022. While two consecutive quarters of negative GDP growth is one working definition of recession, it is not the official one. We believe the economy is not yet in recession, though we suspect it will be within six months. Defining something as important as a recession is more than mere semantics. In a recent report, we unpacked the *right* variables to watch and introduced a new at-a-glance tool to get the next recession call right.

The definitive U.S. recession call is up to the National Bureau of Economic Research (NBER), of which the Business Cycle Dating Committee determines the dates for each economic cycle. The committee considers a recession to involve "a significant decline in economic activity that is spread across the economy and lasts more than a few months." The committee relies on six variables that fall into four primary categories: production, income, employment and spending...or what we refer to as PIES.



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

As shown above, we find the monthly change of *all* four indicators is negative when the economy is in recession. Over the past 28 years, all four variables have been negative only once outside recession (July 2002). Put differently, the economy has never been in recession when at least three indicators rose during the month, and only very rarely has there been two indicators positive during a recessionary period. Through May, these key NBER variables are not yet consistent with recession. While we do not yet have real sales for May, nonfarm employment, real personal income less transfers and industrial production all rose. How should we think about these indicators in coming months?

Production: Industrial production appears to be losing steam, and revisions bit hard into past data on manufacturing. Leading indicators of production have also rolled over. In June, the ISM manufacturing new orders component slipped into contraction territory and small business cap-ex plans dipped lower.

Income: Income is struggling to keep up with inflation. In June, average hourly earnings advanced at a 4.2% annualized pace over the previous three months, which is slower than the 5.1% 12-month pace and is consistent with other broad measures of a slowdown in earnings growth.

Employment: The job market is showing signs of vulnerability. Average weekly hours for factory workers were cut in June and initial jobless claims rose. While still at a historically low level, claims have been trending higher since March, a rise which continued thus far in July.

Spending: People are paying more but getting less. After a surge in goods spending, a moderation is underway. Demand was largely pulled forward throughout the pandemic and higher prices are more meaningfully eroding consumers' broad purchasing power today. (Return to Summary)

Market Data • Mid-Day Friday

U.S. Interest Rates

	Friday 7/29/2022	1 Week Ago	1 Year Ago
SOFR	2.28	1.53	0.05
3-Month LIBOR	2.78	2.78	0.13
3-Month T-Bill	2.36	2.38	0.04
1-Year Treasury	2.68	2.70	0.02
2-Year Treasury	2.90	2.97	0.20
5-Year Treasury	2.70	2.84	0.74
10-Year Treasury	2.65	2.75	1.27
30-Year Treasury	2.99	2.97	1.92
Bond Buyer Index	3.27	3.36	2.04

Foreign Exchange Rates

	Friday 7/29/2022	1 Week Ago	1 Year Ago
Euro ($/€)	1.020	1.021	1.189
British Pound ($/£)	1.217	1.200	1.396
British Pound (£/€)	0.838	0.851	0.852
Japanese Yen (¥/$)	133.590	136.120	109.480
Canadian Dollar (C$/$)	1.282	1.292	1.245
Swiss Franc (CHF/$)	0.952	0.963	0.906
Australian Dollar (US$/A$)	0.698	0.693	0.740
Mexican Peso (MXN/$)	20.361	20.529	19.855
Chinese Yuan (CNY/$)	6.747	6.752	6.456
Indian Rupee (INR/$)	79.269	79.854	74.284
Brazilian Real (BRL/$)	5.198	5.498	5.081
U.S. Dollar Index	106.187	106.730	91.864

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

Foreign Interest Rates

	Friday 7/29/2022	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.58	-0.59	-0.57
3-Month Sterling LIBOR	1.95	1.90	0.07
3-Month Canada Banker's Acceptance	3.49	3.43	0.44
3-Month Yen LIBOR	-0.01	-0.01	-0.10
2-Year German	0.29	0.45	-0.76
2-Year U.K.	1.76	1.85	0.08
2-Year Canadian	2.93	3.06	0.46
2-Year Japanese	-0.08	-0.08	-0.13
10-Year German	0.84	1.03	-0.45
10-Year U.K.	1.91	1.94	0.57
10-Year Canadian	2.57	2.84	1.21
10-Year Japanese	0.19	0.22	0.02

Commodity Prices

	Friday 7/29/2022	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	101.64	94.70	73.62
Brent Crude ($/Barrel)	110.55	103.20	76.05
Gold ($/Ounce)	1764.62	1727.64	1828.17
Hot-Rolled Steel ($/S.Ton)	855.00	923.00	1888.00
Copper (¢/Pound)	355.00	334.85	452.35
Soybeans ($/Bushel)	16.17	14.80	14.60
Natural Gas ($/MMBTU)	8.09	8.30	4.06
Nickel ($/Metric Ton)	21,883	21,431	19,533
CRB Spot Inds.	601.87	595.88	620.30

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Economics Group

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