WELLS FARGO

Weekly — February 17, 2023

Weekly Economic & Financial Commentary

United States: **Do Not Go Quietly Into That Good Night**

- Resilience was on full display in this week's economic indicators and market-based rate expectations moved closer in line to the forecast we have maintained for months: that the Federal Reserve will guide its main borrowing rate higher still to 5.25% and hold it there through year-end.
- Next week: Existing Home Sales (Tue), Personal Income & Spending (Fri), New Home Sales (Fri)

International: **Inflation Is Hot and Growth Is Not. What's New?**

- In good news, inflation in the U.K. receded for the third straight month in January, with the headline rate coming in at 10.1% year-over-year. In bad news, this is still five times the Bank of England's 2% target. Elsewhere, Japan's economy rebounded 0.2% quarter-over-quarter in Q4 after a negative print in Q3, and we expect these mixed growth trends to continue this year. Down under in Australia, the job market failed to regain its footing last month, with employment declining for the second month in a row. Notably in contrast to the December jobs report, this drop in employment was completely due to a decline in full-time employment.
- Next week: Eurozone PMIs (Tue), U.K. PMIs (Tue), Canada CPI (Tue)

Interest Rate Watch: **Rates Market Reset**

- Treasury yields have climbed higher in recent weeks amid a string of especially hot economic data. The yield on a 10-year Treasury note is nearly back to where it started the year, and the two-year note yield is above its 2023 starting point.

Topic of the Week: **The Bottom Line: Margin's Getting Squeezed**

- S&P 500 profit data show that even as sales continued to grow in the fourth quarter, margins compressed. We won't get economy-wide margins until the end of March, but we look for a similar squeeze. Declining profitability can motivate firms to keep prices high or force cost-cutting to protect the bottom line; neither is good for the economy.

Wells Fargo U.S. Economic Forecast

	Actual 2022				Forecast 2023				Actual		Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2021	2022	2023	2024
Real Gross Domestic Product [1]	-1.6	-0.6	3.2	3.0 [4]	-0.6	0.8	-1.9	-1.6	5.9	2.1	0.6	0.5
Personal Consumption	1.3	2.0	2.3	2.1 [4]	0.1	0.8	-1.0	-1.7	8.3	2.8	0.7	0.3
Consumer Price Index [2]	8.0	8.6	8.3	7.1	5.5	3.5	2.4	2.2	4.7	8.0	3.4	2.3
"Core" Consumer Price Index [2]	6.3	6.0	6.3	6.0	5.3	4.3	3.3	2.9	3.6	6.1	3.9	2.7
Quarter-End Interest Rates [3]												
Federal Funds Target Rate	0.50	1.75	3.25	4.50	5.00	5.25	5.25	5.25	0.25	2.02	5.19	3.25
Conventional Mortgage Rate	4.27	5.58	6.01	6.36	6.30	6.10	5.65	5.40	3.03	5.38	5.86	5.00
10 Year Note	2.32	2.98	3.83	3.88	3.70	3.60	3.25	3.10	1.45	2.95	3.41	2.94

Forecast as of: February 08, 2023
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Annual Numbers Represent Average
[4] Forecast for the Second Estimate of Q4 GDP

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

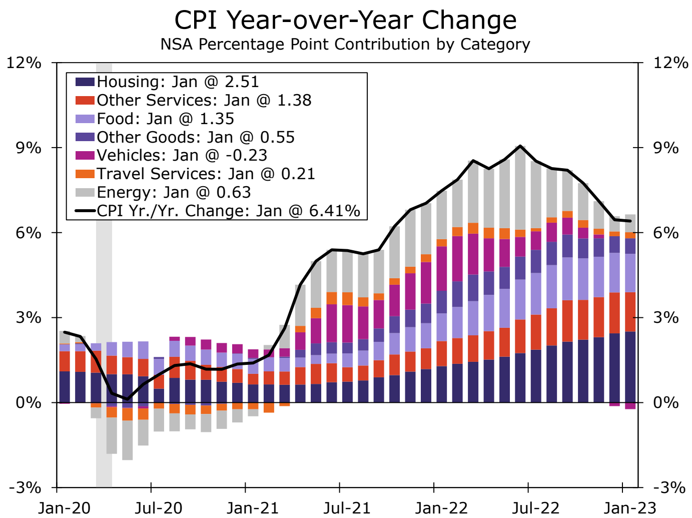
Please see our full U.S. Economic Forecast.

U.S. Review

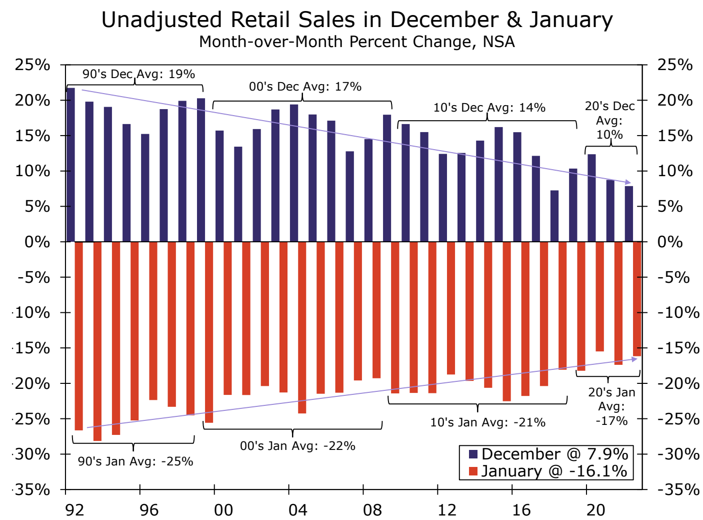
Rage, Rage Against the Dying of the Light

Until the release of the January jobs report two weeks ago, many measures of economic activity revealed gradual slowing mixed with outright contraction even as inflation, while still high, trended lower. Debate may have lingered about whether the economy was on a glide path to recession or a soft-landing, but financial markets generally observed that the past year's rate hikes were having the intended effect on prices which guided market expectations for eventual rate cuts later this year.

The economic data this week bucked those trends and pushed market-based rate expectations closer in line to the view we have maintained for months: that the Federal Reserve would hike its main borrowing rate higher still and hold it there through year-end. The poet Dylan Thomas urged that we ought to rage against the dying of the light and not go gentle into that good night. This week's indicators certainly raged against any notion of dying lights for the economy. Retail sales and manufacturing production both surprised to the upside in January, and inflation posted its biggest monthly increase since October. Residential construction did slow for a fifth straight month, but even in this sector hit hard by rising rates, there was a modest uptick in permits pulled for future construction.



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



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

We Will Not Go Quietly Into the Night

Inflation, in particular, is not going away quietly. Consumer prices increased 0.5% in January, the biggest monthly move since October. Over the past three months, the core CPI rose at a 4.6% annualized pace. In the first release of last month's CPI, the run-rate for the three-month period ended in December was 3.1%; that got revised higher to 4.3% in this week's report. An upshot of a resilient labor market is that it may keep inflation stubbornly above the Fed's 2% target for price growth.

We still see inflation set to grind lower, but the process is likely to be bumpy and take time. Despite some directional improvement over the past couple of quarters, prices are still growing well-above the Fed's 2% target, and the tight labor market suggests that there are still inflationary pressures that could forestall a full return to 2% inflation.

Retail sales bounced back at the start of the year, rising 3% in January after declining in three of the prior four months. The data point to consumer resilience and upside risk to Q1-2023 spending. Factoring in recent volatility as well as the scope for seasonal factors boosting the headline, the 3.0% surge likely overstates the health of the consumer. Still, the stronger labor market means paychecks rather than rainy-day savings can fuel spending. That is the most consequential development in recent weeks and one that will define our expectations for the consumer and could allay some of our fears about a contraction in spending later this year.

Industrial production was flat in January after having declined in six of the prior eight months. The details were favorable for manufacturing activity which rose for the first time in three months, but a record drop in utilities output held back overall production. Other data still indicate manufacturing is losing steam. New demand is drying up as conditions become less favorable for new capex investment.

Total housing starts dropped 4.5% to a 1.3 million-unit annual pace in January, marking the fifth straight monthly decline, the longest losing streak since 2009. An uptick in building permits and a recent bounce in builder confidence point to some resilience in the hard-hit residential construction market.

Forty-three years after Dylan Thomas's death, one of the more memorable scenes in the 1996 blockbuster film *Independence Day* drew inspiration from his work when the president rallied the troops saying "we will not go quietly into the night, we will not vanish without a fight." Like all things, the days of this economic cycle are numbered, but this week's data suggest that expansion will live on for at least a little while longer.

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U.S. Outlook

Weekly Domestic Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
21-Feb	Existing Home Sales (SAAR)	Jan	4.11M	4.04M	4.02M
24-Feb	Personal Income (MoM)	Jan	0.9%	0.8%	0.2%
24-Feb	Personal Spending (MoM)	Jan	1.3%	2.0%	-0.2%
24-Feb	PCE Deflator (MoM)	Jan	0.5%	0.5%	0.1%
24-Feb	Core PCE Deflator (MoM)	Jan	0.4%	0.5%	0.3%
24-Feb	New Home Sales (SAAR)	Jan	620K	613K	616K

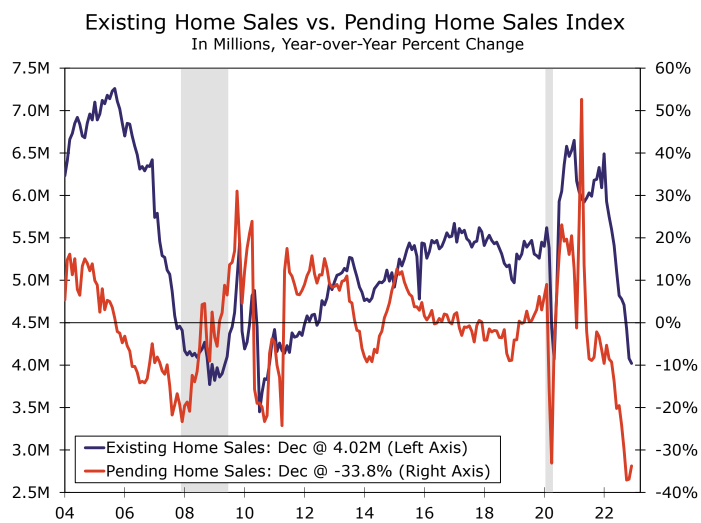
Forecast as of February 17, 2023

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

Existing/New Home Sales • Tuesday/Friday

The run-up in mortgage rates in 2022 eroded affordability and significantly depressed demand for housing. Nearly every housing market indicator weakened over the year as a result. To close out 2022, new home sales registered a 26.6% year-over-year decline and existing home sales similarly posted a 34% annual drop. The downward trajectory of mortgage rates in the last few months of the year has sparked hope for a turnaround. New home sales registered three consecutive monthly increases in October, November and December. Existing home sales also declined at a less-than-expected rate in December, falling only 1.5% compared to November's 7.9% drop. Pending home sales, reflecting signed real estate contracts, also rose 2.5% in December, the first monthly improvements since May.

Mortgage rates continued to slide through the beginning of the year, averaging 6.36% in December and 6.18% in January. This decline in financing costs appeared to bring some buyers back from the sidelines, triggering a 24.7% jump in mortgage applications for purchase the second week of January. Although mortgage rates began inching up again in February, next week's data releases will be reflective of sales activity before mortgage rates reversed their decline. We expect the recent positive reading in pending home sales to carry over into January and look for existing home sales to rise by 0.5%. Conversely, we forecast that new home sales dipped by a modest 0.5%.



Source: National Association of Realtors and Wells Fargo Economics

Personal Income and Spending • Friday

Despite the Fed's historically rapid tightening cycle, a tight jobs market combined with inflation that is now easing is providing a tailwind for consumers. This combination supported real income gains during the last six months of 2022, providing a more sustainable source of purchasing power beyond pandemic savings to sustain spending. Continuing that trend, the blowout net employment gain in January and spike in hours worked—afforded by relatively fewer seasonal separations and unseasonably warm weather—likely provided a solid boost to personal income over the month. Cost-of-living adjustments to social security also take place in January and have put more money in the pockets of consumers. All together, we look for nominal personal income growth to shift up 0.8% in January.

Retail sales also posted a surprisingly strong 3.0% gain in January after declining in each of the prior two months. This renewed strength suggests that weakness at the end of 2022 was not an indication of sustained spending pullbacks, but rather a product of discounts pulling forward holiday sales and gift card spending being redeemed after the holidays. Control group sales, which directly factor into BEA's calculation of personal consumption expenditures, also increased at a solid 1.7% nominal pace. We expect this strength to materialize in January's personal spending print and look for personal spending to rise by 2.0%. Looking forward to next month, the seasonal factors that flattered January's spending numbers may lead to some giveback in February.

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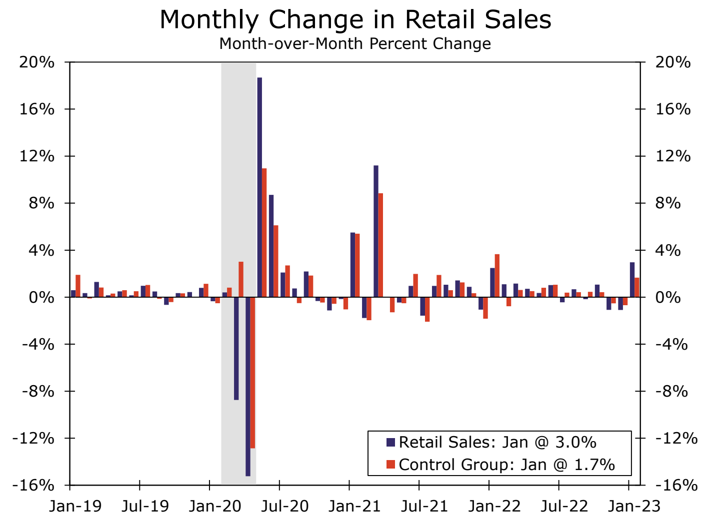

Source: U.S. Department of Commerce and Wells Fargo Economics

International Review

Inflation Is Hot and Growth Is Not. What's New?

Inflation in the U.K. receded for the third straight month in January, with the headline rate coming in lower than expected at 10.1% year-over-year. The biggest upward contributions to the headline rate came from household energy and food prices. Excluding those more volatile factors, core CPI fell to 5.8% year-over-year. Given that headline inflation is still five times the Bank of England's (BoE) 2% target, the central bankraised its policy rate 50 bps to 4.00% at its February meeting and signaled further monetary tightening ahead. Against this backdrop, we forecast a final 25 bps rate increase at the BoE's March meeting. Inflation slowing more sharply than expectations also reinforces the view that an end to BoE rate hikes is in sight, especially against a backdrop of underwhelming U.K. economic activity. We expect the policy rate to remain at 4.25% through late 2023, before the BoE begins cutting rates in Q4 of this year.

Elsewhere, Japan's economy experienced a somewhat uneven growth path in 2022, bouncing back and forth between expansion and contraction. While it ended on a positive note, Japan's Q4 GDP data release showed that the economy grew less than expected. More specifically, GDP rebounded 0.2% quarter-over-quarter in Q4 after a negative print in Q3. The underlying details of the report reflected mixed sector trends, with private consumption rising 0.5% quarter-over-quarter but business spending falling 0.5%. We expect these mixed economic trends to flow through to this year, altogether expecting growth in Japan to average a moderate 1.3% in 2023, essentially unchanged from last year. At the same time, inflation appears to be trending higher. In December, nationwide headline CPI reached 4% year-over-year, and while more contained compared to its global peers, this is quite elevated compared to Japan’s recent history. Only moderate growth combined with rising inflation pressures adds to the Bank of Japan's (BoJ) dilemma of if and when it should begin to tighten monetary policy, especially with a new BoJ governor on the way. While our base case is for no change in policy settings this year, we will be closely watching for any signals that the BoJ is ready to move away from easy monetary policy.

Down under in Australia, labor trends continued to soften in January. The job market failed to regain its footing last month, with employment declining for the second month in a row. Although consensus expectations were for a 20,000-job gain, employment actually fell by 11,500. Notably in contrast to the December jobs report, this drop in employment was completely due to a decline in full-time employment (-43,300), while part-time employment increased (+31,800). Other parts of Australia's economy also experienced some softness late last year, but we believe this soft patch is temporary and do not forecast Australia to fall into recession this year, nor do we expect slower growth to prevent the Reserve Bank of Australia (RBA) from continuing to tighten monetary policy in order to bring down inflation.

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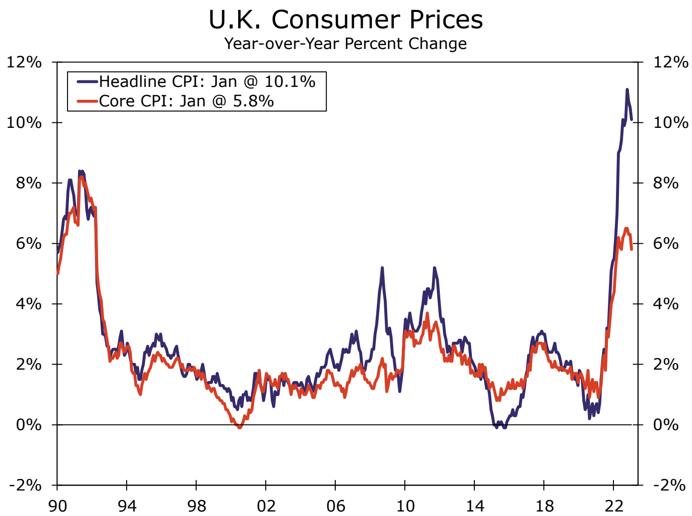
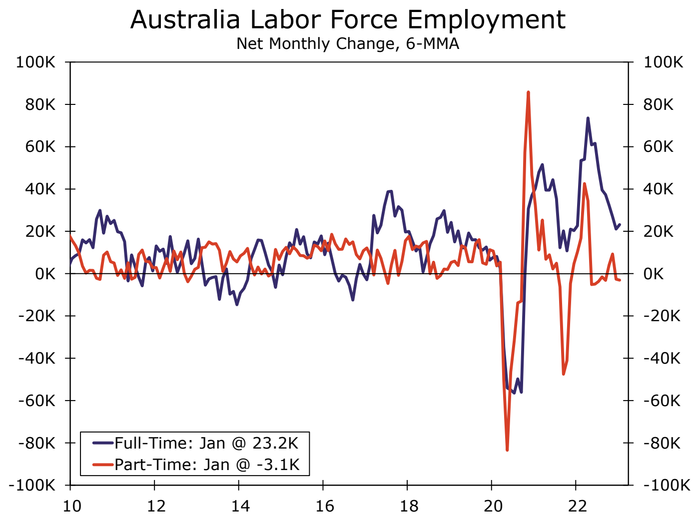


Source: Bloomberg Finance L.P. and Wells Fargo Economics



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

International Outlook

Date	Indicator	Period	Consensus	Wells Fargo	Prior
21-Feb	Eurozone Manufacturing PMI	Feb	49.3	--	48.8
21-Feb	Eurozone Services PMI	Feb	51.0	--	50.8
21-Feb	United Kingdom Manufacturing PMI	Feb	47.5	--	47.0
21-Feb	United Kingdom Services PMI	Feb	49.2	--	48.7
21-Feb	Canada CPI NSA (MoM)	Jan	--	0.6%	-0.6%
21-Feb	Canada CPI NSA (YoY)	Jan	--	6.0%	6.3%

Weekly International Indicator Forecasts

Forecast as of February 17, 2023

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

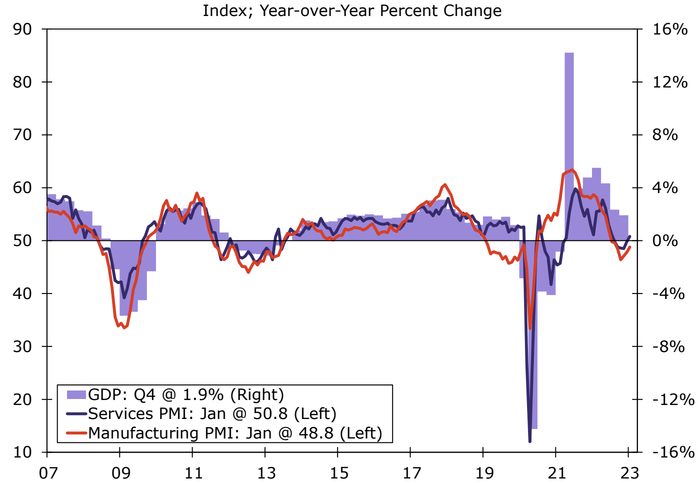
Eurozone PMIs • Tuesday

Given recent developments, Eurozone growth trends this year may be better than originally expected. In encouraging news, global natural gas and oil prices have come down, and overall lower energy prices have likely contributed to firmer business sentiment. The Eurozone economy managed to avoid contraction in the last quarter of 2022, and although we still forecast a recession this year, we expect it to be short and shallow. For 2023 as a whole, we expect Eurozone GDP to edge up 0.1%.

Recent PMI survey data have been in line with this somewhat more optimistic outlook for the Eurozone. The manufacturing PMI has seen gains for the past four months and has provided some signals that the worst of the manufacturing sector's downturn is over. Meanwhile, the services PMI moved back into expansionary territory for the first time since July 2022 on the back of smaller backlogs and a stabilization in new business volumes.

The Bloomberg consensus expects this gradual improvement in sentiment to continue, with the February manufacturing PMI expected to rise to 49.3 and the services PMI expected to remain in expansionary territory at 51.0.

Eurozone PMI Indices vs. GDP Growth



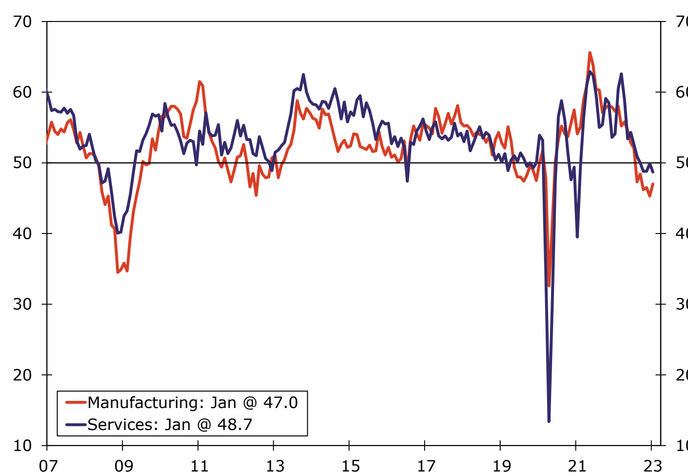
Source: Datastream, Bloomberg Finance L.P. and Wells Fargo Economics

U.K. PMIs • Tuesday

We also expect growth in the U.K. to be more sturdy than previously forecast. Falling energy prices and slowing inflation should prove to be less of a drag on real household incomes than originally anticipated, and other areas of the economy have shown some resilience in recent months as well. This week, updated data showed that the labor market remained sturdy in January, with a larger-than-expected gain in payrolls and a surprise fall in jobless claims. However, even with an upgraded growth outlook for the U.K., we still expect the economy to fall into recession and contract by 0.6% in 2023.

Recent trends in the U.K. PMI surveys have been mixed. The manufacturing and services readings have remained in contractionary territory for the past several months. While expectations are for another below-50 reading for February, there may be some light at the end of the tunnel due to softer input cost pressures. The February U.K. manufacturing PMI is expected to tick up to 47.5, while the services PMI is expected to improve to 49.2. Gradual improvement in the PMI readings would be in line with our somewhat less negative view of the U.K. economy as well.

United Kingdom PMIs



Source: Datastream and Wells Fargo Economics

Canada CPI • Tuesday

Canada CPI figures released next week are likely to show that inflation continued to come down in January. Recent inflationary trends in Canada have been encouraging, with the overall CPI inflation rate receding from its peak of 8.1% year-over-year to 6.3% in December. December was also when gasoline prices saw their largest monthly decline since April 2020, putting them up only 3% compared to a year ago. As the pressure from high energy prices continues to dissipate, we expect headline inflation to have eased further to 6.0% in January.

Against a backdrop of improving inflation dynamics, the Bank of Canada (BoC) formally announced an end to its monetary tightening cycle with a final 25 bps hike to 4.50%. After a cumulative 425 bps of rate hikes, BoC policymakers said they prefer to see the effects of cumulative tightening on the economy before adjusting policy rates further. In our view, the Bank of Canada will remain on hold for the next few quarters before being among the first to start cutting policy rates. Our forecast sees the BoC beginning its easing cycle in Q4 of this year as recessionary conditions start to crystallize.

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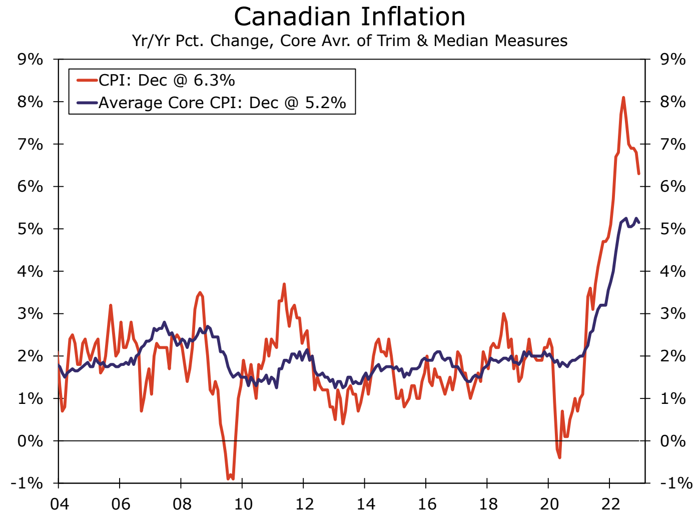


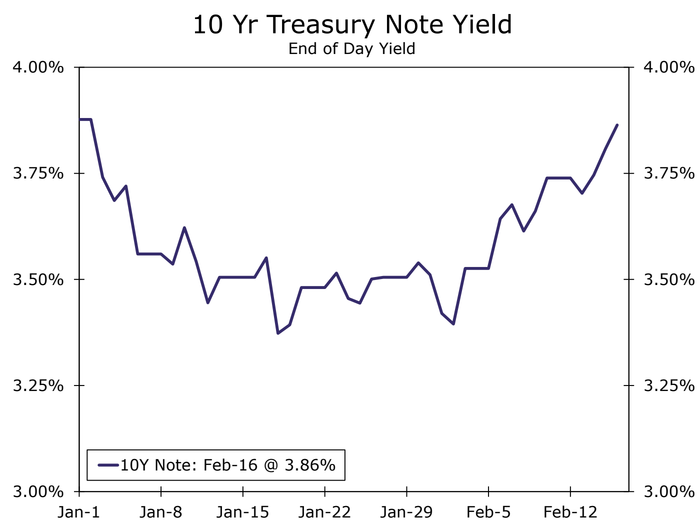
Source: Bloomberg Finance L.P. and Wells Fargo Economics

Interest Rate Watch

Rates Market Reset

Headed into the February 3 employment report, Treasury yields had been steadily drifting lower since the start of the year. The yield on a 10-year Treasury note, which started the year at 3.88%, had fallen to 3.40% by February 2. Similarly, the yield on a two-year Treasury note fell from 4.43% to 4.11% over the same period. In the past two weeks, however, yields have moved sharply higher. At 3.85%, the 10-year yield is nearly back to where it started the year, and the yield on the two-year note is about 21 bps above where it began 2023.

This reversal in interest rates has occurred amid a string of especially hot economic data. Nonfarm payrolls blew past expectations in the February 3 jobs report, growing by 517K. The ISM services index for January was also much stronger than expected. On the inflation front, upward revisions to the historical CPI signaled that inflation had more momentum coming into 2023 than was the case previously. This week's robust increase in producer prices and a blowout retail sales report for January added to the recent evidence showing that inflation remains intolerably high and economic growth remains resilient.



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

Against this backdrop, market participants have revised higher their expectations for the federal funds rate. Market pricing for the expected peak in the fed funds rate has gone from roughly 4.84% on February 2 to 5.29% as of this writing. Markets not only expect a higher peak in the near term but also fewer rate cuts later this year and into 2024. On February 2, markets were priced for a fed funds rate of roughly 4.40% at year-end, but as of today, that figure has surged higher to 5.01%. Our own forecast looks for the federal funds target range to peak at 5.00%-5.25% in May and remain there through the end of the year.

There is still a significant amount of new economic data to be released between now and the next FOMC meeting, including another employment report and CPI report. It will take softer economic data for the FOMC to feel assured that inflation is firmly moving toward the central bank's 2% target, and until then, rates markets will be sensitive to upside surprises in the data like the ones that have occurred in recent weeks.

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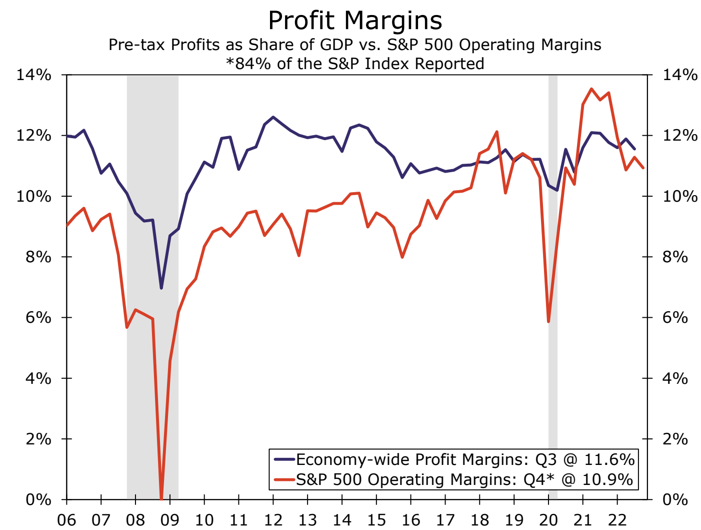
Topic of the Week

The Bottom Line: Margins Getting Squeezed

Firms saw a surge in profitability during the pandemic-induced demand surge over the past two years, but that looks to be changing. Profit data reported by companies included in the S&P 500 index show that even as sales continued to grow in the fourth quarter, margins compressed. The operating margins of the S&P 500 index are tracking to be around 10.9% in Q4. That's only about 35 bps lower than in the third quarter, but a remarkable 261 bps off peak margins in 2021.

We won't get economy-wide profit margins data until the third estimate of GDP to be released on March 30. But as seen in the nearby chart, the S&P operating margins provide a decent proxy for how broader profitability has behaved. We too expect to see margin-compression in the economy-wide data for the fourth quarter. Specifically, our latest forecast for a 3% annual gain in fourth quarter pre-tax profits is consistent with economy-wide margins falling to around 11.3% in Q4.

Declining profitability bodes poorly for economic growth. It can motivate firms to keep prices high or force cost-cutting, and labor is notoriously an item on the chopping block. For now, the labor market remains remarkably tight and layoffs are concentrated in specific industries. We expect the struggle to find qualified talent is reason to make businesses think twice before letting workers go. But even as demand has remained robust to start the year and inflation is showing signs of cooling, firms still face high operating costs between key commodities and labor. Furthermore, for industries that have overstocked product, discounting in order to right-size can be costly and is likely denting profitability. How these factors unfold over the next 12 months is key to the labor discussion, making profits a must-watch indicator to gauge firms' ability to retain workers this year.



Source: U.S. Department of Commerce, S&P Global and Wells Fargo Economics

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Market Data • Mid-Day Friday

U.S. Interest Rates

	Friday 2/17/2023	1 Week Ago	1 Year Ago
SOFR	4.55	4.55	0.05
3-Month LIBOR	4.90	4.87	0.49
3-Month T-Bill	4.79	4.73	0.34
1-Year Treasury	4.92	4.82	1.08
2-Year Treasury	4.64	4.52	1.47
5-Year Treasury	4.06	3.92	1.84
10-Year Treasury	3.85	3.73	1.96
30-Year Treasury	3.92	3.82	2.29
Bond Buyer Index	3.65	3.51	2.41

Foreign Exchange Rates

	Friday 2/17/2023	1 Week Ago	1 Year Ago
Euro ($/€)	1.066	1.068	1.136
British Pound ($/£)	1.200	1.206	1.362
British Pound (£/€)	0.888	0.885	0.834
Japanese Yen (¥/$)	134.360	131.360	114.940
Canadian Dollar (C$/$)	1.350	1.334	1.271
Swiss Franc (CHF/$)	0.928	0.924	0.920
Australian Dollar (US$/A$)	0.686	0.692	0.719
Mexican Peso (MXN/$)	18.454	18.670	20.300
Chinese Yuan (CNY/$)	6.870	6.815	6.338
Indian Rupee (INR/$)	82.831	82.504	75.110
Brazilian Real (BRL/$)	5.189	5.214	5.170
U.S. Dollar Index	104.143	103.630	95.800

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

Foreign Interest Rates

	Friday 2/17/2023	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.58	-0.59	-0.57
3-Month Sterling LIBOR	4.19	4.17	0.87
3-Month Canada Banker's Acceptance	4.99	4.99	0.87
3-Month Yen LIBOR	-0.03	-0.03	-0.08
2-Year German	2.89	2.76	-0.43
2-Year U.K.	3.82	3.63	1.34
2-Year Canadian	4.15	4.09	1.51
2-Year Japanese	-0.03	-0.04	-0.01
10-Year German	2.46	2.36	0.23
10-Year U.K.	3.53	3.40	1.46
10-Year Canadian	3.30	3.15	1.92
10-Year Japanese	0.51	0.50	0.23

Commodity Prices

	Friday 2/17/2023	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	76.41	79.72	91.76
Brent Crude ($/Barrel)	83.17	86.39	92.97
Gold ($/Ounce)	1836.22	1865.57	1898.43
Hot-Rolled Steel ($/S.Ton)	900.00	860.00	960.00
Copper (¢/Pound)	410.70	401.65	452.30
Soybeans ($/Bushel)	15.29	15.45	15.73
Natural Gas ($/MMBTU)	2.27	2.51	4.49
Nickel ($/Metric Ton)	26,268	28,952	23,720
CRB Spot Inds.	566.76	574.16	646.59

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Required Disclosures