Economics and Finance in a Two-Percent Economy
Appalachian State University

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March 31, 2017
Where Are We Now?

Five benchmarks for good decision making

- Inflation
- Interest Rates
- Growth
- Profits
- The Dollar
Expectations for the Future

- Sustained trend growth, no recession in the forecast
- Employment—cyclical and structural change
- Consumer solid—key support to growth
- Below consensus on housing starts and auto sales
- Trade will be a drag on economic growth in the U.S.
- Unsustainable long-run fiscal policy
- Europe growth remains steady post-Brexit
- China growth slower for 2017, 2018
Sustained Growth—The Anchoring Bias

Trend growth at 2-2.5 percent in the year ahead. A more balanced composition of domestic growth should prevail, but trade will be a drag going forward.

Source: U.S. Department of Commerce and Wells Fargo Securities
Supply-Side Challenges
Potential Growth—Little Help From Productivity

Productivity growth has downshifted over the past cycle.

Nonfarm Labor Productivity
Average Annual Percent Change in Output Per Hour Worked

Source: U.S. Department of Labor and Wells Fargo Securities
Potential Growth—Little Help from Labor

Labor supply growth is slowing, particularly for prime-age workers. Labor force participation has improved but remains historically low.

Source: U.S. Department of Labor and Wells Fargo Securities
Low labor force participation and lackluster productivity growth have lowered the path of potential GDP.
Production and Employment: Divergent Long-Run Trends

Manufacturing output has more than doubled since the late 1970s, but employment has declined on a secular basis.

Source: U.S. Department of Labor, Federal Reserve Board and Wells Fargo Securities
Workers’ Earnings

Average hourly earnings growth has picked up modestly but remains limited by lower-skilled workers entering the workforce and Baby Boomers beginning to retire—the Atlanta Fed measure tracks individuals over time, eliminating compositional effects on wage growth.

Source: U.S. Department of Labor, Federal Reserve Bank of Atlanta and Wells Fargo Securities
Personal Income Gains: Disparity

Income growth has finally begun to turn around but still lags prior recoveries.

Source: U.S. Department of Labor and Wells Fargo Securities
Divergence in Commercial Real Estate
Property Prices: CBD, Suburbs Differ

High valuations have caught the Fed’s attention

Source: RCA and Wells Fargo Securities
Property Prices: Major/Non-Major Market Splits

Valuations have grown the fastest in major markets

Source: RCA and Wells Fargo Securities
Unsustainable Fiscal Policy
The composition of federal spending has shifted dramatically. The CBO projects that the debt-to-GDP ratio will surpass 88 percent by 2027.

**Composition of Federal Spending**

- **1970**
  - Total Spending: 19% of GDP
  - Discretionary: 62%
  - Mandatory: 31%
  - Net Interest: 8%

- **2015**
  - Total Spending: 21% of GDP
  - Discretionary: 32%
  - Mandatory: 62%
  - Net Interest: 6%

- **2050**
  - Total Spending: 28% of GDP
  - Discretionary: 19%
  - Mandatory: 60%
  - Net Interest: 21%

**Federal Debt Continues to Rise**

- **Baseline Debt: 2027 @ 88.9%**

Source: Congressional Budget Office and Wells Fargo Securities
Corporate income tax receipts accounted for less than 10 percent of federal revenues in FY 2016. The top income quintile pays an outsized share of federal taxes.

**Composition of Federal Revenues**

- **Individual Income Taxes**: 47.4%
- **Payroll Taxes**: 34.0%
- **Corporate Income Taxes**: 9.2%
- **Other**: 9.4%

**Federal Taxes Paid by Income Quintile**

- **Share of Federal Taxes By Before-Tax Income Group**

Source: Congressional Budget Office and Wells Fargo Securities
Federal Debt and Interest Payments: A Ticking Time Bomb?

Despite a historically high debt-to-GDP ratio, net interest costs remain low—challenges going forward in the face of rising rates.

Source: U.S. Department of the Treasury and Wells Fargo Securities
Key Issues to Watch in the 115th Congress

- Will Congressional leaders put the Affordable Care Act on the back burner and turn to other legislative priorities, or will ACA continue to consume precious time and delay other items on the agenda?

- Some form of corporate/individual income tax cuts/reforms are likely. Deficit-neutrality will likely be the key challenge, as will progressivity.

- Other policy areas, such as infrastructure spending, immigration reform and regulatory changes, are likely to play out over time and may take longer than markets currently anticipate. The path forward on trade remains highly uncertain.

- Consider that in 2009 Democrats controlled the House, the White House and had a supermajority in the Senate yet failed to enact a highly-sought cap-and-trade bill.

- Political capital, like its financial cousin, is a finite resource.
Corporate Tax Reform—As Proposed by House Republicans—Summary

Who is positioned to benefit?
- High cash taxpayers
- Cash rich and capital intensive industries
- Domestic producers
- Issuers with overseas cash/earnings
- Companies with low cost, long-term debt
- Sectors:
  - IG: Technology, Pharmaceuticals, E&P & Metals
  - HY: Technology, Food & Beverage, Services, Telecom

Who is at risk?
- Low cash taxpayers
- Cash and capital light companies
- Issuers with high cost, short-term debt
- Debt-financed payouts to equity holders
- Sectors:
  - IG: Retail, Autos, Utilities (Hold Co.)
  - HY: Retail, Consumer Products

*Bory et. al. (February 2017). “Credit Connections: Corporate Tax Reform—Speculation on Speculation.” Wells Fargo Credit Strategy.
Inflation & Interest Rates

Key Drivers

- Core Inflation
- Interest Rates
- Yield Curve
- The Dollar
- Wage-Price Spiral
- Market Expectations
Inflation is approaching the FOMC’s target—average less than two percent since 1992.
Inflation for services has been much firmer than for commodities.
The jump in inflation expectations was sharp and sustained.

Source: Bloomberg LP and Wells Fargo Securities
Interest Rate Path
Pace of Policy Firming: We Say Three Hikes in 2017

After several years of downward revisions, the FOMC modestly adjusted the dots up at the December meeting.

Source: Federal Reserve Board, Bloomberg LP and Wells Fargo Securities
Inflation and the Fed Funds Rate

Inflation is gaining momentum. Fed funds rate to follow? Declining real rates.

Source: Federal Reserve Board, U.S. Department of Labor and Wells Fargo Securities
The yield curve flattened after the Taper Tantrum in 2013 but steepened post-election. We expect a flatter yield curve as 2017 progresses.

Source: Federal Reserve Board and Wells Fargo Securities
Foreign Purchases of U.S. Securities: Still Solid

Capital flows and asset allocation by global investors play a strong role in rate determinations

Source: U.S. Department of the Treasury and Wells Fargo Securities
Profits and the U.S. Dollar
IT and Materials earn the highest share of their revenues abroad, making those industries the most at risk to the stronger dollar—Invoicing in dollars?

Source: Bloomberg LP and Wells Fargo Securities
Corporate profit growth has slowed recently—typical mid- to late-cycle slowdown.

Source: U.S. Department of Commerce and Wells Fargo Securities
Corporate Profit Margins

Corporate profits as a share of gross value added remains historically high but is now past its peak.

Nonfinancial Domestic Profits
Share of Gross Value Added of Nonfinancial Corporations

Source: U.S. Department of Commerce and Wells Fargo Securities
Dollar appreciation should be more modest moving forward. Interventions from other countries (China, Mexico) limit dollar gains.
The dollar has appreciated against most of our large trading partners over the past year, but movements have varied significantly.
The U.S. trade balance with Canada and Mexico is modest compared to the rest of the world—particularly China.

Source: U.S. Department of Commerce and Wells Fargo Securities
Global Exports: Downshift

Global trade has clearly downshifted

Global Export Volumes
Year-over-Year Percent Change

Source: IHS Global Insight and Wells Fargo Securities
Chinese GDP

Growth in China will likely continue to downshift to a more sustainable pace.

Source: Bloomberg LP and Wells Fargo Securities
We expect global economic growth will remain below its long-run trend.

Source: International Monetary Fund and Wells Fargo Securities
Five Takeaways

- Growth: Continued moderate growth led by domestic consumer
- Inflation: Rising, but is the pace slow enough to delay additional Fed moves?
- Interest Rates: Rising short rates, but relatively flat long rates as capital flows favor the U.S.
- Dollar: Stronger dollar as rates and growth favor U.S.
- Profits: A late cycle slowdown
Wells Fargo U.S. Economic Forecast

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<tr>
<th>Category</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
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<tr>
<td></td>
<td>1Q</td>
<td>2Q</td>
<td>3Q</td>
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<tr>
<td>Real Gross Domestic Product</td>
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<td>Personal Consumption</td>
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<td>Business Fixed Investment</td>
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<td>Intellectual Property Products</td>
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<td>Structures</td>
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<td>Residential Construction</td>
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<td>Government Purchases</td>
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<td>Net Exports</td>
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<tr>
<td>Inventories</td>
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<td>Nonfarm Payroll Change</td>
<td>196</td>
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<td>Unemployment Rate</td>
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<td>Consumer Price Index</td>
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Quarter-End Interest Rates

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<td>Federal Funds Target Rate</td>
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<td>2 Year Note</td>
<td>0.73</td>
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<td>10 Year Note</td>
<td>1.78</td>
<td>1.49</td>
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Forecast as of: March 15, 2017

1 Compound Annual Growth Rate Quarter-over-Quarter
2 Percentage Point Contribution to GDP
3 Year-over-Year Percentage Change
4 Average Monthly Change
5 Annual Numbers Represent Averages

Source: U.S. Department of Commerce, U.S. Department of Labor, Federal Reserve Board, Freddie Mac and Wells Fargo Securities
Appendix
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