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The Evolution of the Economy, Credit & Economic Policy*

As we approach the third anniversary of the start of the economic recovery and the second year of an economic expansion, our outlook reflects more of the same for the year ahead; what you see is what you get. We expect the economy to expand at 1.9 percent for the year ahead, driven by many of its components as opposed to a major contribution from one segment. Yet, within the context of a cyclical expansion, there are numerous structural changes that will set the tone for overall economic performance.

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Consumer spending will continue to add to economic growth as real income gains benefit from slower inflation and steady gains in employment. Business fixed investment most likely will also continue to support growth with gains in both capital equipment and nonresidential construction. Residential construction, particularly remodeling, will also add to growth. Government spending remains the primary negative for 2012, while net exports will also subtract a bit from growth.

Inflation will slow in the year ahead as commodity and producer prices moderate and unit labor costs stay tame. With moderate growth and lower inflation, we expect short-term interest rates to remain low for most of the year, while longer-term borrowing rates rise as the search for yield continues; risk trade moderates and investors seek opportunity away from Treasury debt.

Figure 1

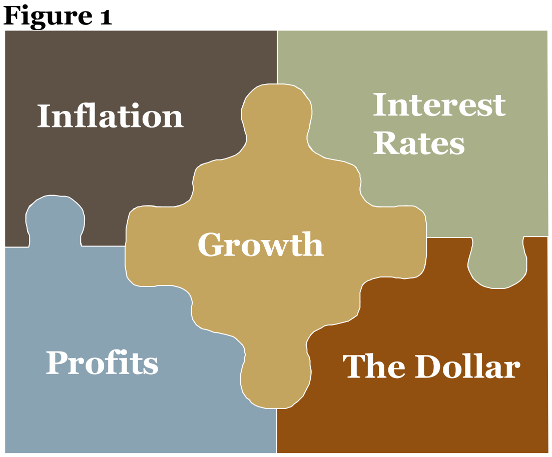


Figure 2

How Do We Differ From Consensus?

- Sustained below-trend growth
- Still cautious on the consumer
- Still cautious on housing
- State and local governments—still restructuring
- Employment—cyclical and structural change

Source: Wells Fargo Securities, LLC

Europe, political developments and Middle East tensions in this election year are the main sources of surprise with outcomes in many possible directions. We suspect a European recession is in swing right now and that it will persist through June, which should lower export growth and

*** This report is based on the presentation given at the Federal Reserve Bank of Atlanta's 2012 Annual Banking Outlook Conference on March 1, 2012. Special thanks to Sarah Watt, Sam Bullard and Tim Quinlan for their research support.**

earnings for many U.S. companies. Politics always brings out the event risk associated with new proposed policies.

Where Are We Now? Recessions Come, but They Also Go

Our current outlook is for moderate growth at 1.9 percent for 2012 with a slower pace at the start of this year.

Our current outlook is for moderate growth at 1.9 percent for 2012 with a slower pace at the start of this year in response to the 3.0 percent gain for the fourth quarter of 2011. In Figure 3 we illustrate our baseline expectations for real GDP growth. Real final sales are expected to grow 1.8 percent in 2012 with positive contributions from consumer spending, business investment and residential investment. Weakness will be in government spending, while net exports will subtract slightly from economic growth. Federal, state and local governments will be significant drags on growth in the short run as all levels of government restructure to a new set of demographic and global economic forces.

As we had stated in our 2009 presentation here, we have believed that throughout this financial crisis, while there were endless comparisons between today's environment and the 1930s, a more apt comparison is the deep 1973—1975 recession, a period that also dealt with an oil price shock, a housing collapse and a banking crisis (Figure 4). This more recent recession, and not the Great Depression, provides a template for our outlook. This was indeed the correct approach as the recovery appears on track—although at a pace below that of earlier post-1973 recoveries.

Figure 3

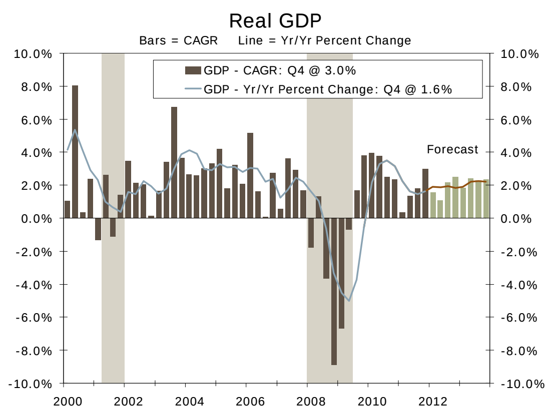
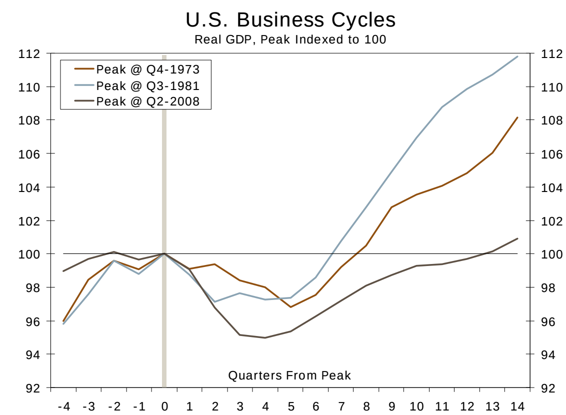


Figure 4



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

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For bankers and regulators, the pattern of the recovery continues to intimate a more modest pace of growth as we indicated in our 2009 presentation for many of the same reasons. First, in contrast to the historical pattern of housing, we suspect housing starts will not recover neatly in line with the economic cycle. Traditional economic recoveries since World War II have been led by Federal Reserve policy easing that brought down interest rates and thereby kick-started housing. In this cycle, however, housing continues to go through a long-term correction that reflects a fundamental revaluation of the proper price and credit availability associated with home buying. Second, in accordance with historical patterns, we suspect that nonresidential construction will lag the business cycle due to the negative effect of lowered economic expectations, higher energy prices and weaker corporate profits. Finally, the labor market has been altered by the upgrading of skills required by the global labor market reallocation on a scale previously unseen in the post-WWII period.

Yet, the recovery is quite typical in some sectors—note, the pattern of the Institute for Supply Management's survey on manufacturing (Figure 5). Moreover, the expansion now appears sustainable with no hint of another recession (Figure 6).

Figure 5

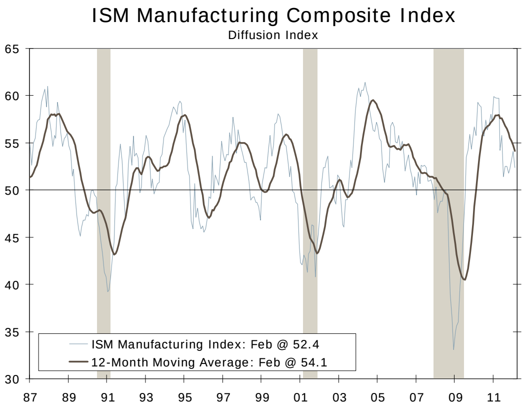
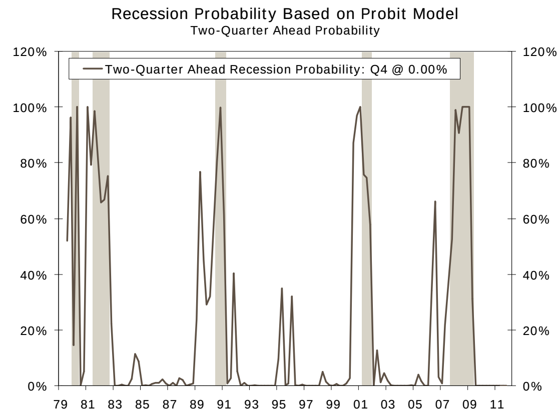


Figure 6



Source: Institute for Supply Management and Wells Fargo Securities, LLC

Consumer Spending and the Altered Reality of the Labor Market

Consumer spending will likely slow in the first half of this year after a strong gain of 2.1 percent in the fourth quarter. Consumer spending gains follow the improvement in real income as inflation slows and employment continues to increase. For 2012, we anticipate consumer spending rises 1.5 percent after a gain of 2.2 percent last year. The continued gains in consumption reflect the cyclical improvement in employment, as evidenced by the decline in jobless claims (Figure 7) and the gradual advance in the labor market recovery—even at a subdued pace compared to prior cycles (Figure 8).

Consumer spending gains follow the improvement in real income as inflation slows and employment continues to increase.

Figure 7

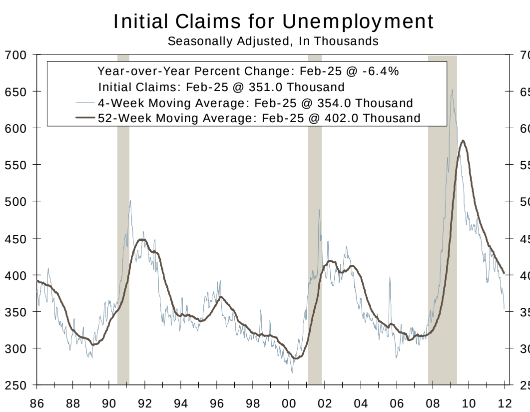
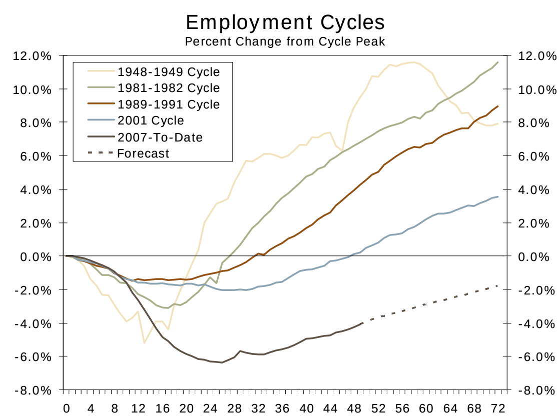


Figure 8



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Over the long term, however, there is a sharp change in the employment experience of the population (Figure 9) and participation in the labor force among age groups (Figure 10). For us, these observations imply a more subdued pace of overall consumer spending compared to earlier cycles and a greater burden of the dependent population on a smaller working population.

Figure 9

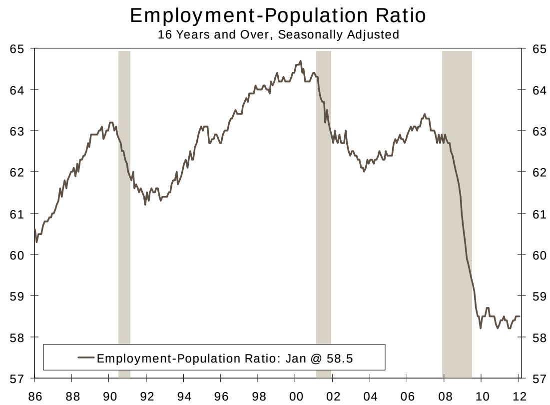
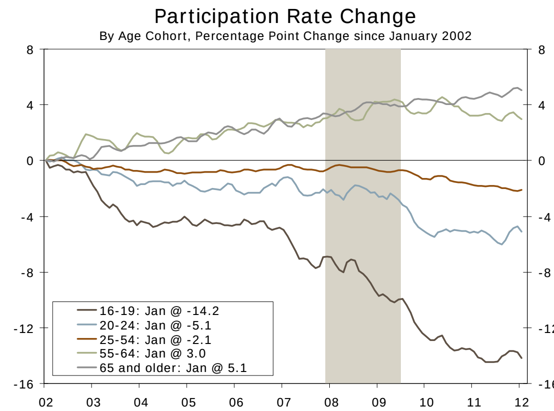


Figure 10



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Household Finances and the Income-Education Link: Structural Changes

Consumer spending advances this cycle are also likely to be exceedingly different in its distribution among the population due to the legacy of credit assumptions in the prior cycle and the changing demand for skilled labor in the 21st century. As evidenced by the rapid drop in the household debt service ratio (Figure 11), many households have reduced their debt service burden, and on average, consumer deleveraging and lower interest rates may have led to a new balance between debt service and income. However, we suspect the deleveraging is not even among all households and that households that have deleveraged are not eager to resume running up debts anytime soon.

Another important change in consumer behavior is the growing income disparity driven by the rising returns to education in the 21st century.

Another important change in consumer behavior is the growing income disparity driven by the rising returns to education in the 21st century (Figure 12). In the early post-WWII period, the dominance of the U.S. economy as a producer and household consumer gains associated with the growth of the suburbs and the baby boom opened up economic opportunities for less-skilled and semiskilled blue collar workers. Yet, those factors have now taken a back seat, and the returns to education in a society more focused on the need for professional services rather than more goods indicates that consumer spending increasingly becomes the purview of the better educated and not as uniform in pattern as might have been seen in earlier recoveries.

Figure 11

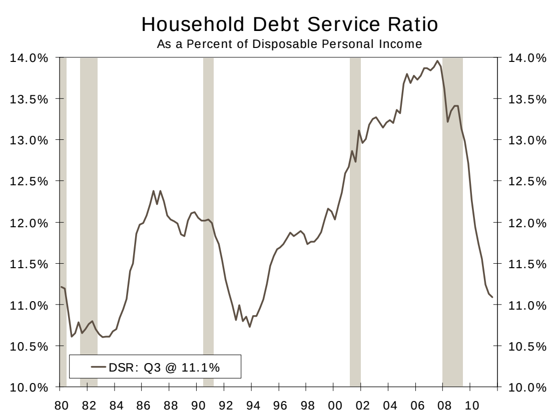
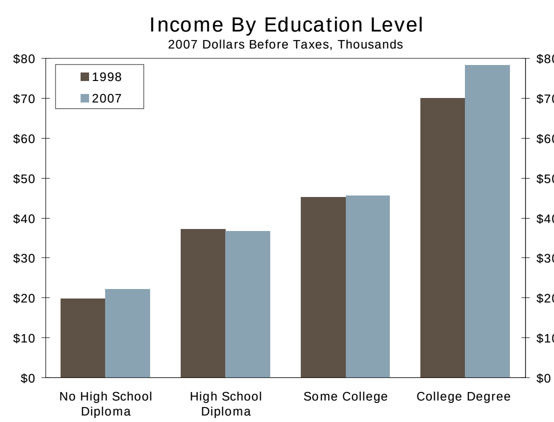


Figure 12



Source: Federal Reserve Board and Wells Fargo Securities, LLC

Rebalancing the Consumer Credit Market

Banks' willingness to lend to consumers has certainly recovered from the dark days of the Great Recession (Figure 13) and is now giving evidence that such willingness is approaching a more neutral position. This move to neutral is also hinted at by the decline in credit card delinquencies (Figure 14) to a position similar to the delinquency rate prior to the recession. These developments intimate that the consumer credit market may be a lot closer to equilibrium than many commentators perceive.

Figure 13

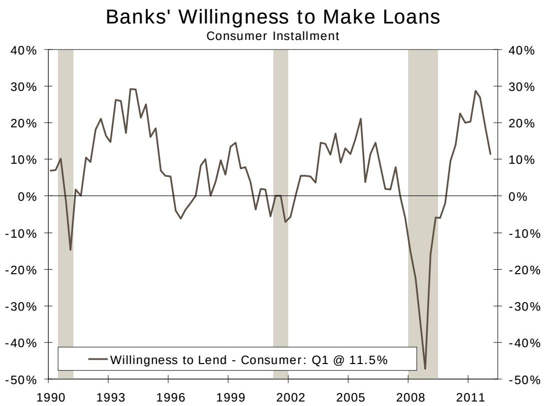
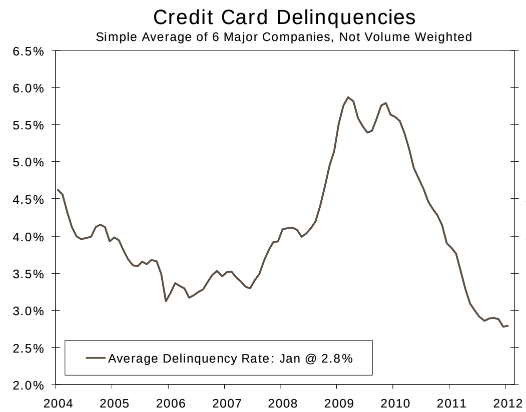


Figure 14



Source: Federal Reserve Board, Bloomberg LP and Wells Fargo Securities, LLC

Business Investment and the Credit Market for C&I Loans

Business investment has been the strongest growth sector of the economy during this recovery with growth rates for equipment and software spending of 14.6 percent and 10.2 percent in 2010 and 2011, respectively. Our expectation is for another gain of 7.5 percent this year.

Investment should reflect the imperatives of global competition and continued economic growth.

Business fixed investment is expected to rise by more than 6 percent in the first half of this year as equipment and software, as well as structures, continue to improve. Slower gains in orders and a reduction in the accelerated depreciation schedules reinforce our view that a more moderate pace of equipment investment spending is ahead. Nonetheless, investment should reflect the imperatives of global competition and continued economic growth. Energy and power spending, as well as industrial structures, likely will continue to lead the contribution of nonresidential construction to growth. However, spending on offices likely will remain subdued as vacancy rates have just started to turn down. Retail space is still a work in progress.

What is intriguing to us is that the credit markets for the nonfinancial corporate business sector have taken on the appearance of a balanced market for bank lending and a much more solid capital market. As illustrated in Figure 15 and Figure 16, the net percentage of banks tightening standards has fluctuated around neutral for some time, while the net percent of banks reporting stronger demand also appears to be fluctuating around neutral. The bank credit market for private sector business lending appears to have stabilized at this point in the economic expansion.

Figure 15

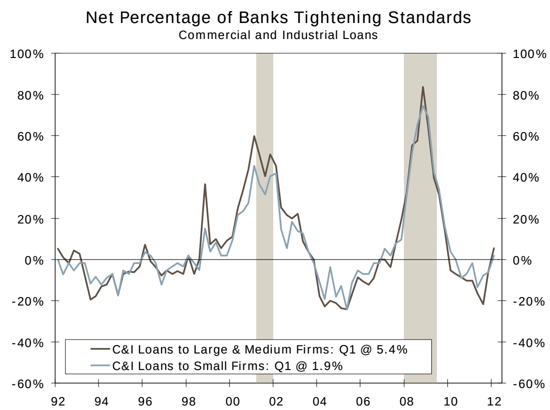
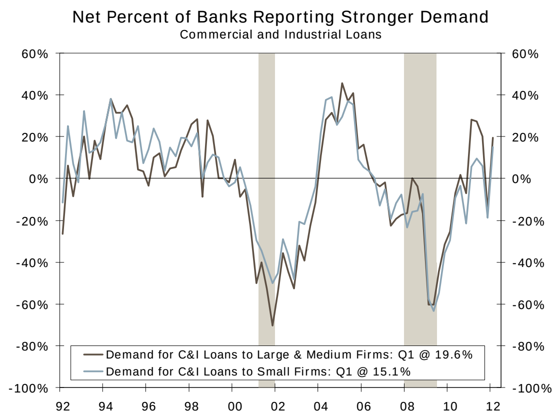


Figure 16



Source: Federal Reserve Board and Wells Fargo Securities, LLC

Business lending through banks is consistent with the economic forces of inventory finance, and little evidence exists of a credit crunch at banks at this time.

Further reassurance is offered by the pattern of commercial and industrial loans that appears to follow the pattern of inventory gains, as illustrated in Figure 17. This hints that business lending through banks is consistent with the economic forces of inventory finance, and little evidence exists of a credit crunch at banks at this time. Meanwhile, banks of all types—domestic and foreign—as well as size—small and large—appear to be participating in the growth of lending overall (Figure 18).

Figure 17

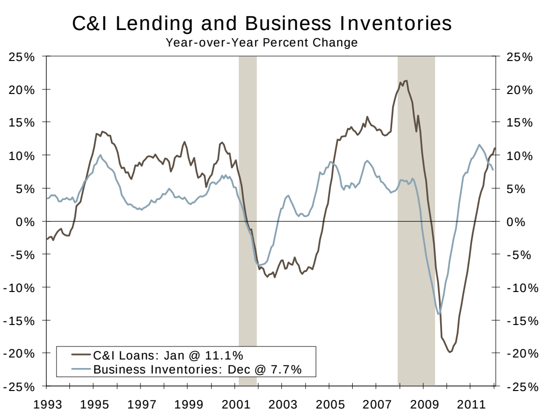
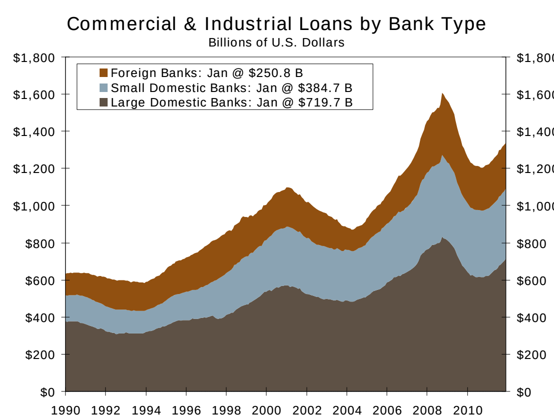


Figure 18



Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities, LLC

Structural Issues on the Credit Side: Whatever Happened to the Risk-Free Rate?

Yet, there are two credit issues on the bank lending side that represent structural challenges to the recovery. First, real estate lending, Figure 19, is clearly subpar compared to the growth of lending in prior expansions. From the borrower's perspective, the demand for real estate credit is a derived demand from the demand for housing. With today's buyers uncertain about the value of the home as well as the future price of the home, the demand for mortgage credit is extremely limited. On the supply side, lenders have limited ability to see across a minefield of present and future regulations and economic conditions in order to estimate an expected rate of return on mortgage lending.

Meanwhile, the net interest margins in banking (Figure 20) clearly have been declining since the early 1990s, thereby, raising the issue of how much bank lending can respond to economic growth and/or how much bank lending can be a force supporting economic growth in the future. The trend in Figure 19 indicates that real estate lending will not be as strong a supporter of growth going forward as it has in the past.

Figure 19

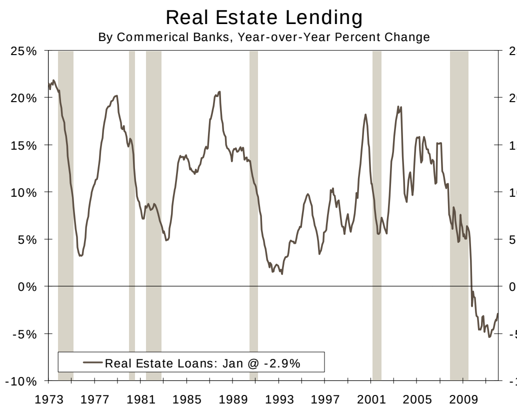
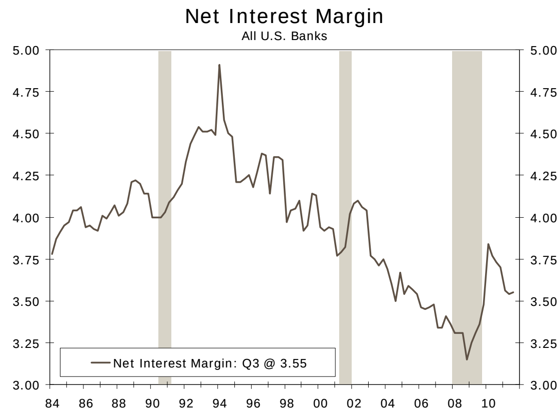


Figure 20



Source: Federal Reserve Board, Federal Financial Institutions Examination Council and Wells Fargo Securities, LLC

Capital Markets: Supporting Growth

Investment-grade issuance (Figure 21) has been exceedingly strong in recent years. February, 2012 was the strongest February on record with issuance at just over $81 billion, including deals such as Viacom being seven times oversubscribed and with the lowest BBB three-year coupon ever. Spreads in the high-grade market have also stabilized at a level far below the flight-to-safety rates during the recession. Foreign demand continues to be focused on Treasury securities (Figure 22) in a continued flight-to-safety trade, and yet, the demand for agencies and equity continues to move along. Our suspicion is that the decline in the purchase of corporate debt represents a large downshift in the purchases of securitized products.

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Figure 21

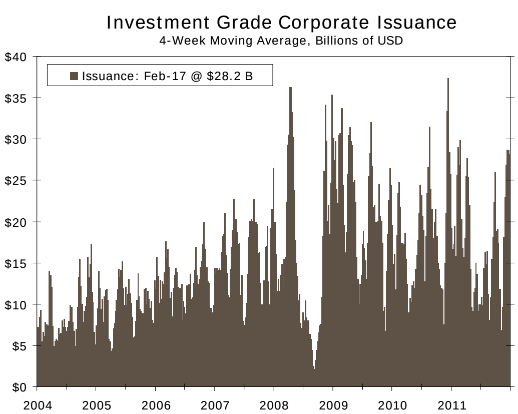
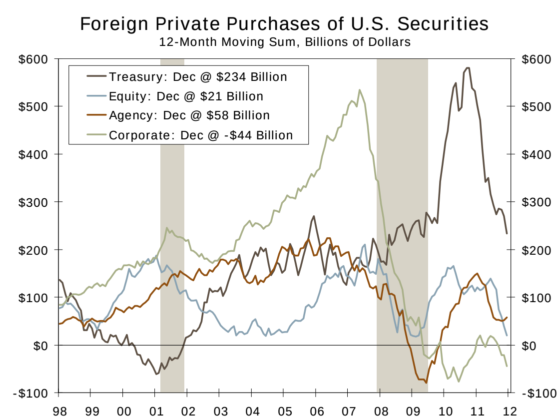


Figure 22



Source: U.S. Department of Treasury and Wells Fargo Securities, LLC

Housing: Structural Challenges Hamper a Cyclical Recovery

Residential construction, particularly remodeling, should add to economic growth, although the real recovery in housing is still a ways off as new home prices remain uncompetitive with existing home prices. Construction of multifamily units should continue to strengthen. As illustrated in

The fundamental strategic question for housing is what is the sustainable trend pace of housing starts that would be consistent with the scale of the lending franchise for a mortgage lender?

Figure 23, the pace of housing starts represents a significant strategic challenge to lenders and regulators. The fundamental strategic question for housing is what is the sustainable trend pace of housing starts that would be consistent with the scale of the lending franchise for a mortgage lender? At a minimum, the pace is not likely to be near the 1.8 million—2.1 million pace associated with the subprime lending boom of the prior decade. In contrast, the pace is likely to be near the pace of long-term growth of the homebuyer demographic of 25—34 year olds.

Meanwhile, cyclical improvement in mortgage delinquency rates indicates the worst is behind us on these delinquencies, and thereby, there would be greater confidence on the part of lenders that credit quality is improving (Figure 24).

Figure 23

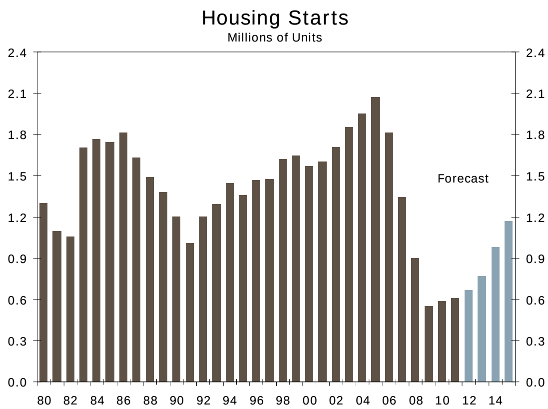
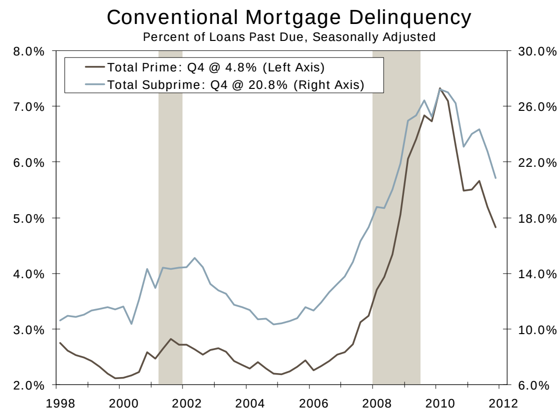


Figure 24



Source: U.S. Department of Commerce, Mortgage Bankers Association and Wells Fargo Securities, LLC

Another damper on new home construction is the gap in house prices between median new and existing homes (Figure 25). In contrast to the usual gap of roughly $20,000 during the decade up to 2007, today's nearly $60,000 differential is a significant barrier to new home construction. In addition, a secular shift may be taking place due to a mismatch in supply and demand. As illustrated in Figure 26, the median home size has risen steadily since 1980 from about 1,600 square feet to 2,235 square feet, while the size of the average household has declined from 2.75 persons to 2.58 persons. In essence, the size of the house has steadily increased over the past 30 years, while the average household size has declined during the same period. This intimates that many large, suburban McMansions will not provide the expected economic return to their owners as families opt for smaller, more urban living and not estates in the ex-urbs.

Figure 25

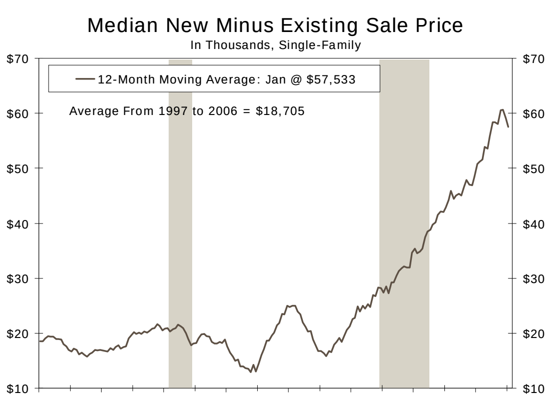
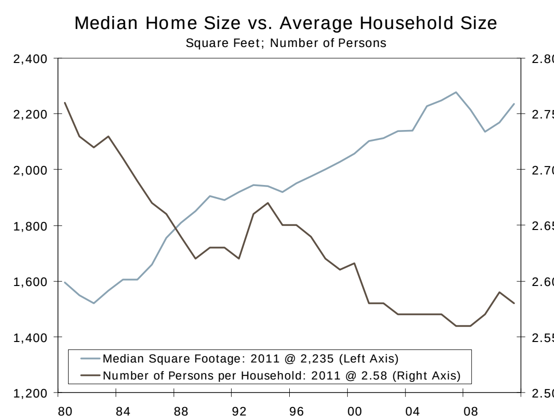


Figure 26

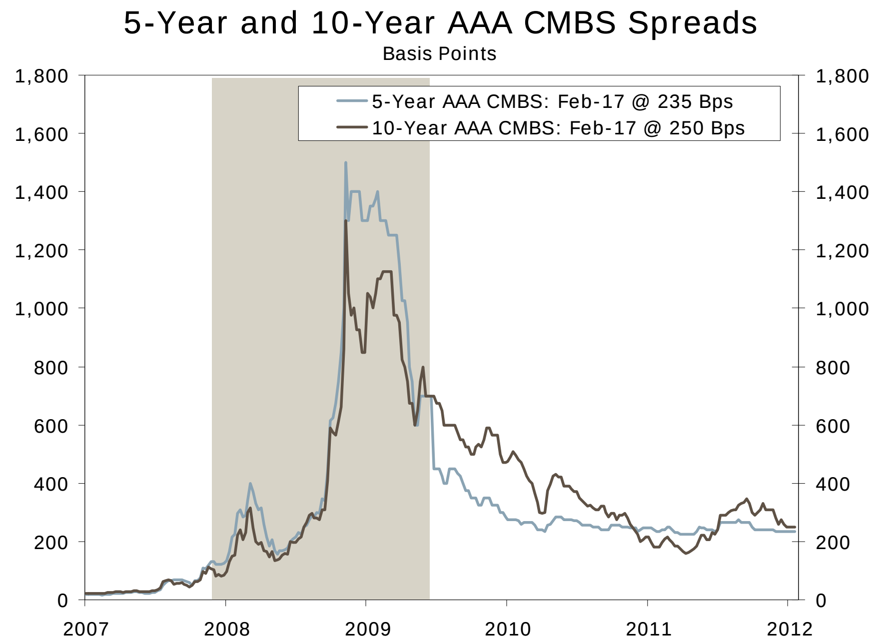


Source: U.S. Department of Commerce, Mortgage Bankers Association and Wells Fargo Securities, LLC

Commercial MBS Spreads: Stabilized

At this point, commercial mortgage backed spreads (Figure 27) appear to have reached an equilibrium spread over Treasuries such that financing of commercial real estate products can take place in a fairly stable credit pricing environment. This is consistent with the gains we have witnessed in commercial real estate activity in recent quarters. Our outlook is for 4.9 percent growth in real commercial construction spending in 2012 after an increase of 4.4 percent last year.

Figure 27



Source: Wells Fargo Securities, LLC

Inflation and Interest Rates: Were the 1970s the Aberration?

Inflation should moderate in the year ahead as commodity and producer price inflation slows and unit labor costs remain tame. The employment cost index likely will moderate to 2.1 percent from 2.6 percent in 2011. Producer price increases are expected to slow to 2.8 percent in 2012 after a gain of 6.0 percent last year. When viewed over time, the high consumer inflation of the 1970s appears to be an aberration (Figure 28) and that inflation seems to have settled into a range between 2 percent and 3 percent. On a cyclical basis, this appears to be consistent with the modest upswing in 10-year implied inflation expectations (nominal less TIPS), as illustrated in Figure 29.

Inflation should moderate in the year ahead as commodity and producer price inflation slows and unit labor costs remain tame.

Figure 28

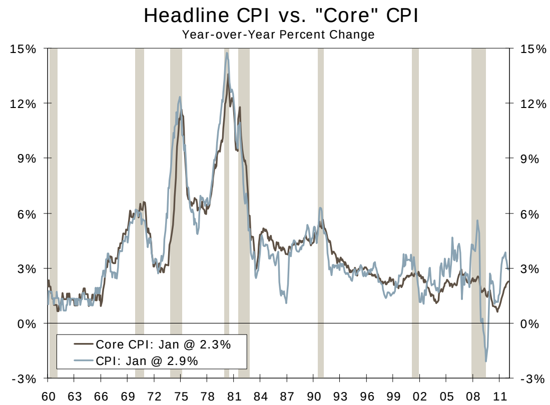
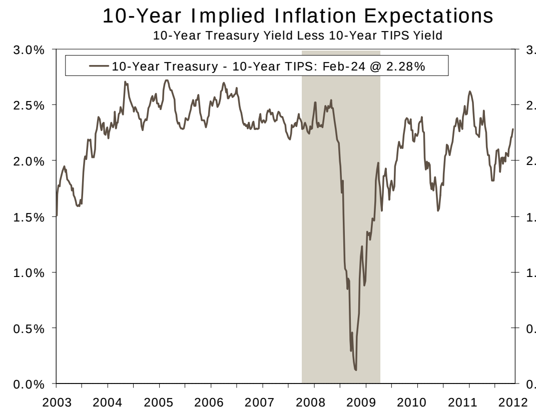


Figure 29



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

Global Inflation and the Bond Market Disconnect: Central Banks Misprice Interest Rates, Private Markets Misprice Credit

At the global level, average consumer price inflation has been remarkably steady at just under 5 percent since the mid-1990s despite all the talk about escalating inflation being just around the corner.

At the global level, average consumer price inflation has been remarkably steady at just under 5 percent since the mid-1990s (Figure 30) despite all the talk about escalating inflation being just around the corner. Yet, interestingly enough, the five-year Treasury yield appears to be disconnected from U.S. inflation expectations over the same period (Figure 31). In this case, the influence of the risk-off trade from Europe and concerns about the sustainable pace of the U.S. expansion appear to be the driving force in the Treasury market.

Figure 30

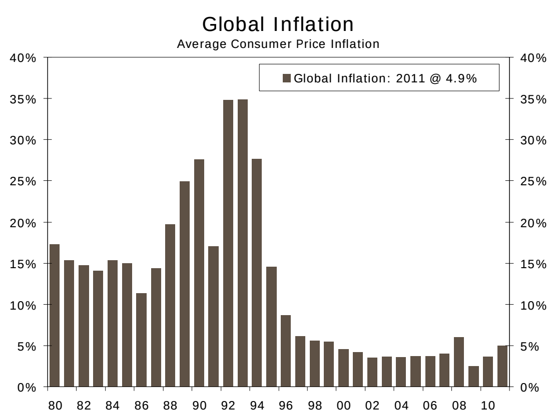
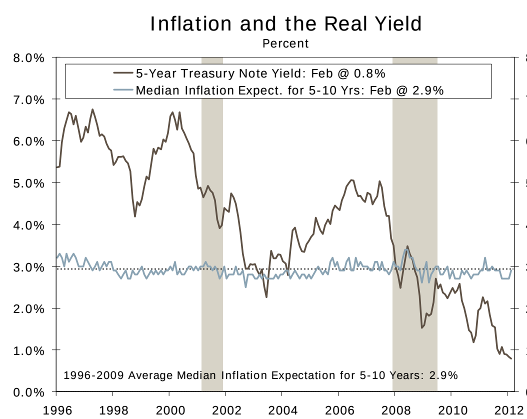


Figure 31



Source: IMF, University of Michigan, Federal Reserve Board and Wells Fargo Securities, LLC

Meanwhile, the risk trade is evidenced in the LIBOR-OIS spreads in the euro versus the dollar market (Figure 32), and this is probably a factor helping to explain the difference between inflation expectations and the current five-year yield reviewed above. Recently, this risk premium in the euro has declined and perhaps signals a less risk-averse global investor and perhaps some upward movement in Treasury rates. In addition, a greater interest in nonfinancial corporate debt in the United States (Figure 33) implies that the private bond market has indeed moved to a middle ground between the recession fears of 2008—2009 and the overconfidence position of the Great Moderation of the 2006—2007 period. This middle ground may indeed advocate the case for a new equilibrium in the financing of nonfinancial corporate debt.

Figure 32

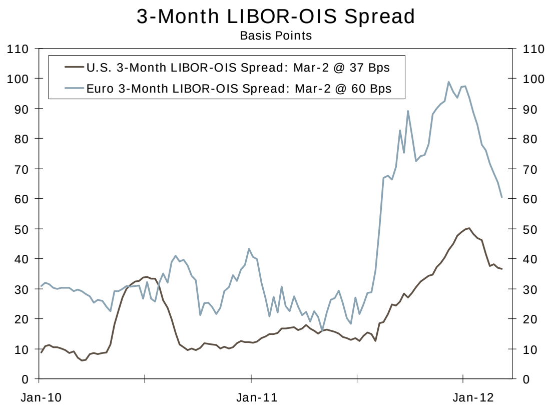
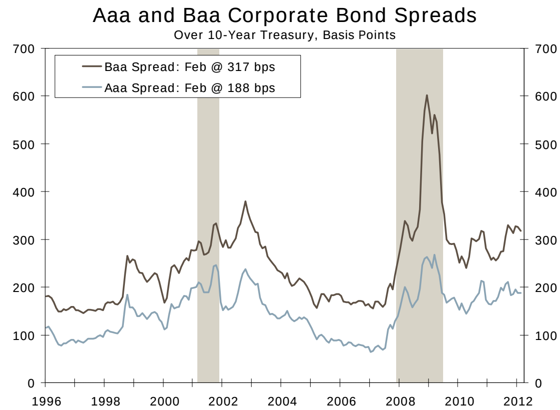


Figure 33



Source: Bloomberg LP, Federal Reserve Board and Wells Fargo Securities, LLC

With moderate growth and lower inflation, we expect short-term interest rates to remain low for most of the year, while longer-term borrowing rates begin to rise as the search for yield continues; the risk-averse trade moderates and investors seek opportunity. Our outlook is for the yield on the 10-year Treasury note to gradually rise to end the year at 2.3 percent. For now, we estimate that any Federal Reserve action toward more quantitative easing would take place through a purchase of mortgage-backed securities and, therefore, work primarily to provide liquidity, while lowering the mortgage rate. This outlook argues the case that the five-year Treasury yield is too rich relative to the pace of nominal growth as illustrated in Figure 34. While there have been periods of sharp differences in these two series, over time, the patterns are roughly consistent, and at least when they differ, they motivate decision makers to think about the reasons for such a difference. Finally, at the short end of the curve, the TED spread (Figure 35) remains consistent with the prerecession period, although there appears to be some fallout from the recent European financial concerns.

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Figure 34

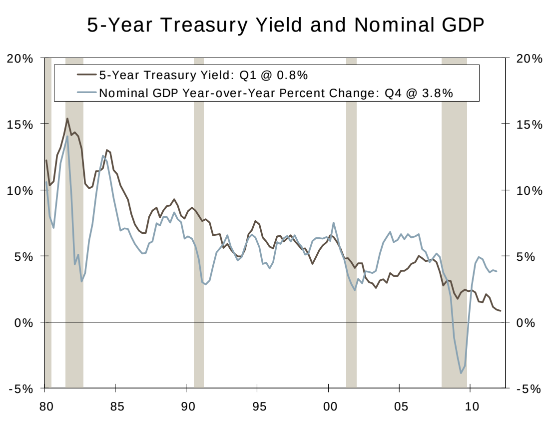
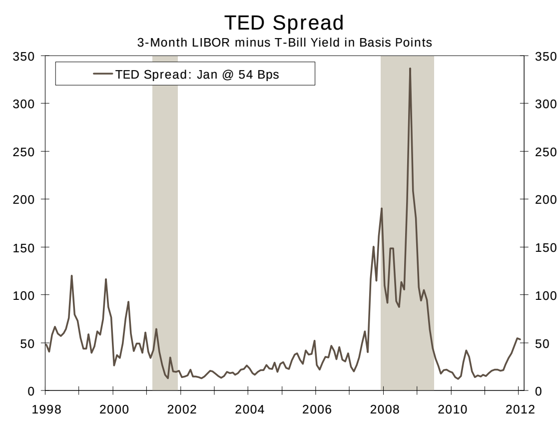


Figure 35



Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities, LLC

Global Opportunity as a Shift in Future Capital Flows

Going forward, one of the structural changes we may witness is a shift of investor interest from the safety of U.S. Treasury debt toward emerging market opportunities. As illustrated in Figure 36, emerging markets offer a significant growth advantage over the western European, American and Japanese opportunities. Moreover, these emerging markets are not the same as in the past as they represent a more modern combination of political and economic reforms that support greater economic stability going forward than their history in the earlier post-WWII period.

In the short term, we expect a growth slowdown to continue in the Asia-Pacific countries, especially in the open export-oriented markets with significant exposures to Europe. Case in point, Singapore recently released its advance estimate of fourth-quarter GDP and the data looked very unfavorable. Annualized GDP for Singapore fell 4.9 percent, manufacturing output declined at a 21.7 percent annualized pace and construction plunged at a 6.7 annualized rate in the fourth quarter. Over the year, Singapore's economy managed a positive 3.6 percent growth rate, a marked deceleration from the end of 2010 when year-over-year growth came in at a sizzling 12.0 percent pace.

The rise in global equity prices and stabilization of global financial conditions has improved the odds of a gradual slowdown in global growth rather than a plunge off the cliff.

Although, in the short run, the focus remains on global downside risks, the rise in global equity prices and stabilization of global financial conditions has improved the odds of a gradual slowdown in global growth rather than a plunge off the cliff. In contrast to the long-run optimism of growth in the reformed countries of the emerging world, the outsized fiscal deficits in the United States (Figure 37) represent a significant downside risk in a political environment that finds it practically impossible to come to a set of solutions. Moreover, these outsized deficits are likely to persist over the long run (Figure 38), bringing into question the viability of the current mix of low interest rates, moderate inflation, modest growth and a stable dollar exchange rate. Overtime, something has to give. Furthermore, the persistence of these fiscal deficits reflects the influence of entitlements.

Figure 36

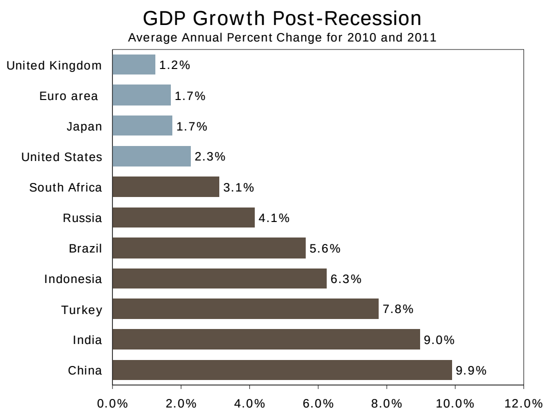
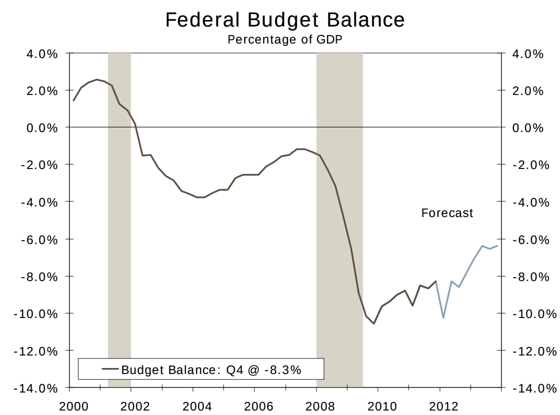


Figure 37



Source: IMF, U.S. Dept. of Commerce, U.S. Dept. of Treasury and Wells Fargo Securities, LLC

Meanwhile, we expect a persistent restructuring going on at the state and local level (Figure 39), as these governments come to grips with limited revenue growth and a legacy of overpromised benefits from the prior 40-plus years of generous political promises.

Figure 38

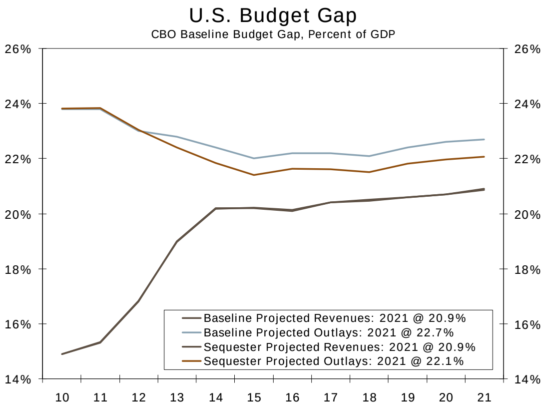
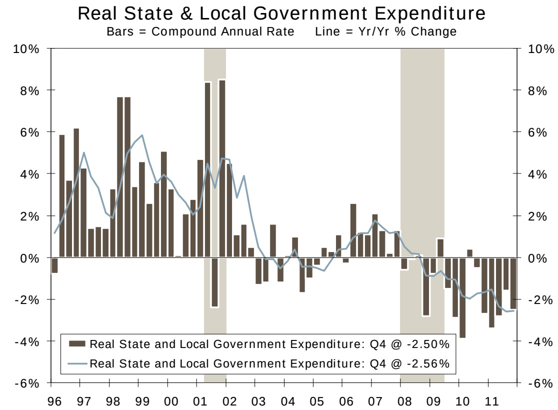


Figure 39



Source: Congressional Budget Office, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

Outlook Risks: Europe, Politics and Oil

Our three primary risks to the outlook begin with our concern of a greater downside risk to the expected recession in Europe. We expect a European recession is in swing now and that it will persist through midyear, which would lower export growth and earnings for many U.S. companies. Second, politics always brings out the event risk associated with new proposed policies as well as the confusion that policy change may bring to central industries, such as finance, energy and resource development. Finally, oil and the tensions with Iran represent another source of risk and would bias our growth expectations downward and our inflation expectations upward.

Politics always brings out the event risk associated with new proposed policies as well as the confusion that policy change may bring to central industries.

Figure 40

Potential Challenges to the Outlook

- Easier monetary policy brings questions for the dollar, inflation and interest rate outlook
- Fiscal policy: spending completely unconstrained
- Housing: unable to sustain growth on its own
- European debt crisis weighs on global growth
- Rising oil and gasoline prices drag down real consumption

Source: Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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