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# Economic Outlook: Cyclical Recovery, Structural Challenges

## Federal Reserve Bank of Atlanta Annual Banking Outlook Conference

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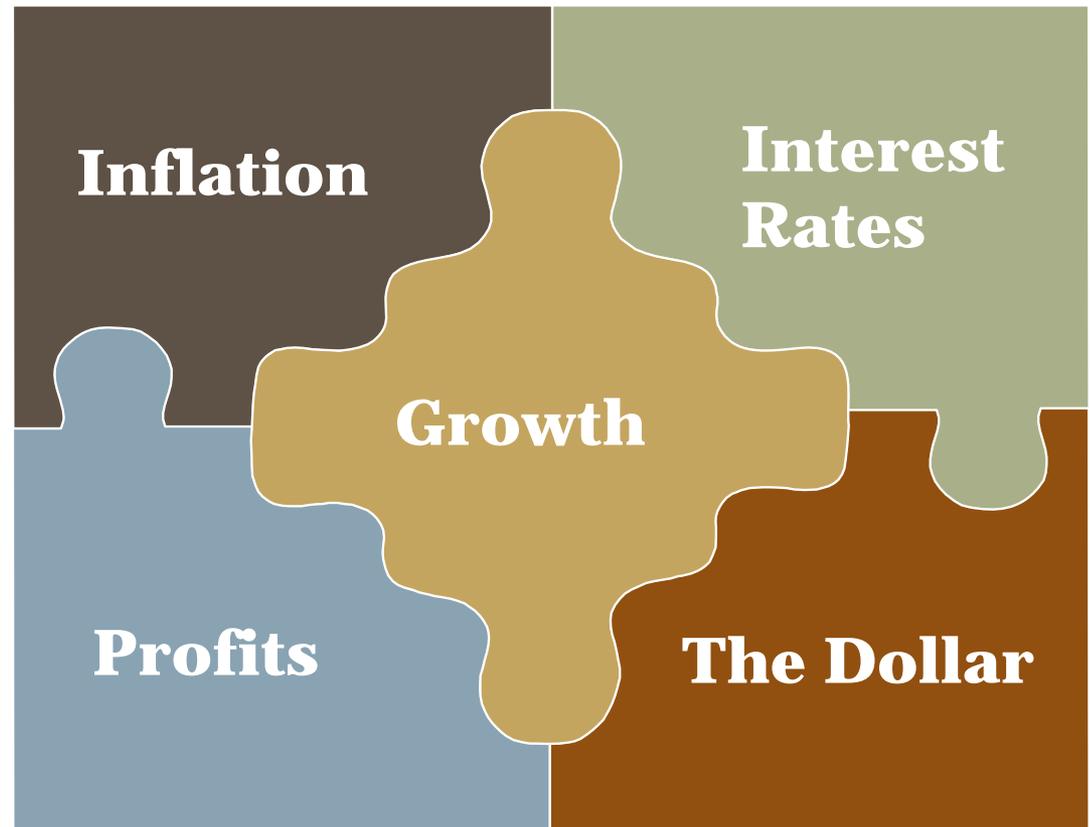
John E. Silvia, Chief Economist

March 1, 2012

Together we'll go far



Five benchmarks for good  
decision making

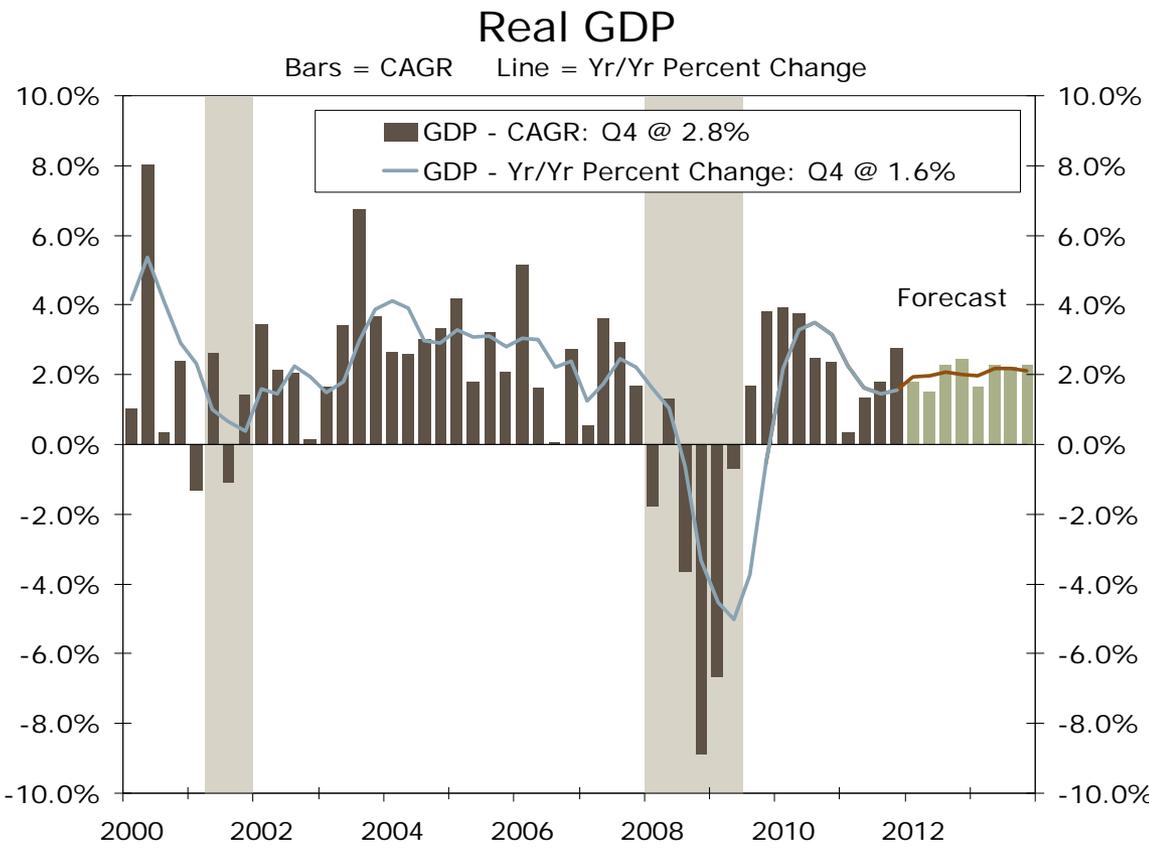


How do we differ from  
consensus?

## Expectations for the Future

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

Sustained recovery in 2012, but still below historical experience

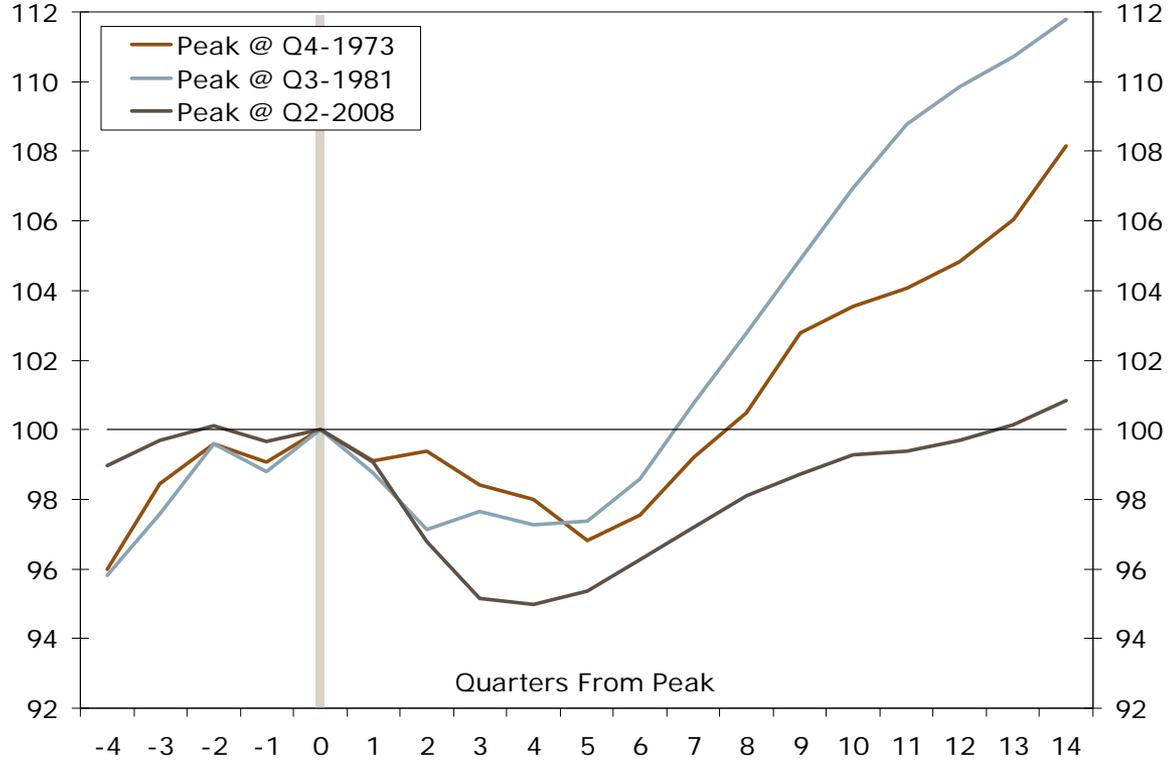


Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Slow cyclical recovery, but GDP has overtaken its prerecession peak

### U.S. Business Cycles

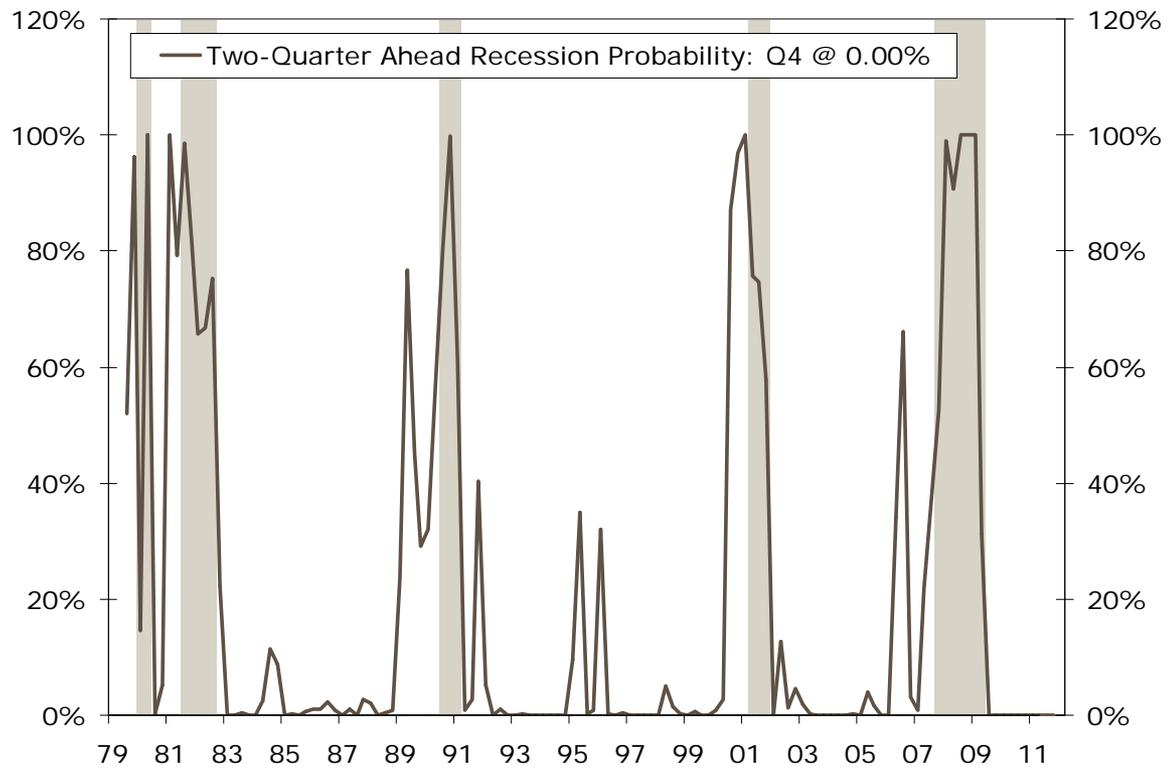
Real GDP, Peak Indexed to 100



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

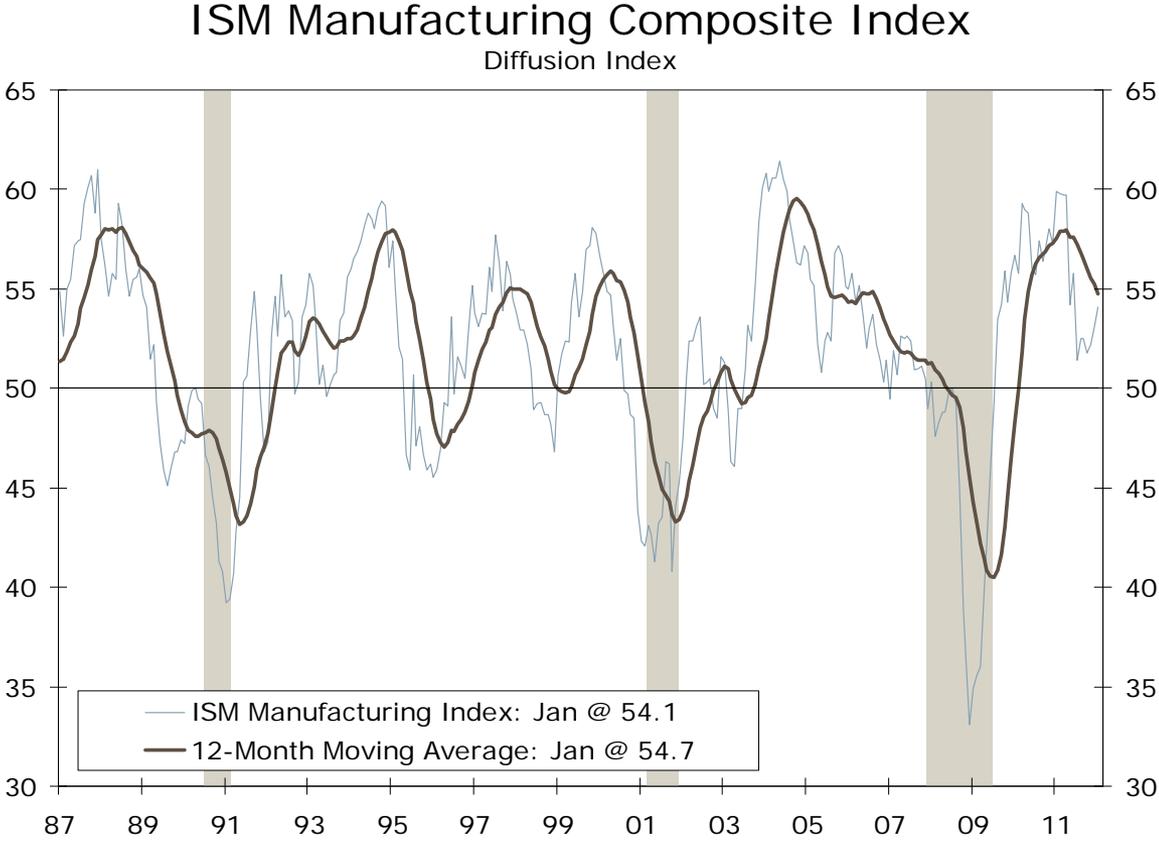
The outlook for growth ahead remains in tact

### Recession Probability Based on Probit Model Two-Quarter Ahead Probability



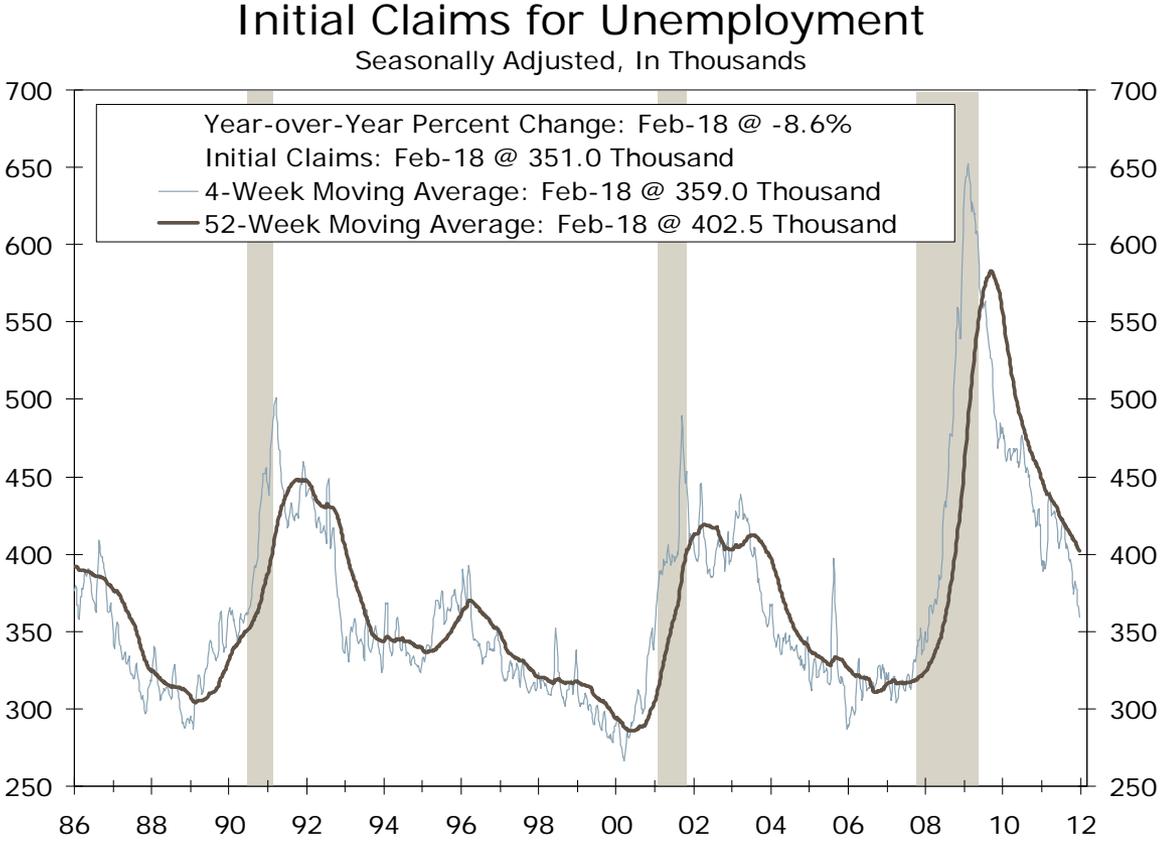
Source: Wells Fargo Securities, LLC

Large, Global Businesses:  
Moderate growth in  
manufacturing



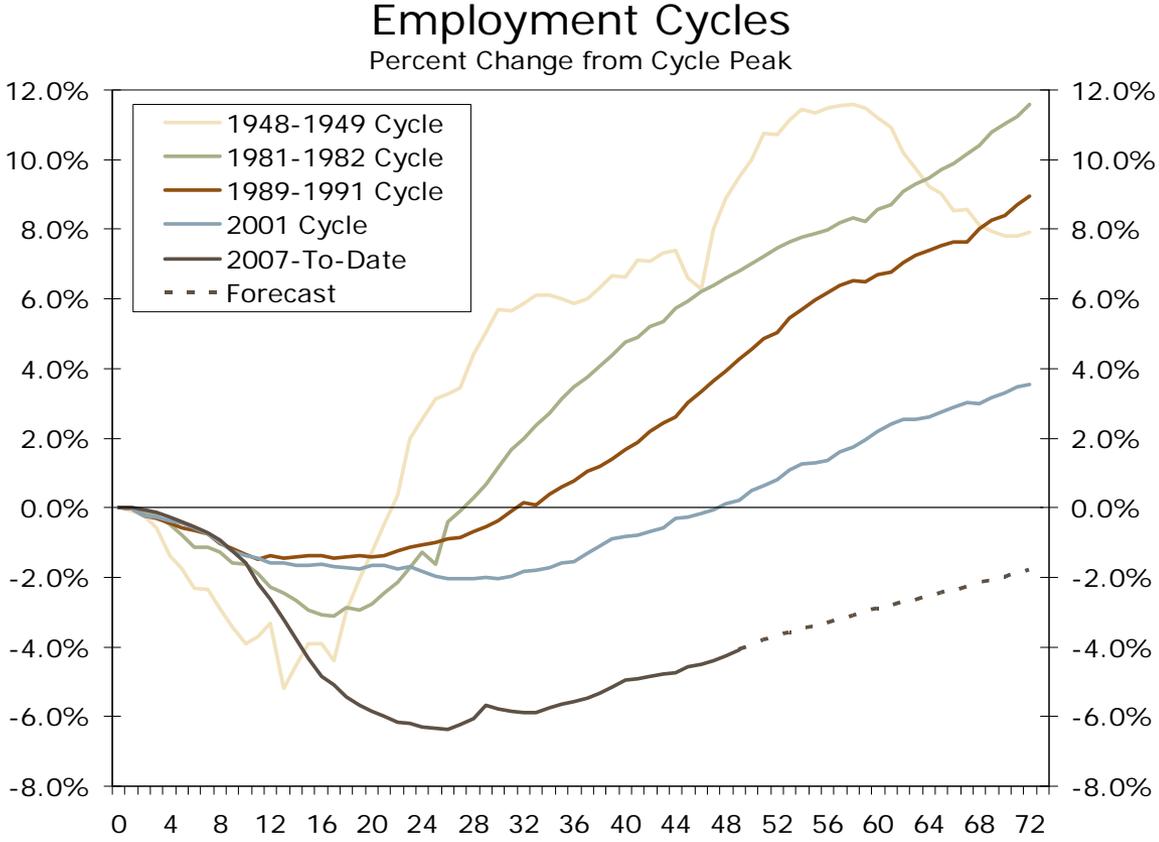
Source: Institute for Supply Management and Wells Fargo Securities, LLC

Signaling continued job gains



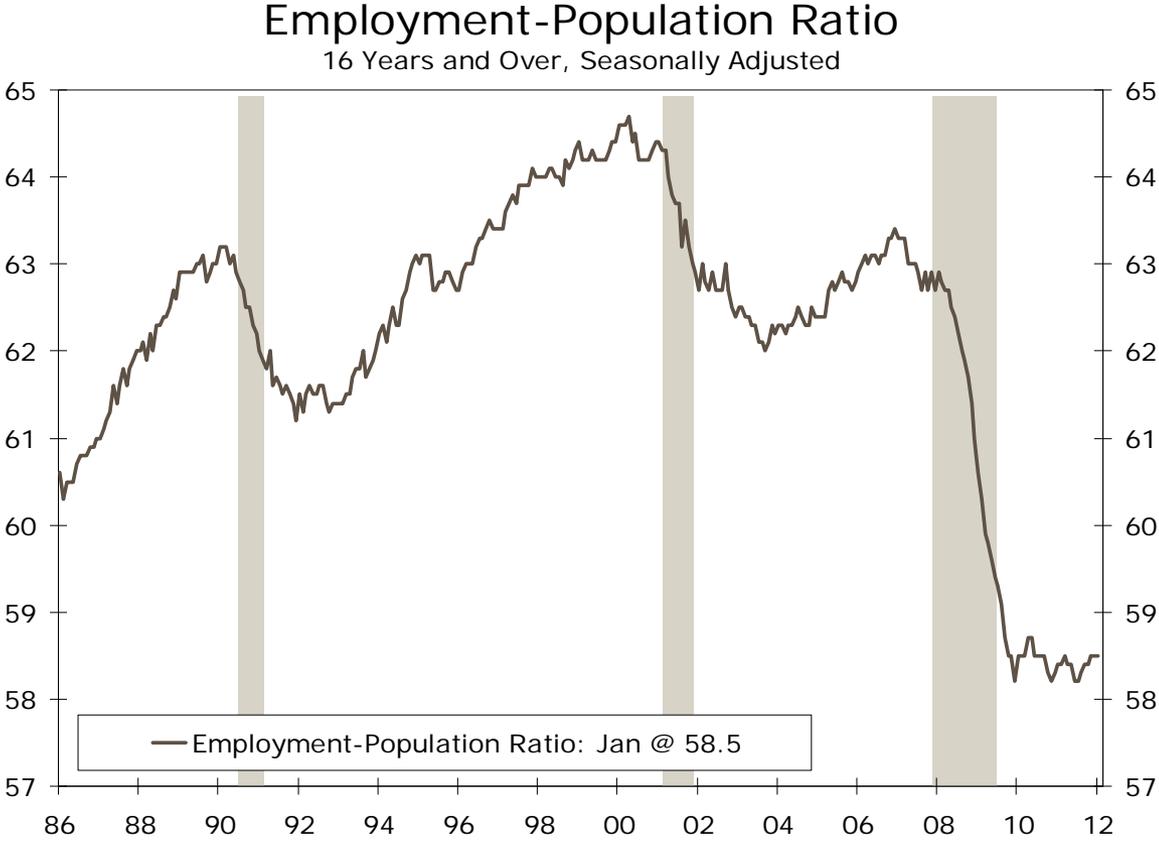
Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Employment will eventually regain its peak, but not quickly



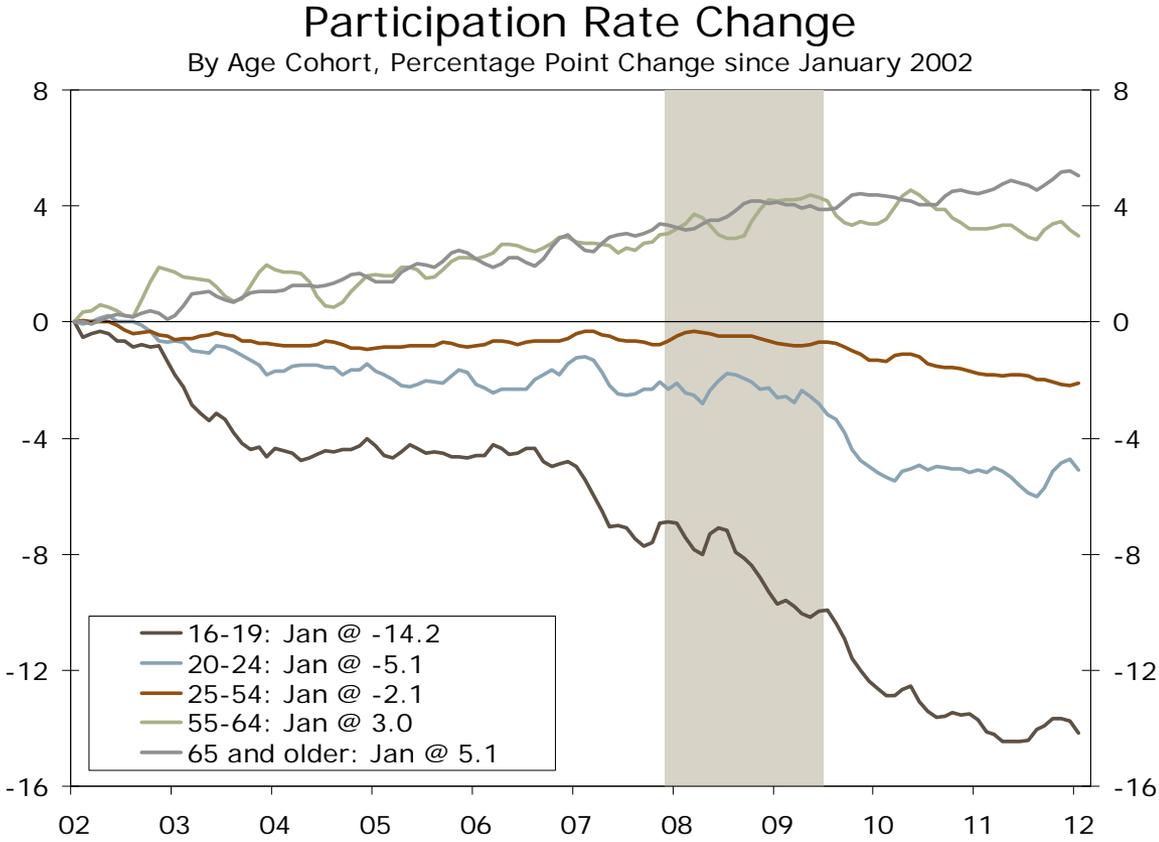
Source: U.S. Department of Labor and Wells Fargo Securities, LLC

A much lower base to support spending



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

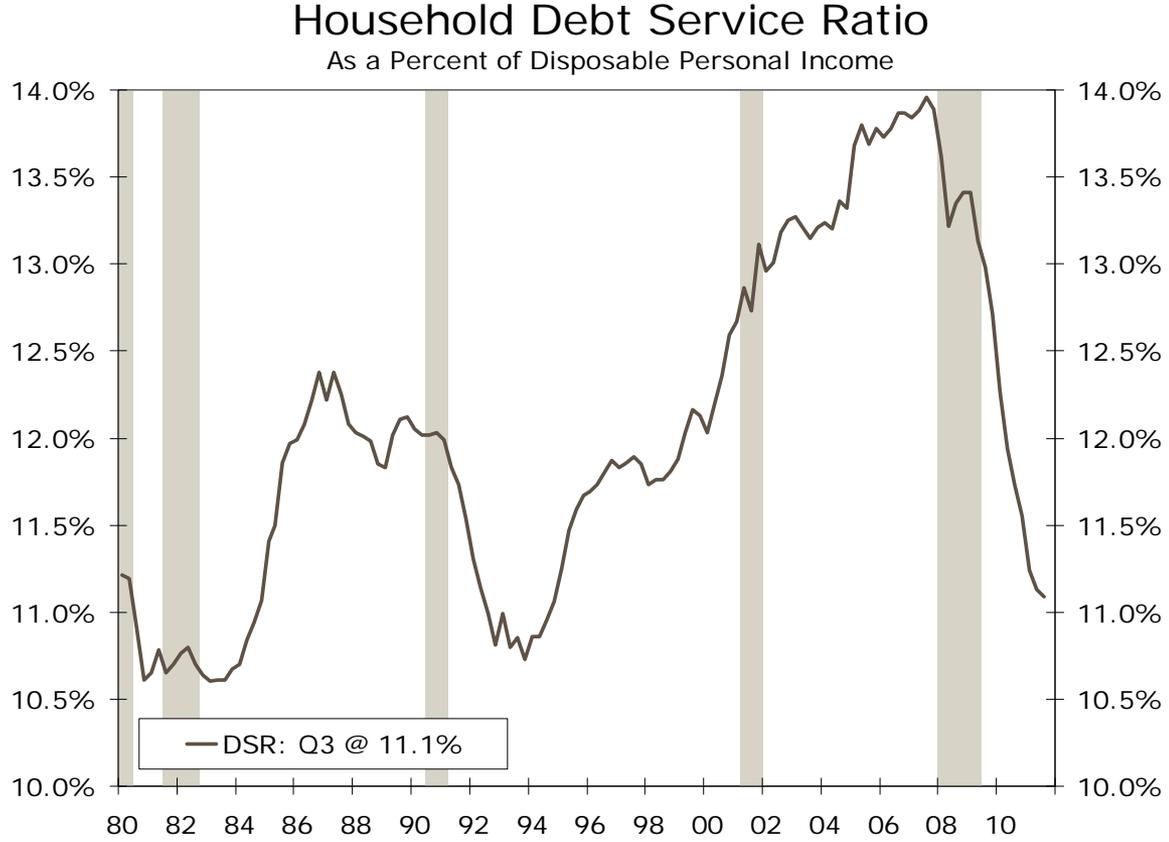
Secular shifts in labor force participation



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

# Debt Service Ratio: Cyclical or Structural?

Debt service has returned to more sustainable levels

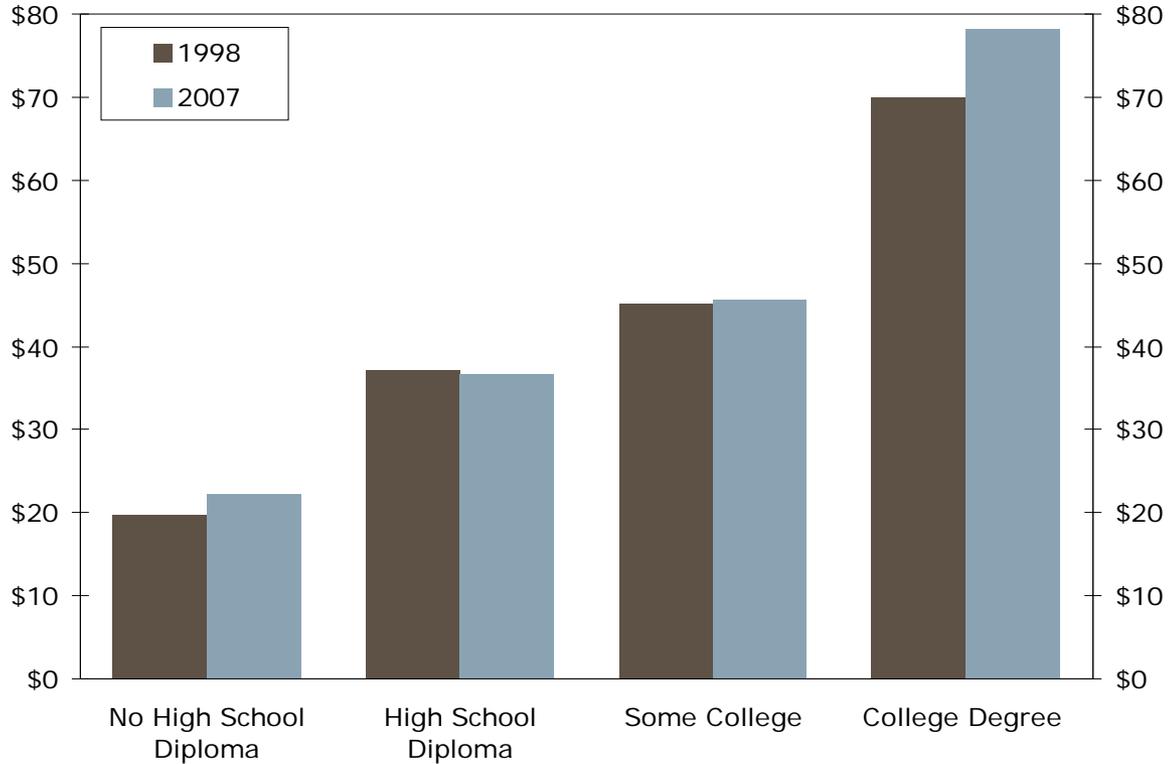


Source: Federal Reserve Board and Wells Fargo Securities, LLC

Real income has remained relatively flat over the past year, except for those with a college degree

## Income By Education Level

2007 Dollars Before Taxes, Thousands

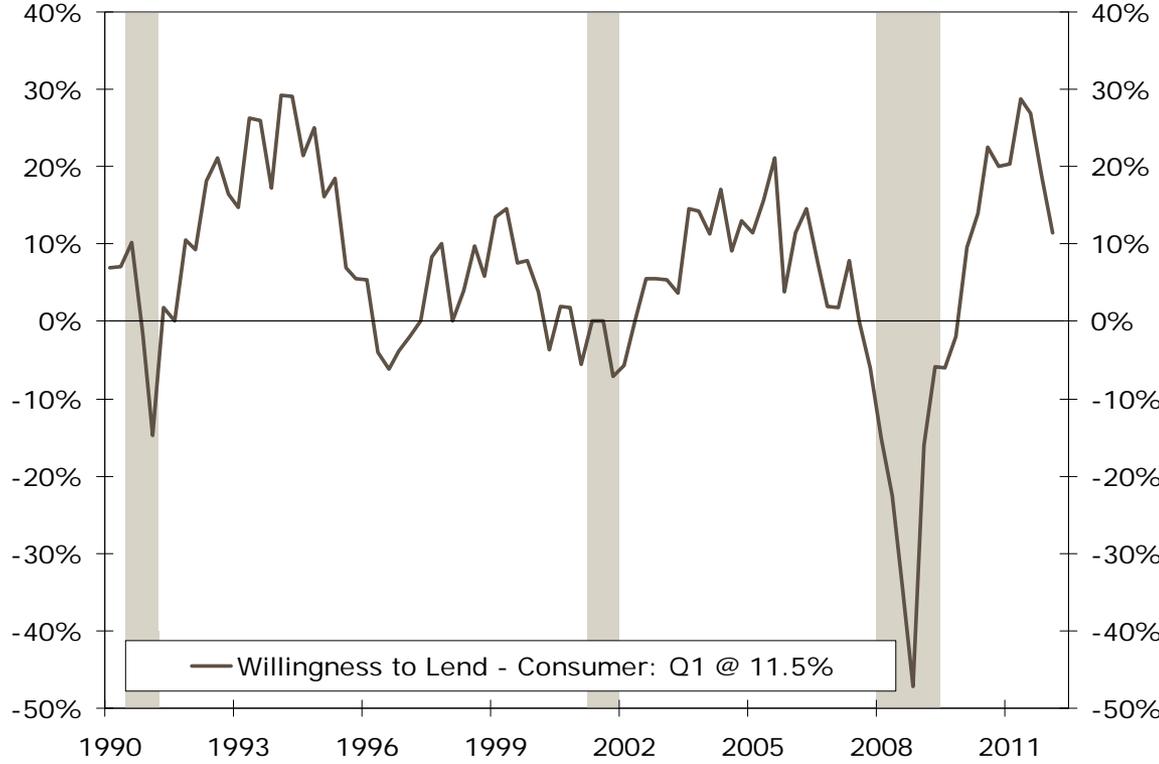


Source: Federal Reserve Board and Wells Fargo Securities, LLC

Increased lending is offering some support to consumer spending

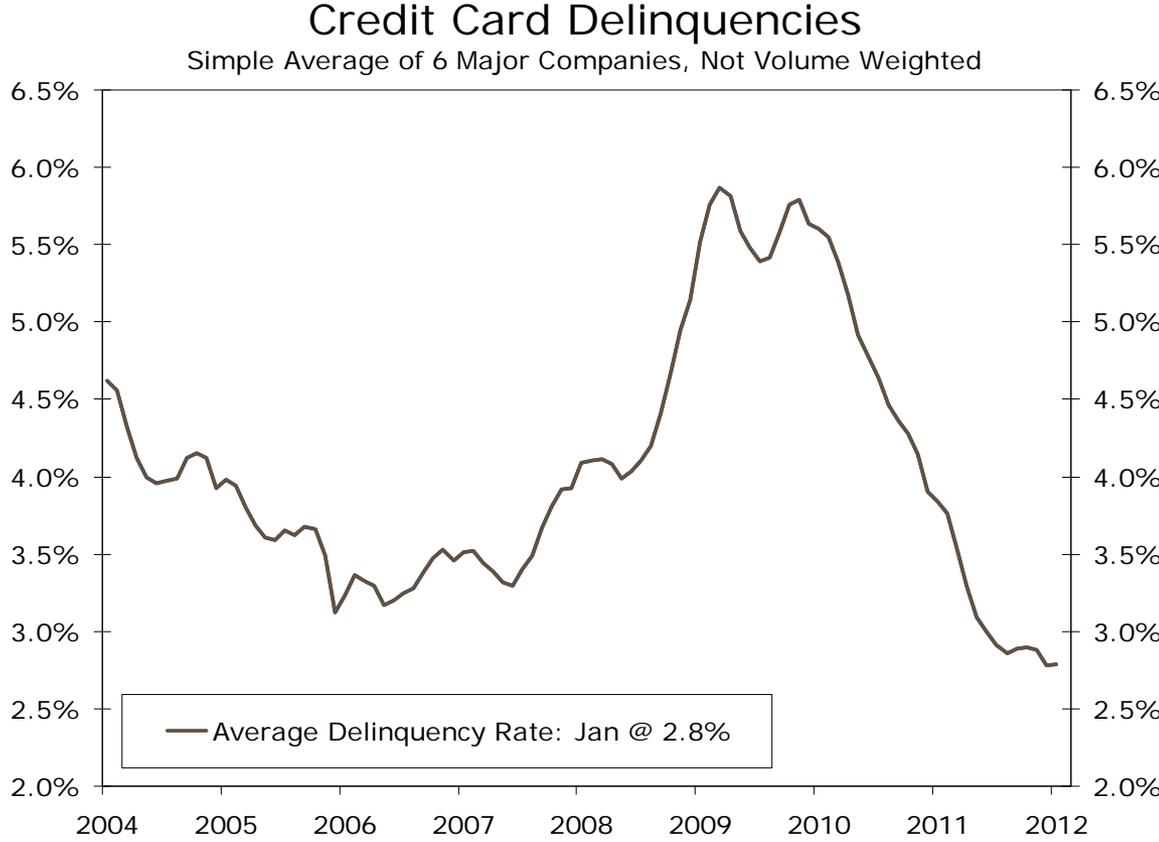
## Banks' Willingness to Make Loans

Consumer Installment



Source: Federal Reserve Board and Wells Fargo Securities, LLC

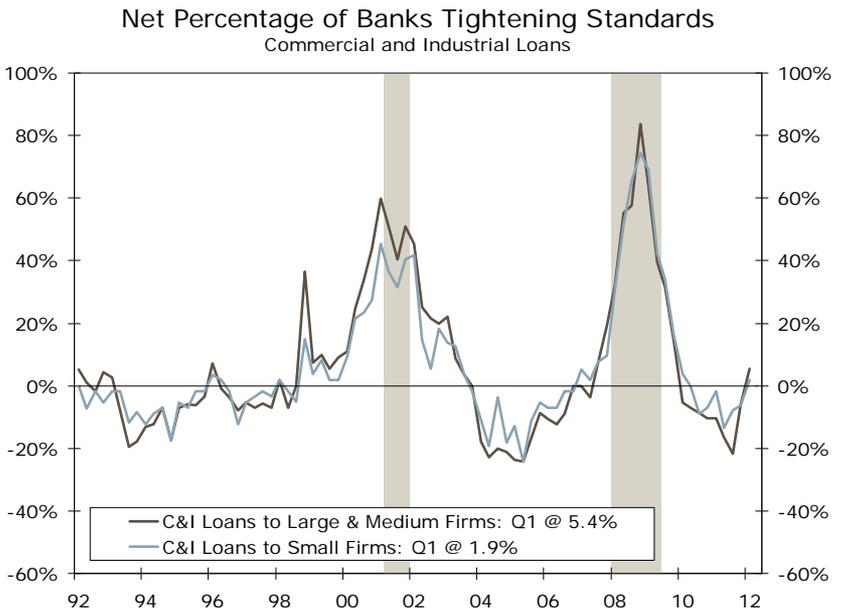
Credit card delinquencies have declined below prerecession rates, reflecting improvement in consumers' balance sheets



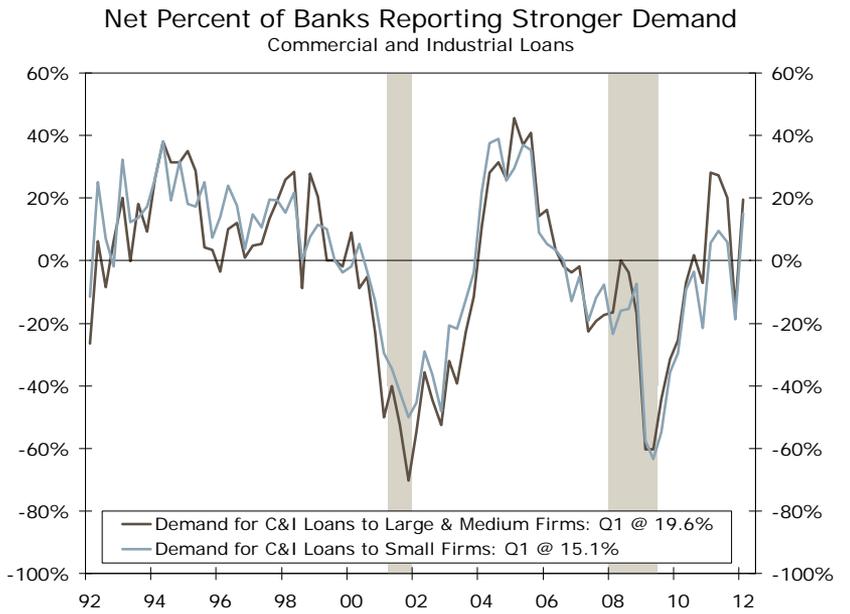
Source: Bloomberg and Wells Fargo Securities, LLC

Demand for loans has picked up, but credit standards are slightly tighter

## Standards



## Demand

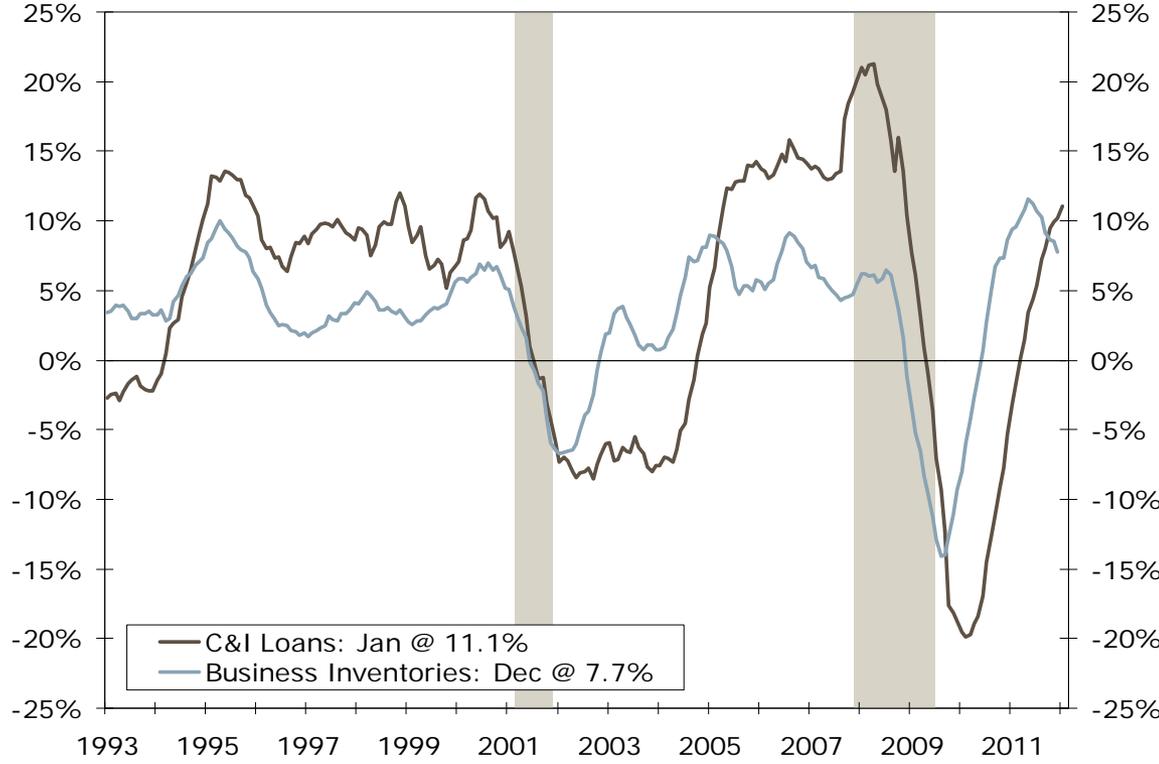


Source: Federal Reserve Board and Wells Fargo Securities, LLC

Banks are lending and helping to support business operations

### C&I Lending and Business Inventories

Year-over-Year Percent Change

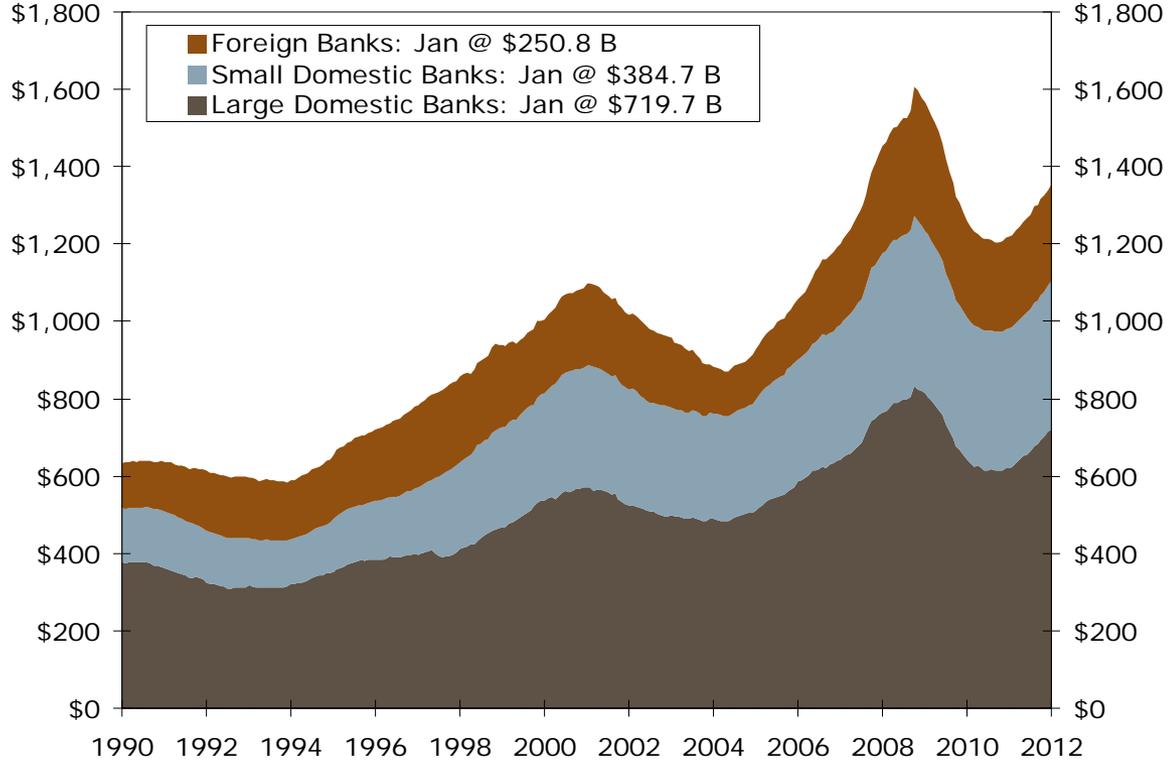


Source: Federal Reserve Board and Wells Fargo Securities, LLC

Banks of all types are integral to business lending

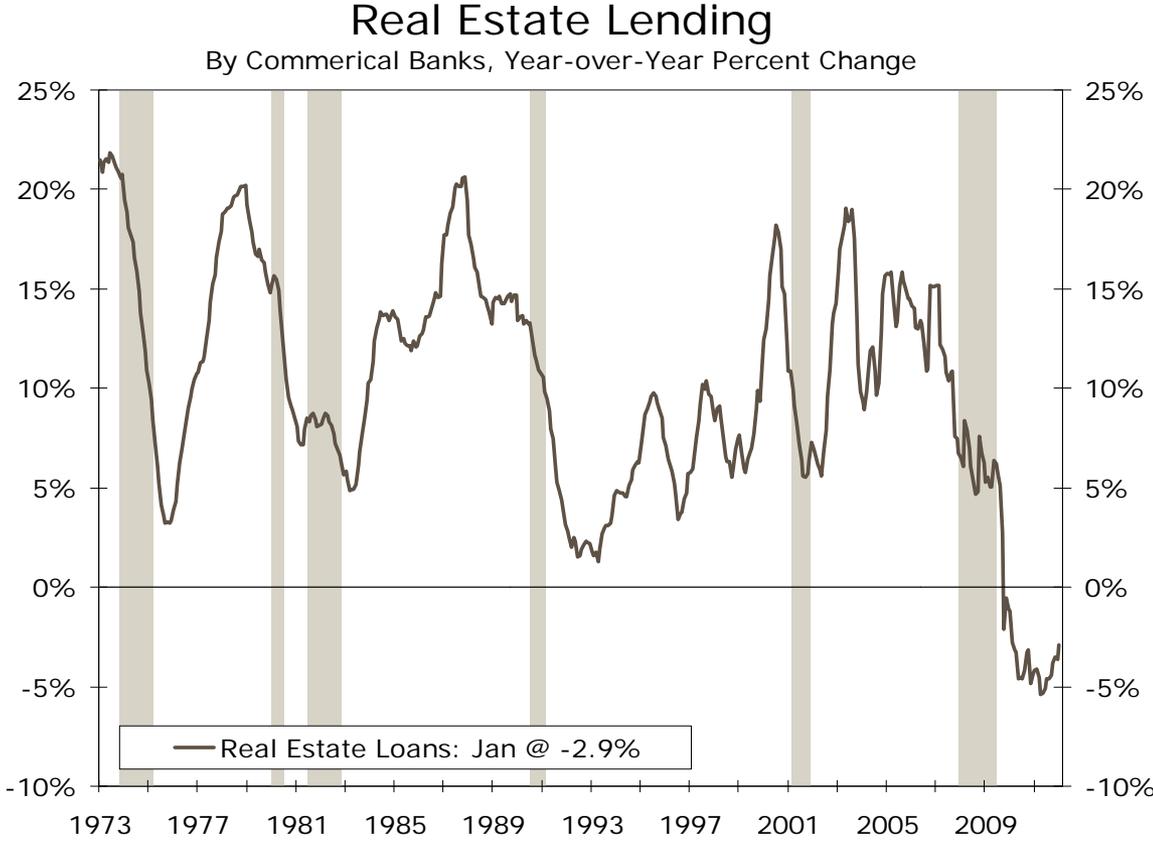
### Commercial & Industrial Loans by Bank Type

Billions of U.S. Dollars



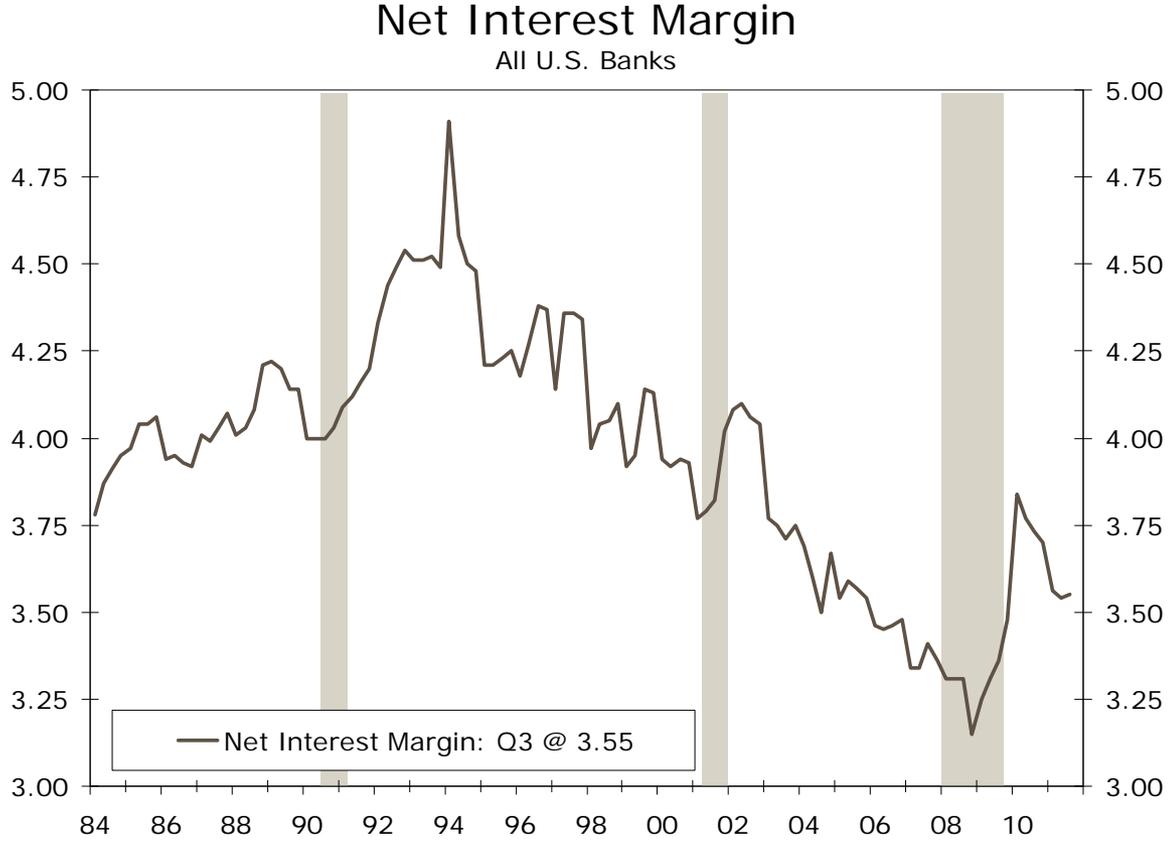
Source: Federal Reserve Board and Wells Fargo Securities, LLC

Retrenchment in real estate lending continues



Source: Federal Reserve Board and Wells Fargo Securities, LLC

The initial boost to margins from a low fed funds rate is fading

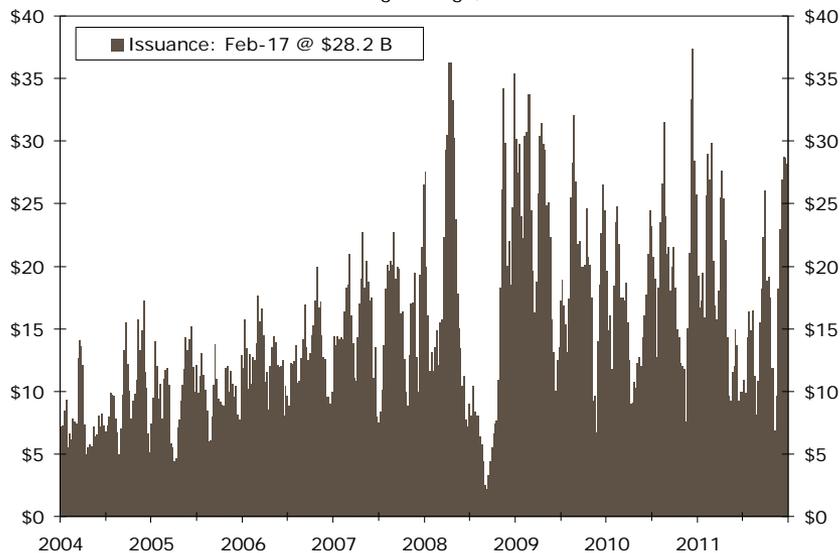


Source: Federal Financial Institutions Examination Council and Wells Fargo Securities, LLC

## Issuance is strong, spreads are declining

### Issuance

Investment Grade Corporate Issuance  
4-Week Moving Average, Billions of USD



### Spread

Investment Grade Corporate Spread  
Basis Points

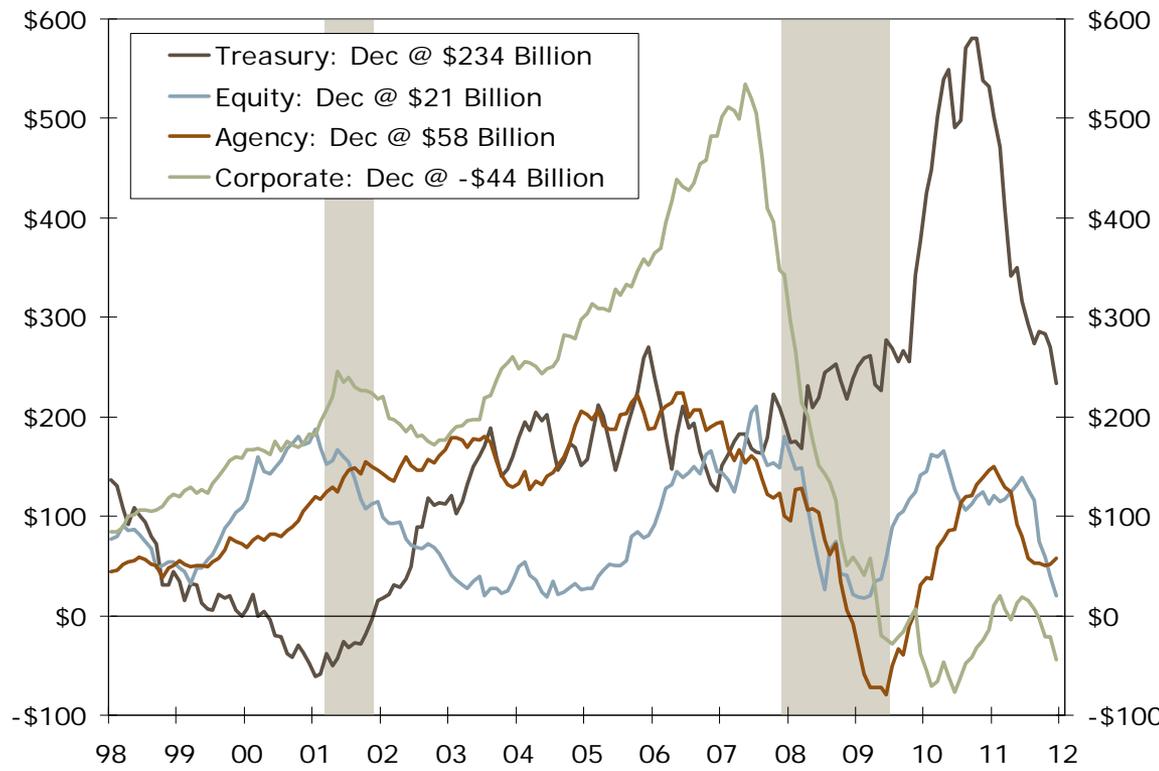


Source: Wells Fargo Securities, LLC

Foreigners continue to invest heavily in Treasuries; recent uptick in agency debt to watch

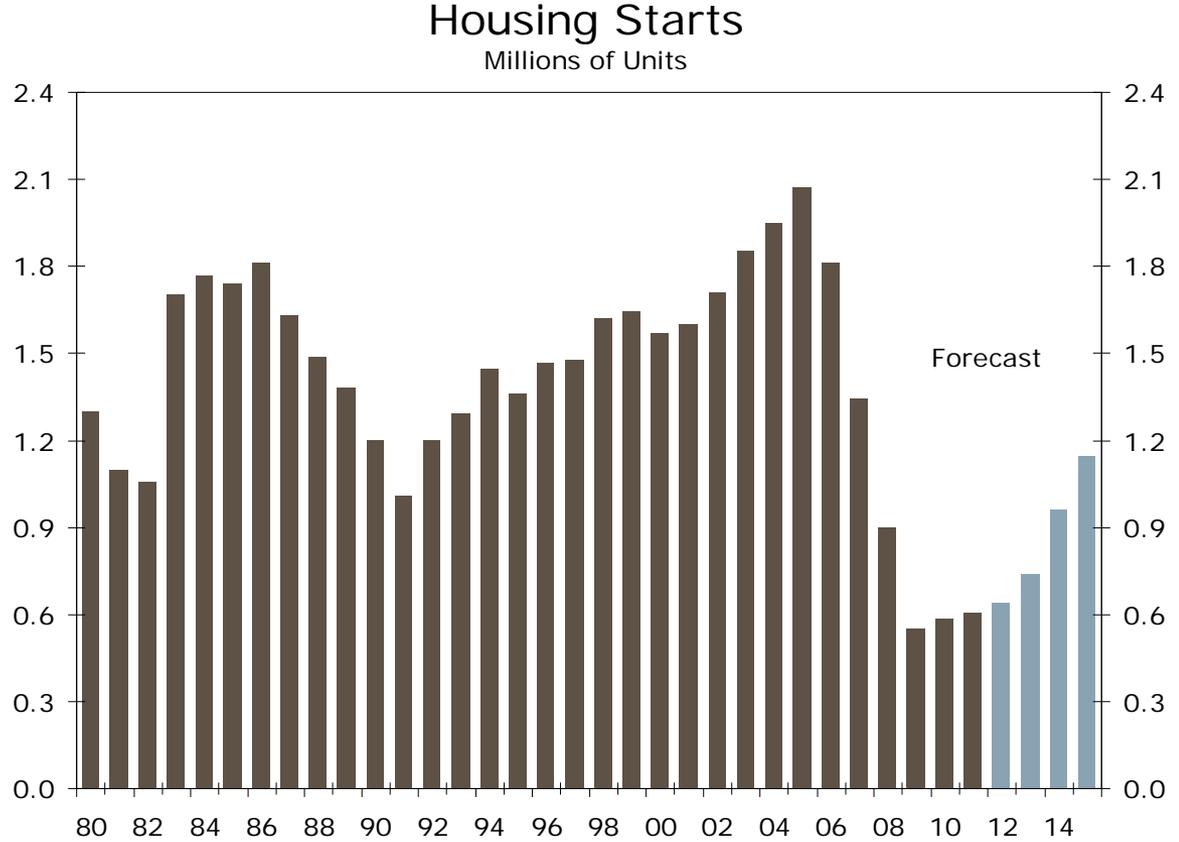
### Foreign Private Purchases of U.S. Securities

12-Month Moving Sum, Billions of Dollars



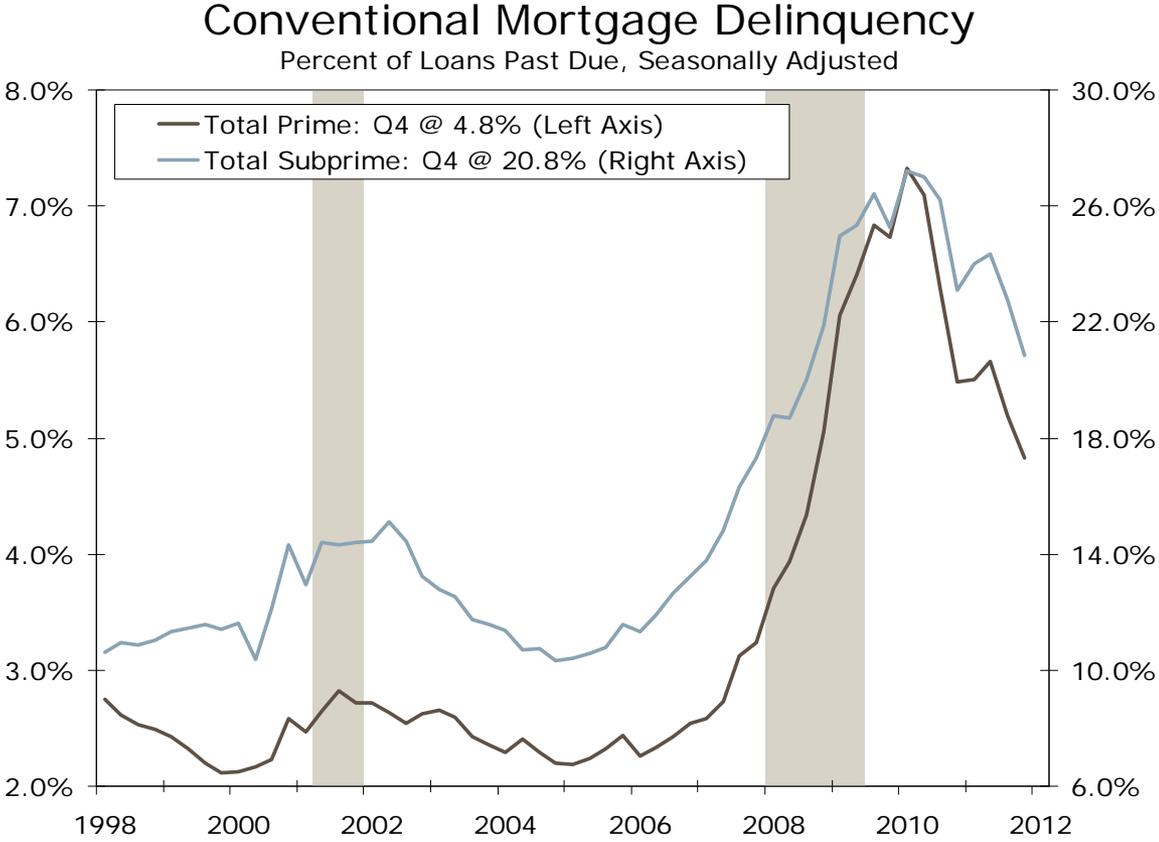
Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

Structural Challenge:  
What is the new sustainable  
pace?



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

Delinquencies are falling from all-time highs, but are still elevated by historic standards

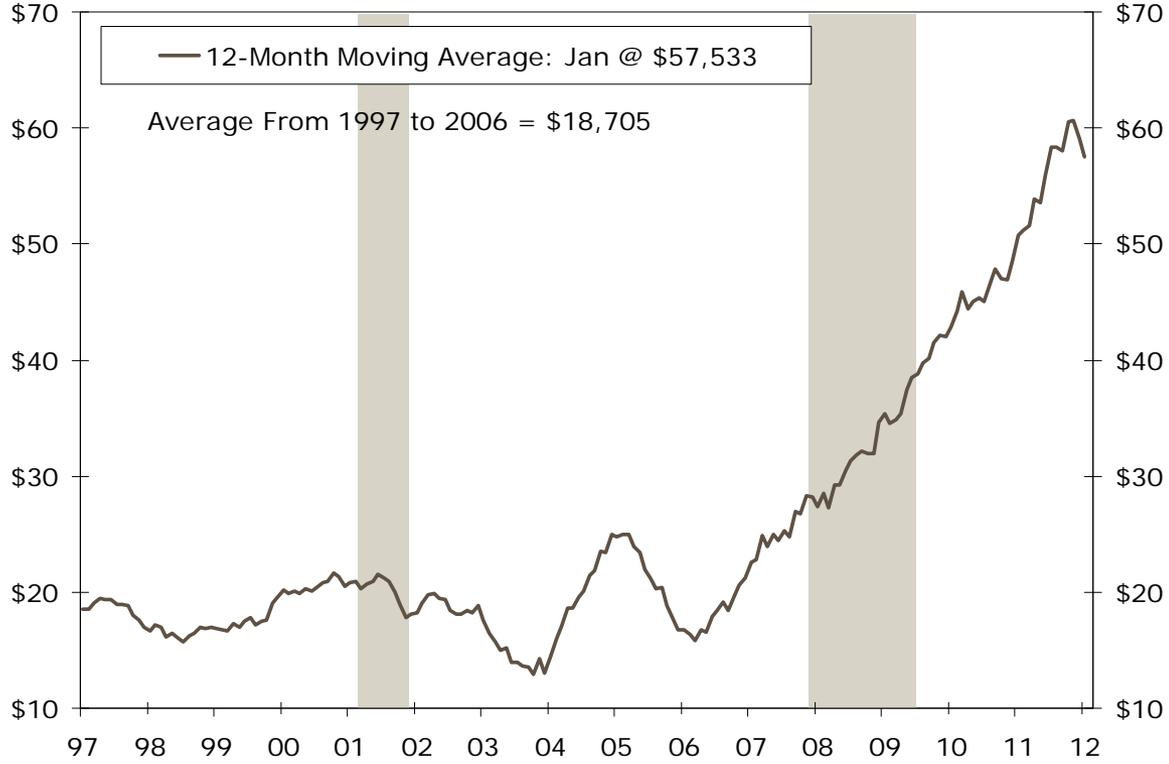


Source: Mortgage Bankers Association and Wells Fargo Securities, LLC

The high inventory of discounted existing homes has led to a large price premium for new homes

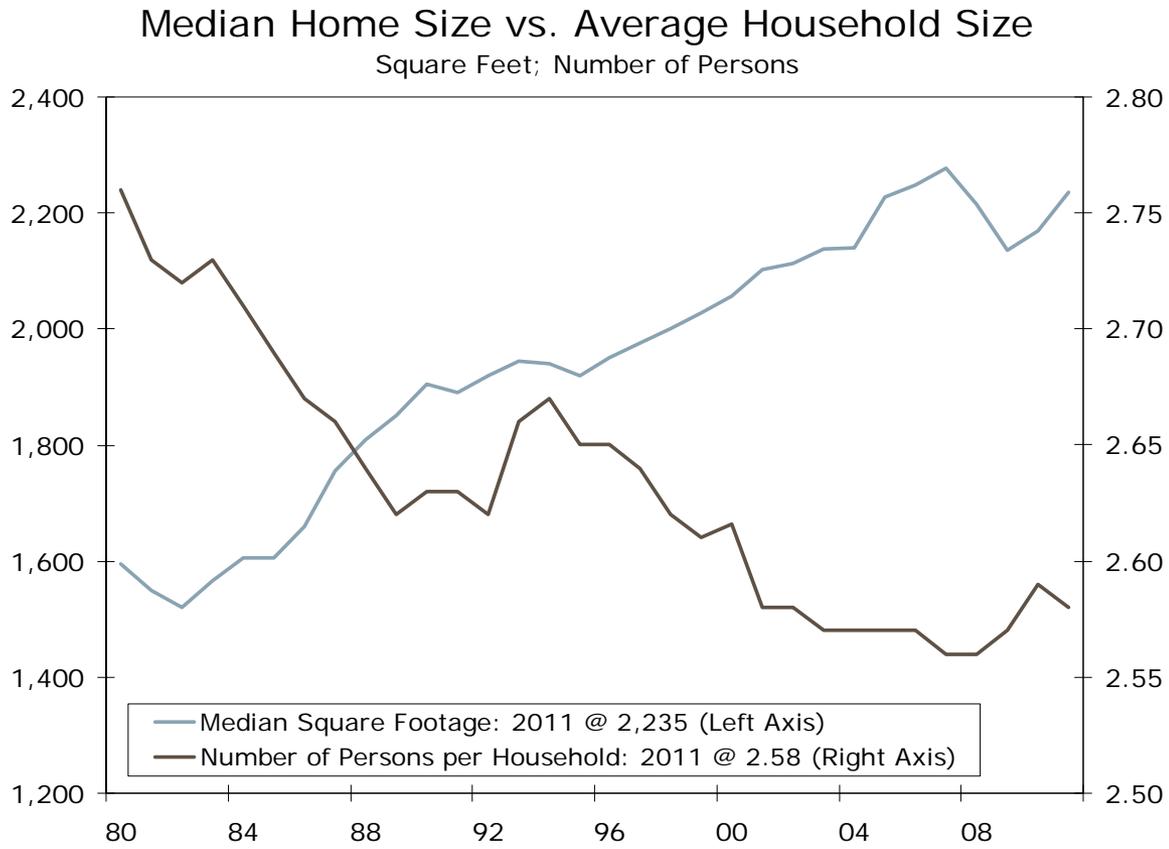
## Median New Minus Existing Sale Price

In Thousands, Single-Family



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

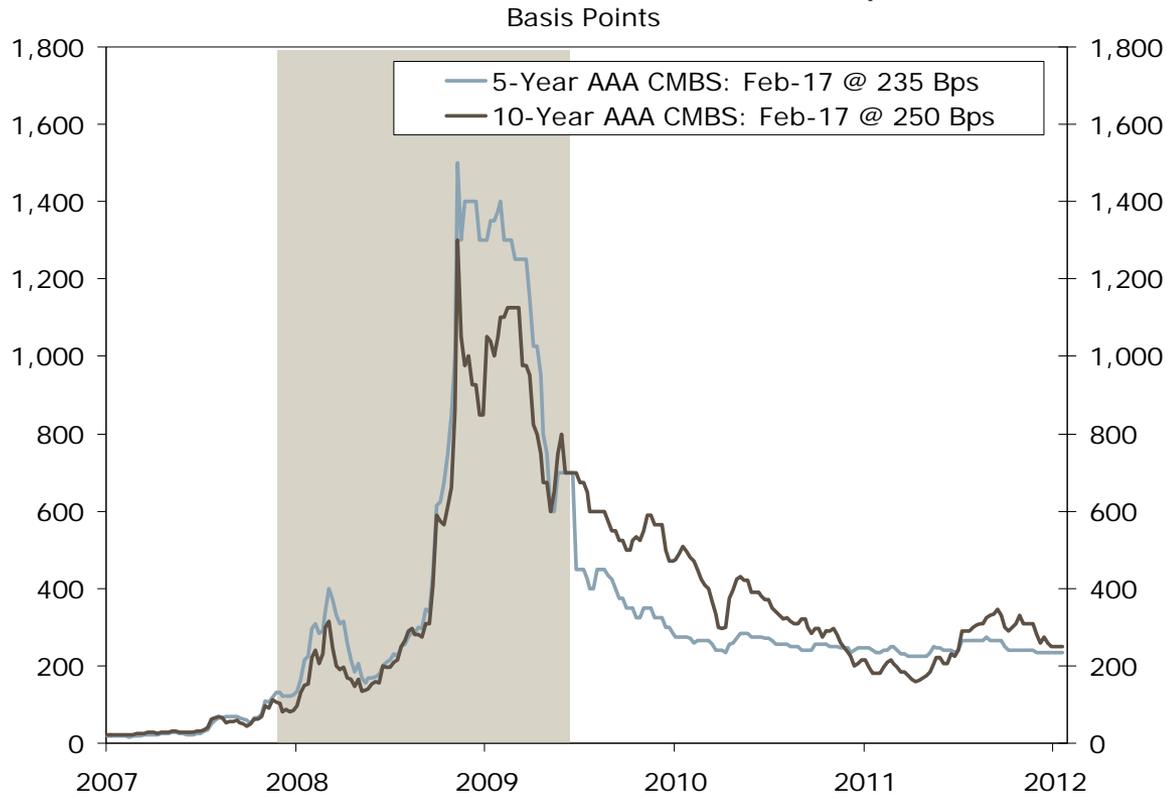
**Secular Shift?**  
Households are living in smaller homes with more people since the recession, but longer-term trends may win out



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

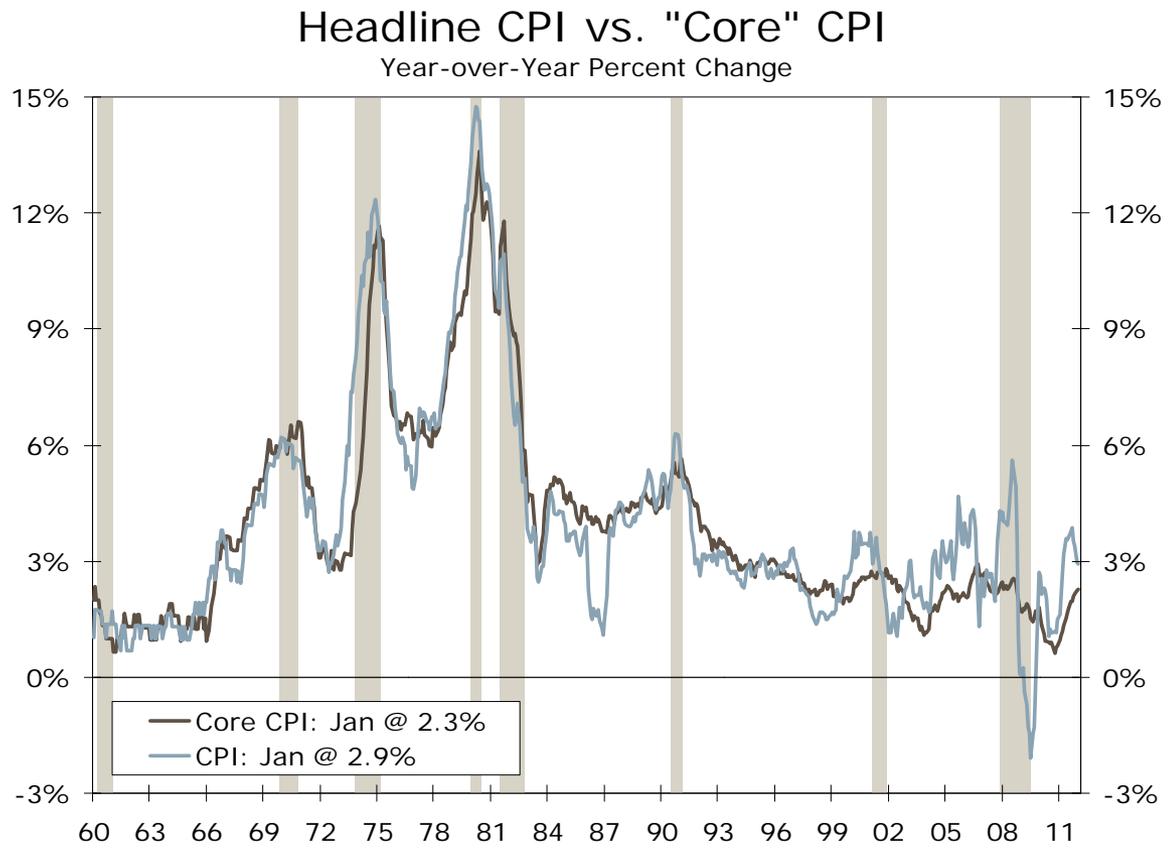
Spreads have stabilized

### 5-Year and 10-Year AAA CMBS Spreads



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

Rising volatility for headline inflation as food and energy prices are increasingly dependent on global demand

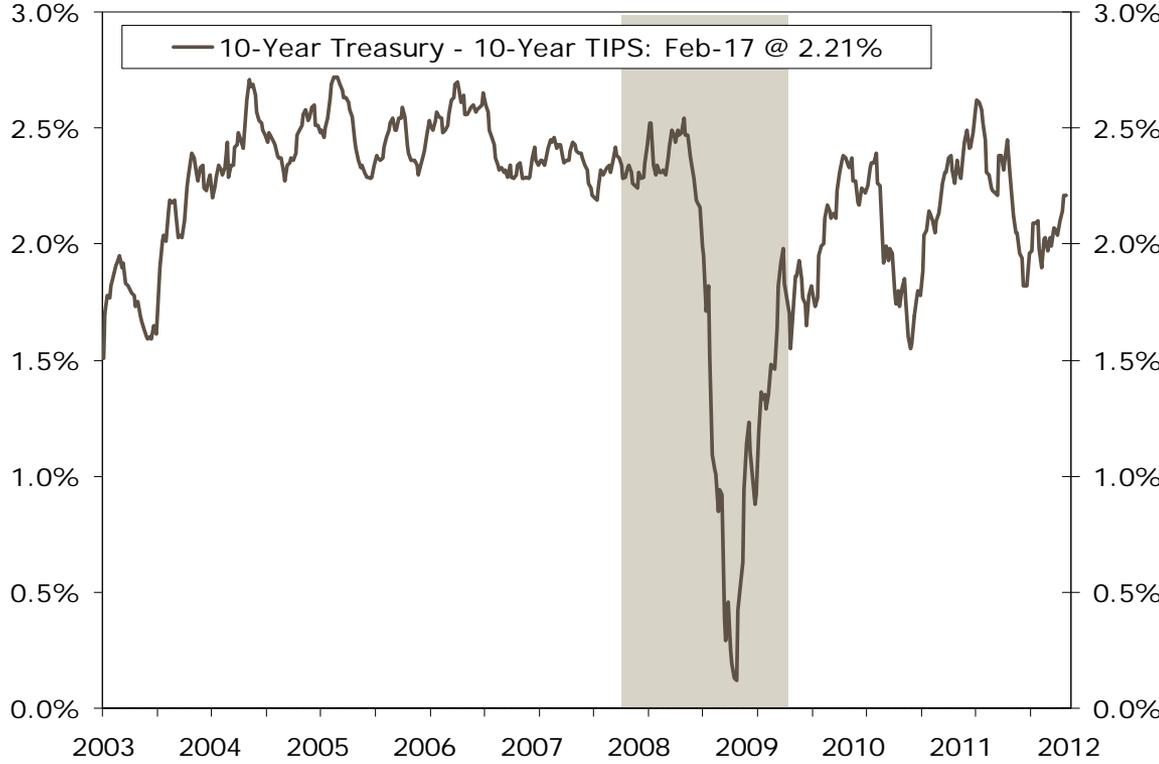


Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Inflation expectations are rising

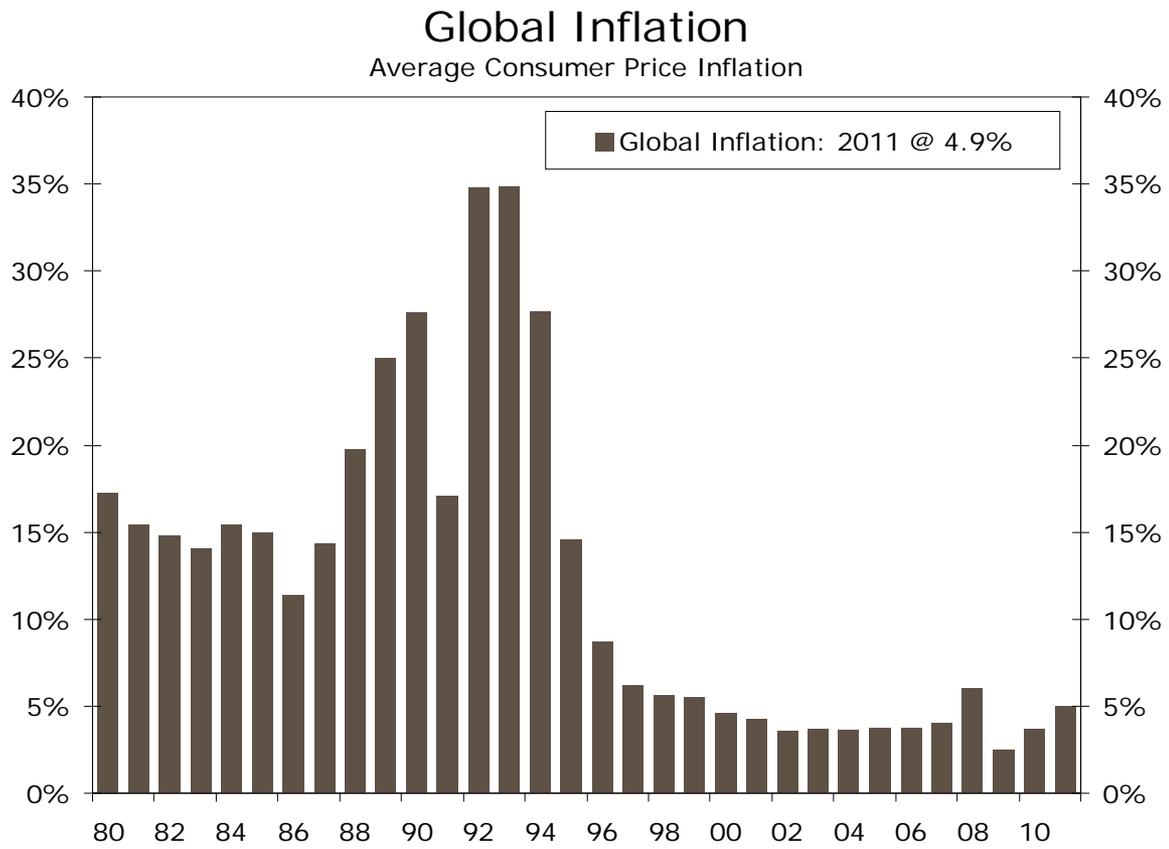
## 10-Year Implied Inflation Expectations

10-Year Treasury Yield Less 10-Year TIPS Yield



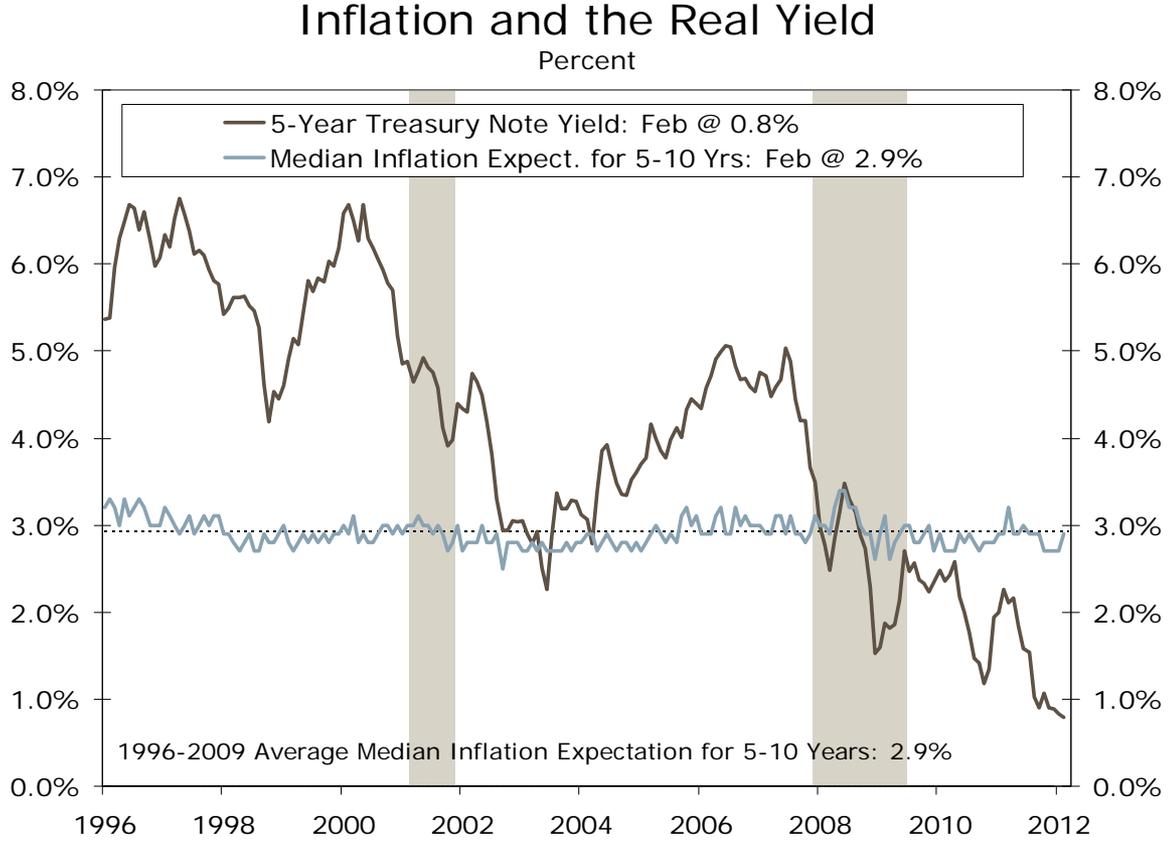
Source: Federal Reserve Board and Wells Fargo Securities, LLC

Moderating global inflation



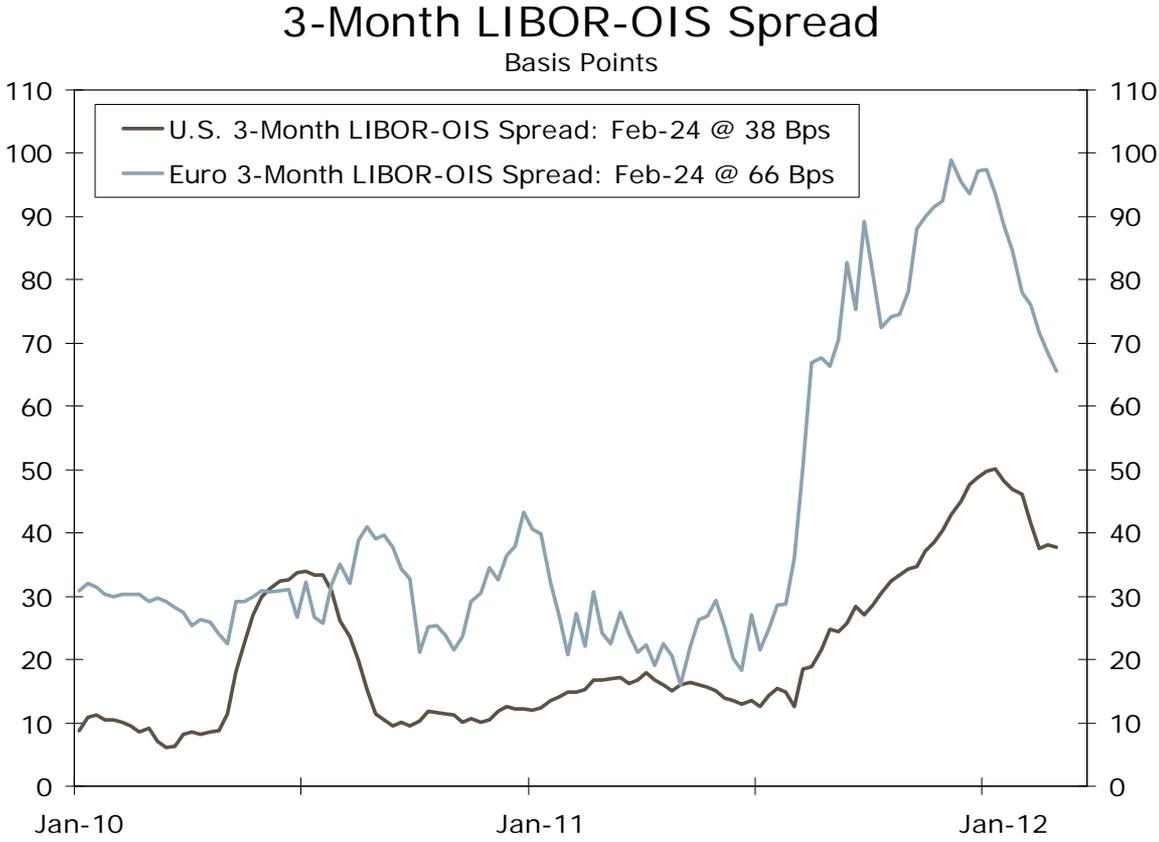
Source: International Monetary Fund and Wells Fargo Securities, LLC

Inflation expectations exceed nominal returns. What is the real risk-free rate?



Source: Federal Reserve Board and Wells Fargo Securities, LLC

Risk remains elevated despite falling in recent weeks

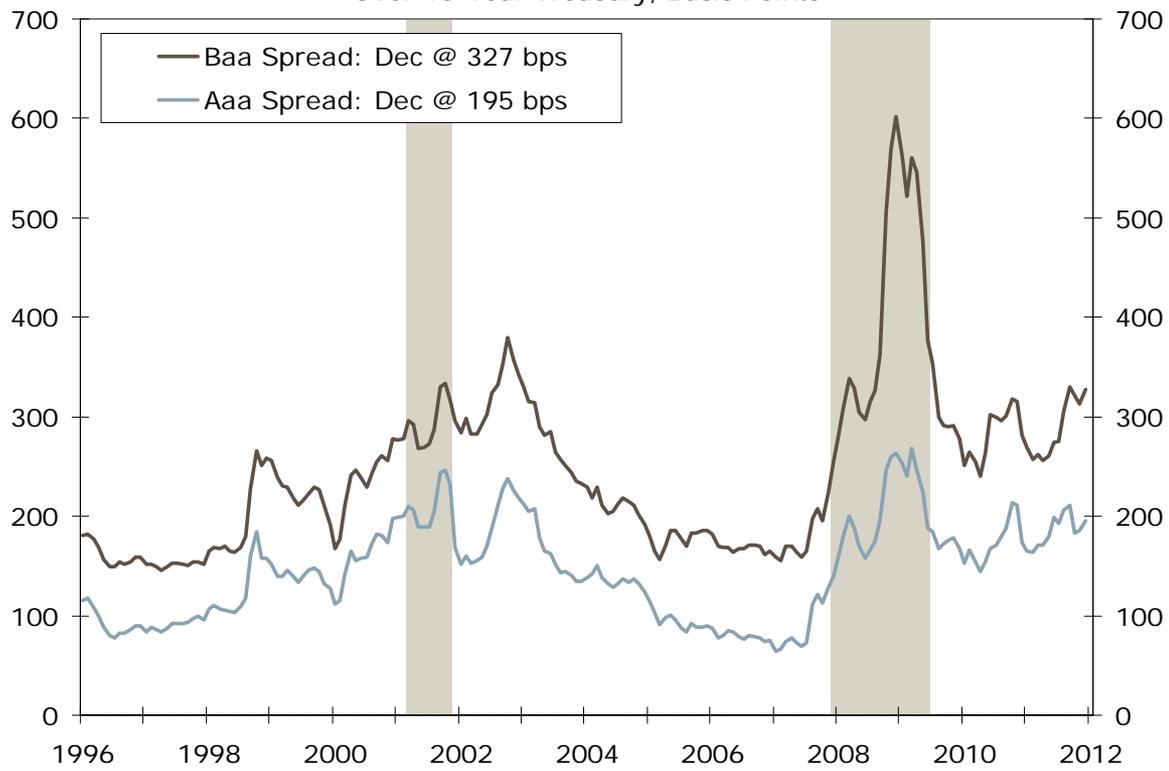


Source: Federal Reserve Board and Wells Fargo Securities, LLC

Spreads have returned to a more normal level; bond issuance is strong

## Aaa and Baa Corporate Bond Spreads

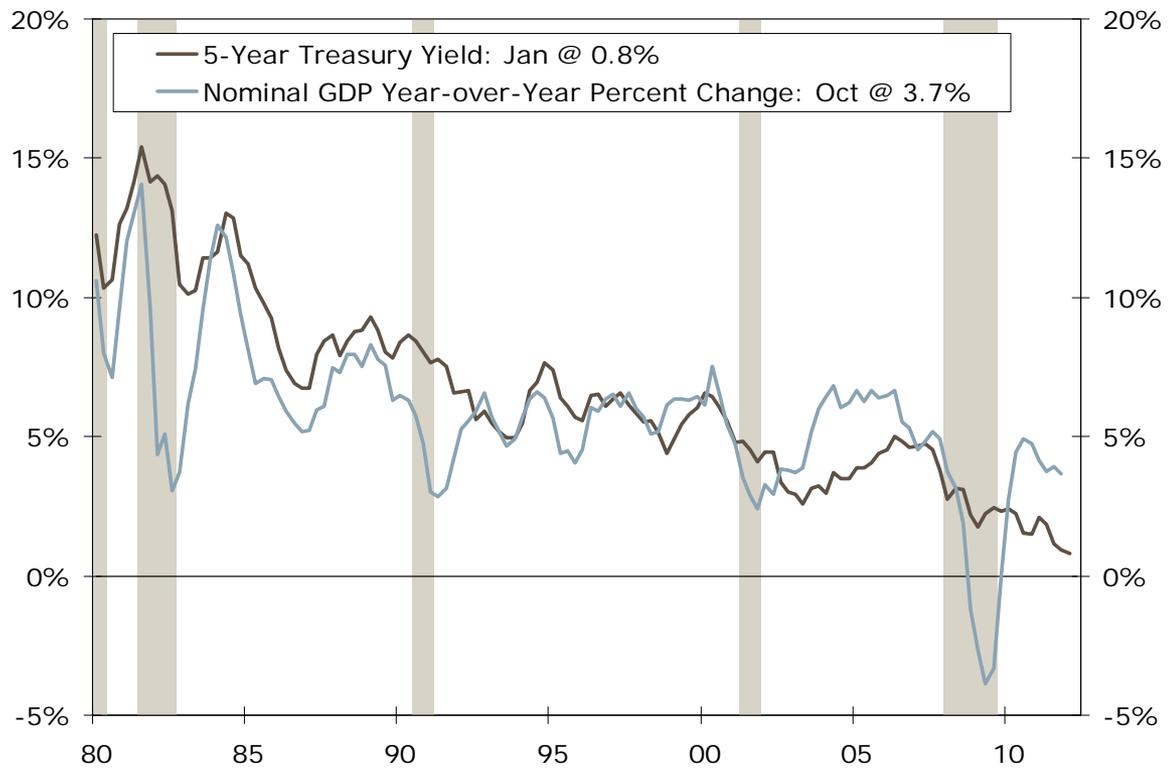
Over 10-Year Treasury, Basis Points



Source: Federal Reserve Board and Wells Fargo Securities, LLC

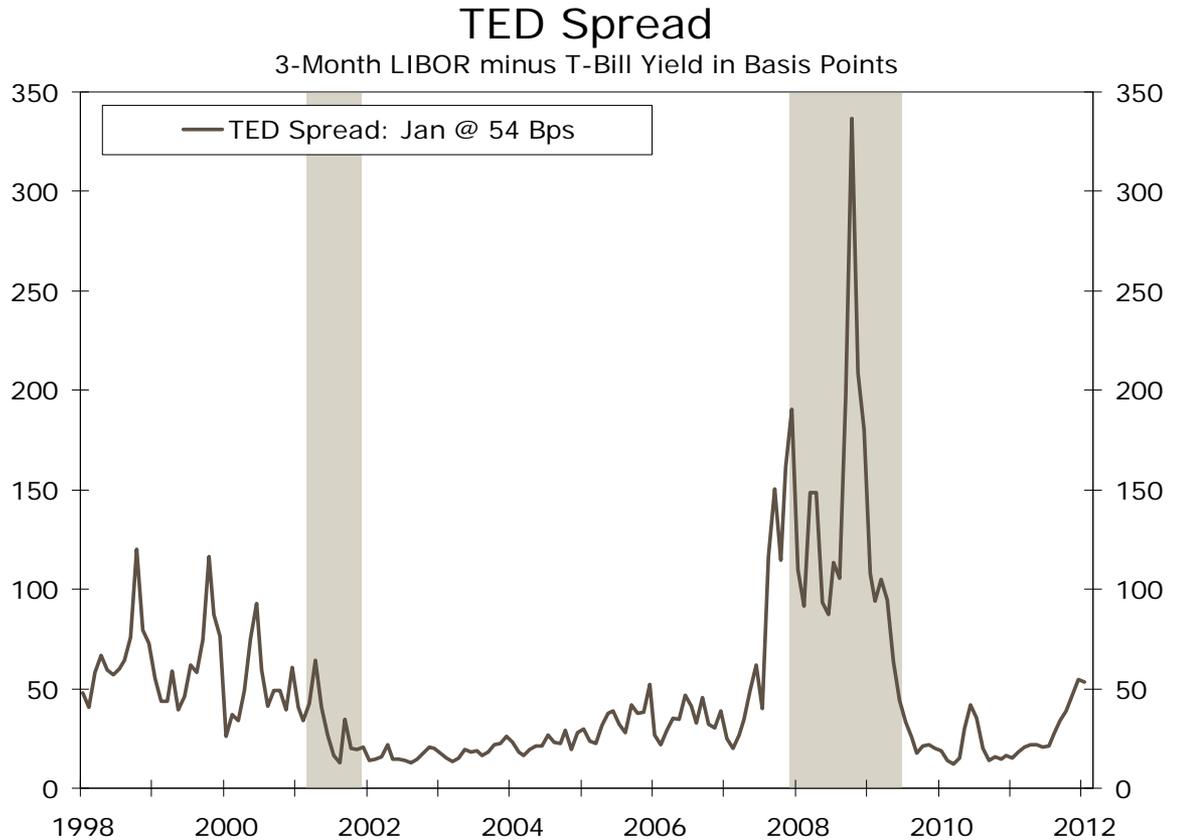
Disconnect:  
cyclical or secular?

5-Year Treasury Yield and Nominal GDP



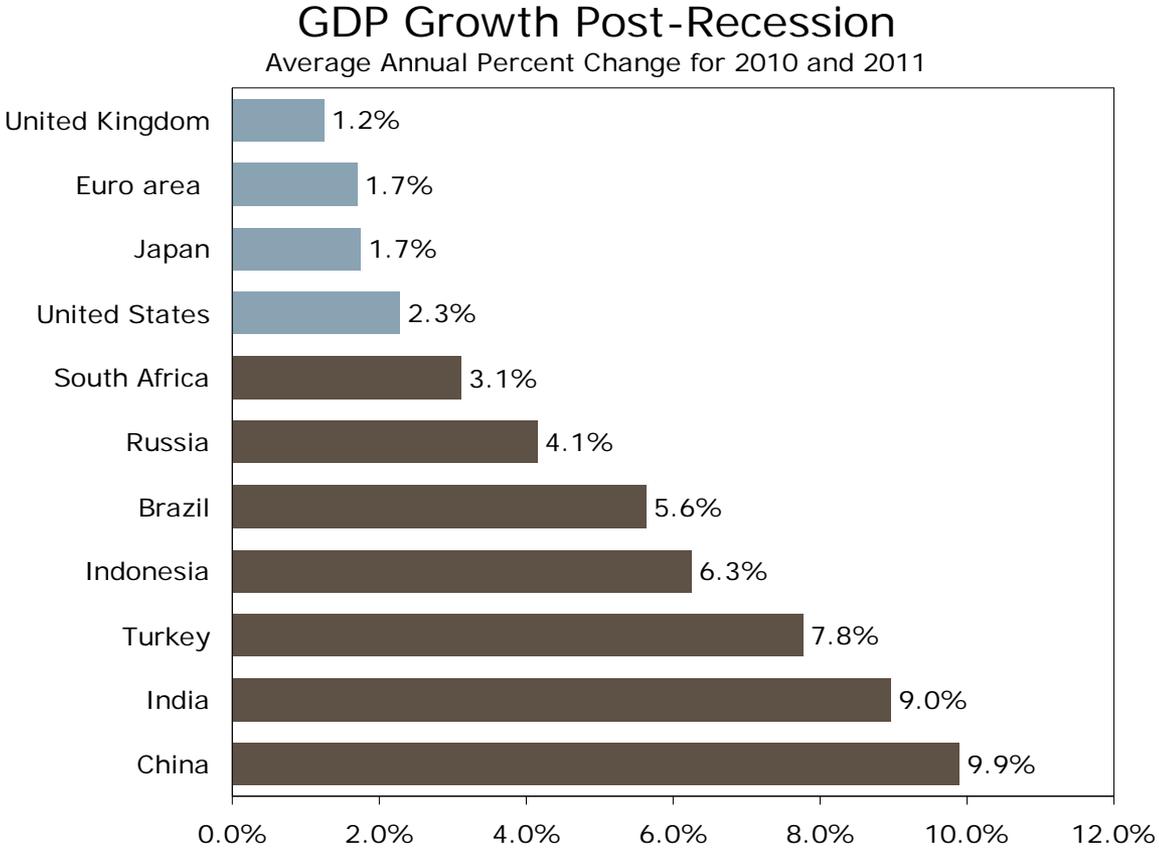
Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities, LLC

Uncertainty driven by the Eurozone debt crisis is keeping risk heightened



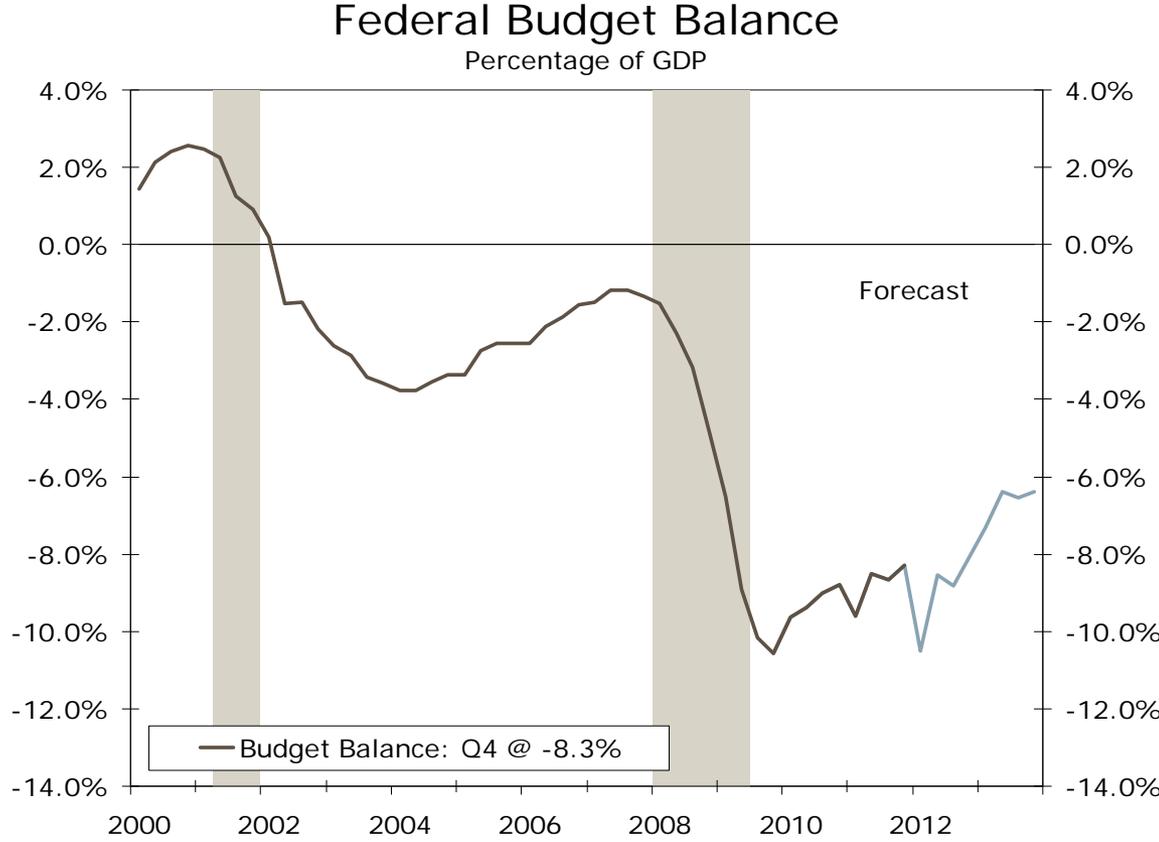
Source: Federal Reserve Board and Wells Fargo Securities, LLC

The global recovery is being driven by emerging markets



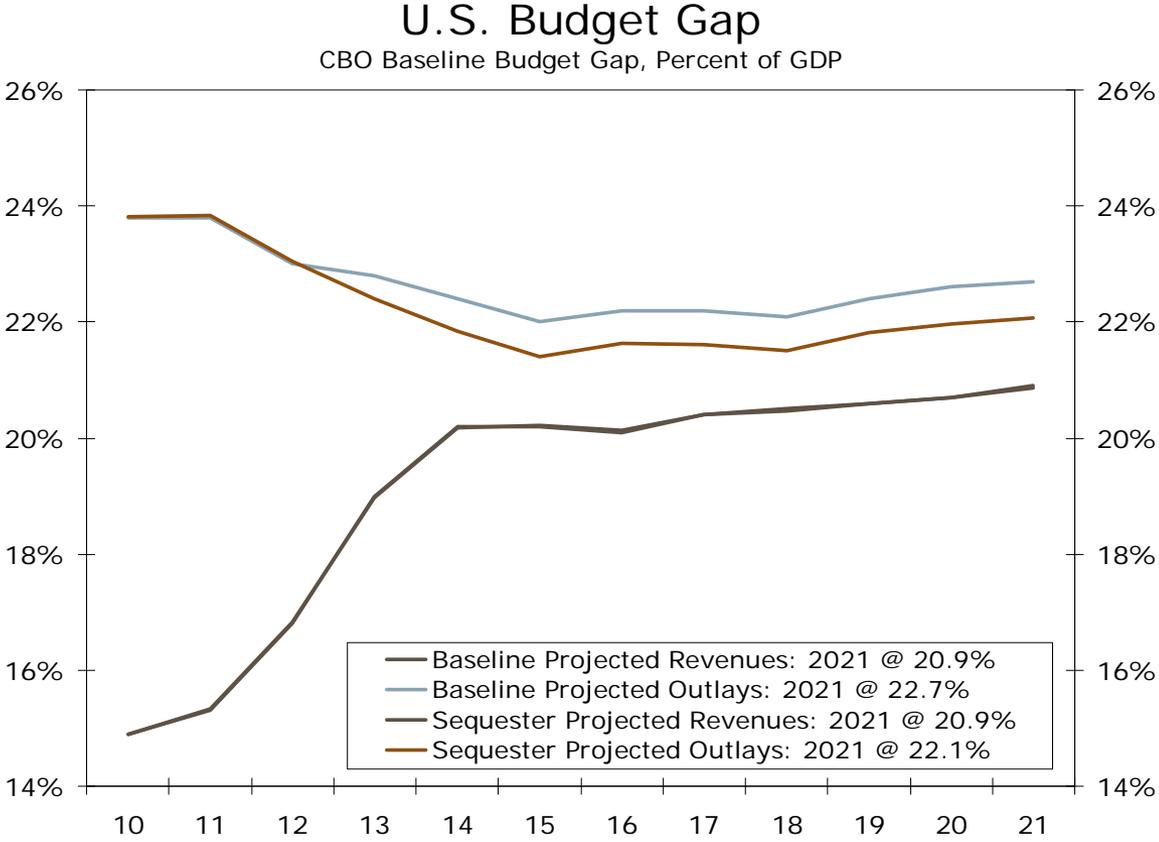
Source: International Monetary Fund and Wells Fargo Securities, LLC

The nation has entered uncharted waters in fiscal policy



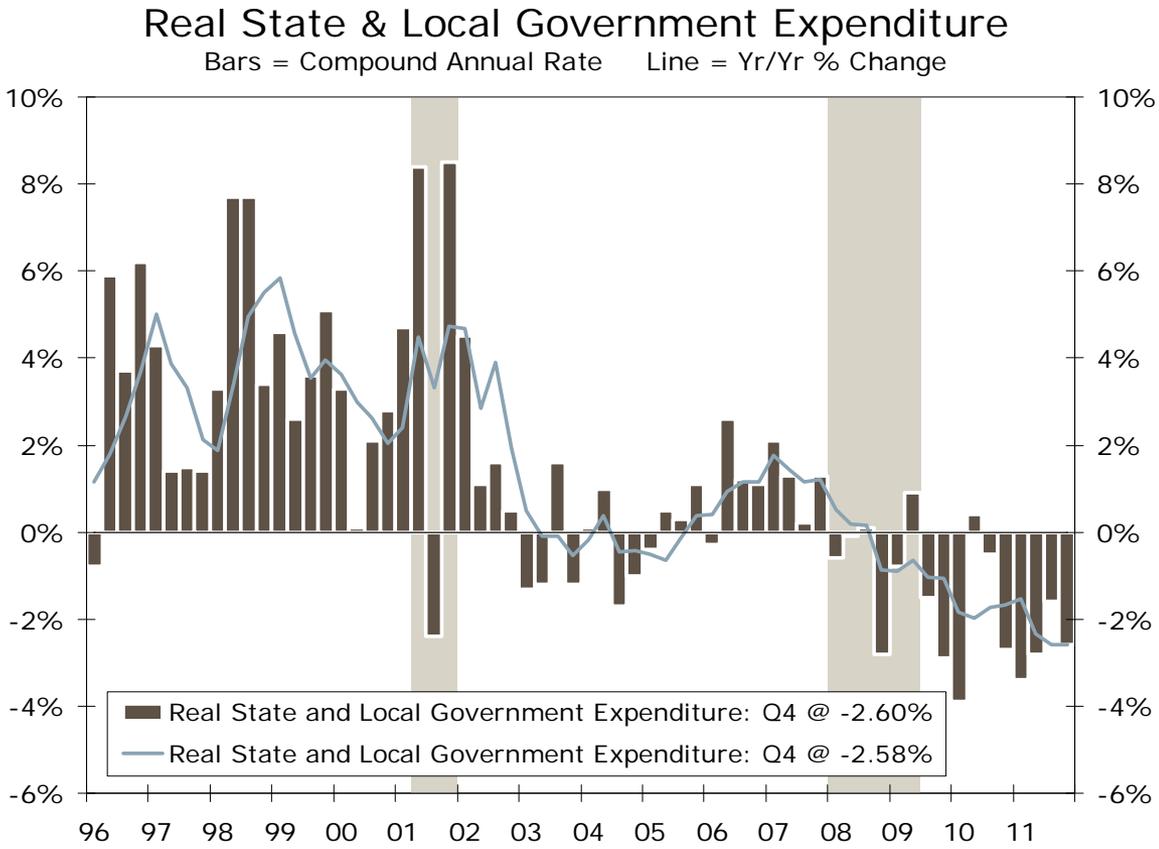
Source: U.S. Department of Commerce, U.S. Department of the Treasury and Wells Fargo Securities, LLC

Even with the automatic budget stabilization measures, outlays are projected to run above revenues over the next decade



Source: Congressional Budget Office and Wells Fargo Securities, LLC

State and local fiscal conditions will limit expenditures and will be a drag on GDP



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

What are the primary risks to the outlook?

### Potential Challenges to the Outlook

- Easier monetary policy brings questions for the dollar, inflation, interest rate and outlook
- Stronger job recovery takes hold
- 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

## Wells Fargo U.S. Economic Outlook

	Actual				Forecast	
	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Real Gross Domestic Product <sup>1</sup>	-0.4	-3.6	3.0	1.7	2.0	2.1
Personal Consumption	-0.7	-2.0	2.0	2.2	1.7	1.4
Equipment and Software	-4.1	-16.3	14.6	10.3	8.1	5.3
Government Purchases	2.5	1.7	0.7	-2.1	-1.9	-1.2
Consumer Price Index <sup>2</sup>	3.8	-0.3	1.6	3.1	2.0	2.0
Corporate Profits Before Taxes <sup>2</sup>	-16.4	9.1	32.2	7.8	6.3	6.6
10-Year Treasury Note	3.66	3.26	3.22	2.78	2.08	2.30

Forecast as of: February 24, 2012

<sup>1</sup> Compound Annual Growth Rate Quarter-over-Quarter

<sup>2</sup> Year-over-Year Percentage Change

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

# Appendix

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## A Sampling of Our Recent Special, Regional & Industry Commentary

Recent Special Commentary		
Date	Title	Authors
February-16	Does the New LEI Alter Recession Predictability Accuracy?	Silvia & Iqbal
February-13	Disparities of Education and Structural Unemployment	Silvia, Brown & Swankoski
February-13	WTI: No Longer A Benchmark For Oil Prices	Aleman
February-08	Bank Lending: Fed's Survey Suggests Support for Growth	Silvia & Watt
February-02	The Fragile Fiscal Policy Outlook: I	Silvia & Brown
January-31	Housing Chartbook: January 2011	Vitner, Khan & Seydl
January-31	How Does The Recent Drop In The Unemployment Rate Square With Okun's Law?	Vitner & Seydl
January-25	FOMC: Why the Recent Past Seldom Predicts the Future	Silvia
January-19	Vacancies and the Housing Recovery	Vitner & Seydl
January-13	How Might Fiscal Restraint Generate Economic Growth?	Silvia & Watt
January-13	Eastern Europe Faces Monetary Policy Dilemma	Anderson & Kashmarek
January-12	Global Chartbook: January 2012	
January-11	Bank Credit: A Surprisingly Typical Cycle	Silvia & Watt
January-05	The Charlotte Economy: Improvement Ahead	Silvia & Brown
December-30	Commodity Price Volatility to Continue	Aleman
December-28	Colorado Outlook: December 2011	Anderson & Kashmarek
December-22	South Korea Moves Forward on Free Trade	Anderson
December-21	Indian Economy: Still Deteriorating at the Margin	Bryson
December-21	Georgia Economic Outlook: December 2011	Vitner & Seydl
December-20	What's Behind the Upward Trend in Housing Activity?	Vitner & Khan
December-14	New Jersey Faces Additional Hurdles	Vitner, Khan & Watt
December-14	Russia: Black Gold and Political Stranglehold	Anderson & Kashmarek
December-20	Arizona: Growth, but at a Lower Gear	Aleman & Swankoski
December-19	Europe in 2012: Renaissance or More Dark Ages	Bryson, Quinlan, & Seydl
December-12	Thunder Down Under: Australia Braces for a Storm	Quinlan
December-09	Pennsylvania Economic Update and Outlook	Bryson, Quinlan, & Seydl
December-08	Minnesota Economic Outlook: December 2011	Anderson & Kashmarek
December-08	Credit Quality Monitor - December 2011	Anderson & Kashmarek
December-05	What is Driving Construction Spending?	Vitner & Khan
November-30	Coordinated Action by Major Central Banks	Bryson
November-30	California Outlook: November 2011	Anderson & Watt
November-22	The Deficit Reduction Committee: A Successful Failure	Silvia, Bullard, Brown & Watt
November-22	Giddy-Up Jingle Horse: Holiday Sales Preview	Vitner, Quinlan, & Seydl
November-16	Global Chartbook: November 2011	
November-15	Has the Fed's Unconventional Approach Been Successful?	Silvia & Khan
November-15	Economic Mobility: Is "Rags to Riches" Still Possible?	Silvia, Quinlan & Seydl
November-14	U.S. States with Exposure to a European Recession	Vitner & Brown
November-07	North Carolina: A Story of Uneven Progress	Silvia & Brown
November-03	Is U.S. Manufacturing in Decline?	Anderson, Brown & Swankoski
November-02	ASEAN-5 Economies Fundamentally Sound	Bryson
November-02	Employment: Beyond the Sound Bites—Reading the Signals IV	Silvia & Watt
November-01	Character of Recovery V: Sector and Employment Differences	Silvia & Iqbal

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