WELLS FARGO

Weekly — January 26, 2024

Weekly Economic & Financial Commentary

United States: **Almost Everything Coming Up Roses**

- Data released this week garnered further optimism that the economy can power through the Federal Reserve's efforts to corral inflation—an endeavor the Fed could increasingly be construed as achieving. Economic activity ended the year on better footing than expected, and inflation continued its deceleration.
- Next week: Construction Spending (Thu.), ISM Manufacturing (Thu.), Employment (Fri.)

International: **Foreign Central Banks at the Forefront**

- It was a busy week for foreign central banks. The Bank of Japan appears to be on course for an April rate hike, while a dovish Bank of Canada announcement suggested the risks are tilted toward an earlier initial rate cut than our June base case. We still forecast an initial rate cut from the European Central Bank in April, though we acknowledge that risks for a later June move do exist.
- Next week: China PMIs (Wed.), Bank of England Policy Rate (Thu.), Eurozone CPI (Thu.)

Interest Rate Watch: **In a Holding Pattern**

- As discussed in our Fed Flashlight report released this week, we share the near-universally held view that the FOMC will leave the fed funds rate and pace of quantitative tightening (QT) unchanged at its upcoming meeting on January 31.

Credit Market Insights: **Increased Borrowing in the Beige Book**

- In the most recent Beige Book released by the Fed, a majority of the 12 Federal Reserve Districts reported little or no change in economic activity, reflecting the continuing resilience of the economy. However, closer examination of this month's Beige Book reveals the cracks that are beginning to emerge in the economy, particularly for household borrowing.

Topic of the Week: **Sea of Red**

- The recent Houthi militant attacks in the Red Sea have thrown a wrench in global supply chains. Container ship spot rates have jumped as capacity is stretched and popular trade routes are diverted around the southern tip of Africa. For the U.S., the impact may be more muted as businesses look to be in far better shape to weather any potential supply disruption today.

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Wells Fargo U.S. Economic Forecast

	Actual 2023				Forecast 2024				Actual		Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2022	2023	2024	2025
Real Gross Domestic Product [1]	2.2	2.1	4.9	3.3	1.4	1.1	0.5	1.0	1.9	2.4	1.7	1.7
Personal Consumption	3.8	0.8	3.1	2.8	1.0	0.5	0.5	1.1	2.5	2.2	1.3	1.4
Consumer Price Index [2]	5.8	4.1	3.6	3.2	2.9	2.8	2.4	2.3	8.0	4.1	2.6	2.3
"Core" Consumer Price Index [2]	5.6	5.2	4.4	4.0	3.6	3.2	3.0	2.7	6.1	4.8	3.1	2.4
Quarter-End Interest Rates [3]												
Federal Funds Target Rate[4]	5.00	5.25	5.50	5.50	5.50	5.00	4.50	4.25	2.02	5.23	4.81	3.63
Conventional Mortgage Rate	6.54	6.71	7.20	6.82	6.80	6.60	6.35	6.05	5.38	6.80	6.45	5.76
10 Year Note	3.48	3.81	4.59	3.88	4.00	3.85	3.70	3.60	2.95	3.96	3.79	3.51

Forecast as of: January 12, 2024 [1] Compound Annual Growth Rate Quarter-over-Quarter [2] Year-over-Year Percentage Change
[3] Quarterly Data - Period End; Annual Data - Annual Averages [4] Upper Bound of the Federal Funds Target Range

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.

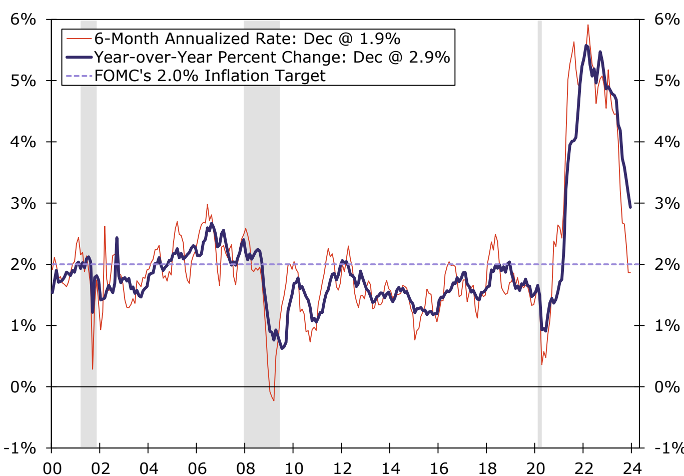
U.S. Review

Almost Everything Coming Up Roses

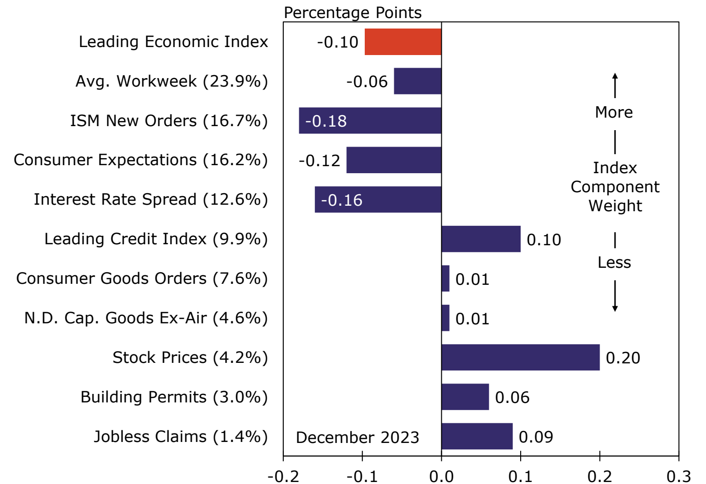
Data released this week garnered further optimism that the economy can power through the Federal Reserve's efforts to corral inflation—an endeavor the Fed could increasingly be construed as achieving. Economic activity ended the year on better footing than expected. GDP in the fourth quarter expanded at a 3.3% annualized rate, topping expectations for a more run-of-the-mill 2.0% increase. While Q4's advance marked a slowdown from the third quarter's 4.9% pace, drivers were broadly based. Residential investment notched a second straight increase in a sign housing activity has bottomed, while government spending plowed ahead at a 3.3% clip. Business investment also picked up over the quarter, including a rebound in equipment spending. December orders of durable goods, also released this week, signaled capex growth should continue in the near term. Nondefense capital goods orders excluding aircraft came in a bit stronger than anticipated and, at a three-month average annualized rate of 1.5%, is rising at the fastest pace since last June. Beyond fixed investment, businesses signaled optimism in activity in the months ahead with a faster pace of inventory accumulation in the final quarter of 2023. The stronger inventory build gave a lift to Q4 GDP and contributed to the upside surprise. Trade also lifted the headline more than expected amid a meaningful pickup in export activity.

The U.S. consumer, however, continues to be the stalwart of growth. Real consumer spending grew 2.8% annualized in Q4, barely slowing from the third quarter's impressive 3.1% showing. December's data showed spending wielding more momentum through the final month of the year. Personal outlays adjusted for inflation rose 0.5% as consumers splashed out for goods (up 1.1%) and continued to defy expectations that further growth in services (up 0.3% in December) would come at the expense of longer-lasting "things." The solid rate of spending in December, however, did come at the expense of a slightly lower rate of saving. The saving rate dipped to a 12-month low of 3.7%, as inflation-adjusted incomes rose just 0.1% over the month. With credit growth slowing and excess liquidity dwindling, income will be an increasingly important driver of spending ahead.

The Fed received good news this week not only on U.S. growth, but also on inflation. The PCE deflator excluding food and energy—the FOMC's preferred gauge of the recent trend in inflation—rose a rather tame 0.2% in December. Over the past six months, core PCE inflation has risen at a 1.9% annualized pace, a touch lower than the central bank's target of 2.0%. Not only has the run-up in goods inflation continued to unwind, but inflation for core services excluding housing—a more lingering source of concern among Fed officials—has also decelerated to a 3.5% year-over-year pace from 5.0% at the start of 2023.



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



Source: The Conference Board and Wells Fargo Economics

Although we now think it is more likely than not that the economy will continue to expand in the coming quarters, we note that the economy is not completely out of the danger zone, and the probability of a U.S. recession this year is significantly elevated above its baseline. We remain cognizant of the continued signs that the U.S. economy cannot hum along above potential forever, and certain

releases this week remind us that we have not yet received an "all clear" report from the economic data.

Regional indicators of activity all missed to the downside in recent releases from the regional Federal Reserve banks. The Richmond Fed's manufacturing index fell to -15, which is the lowest the manufacturers' sentiment in the mid-Atlantic region has been since spring 2020. The Philly Fed's General Business Activity Index again contracted in January after it had broken into positive territory for the first time in over a year back in December. On a national scale, the Leading Economic Index (LEI) continues to signal recession. Having slid 0.1% in December, the indicator has declined for 22 consecutive months, and now stands just three points above its low point during the initial pandemic lockdown. That said, six components positively contributed to the LEI in December—the most since early 2022. Furthermore, the monthly decline was a much smaller magnitude than the 0.7% fall that has averaged over the previous three months. The milder pace of contraction suggests that activity, especially in interest-rate sensitive sectors, has found a floor.

As we wrote in a recent report, we are paying special attention to signs of softening in the labor market as a negative turn in employment growth could catalyze a vicious cycle and dampen consumer spending. With real income growth slowing, the labor market will become an increasingly important leg of spending power. Jobless claims remain historically low but surprised to the upside for both initial and continuing claims at 214K and 1,833K, respectively, in their most recent readings. Overall, we interpret the data of this week as indicative of a resilient U.S. economy, likely to continue to grow, but at a more sluggish pace than seen over the past few years.

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U.S. Outlook

Weekly Domestic Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
1-Feb	Construction Spending (MoM)	Dec	0.5%	0.5%	0.4%
1-Feb	ISM Manufacturing Index	Jan	47.3	47.6	47.4
2-Feb	Nonfarm Payrolls	Jan	180K	155K	216K
2-Feb	Unemployment Rate	Jan	3.8%	3.8%	3.7%
2-Feb	Average Hourly Earnings (MoM)	Jan	0.3%	0.3%	0.4%

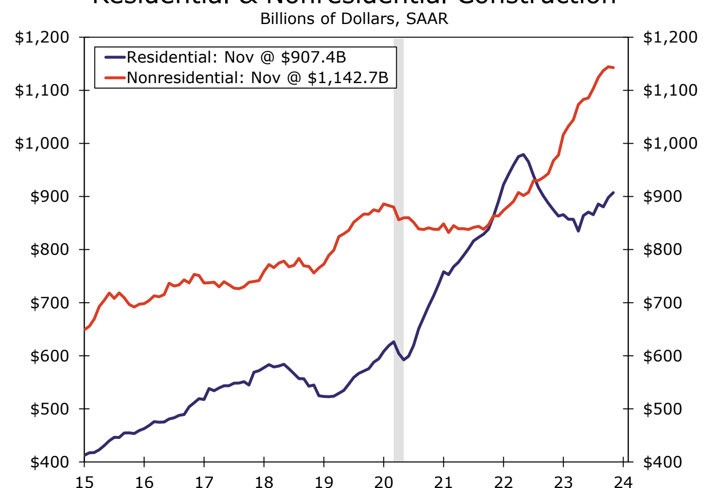
Forecast as of January 26, 2024

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

Construction Spending • Thursday

Construction spending rose a solid 0.4% in November, which translates to an 11.3% annual gain. Overall growth in construction outlays continues to be fueled by private single-family outlays, which have picked up for seven consecutive months. The recent gains in the single-family category reflect lower mortgage rates and relative attractiveness of new construction amid scarce supply and tough affordability conditions in the existing home market. On the downside, multifamily outlays continue to moderate off of the post-pandemic construction boom alongside normalizing apartment demand and declining multifamily starts.

In terms of nonresidential spending, soaring manufacturing project outlays continue to boost overall outlays, a trend that is likely to continue. However, a considerable drop in commercial construction starts amid uncertain demand for commercial real estate, elevated financing costs and restrictive lending conditions suggests nonresidential spending will weaken in the months ahead. That noted, strengthening single-family construction should continue to lift overall spending, and we expect a 0.5% gain in total outlays for December.

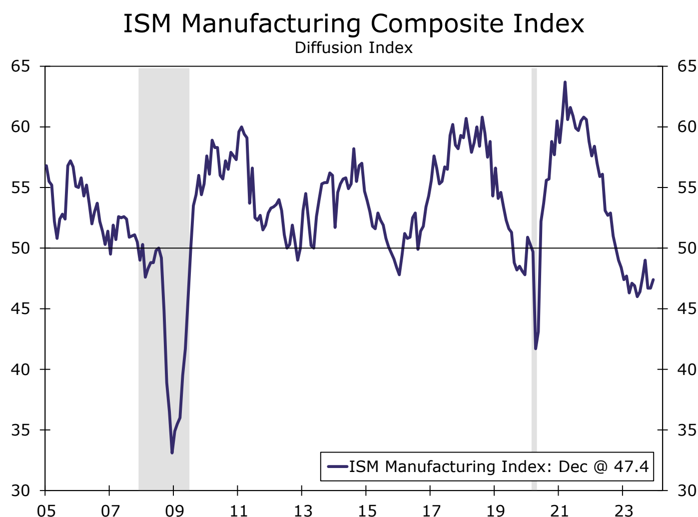


Source: U.S. Department of Commerce and Wells Fargo Economics

ISM Manufacturing • Thursday

High interest rates, moderating goods consumption and weaker global economic growth continue to weigh on the factory sector. The headline ISM manufacturing index, which increased to 47.4 in December, has been hovering below the break-even 50 level for 14 straight months.

That noted, the top-line index did notch a gain to end 2023, and several of the underlying details indicate that manufacturing activity may be starting to pick up a bit. New orders declined, but the production and order back-log sub-indexes both rose during December, portending further improvement in overall activity in the months ahead. In addition, the producers who provided comments for December's survey struck a more optimistic tone, given the prospect for lower interest rates. What's more, the preliminary reading for the S&P Global US Manufacturing index covering January jumped more than consensus estimates. With that in mind, we anticipate the ISM manufacturing index edged up to 47.6 in January.



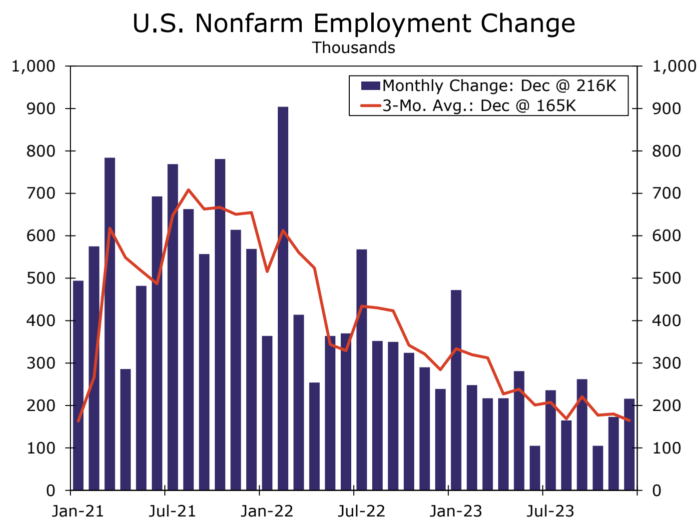
Source: Institute for Supply Management and Wells Fargo Economics

Employment • Friday

The final payroll print of 2023 was fairly unremarkable. Total payrolls rose by 216K during December, continuing the trend of slowing yet sturdy monthly job gains. Hiring in the government, healthcare and leisure & hospitality industries continued to drive overall employment growth. Meanwhile, the unemployment rate held steady at 3.7%, while average hourly earnings registered a 0.4% monthly gain, matching November's pace.

All told, the themes of improving supply, cooling demand and overall labor market normalization likely continued in January. We estimate that nonfarm payrolls rose by 155K in January, a downshift from December's gain and a bit below the current Bloomberg consensus. Although payroll growth has held up remarkably well recently, there are several signs of further moderation in the months ahead. On net, fewer industries are adding headcounts each month and job openings and hiring plans continue to pull back. Furthermore, initial jobless claims remain low, but continuing claims have edged up, which is an indication that displaced workers are having a more challenging time finding new work. We expect the unemployment rate ticked up to 3.8% and average hourly earnings increased 0.3%.

The range of outcomes for the January Employment report will be wider than is typical. New seasonal factors will be introduced in the Establishment Survey in addition to the annual benchmark revisions to nonfarm payrolls. Preliminary estimates point to the level of employment as 306K lower in March 2023 than what is currently reported, indicating somewhat weaker momentum in hiring at the start of last year. January data in the Household Survey will incorporate the annual adjustment to population controls. Unlike the Establishment Survey, prior Household Survey data are not revised, making December to January comparisons in the *level* of household employment, unemployment and the labor force ineffective. Monthly changes in the unemployment and labor force participation *rates* are to be less affected, but the adjustments can result in unusually large monthly swings in these ratios as well.



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

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International Review

Foreign Central Banks at the Forefront

It was a busy week for foreign central banks, with several institutions making their first monetary policy announcements of this year and offering insight to the potential paths of their respective monetary policy stances through 2024. The European Central Bank (ECB) monetary policy announcement was perhaps not quite as hawkish as expected. In the lead up to this meeting, ECB President Lagrade suggested a rate cut was likely by or in the summer, and some of the more hawkish policymakers suggested the summer or later. ECB policymakers have also indicated a desire to see early 2024 wage data before adjusting their monetary policy stance. However, considering this lead-up, the ECB's policy announcement was perhaps more neutral in tone. The ECB reiterated that it "considers that the key ECB interest rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution" toward returning inflation to its 2% medium-term target in a timely manner. The ECB also again highlighted a data-dependent approach to conducting monetary policy. On that front, the ECB said the declining trend in underlying inflation has continued and that past interest rate increases continue to be transmitted forcefully into financing conditions. Tight financing conditions are dampening demand, and this is helping to push down inflation. While ECB policymakers have guided toward summer rate cuts, their assessment on the Eurozone economy appears notably underwhelming. As a result, some market participants, including ourselves, still see potential for ECB easing to come earlier, during the spring.

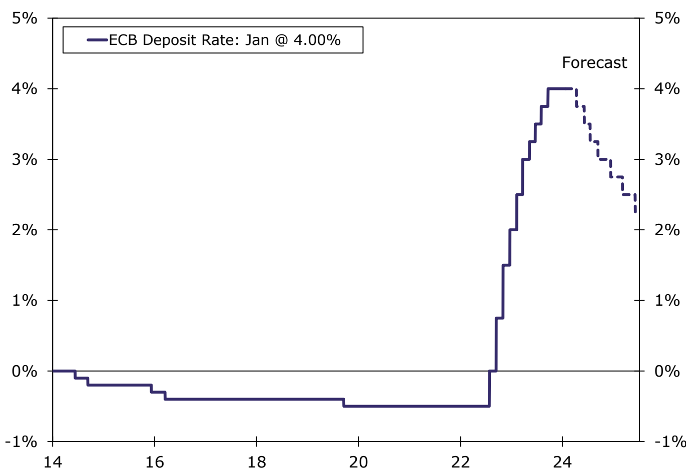
This dichotomy between the ECB's policy guidance and its assessment of the economy was also apparent during ECB President Lagarde's press conference. She said the consensus was that a rate cut debate was premature, and she stood by her comments on summer rate-cut timing. At the same time, she said data signal economic weakness in the near-term, that the December inflation rebound was less than expected and almost all underlying measures fell in December. She added that short-term inflation expectations gauges are down markedly and did not over-emphasize the inflationary risks from the Red Sea crisis. Combining the policy guidance with the assessment of the economy, the upcoming data should still be key as to the exact timing of an initial ECB rate cut. If GDP growth stays soft, sentiment surveys remain in contraction territory and underlying inflation continues to improve, the rate cut debate could intensify in March and April, and monetary easing in April (for now still our base case) remains possible. However, should activity or sentiment data show some resilience, or improving inflation trends get interrupted, the June meeting will come more clearly into focus as the most likely timing for initial ECB easing.

In its first announcement of 2024, the Bank of Canada (BoC) offered a moderately dovish shift in its monetary policy outlook. The BoC lowered its GDP growth forecasts, predicting zero growth in Q4-2023 and shaving its 2024 and 2025 GDP growth forecasts to 0.8% and 2.4%, respectively. Against this backdrop, the BoC said the economy now looks to be operating in "modest excess supply," suggesting some slack has opened up. BoC Governor Macklem also highlighted a shift in monetary policy focus, saying discussions are shifting from whether the policy rate is restrictive enough to how long it needs to stay at the current level. Macklem did not completely rule out further rate hikes though if new developments pushed inflation higher. As for the possible timing of rate cuts, the central bank said it is still concerned about risks to the inflation outlook, particularly the persistence in underlying inflation, and the BoC wants to see further and sustained easing in core inflation. In our view, Canada's economy is already weak enough to elicit rates cuts from the central bank if wage and price inflation cooperate. With wage growth and core inflation still elevated for the time being, however, we maintain our call for an initial BoC rate cut in June. That said, we view the risks as clearly tilted to an earlier April move, a risk that could crystallize if wages or prices were to slow sharply in the next few months.

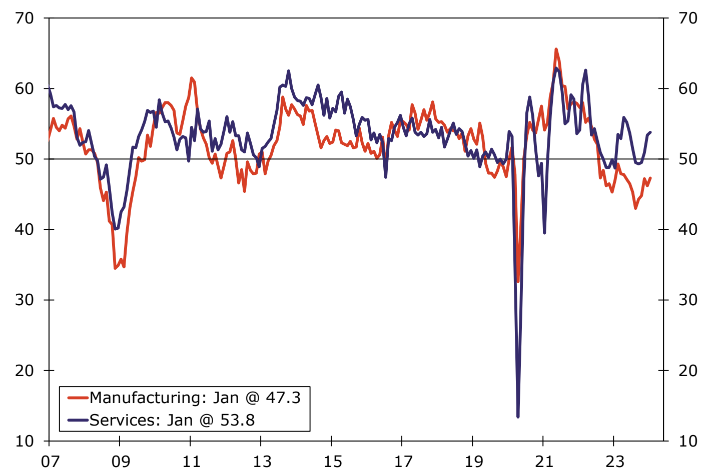
The Bank of Japan (BoJ) held monetary policy steady at its January announcement, keeping its policy rate at -0.10% and leaving its Yield Curve Control parameters untouched. In formal guidance that was unchanged, the BoJ said it will "patiently continue with monetary easing" and "not hesitate to take additional easing measures if necessary." That said, the central bank still appears to be laying the groundwork for a rate hike sometime during the earlier part of 2024, perhaps by April. In a notable shift in language, the BoJ said the certainty of achieving its economic projections has continued to gradually increase. BoJ Governor Ueda said the central bank will carefully assess data, including the spring wage talks, to see if the virtuous cycle of wages and prices is strengthening. Ueda also highlighted that more data will be available in April than March and that a policy decision can even be made ahead of wage details for all small firms being available. Finally, the BoJ raised its forecast for

medium-term (FY-2025) core inflation slightly to 1.8%, from 1.7% previously. Overall, we view BoJ policymakers' assessment of the economy and inflation as encouraging enough to keep our call for a 10 bps policy rate hike to 0.00% in April on track.

Finally, the People's Bank of China (PBoC) announced a reduction in its Reserve Requirement Ratio (RRR) to ease domestic liquidity conditions. Effective starting February 5, the RRR will be lowered by 0.50 percentage points, reducing that ratio to 10.00% for major banks. The move will provide around 1 trillion yuan in long-term liquidity to the market, according to the PBoC governor. Still, these policy moves come in the context of weak domestic demand, disinflation and deleveraging and, as a result, we still anticipate a moderate slowdown in China's GDP growth in 2024.



Source: Datastream and Wells Fargo Economics



Source: Datastream and Wells Fargo Economics

This week's sentiment surveys pointed to varying fortunes for some of Europe's key economies at the start of 2024. In the United Kingdom, the January Purchasing Managers Indices (PMIs) showed further improvement, as the U.K. manufacturing PMI rose to 47.3 and the services PMI gained further to 53.8. As a result, the U.K. composite (or economy-wide) PMI also improved to 52.5. The U.K. economy was weak during the final months of 2023, and it is possible the United Kingdom experienced a technical recession in the second half of last year, but if so, improving sentiment indicators suggest the economy may have returned to positive growth in early 2024. Another key takeaway from the U.K. were the increased price pressures from supply-chain disruptions related to the Red Sea crisis. Input costs reported their steepest rise in five months, driven by cost pressures in the manufacturing sector, while supplier delivery times also lengthened for the first time in 12 months.

The January Eurozone PMI surveys showed only modest overall improvement, with the details less encouraging than their U.K. equivalents. The Eurozone January manufacturing PMI rose to 46.6 from 44.4, as Germany's and France's manufacturing PMIs both firmed. However, the Eurozone January services PMI fell to 48.4, as the services indices for both Germany and France fell. As a result, the Eurozone January composite PMI rose only modestly to 47.9, from 47.6 in December, and is still at levels historically consistent with economic contraction. With respect to prices, the Eurozone PMI surveys showed falling input costs for manufacturers, though at a slower pace than previously, while input costs in the service sector rose to their highest level in eight months, causing overall costs across goods and services to accelerate. In a similar vein, average selling prices across goods and services also rose to the steepest rate since last May.

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International Outlook

Weekly International Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
31-Jan	China Manufacturing PMI	Jan	49.2	--	49.0
31-Jan	China Services PMI	Jan	50.6	--	50.4
1-Feb	Bank of England Policy Rate	1-Feb	5.25%	5.25%	5.25%
1-Feb	Eurozone CPI (YoY)	Jan	2.7%	--	2.9%

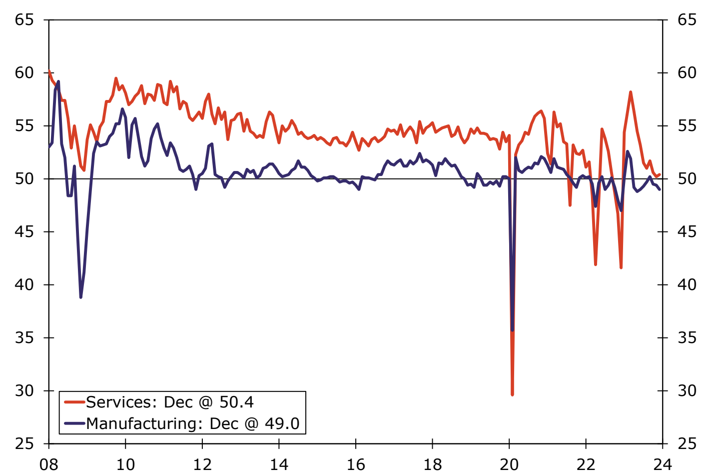
Forecast as of January 26, 2024

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

China PMIs • Wednesday

Next week, PMI data will offer insight into China's economic conditions at the start of this year. The Chinese economy ended 2023 on a mixed note, with GDP coming in below consensus expectations at 5.2% year-over-year and retail sales disappointing, although industrial output exceeded expectations.

When the manufacturing and non-manufacturing PMI figures are released on Wednesday, market participants will gain a view into economic prospects for 2024. The consensus forecast is for the manufacturing reading to tick up to 49.2, from 49.0, and the non-manufacturing figure to edge higher to 50.6, from 50.4. The manufacturing PMI has declined over the past three months, and its non-manufacturing counterpart has been on a general downward trend since the spring of last year. Although the slight increase in the PMIs forecast by the consensus might suggest a more steady start for China's economy in early 2024, we still expect growth to slow as the year progresses, and forecast GDP growth of 4.7% for full-year 2024. Structural challenges—a declining and aging population, a sluggish property sector, and geopolitical tensions—continue to impact the Chinese economy. Although the People's Bank of China announced it will cut the Reserve Requirement Ratio by 0.50 percentage points effective from February 5, it is unlikely, in our view, that this change and other recently-proposed stimulus measures would be enough to avoid an overall economic slowdown this year.

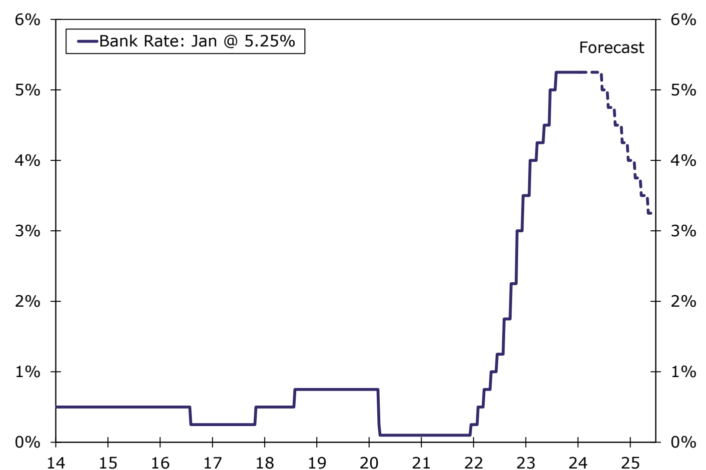


Source: Datastream and Wells Fargo Economics

Bank of England Policy Rate • Thursday

The Bank of England (BoE) delivers its first monetary policy decision of 2024 next Thursday. It is widely expected that policymakers will opt to keep their policy rate steady at 5.25% for the fourth consecutive meeting.

Economic data from the United Kingdom has been generally soft as of late, but neither consensus economists nor our team view rate cuts as appropriate just yet. GDP readings have been underwhelming, December retail sales data surprised to the downside and inflation has generally followed a downward trend late in 2023. In addition, wage data from November showed cooler-than-expected growth in weekly earnings. However, inflation and wage data are probably still running too hot for the BoE's liking, with December core inflation at 5.1% year-over-year. And while wage growth has come down, the measure is certainly still elevated by historical standards. Related to wage inflation is the services CPI—as service-based firms' costs are significantly driven by wages—which is also elevated. These factors contribute to our forecast for the BoE to hold rates steady until delivering a 25 bps cut at the June meeting. While this upcoming meeting will likely not



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

bring a change in the policy rate, market participants will closely scrutinize the monetary policy statement for any dovish-leaning tone changes that may signal possibilities for a monetary easing timeline.

Eurozone Inflation • Thursday

When Eurozone inflation data for January is released next week alongside Q4-2023 GDP data, market participants will be keenly watching for insight into the European Central Bank's (ECB) monetary policy path in the coming months.

The consensus forecast is for headline inflation to ease to 2.7% year-over-year, from 2.9% previously. Core CPI inflation is also expected to ease modestly to 3.2%, from 3.4% previously. Overall, we suspect market participants could be most sensitive to a downside surprise in CPI inflation in the context of expectations for the timing of rate cuts. As for economic growth, the Eurozone likely remained weak in the fourth quarter, with consensus economists calling for a contraction of 0.1% quarter-over-quarter, after a similar-sized decline in Q3. While soft economic data may suggest that monetary easing would now be appropriate, our view is that we still need to wait and see how inflation trends in early 2024 to get a sense of when ECB rate cuts may actually happen. As long as GDP remains weak and inflation continues to soften, we believe that rate cuts could come as early as the April ECB meeting, although we acknowledge the risks are tilted toward a later move.

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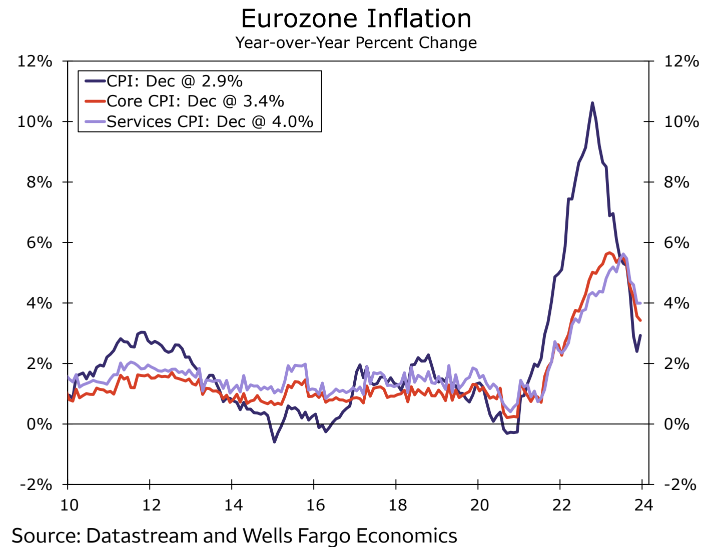


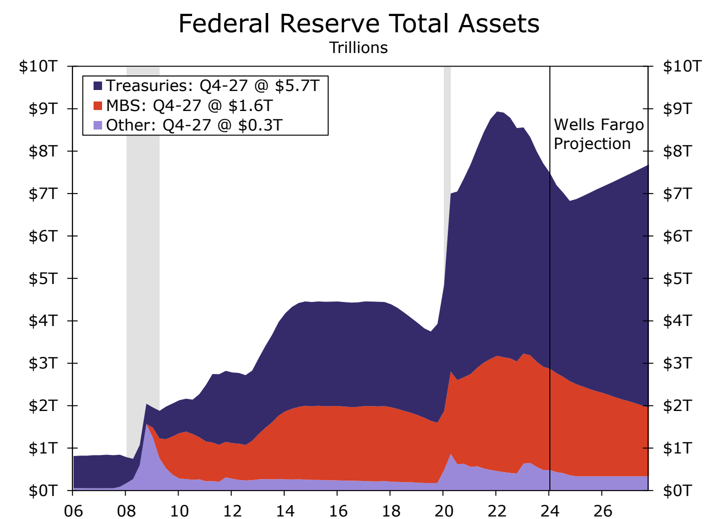
Source: Datastream and Wells Fargo Economics

Interest Rate Watch

In a Holding Pattern

As discussed in our Fed Flashlight report released this week, we share the near-universally held view that the FOMC will leave the fed funds rate and pace of quantitative tightening (QT) unchanged at its upcoming meeting on January 31. Last month, the FOMC decided to leave the fed funds rate unchanged for the third consecutive meeting, making it increasingly clear that its tightening cycle has come to an end. Both the post-meeting statement and press conference supported this notion. In the post-meeting statement, the insertion of "any" into the sentence "In determining the extent of *any* additional policy firming that may be appropriate..." indicated that the Committee is more confident that the current policy setting is sufficient to return inflation to 2% on a sustained basis. Moreover, in the post-meeting press conference, Chair Powell underscored the committee's shifting focus away from potential further hikes and toward policy easing.

Inflation has fallen sharply in recent months, with the core PCE deflator (the Fed's preferred measure of inflation) rising at an annualized rate of 2.0% in Q4. However, FOMC members have indicated they need to see progress continue in the coming months to be convinced inflation can return to 2% for the long haul. Meanwhile, economic growth continues to hold up well. Employment increased more than expected in December, the unemployment rate remained unchanged at 3.7% and layoffs remain near record lows. GDP grew at an annualized rate of 3.3% in the fourth quarter, which was significantly stronger than the 2.0% rate that the consensus forecast had anticipated. Therefore, we look for the FOMC to remain in a holding pattern in January for the fed funds rate and with its policy guidance. To limit further near-term easing in financial conditions, we suspect only a few material changes in the post-meeting statement, as Fed policymakers will likely want to be careful about sounding too dovish. Overall, we view this meeting as one where the Committee will buy time to determine if inflation is returning to 2% on a sustained basis and build consensus around the conditions for eventual policy easing. Our current view is that the first "normalization cut" of 25 bps will occur at the May 1 meeting.



Source: Federal Reserve Board and Wells Fargo Economics

In terms of the balance sheet, we suspect the January meeting will include a discussion about the pace of QT. The FOMC currently allows a maximum of $60 billion of Treasury securities and $35 billion of mortgage-backed securities (MBS) to roll off its balance sheet every month. This has helped to bring down the Fed's balance sheet to roughly $7.7 trillion, a significant difference from its pre-pandemic peak of nearly $9 trillion but still much larger than its pre-pandemic size. Our expectation is that the FOMC will announce a plan to slow the pace of QT at its June meeting. Specifically, we expect the runoff caps for Treasury securities and MBS to be reduced to $30 billion and $20 billion, respectively. We anticipate this slower pace of QT running until year-end 2024. Starting in 2025, we look for balance sheet growth to resume to accommodate organic growth in liabilities (e.g., paper currency and bank reserves). We expect the FOMC to passively reduce its MBS holdings in 2025 and beyond, while replacing these MBS with Treasury securities. If realized, the Fed's balance sheet would reach a trough of $6.8 trillion or so at year-end 2024 and begin growing gradually again thereafter.

For further detail on our expectations ahead of the FOMC's January 31 meeting, please read our latest Fed Flashlight report.

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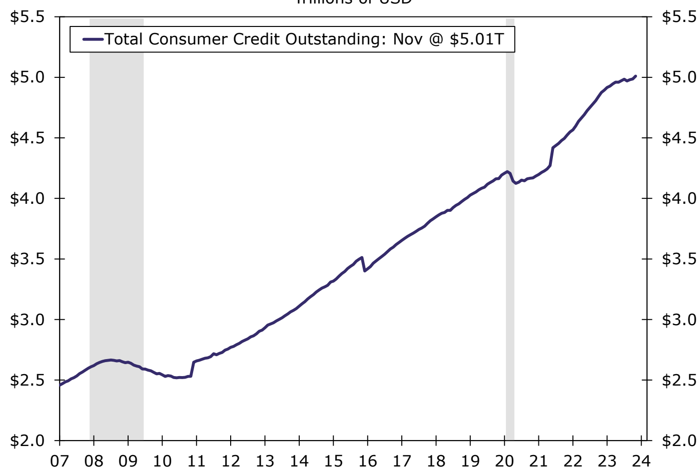
Credit Market Insights

Increased Borrowing in the Beige Book

In the most recent Beige Book released by the Fed, a majority of the 12 Federal Reserve Districts reported little or no change in economic activity since the prior Beige Book released in November. Across the board, consumers continued to spend through the holidays by exceeding or meeting Fed bank expectations over the month. In addition, contacts from nearly all districts reported decreases in manufacturing activity. The labor market saw little or no net change in seven of the districts, while four reported moderate growth and two continued to note a tight labor market. Overall, the little economic change over the month reflects the continuing resilience of the economy. However, closer examination of this month's Beige Book reveals the cracks that are beginning to emerge in the economy, particularly for household borrowing.

The staying power of the consumer was evident, with all districts reporting that consumers met or exceeded expectations. This is in line with December retail sales, which rose 0.6% over the month, handily exceeding expectations. We suspect that much of the power helping to prop up consumer spending has shifted away from excess liquidity and toward a reliance on borrowing, and recent data have supported that idea**.** November's consumer credit report revealed that total consumer credit outstanding rose $23.8 billion and surpassed $5 trillion for the first time (chart). Much of this gain was due to revolving consumer credit, a category that primarily consists of credit cards and accounted for $19.1 billion of the overall increase. While higher rates have yet to deter borrowing, we foresee mounting vulnerabilities as households begin to feel the squeeze of high payments. Indeed, most of the districts reported reduced credit availability and higher delinquency rates as points of concern. Contacts from sectors of the NY Fed have reported that households are facing increasing financial pressure because "many families have accumulated high debt burdens." In addition, the Philadelphia Fed commented on an increasing divergence as low-income households spent less but paid more on credit, while high-income households continued to spend freely. The Cleveland Fed reported similarly, stating that lower-income households had become more reliant on credit cards and "buy now, pay later" payment options. The Atlanta Fed saw a rise in delinquencies for credit cards, auto loans and unsecured personal loans, while the Kansas City Fed expressed concern about "future credit performance and lack of borrower liquidity." Overall, the January Beige Book reveals the increasing pressure on consumers across the country.



Source: Federal Reserve Board and Wells Fargo Economics

Though increased credit reliance has allowed consumers to spend at a growing rate, we do not foresee this being a sustainable source of purchasing power. This year, as the labor market moderates further, real wage gains slow and rates remain elevated, we anticipate a slowdown in consumer spending. While consumption may avoid contraction, pockets of weakness are beginning to emerge.

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Topic of the Week

Sea of Red

Recent Houthi militant attacks on container and other cargo ships in the Red Sea have propelled the globally important region into chaos and thrown a wrench in global supply chains. The attacks have occurred over the past two months, beginning with the hijacking of a car transporter in mid-November. In the ensuing months, the group has targeted more cargo vessels, as well as military vessels sailing near the Bab al-Mandab Strait that flows between Djibouti and Yemen and serves as the southern entrance to the Red Sea. The Red Sea and Suez Canal annually see 12% of total global trade and about 30% of container trade flow through them. This has caused shipping companies across the globe to rethink shipping routes that run through the region, with the Denmark-based maritime shipping giant Maersk suspending all operations in the Red Sea earlier this week.

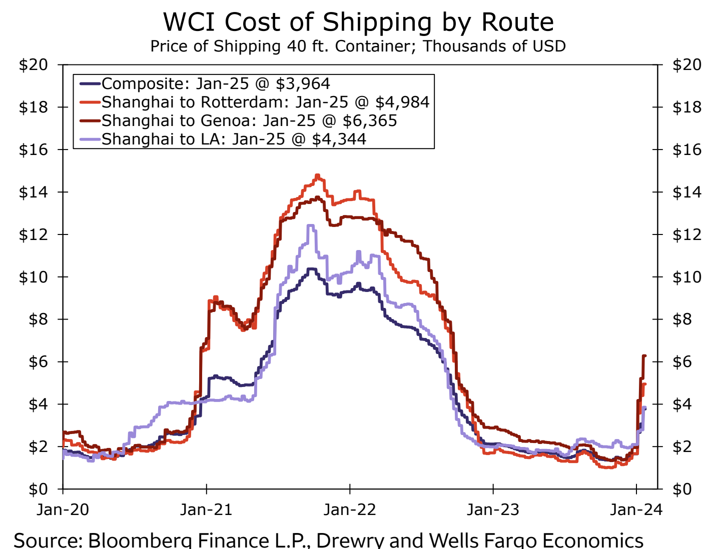
The immediate macro impact is showing up in higher shipping costs. Demand for alternative routes that avoid the conflict in the Red Sea, and longer journeys weighing on the availability of container ships, have driven spot rates for shipping routes across the world higher (chart). Trade between Europe and Asia is experiencing the brunt of the impact as ships are diverted away from the Suez Canal and instead must go around the Cape of Good Hope at the southern tip of Africa to reach their destination. This route change is estimated to add roughly 12 days to the shipping time, though some industry experts say it's really taking upwards of 20 additional days due to congestion and capacity limitations. Spot rates for shipping a 40-foot cargo container from Shanghai to Genoa or Rotterdam have shot up close to 400% since November. Even routes between East Asia and the U.S. West Coast, such as from Shanghai to Los Angeles, have seen shipping rates jump as supply is stretched across the industry.

Despite the recent jump in shipping spot rates, they're only up about half as much as they were in the wake of the pandemic. Today, the transportation bottleneck is contained only to vessels, and shippers have options. This wasn't the case in the depths of the pandemic-related supply problems for 2021 and 2022. Today, shippers can seek alternative routes or shipping mediums to get the goods where they need to be, which should prevent a more severe disruption from taking hold. Still, higher spot rates should translate to contracts in coming months and boost costs in the industry.

Something more comparable than the pandemic may be the Suez Canal blockage by the Ever Given container ship in March 2021. But it halted trade flows for just seven days, and it's challenging to disentangle the effects from pandemic-related bottlenecks at the time.

So how big of a problem is this? For Europe and countries closely located to the Red Sea, delays and alternative modes of transportation will prove both challenging and costly. But for the United States, it's ultimately likely not a huge deal on its own. While it may cause a delay for domestic manufacturers trying to procure inputs and result in some inflationary pressure, this supply disruption is not nearly as severe as the pandemic. Businesses look to be in far better shape to weather any potential supply disruption today without having to resort to immediately lifting prices.

Specifically, inventory levels are elevated relative to sales at the retail and wholesale level. There could still be somewhat of an inventory mismatch that causes some headaches for retailers going into the spring, and with shipping challenges coming up against the start of Chinese New Year next month, there's even more of an urgency to pull product demand forward. But with domestic inventory in better balance and consumer demand not nearly as insatiable today as it was at the height of the pandemic, the need and ability for retailers to raise prices in order to boost profits has lessened. Elevated margins of retailers and wholesalers also suggest there is some ability to absorb higher shipping costs and less need to resort to price hikes. Ultimately supply strain could stem some of the recent disinflationary impulse in core goods inflation, but we don't anticipate it will derail progress on its own.



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

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Market Data • Mid-Day Friday

U.S. Interest Rates

	Friday 1/26/2024	1 Week Ago	1 Year Ago
SOFR	5.32	5.31	4.31
Effective Fed Funds Rate	5.33	5.33	4.33
3-Month T-Bill	5.35	5.34	4.66
1-Year Treasury	4.63	4.50	4.52
2-Year Treasury	4.35	4.38	4.18
5-Year Treasury	4.04	4.05	3.59
10-Year Treasury	4.14	4.12	3.49
30-Year Treasury	4.37	4.33	3.64
Bond Buyer Index	3.43	3.39	3.37

Foreign Exchange Rates

	Friday 1/26/2024	1 Week Ago	1 Year Ago
Euro ($/€)	1.086	1.090	1.089
British Pound ($/£)	1.272	1.270	1.241
British Pound (£/€)	0.854	0.858	0.878
Japanese Yen (¥/$)	147.940	148.120	130.220
Canadian Dollar (C$/$)	1.346	1.343	1.332
Swiss Franc (CHF/$)	0.864	0.868	0.921
Australian Dollar (US$/A$)	0.659	0.660	0.712
Mexican Peso (MXN/$)	17.158	17.085	18.794
Chinese Yuan (CNY/$)	7.177	7.193	6.785
Indian Rupee (INR/$)	83.116	83.120	81.589
Brazilian Real (BRL/$)	4.916	4.930	5.070
U.S. Dollar Index	103.364	103.288	101.839

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

Foreign Interest Rates

	Friday 1/26/2024	1 Week Ago	1 Year Ago
3-Month German Govt Bill Yield	3.73	3.76	2.11
3-Month U.K. Govt Bill Yield	5.22	5.22	3.82
3-Month Canadian Govt Bill Yield	5.03	5.02	4.39
3-Month Japanese Govt Bill Yield	-0.17	-0.20	-0.18
2-Year German Note Yield	2.63	2.74	2.58
2-Year U.K. Note Yield	4.35	4.32	3.46
2-Year Canadian Note Yield	4.04	4.09	3.63
2-Year Japanese Note Yield	0.05	0.04	0.00
10-Year German Bond Yield	2.30	2.34	2.22
10-Year U.K. Bond Yield	3.97	3.93	3.32
10-Year Canadian Bond Yield	3.50	3.49	2.86
10-Year Japanese Bond Yield	0.72	0.67	0.49

Commodity Prices

	Friday 1/26/2024	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	76.47	73.41	81.01
Brent Crude ($/Barrel)	81.71	78.56	87.47
Gold ($/Ounce)	2017.88	2029.49	1929.21
Hot-Rolled Steel ($/S.Ton)	1077.00	1070.00	780.00
Copper (¢/Pound)	386.35	378.65	426.75
Soybeans ($/Bushel)	12.26	12.16	14.73
Natural Gas ($/MMBTU)	2.52	2.52	2.94
Nickel ($/Metric Ton)	16,469	15,918	28,953
CRB Spot Inds.	546.47	538.56	586.44

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