

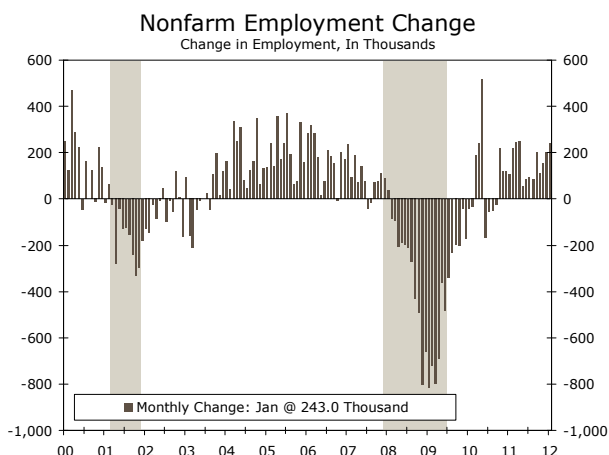
# Economics Group

## Weekly Economic & Financial Commentary

### U.S. Review

#### Off to a Good Start for the Year

- The employment report for January showed that 243,000 jobs were added with the unemployment rate declining slightly to 8.3 percent. The details of the report however, suggest that unseasonably warm weather may be playing a role in the stronger job gains.
- The ISM-Manufacturing Index posted a marginal improvement in January as new orders jumped for the month. Export orders also posted a nice increase suggesting that the effects of a Eurozone slowdown have yet to affect U.S. manufacturers.



### Global Review

#### Europe Agrees on Fiscal Pact; Manufacturing Improves

- This week, European leaders agreed on a fiscal pact designed to shore up budget deficits and restore investor confidence in European sovereign debt markets. The pact will require balanced budgets and impose sanctions on countries breaching deficit limits. However, an accord to restructure Greece's debt has not yet been finalized.
- Manufacturing indices around the world turned higher in January. However, European manufacturing remains in contraction, while Russian manufacturing slowed. The industry will remain under pressure in the near term amid a slowdown in China and austerity in Europe.



Wells Fargo U.S. Economic Forecast														
	Actual				Forecast				2009	Actual			Forecast	
	2011				2012					2010	2011	2012		2013
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product <sup>1</sup>	0.4	1.3	1.8	2.8	1.4	1.6	2.3	2.4	-3.6	3.0	1.7	1.9	2.1	
Personal Consumption	2.1	0.7	1.7	2.8	1.8	1.5	1.6	1.8	-2.0	2.0	2.2	1.7	1.4	
Inflation Indicators <sup>2</sup>														
PCE Deflator	1.8	2.5	2.9	2.6	2.0	1.7	1.6	1.9	0.6	1.8	2.4	1.8	1.9	
Consumer Price Index	2.2	3.3	3.8	3.3	2.4	1.8	1.5	1.8	-0.3	1.6	3.1	1.9	2.0	
Industrial Production <sup>1</sup>	4.8	0.7	6.3	3.1	3.8	3.6	3.0	2.2	-11.1	5.3	4.1	3.5	2.3	
Corporate Profits Before Taxes <sup>2</sup>	8.8	8.5	7.5	6.4	6.2	6.0	6.4	6.6	9.1	32.2	7.8	6.3	7.0	
Trade Weighted Dollar Index <sup>3</sup>	70.6	69.4	72.8	73.3	74.0	74.5	75.0	76.0	77.7	75.6	70.9	74.9	78.5	
Unemployment Rate	9.0	9.0	9.1	8.7	8.3	8.2	8.4	8.4	9.3	9.6	9.0	8.3	8.3	
Housing Starts <sup>4</sup>	0.58	0.57	0.62	0.66	0.66	0.70	0.69	0.70	0.55	0.58	0.61	0.69	0.80	
Quarter-End Interest Rates <sup>5</sup>														
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	
Conventional Mortgage Rate	4.84	4.51	4.11	3.96	4.00	4.10	4.10	4.20	5.04	4.69	4.46	4.10	4.30	
10 Year Note	3.47	3.18	1.92	1.89	1.90	2.00	2.10	2.20	3.26	3.22	2.78	2.05	2.35	

Forecast as of: February 3, 2012  
<sup>1</sup> Compound Annual Growth Rate Quarter-over-Quarter  
<sup>2</sup> Year-over-Year Percentage Change  
<sup>3</sup> Federal Reserve Major Currency Index, 1973=100 - Quarter End  
<sup>4</sup> Millions of Units  
<sup>5</sup> Annual Numbers Represent Averages

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Together we'll go far



## U.S. Review

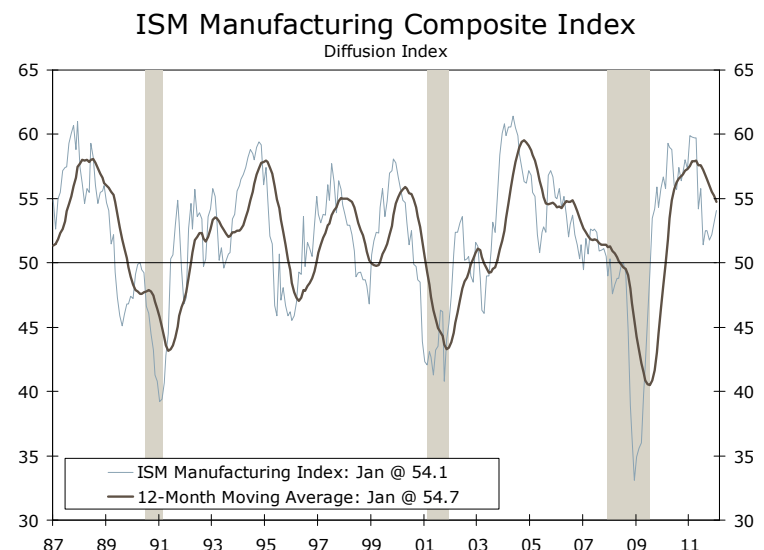
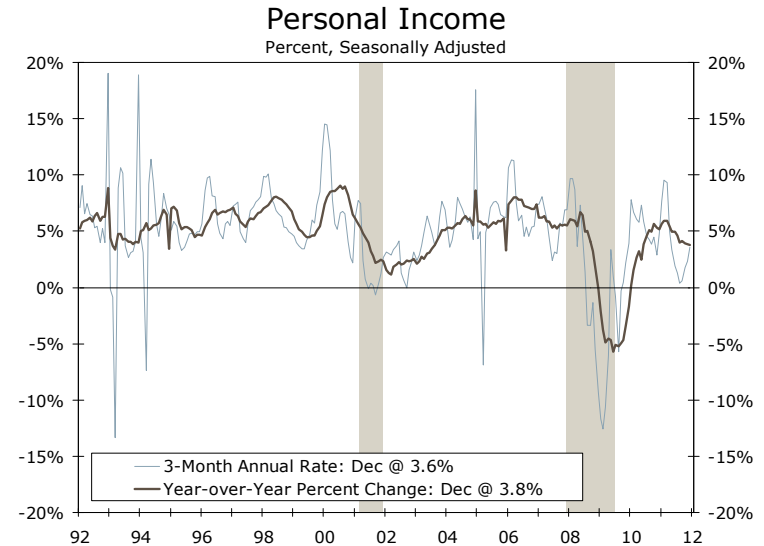
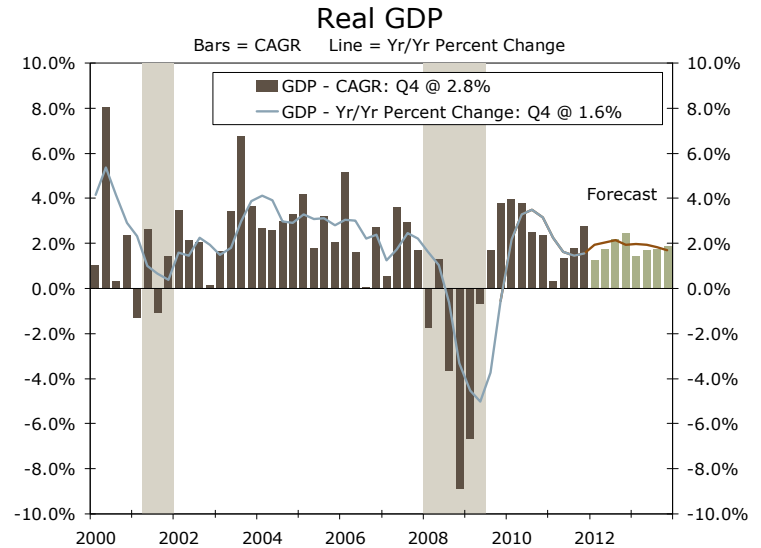
### Stronger-Than-Expected Job Gains to Start the Year

This week's economic data continued to point toward sustained economic growth. The employment situation improved at a better-than-expected pace in January with 243K additional jobs added. Personal income and spending data indicated that personal incomes rose modestly in December, but slightly lower consumer spending resulted in a higher savings rate for the month. In the industrial sector, the ISM-manufacturing survey moved further into explanatory territory in January, with the new orders component posting a modest increase. As a result of this week's data we have revised our GDP forecast for the Q1 to 1.4 percent and 1.9 percent for 2012. The employment report led to a slight upward revision to our employment outlook for the year. We now expect that an average of 155K jobs per month will be added this year.

The improvement in the employment situation in January suggests that the labor market was off to a somewhat stronger start to the year. Job gains were concentrated in the professional and business services, leisure and hospitality and manufacturing sectors while job losses continued in the federal and local government sectors. The unemployment rate fell slightly to 8.3 percent as the labor force participation rate continued to fall. Average hours worked, usually a leading indicator of future job gains, also rose for the month in another sign that the improvement in the labor market may continue. There are, however, some signs that the current pace of job gains may not be sustainable. Unseasonably warm weather may be helping boost the headline employment numbers. Typically, this time of year, around 430K workers report that they are unable to work, a spike that coincides with winter weather. The number of workers reporting that they are unable to work in January fell by more than 200K below this average. We remain somewhat skeptical that job growth in excess of 200K per month will continue over the near term.

Personal income and spending data were also a bit mixed in December. Personal incomes rose a solid 0.5 percent to post the largest gain in 10 months. Disposable personal income also rose modestly for the month, as prices for energy products and services fell. The savings rate rose to 4.0 percent as consumers pulled back on spending even in light of the rise in personal income. Consumer spending contracted slightly in December as electronic store sales plunged in the last month of the year. We expect that consumer spending will remain somewhat constrained in Q1 2012, rising around 1.8 percent.

The ISM-Manufacturing Index inched further into expansionary territory in January as new orders jumped for the month. Export orders also posted a nice increase suggesting that the effects of a Eurozone slowdown have yet to affect U.S. manufacturers. The overall rise in the ISM-manufacturing index continued to support our view for a modest pace of industrial production in Q1 with only moderate gains in the manufacturing sector employment.



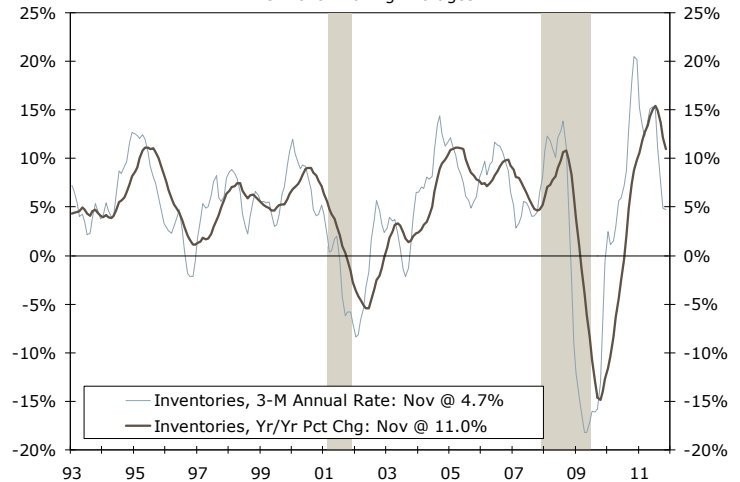
**Wholesale Inventories • Thursday**

Wholesales inventories rose 0.1 percent in November, with modest gains in durable and nondurables. Much of the strength in durable goods was concentrated in inventories of machinery, equipment, and supplies, which were up 1.4 percent on the month. On a year-ago basis, wholesale inventories are up 10.5 percent, but the pace has moderated over the past four months. Moreover, the pace of wholesale inventories should continue to slow in the coming months as import growth continues to retreat due to weak consumer demand. The inventory-to-sales ratio has remained at the low range of 1.15 for the past four months. With sales growth continuing to outpace inventory growth, we will likely continue to see moderate manufacturing output. Indeed, the latest ISM manufacturing reading, which increased to 54.1 in January from 53.1 in December supports this claim.

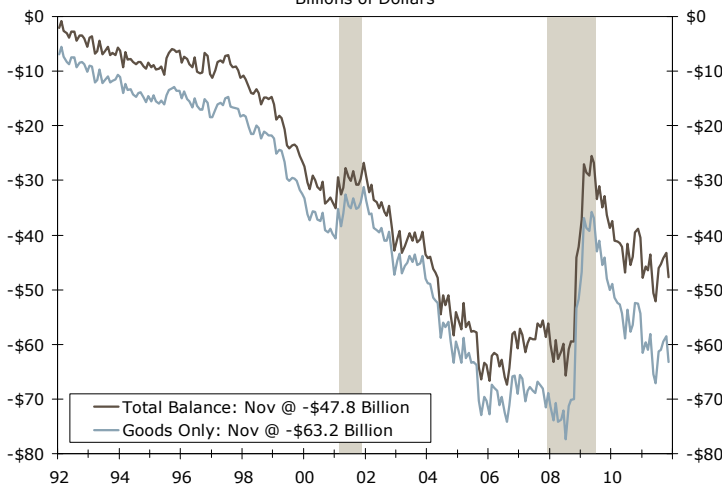
**Previous: 0.1%**

**Consensus: 0.5%**

Wholesalers' Inventories  
3-Month Moving Averages



Trade Balance In Goods And Services  
Billions of Dollars



**International Trade • Friday**

The trade deficit widened in November to \$47.8 billion from \$43.3 billion in October. The increase was driven by a decline in exports as well as a rise in imports. After trending higher throughout most of 2011, exports have declined for two consecutive months. The biggest decline in exports occurred in industrial supplies and materials, which likely reflects the plunge in commodity prices that occurred in August and September. The volume of industrial supplies and materials actually rose. The discrepancy between the value of exports, which declined and the volume of exports, which rose, reflects a decline in export prices. We could continue to see a pullback in January as commodity prices continued to fall in November and December. The import decline is largely attributable to a drop in petroleum imports. The global slowdown that is underway will likely continue to have an adverse effect on U.S. exports in the months ahead.

**Previous: -\$47.8B**

**Wells Fargo: -\$49.0B**

**Consensus: -\$48.1B**

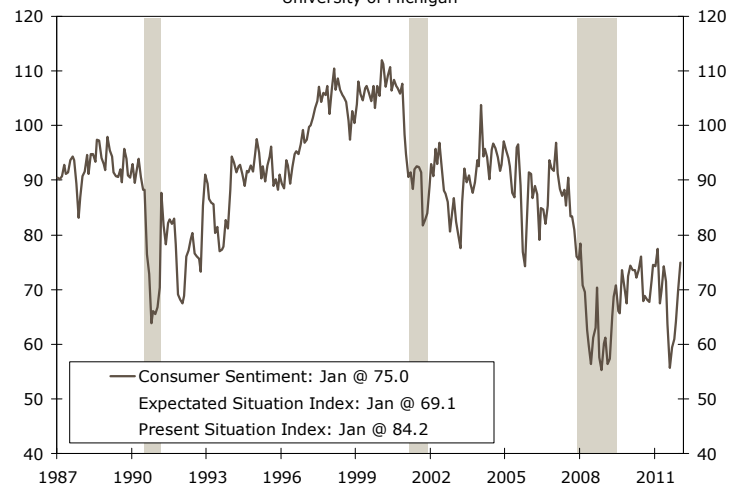
**University of Michigan Confidence • Friday**

Consumer sentiment has trended higher over the past five months. With the Reuters/University of Michigan consumer confidence survey closely correlated to activity in the stock market, the two consecutive monthly gains in the S&P 500 Index likely helped fuel some of the increase. The headline increased to 75.0 in January, the highest level in nearly a year. The monthly gain is a 19 point increase from August. Indeed, during that same period, the S&P 500 Index has increased 7.7 percent. Consumers' assessment of current conditions has also trended higher over the past five months and is now at 84.2, the highest level since February 2011. Inflation expectations over the next year, however, inched higher for the second consecutive month, but fell for five years ahead. That said, we continue to expect a modest pace of consumer spending with moderating inflation over the next two years.

**Previous: 75.0**

**Consensus: 74.0**

Consumer Sentiment Survey  
University of Michigan



## Global Review

### Europe Agrees on Fiscal Pact, but Greece Still Lingers

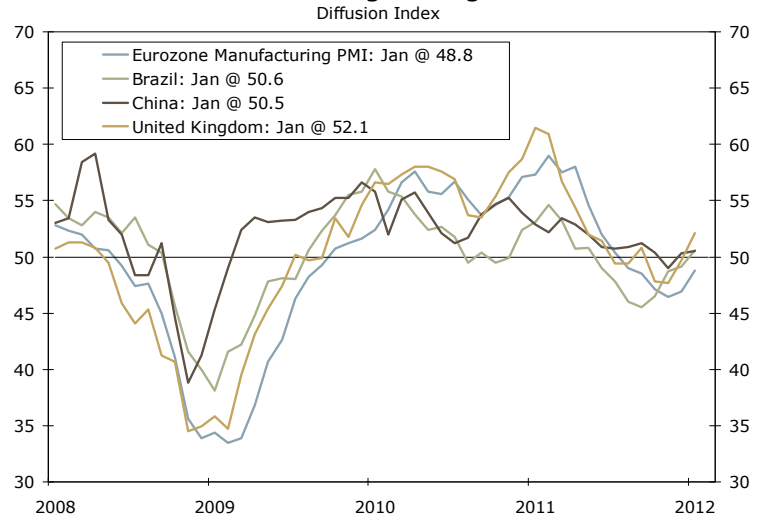
European leaders agreed this week on a fiscal pact designed to shore up budget deficits and restore investor confidence in European sovereign debt markets. The pact will require all countries that ratify it to balance their budgets by law and will impose sanctions on countries that breach budget deficit limits. Twenty five out of 27 European Union countries signed the pact, with Britain and the Czech Republic declining to join. Adding uncertainty to the situation was the fact that French President Nicolas Sarkozy said French ratification of the treaty will likely be delayed until after the spring elections. Furthermore, if the front-runner, Francois Hollande, wins the election, he has vowed to renegotiate the treaty, as he believes it is biased toward austerity. Leaders also agreed to implement the €500 billion European Stability Mechanism (ESM) in July, a year earlier than planned. However, Germany has resisted mounting pressure to increase the size of the ESM, and will not revisit the issue until March.

Unfortunately, the meeting in Brussels ended with no agreement on restructuring Greece's debt. Negotiations continue over how to close Greece's budget gap. While investors are prepared to assume losses of around 70 percent of their Greek debt holdings, the remaining gap must be closed by further austerity measures, more loans from European governments or more help from the European Central Bank (ECB). However, with European governments balking at increasing the €130 billion loan package, Germany refusing to allow the ECB to scale up bond purchases and the ECB saying it will not take a haircut on its Greek bond holdings, the negotiations have essentially come down to more Greek austerity or even bigger investor losses. One option being discussed is adding GDP warrants to the new, lower-coupon bonds, which would pay bondholders when GDP exceeds a certain target, trimming investor losses. Until an agreement on restructuring is finalized, Greece will not receive the €130 billion bailout package, which is vital if Greece is to avoid defaulting on a €14.5 billion bond payment due March 20. The urgency for Europe to get the debt crisis under control was underscored by a jump in Portuguese interest rates to a euro-era record amid rising concerns that the country may need a second bailout.

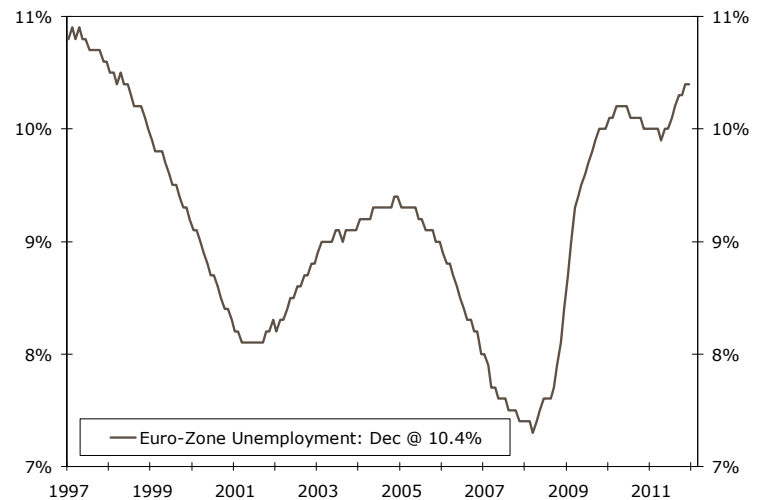
### Manufacturing Improves, but Outlook Remains Tepid

Despite the continued uncertainty in Europe, global manufacturing indices improved in January. The global purchasing managers index (PMI) rose to 51.2 from 50.5 in December as the United Kingdom, China, India, Brazil and the United States all reported higher PMIs. The Eurozone PMI also increased but remained in contraction, while Russia's PMI slid but remained in expansion. Slower growth in China and further austerity in Europe will likely keep manufacturing under pressure in the near term. In December, Eurozone unemployment held at a 14-year high, while German retail sales declined the most since May 2009. In addition, Spain's economy, the fourth largest in the Eurozone, contracted in the Q4 2011 and Italian business confidence fell to a two-year low in January. These developments show why the outlook for manufacturing remains tepid.

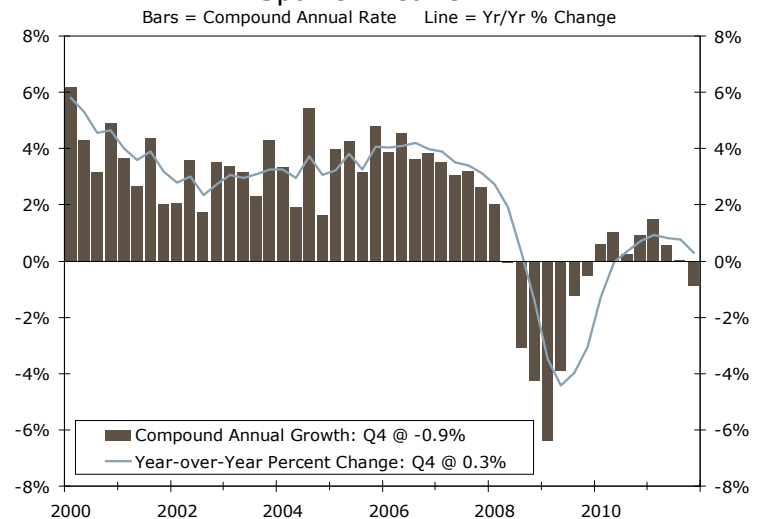
### Global Purchasing Manager Indices



### Eurozone Unemployment Rate



### Spanish Real GDP



## Chinese CPI • Wednesday

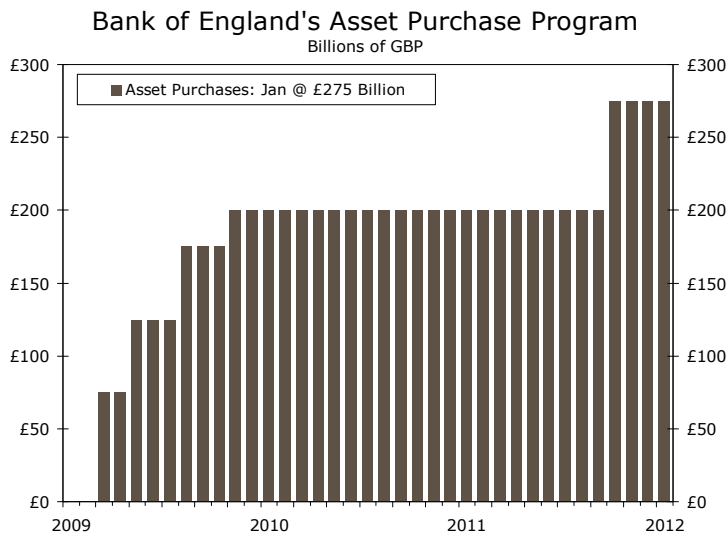
Chinese CPI inflation rose rapidly in 2010 and the first half of 2011 due, at least in part, to sharp increases in food and energy prices. However, the rate of CPI inflation has receded more than 2 percentage points since July, as food price inflation has slowed significantly and as energy prices have stabilized. Although we look for the overall rate of CPI inflation to trend lower over the course of the year, the big declines are probably behind us at this point. With inflation receding, however, monetary authorities will have scope to ease policy, if necessary, to support economic activity.

Trade data for January will also be released next week. Although the trade numbers can bounce around on a month-by-month basis, China's overall trade surplus is trending lower. After peaking at nearly \$300 billion in 2008, the surplus has essentially been cut in half over the past three years.

**Previous: 4.1%**

**Wells Fargo: 4.1%**

**Consensus: 4.0% (Year-over-Year)**



## ECB Policy Meeting • Thursday

Like its counterpart in London, the European Central Bank (ECB) also holds a regularly scheduled policy meeting on Thursday. After hiking rates by 50 bps in the first half of 2011, the ECB quickly reversed course at the end of last year as it became clear that the Eurozone was sliding back into recession. The ECB opted to keep its main policy rate unchanged at 1.00 percent last month, and we believe that it will remain on hold this month as well. Economic activity in the euro area appears to have contracted further thus far in 2012, but the rate of decline may be starting to slow. Moreover, strains in interbank funding markets appear to be easing due to some liquidity-providing steps that the ECB has enacted.

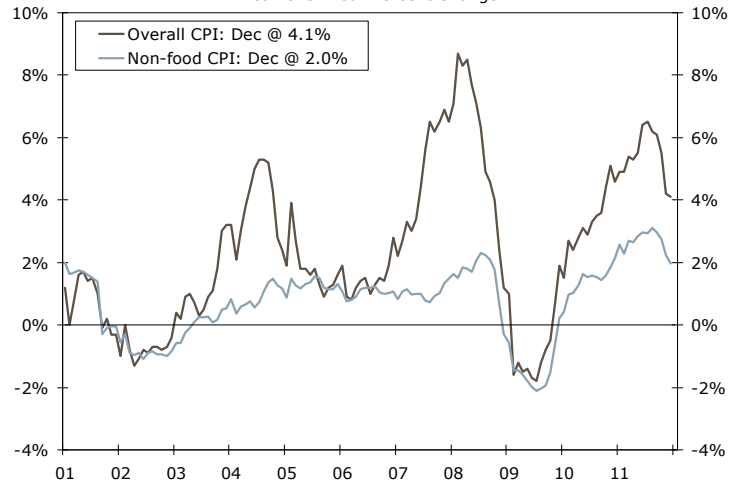
German data on factory orders and industrial production (IP) in December, and French and Italian data on IP in December should generally show that the factory sector ended 2011 on a soft note.

**Previous: 1.00%**

**Wells Fargo: 1.00%**

**Consensus: 1.00%**

Chinese CPI Inflation  
Year-over-Year Percent Change



## Bank of England Policy Meeting • Thursday

The Bank of England holds a regularly scheduled policy meeting on Thursday. The Monetary Policy Committee (MPC) has maintained its main policy rate at only 0.50 percent for nearly three years, and there is little chance that the MPC will alter this rate on Thursday. Rather, the MPC has been easing policy over the past three years by steadily increasing the size of its unconventional asset purchase program (a.k.a. quantitative easing). We think there is a 60 percent chance that the MPC will authorize an increase in its asset purchase program to £325 billion from £275 billion.

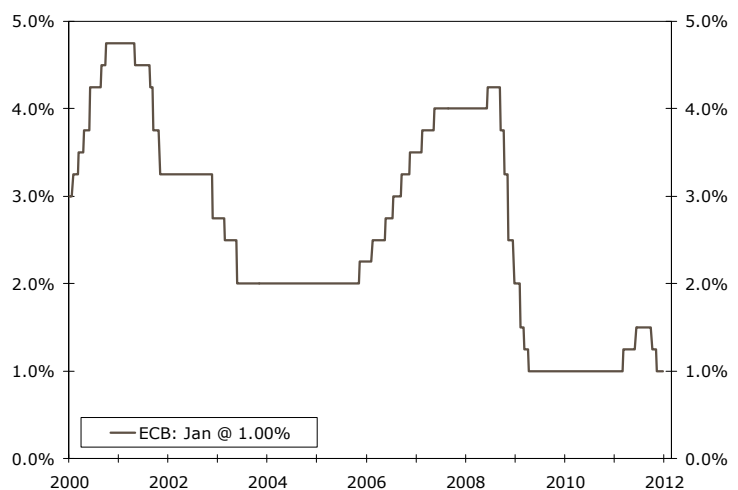
Data on industrial production in December and an estimate of GDP growth in January will give investors additional insights into the present state of the British economy, which contracted slightly in the Q4.

**Previous: £275 billion**

**Wells Fargo: £325 billion**

**Consensus: £325 billion**

European Central Bank Policy Rate





**Interest Rate Watch**

**The Fed Is Still Leaning Toward Ease**

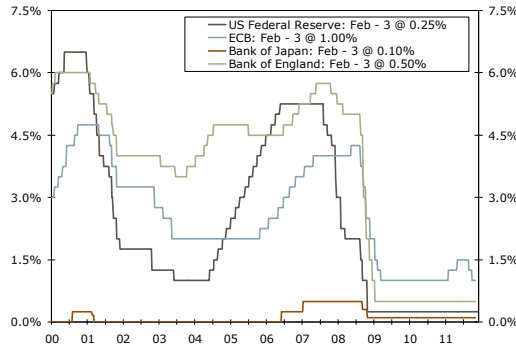
January's surprisingly robust employment figures, which showed employers adding 243,000 jobs and the unemployment rate falling to 8.3 percent, probably do not change the Fed's view about beginning a third securities purchase program this spring. The bottom line on the January employment data is that they are clearly better than expected but there are still too many question marks (e.g., falling labor force participation, no change in average weekly hours and weather impacts) to conclusively say that hiring has ramped up in a self-sustaining way.

A self-sustaining recovery will not take hold until housing begins to recover. Despite a handful of encouraging reports, we are not there yet and this is probably the most important reason why the Fed will follow through with another round of securities purchases this spring. The Fed would like to do everything it can to stay out of the way of the housing recovery. If the economy is truly recovering and they hold mortgage rates down, then the action would likely prove even more effective.

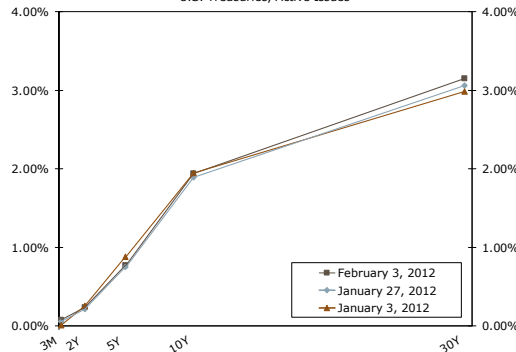
Bonds sold off following this morning's jobs report. The sell-off should be contained, however, and the yield on the 10-year note may very well remain below 2 percent. Economic forecasts are not likely to change much, however. Average hourly earnings rose 0.2 percent in January and are up 1.9 percent over the past year. Average weekly earnings are up 2.5 percent over the past year. By contrast, the Consumer Price Index has risen 3.0 percent over the past year and the PCE deflator has risen 2.4 percent (both are December-to-December figures). With little to no real income growth, consumer spending is likely to slow in the first half of 2012, which will limit real GDP growth to between a 1.5 and 2.0 percent annual rate.

The financial markets do not seem to believe the Fed will remain on hold through mid-2014, however, and neither do we. We expect the Fed's timetable to move around a bit and action/inaction on the fiscal side is likely more important to the Fed's decision than the latest economic numbers.

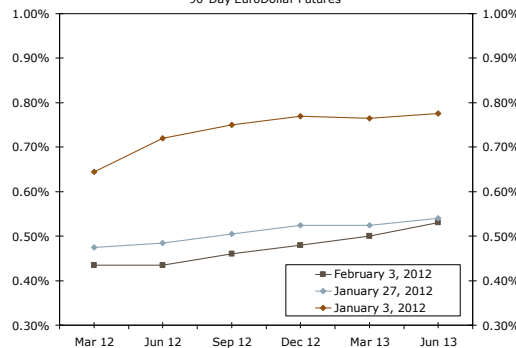
Central Bank Policy Rates



Yield Curve  
U.S. Treasuries, Active Issues



Forward Rates  
90-Day EuroDollar Futures



**Credit Market Insights**

**Is Fed Policy a Boon to High Yield?**

In an interview this week, Philadelphia Fed President Charles Plosser was asked about whether or not bond investors were being pushed into riskier assets, to which he replied, "the Fed has made it very clear that at times we're trying to force people to take some more risk."

To judge from recent activity in the yield bond market, that strategy is having the desired effect. Roughly \$215 billion worth of high-yield debt was issued in 2011—this on the heels of record issuance in 2010. Looking forward, fundamentals seem supportive for more action in this corner of the market. Corporate balance sheets are looking much better than they did in the throes of the recession. Investors, corporate cash managers and individual investors, are hungry for income. The yield on the Merrill Lynch high-grade bond index fell last week to 3.56 percent, just a shade above the multi-year low of 3.43 percent hit in August in the wake of the U.S. credit downgrade. With high grade yields so low, the more than 7.5 percent yield on Merrill's high-yield bond index is alluring. New issuance and investor fund flows in the secondary market should find support as long as these dynamics remain in place, and according to the Fed's guidance of no rate hike until 2014, that could be some time. Retail fund flows into high-yield bond funds over the past few months has been stronger than any other time in the past three years.

**Mortgage Data**

	Current	Week Ago	4 Weeks Ago	Year Ago
<b>Mortgage Rates</b>				
30-Yr Fixed	3.87%	3.98%	3.91%	4.27%
15-Yr Fixed	3.14%	3.24%	3.23%	3.72%
5/1 ARM	2.80%	2.85%	2.86%	3.47%
1-Yr ARM	2.76%	2.74%	2.80%	3.40%
<b>MBA Applications</b>				
Composite	753.3	775.6	634.5	491.7
Purchase	181.7	184.8	163.9	188.7
Refinance	4,113.8	4,265.3	3,448.3	2,261.2

Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

## Topic of the Week

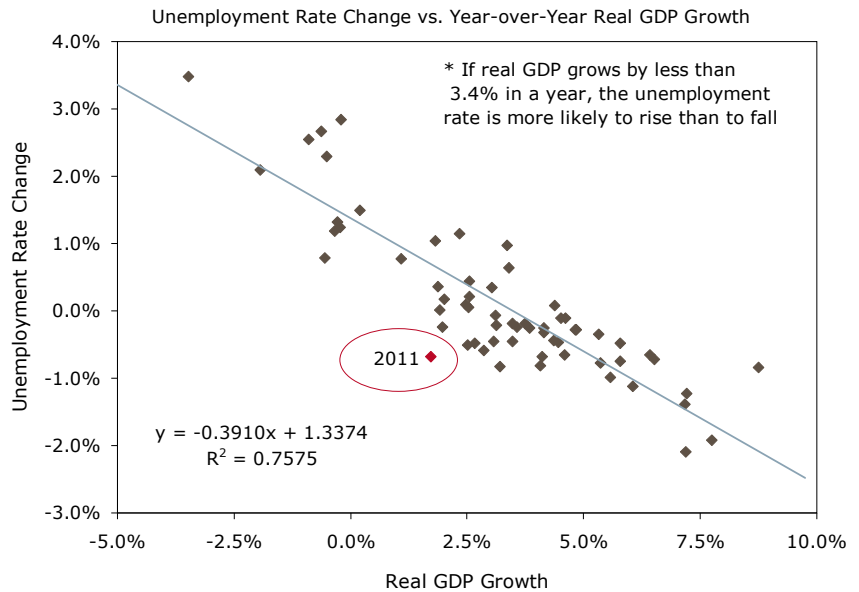
### Okun Lost Some of His Mojo in 2011

With last week's release of Q4 GDP, we can now update our chart showing Okun's Law through 2011 (top chart). Okun's Law is simply the relationship between real GDP growth and movements in the unemployment rate. A simple regression shows that if real GDP grows by less than 3.4 percent over a year, the unemployment rate is more likely to rise than to fall. The 2011 drop in the unemployment rate relative to real GDP growth deviates by a huge 1.34 standard deviations away from its regression line using past years' data back to 1949. We believe two factors explain the apparent breakdown in Okun's Law: 1) distortions in the seasonal adjustment process and 2) the significant drop in labor force participation that has occurred in recent years.

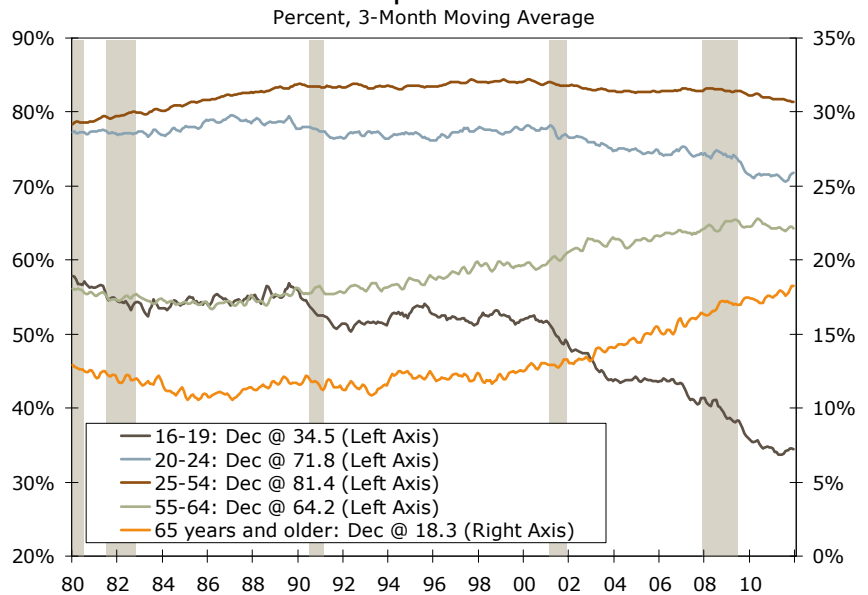
The seasonal adjustment process was distorted by the sharp run-up in the unemployment rate following the onset of the 2007-2009 recession. Because of this, the seasonal adjustment factors are now incorporating less seasonal improvement than would normally occur during the fall and winter months, meaning that there is now a tendency to understate the unemployment rate between October and March. Even after taking the seasonal distortions into account, however, the improvement in the unemployment rate still exceeds what would be expected in an economy recovering this slowly. This abnormally wide deviation from the pre-existing trend is primarily a result of declining labor force participation, particularly among younger workers.

Since the end of the recession, the labor force participation rate has dropped significantly for those between the ages of 16 and 24 (bottom chart). These declines probably have to do with younger workers willfully opting out of the job search process, given today's tougher job market. Moreover, many recent college graduates are likely choosing to pursue graduate studies for fear of entering a difficult job market, thus removing these students from the labor force altogether.

### Okun's Law: 1949 to 2011



### Participation Rate



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## Market Data ♦ Mid-Day Friday

## U.S. Interest Rates

	Friday 2/3/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.08	0.05	0.14
3-Month LIBOR	0.53	0.55	0.31
1-Year Treasury	0.15	0.13	0.26
2-Year Treasury	0.22	0.21	0.70
5-Year Treasury	0.71	0.75	2.18
10-Year Treasury	1.83	1.89	3.55
30-Year Treasury	3.01	3.06	4.66
Bond Buyer Index	3.60	3.68	5.25

## Foreign Exchange Rates

	Friday 2/3/2012	1 Week Ago	1 Year Ago
Euro (\$/€)	1.317	1.322	1.363
British Pound (\$/£)	1.584	1.573	1.614
British Pound (£/€)	0.831	0.841	0.845
Japanese Yen (¥/\$)	76.250	76.700	81.630
Canadian Dollar (C\$/¥)	1.002	1.002	0.991
Swiss Franc (CHF/\$)	0.915	0.913	0.946
Australian Dollar (US\$/A\$)	1.070	1.066	1.015
Mexican Peso (MXN/\$)	12.813	12.917	12.003
Chinese Yuan (CNY/\$)	6.303	6.309	6.585
Indian Rupee (INR/\$)	48.695	49.316	45.615
Brazilian Real (BRL/\$)	1.720	1.737	1.668
U.S. Dollar Index	78.920	78.902	77.748

## Foreign Interest Rates

	Friday 2/3/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.03	1.07	1.03
3-Month Sterling LIBOR	1.08	1.08	0.79
3-Month Canadian LIBOR	1.39	1.38	1.21
3-Month Yen LIBOR	0.20	0.20	0.19
2-Year German	0.20	0.19	1.36
2-Year U.K.	0.38	0.38	1.44
2-Year Canadian	0.99	1.00	1.77
2-Year Japanese	0.14	0.13	0.21
10-Year German	1.84	1.86	3.22
10-Year U.K.	2.10	2.07	3.78
10-Year Canadian	1.94	1.99	3.42
10-Year Japanese	0.95	0.97	1.25

## Commodity Prices

	Friday 2/3/2012	1 Week Ago	1 Year Ago
WTI Crude (\$/Barrel)	96.52	99.56	90.54
Gold (\$/Ounce)	1757.10	1739.07	1354.35
Hot-Rolled Steel (\$/S.Ton)	720.00	730.00	800.00
Copper (¢/Pound)	379.70	388.90	454.45
Soybeans (\$/Bushel)	12.10	12.09	14.13
Natural Gas (\$/MMBTU)	2.48	2.68	4.34
Nickel (\$/Metric Ton)	20,791	21,535	27,978
CRB Spot Inds.	547.99	541.41	612.80

## Next Week's Economic Calendar

	Monday 6	Tuesday 7	Wednesday 8	Thursday 9	Friday 10
U.S. Data		<b>Consumer Credit</b>		<b>Wholesale Inventories</b>	<b>Trade Balance</b>
		Nov ember \$20.374B		Nov ember 0.1%	Nov ember -\$47.8B
		Decem ber \$7.000B (C)		Decem ber 0.5% (C)	Decem ber -\$49.0B (W)
					<b>U. of Mich. Confidence</b>
				January 75.0	
				February 74.0 (C)	
				<b>Monthly Budget</b>	
				December -\$49.8B	
				January -\$62.5B (C)	
Global Data	<b>Canada</b>	<b>Germany</b>	<b>China</b>	<b>Eurozone</b>	
	<b>Ivey PMI</b>	<b>IP (MoM)</b>	<b>CPI (YoY)</b>	<b>ECB Announces Rates</b>	
	Previous (Dec) 63.5	Previous (Nov) -0.6%	Previous (Dec) 4.1%	Previous 1.00%	
				<b>U.K.</b>	
			<b>BOE Announces Rates</b>		
			Previous 0.50%		

Note: (W) = Wells Fargo Estimate (C) = Consensus Estimate



## Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 715-0314	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economist	(704) 374-4407	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 715-0569	michael.a.brown@wellsfargo.com
Joe Seydl	Economic Analyst	(704) 715-1488	joseph.seydl@wellsfargo.com
Sarah Watt	Economic Analyst	(704) 374-7142	sarah.watt@wellsfargo.com
Kaylyn Swankoski	Economic Analyst	(704) 715-0526	kaylyn.swankoski@wellsfargo.com

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