

Economics Group

Weekly Economic & Financial Commentary

U.S. Review

There Is Nothing to Fear, but More Uncertainty!

- The U.S. House voted to suspend the debt limit until May, which means attention will now be focused on automatic spending cuts and passing a continuing resolution. Pushing the debt ceiling decision out further will simply lead to more economic policy uncertainty.
- Existing home sales unexpectedly fell in December to a 4.94 million-unit pace due to a drop in single-family home sales, but the trend in housing still suggests the sector will be a boon for economic growth this year.

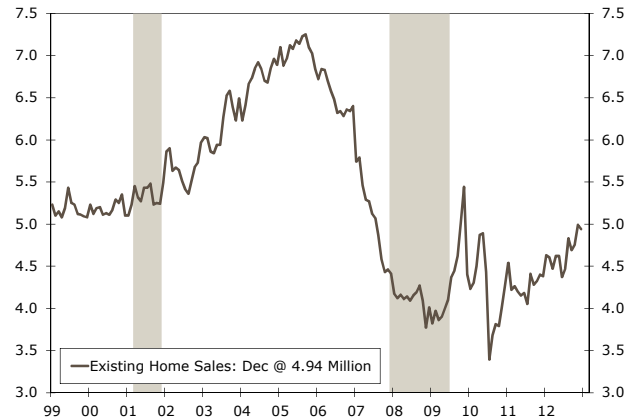
Global Review

Bank of Japan Joins Other Central Banks

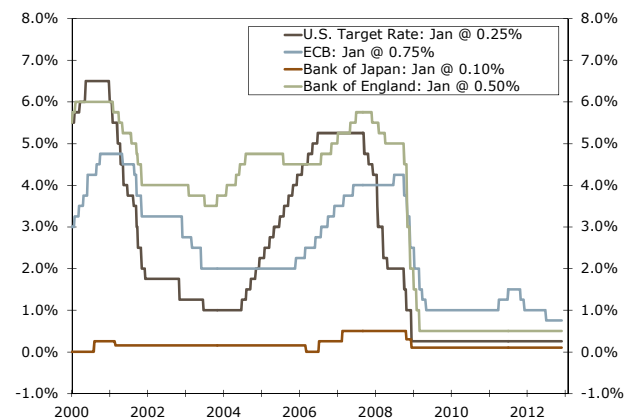
- Despite more than four years of low interest rates and quantitative easing from the world's largest central banks, a sustainable expansion has yet to take hold in many of the developed economies. This has prompted some central banks to embrace a policy of open-ended or outcome-dependent financial market intervention. This week, Japan became the latest large, developed, economy to throw its hat into this ring. In this week's global review section, we look at the pros and cons of this unconventional tool for conducting monetary policy and consider what it might mean for Japan.

Existing Home Resales

Seasonally Adjusted Annual Rate - In Millions



Central Bank Policy Rates



Wells Fargo U.S. Economic Forecast

	Actual				Forecast				Actual		Forecast		
	2012				2013				2010	2011	2012	2013	2014
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product ¹	2.0	1.3	3.1	1.0	1.0	1.7	2.2	2.4	2.4	1.8	2.2	1.7	2.4
Personal Consumption	2.4	1.5	1.6	2.8	1.1	1.2	1.4	1.6	1.8	2.5	1.9	1.6	1.6
Inflation Indicators ²													
PCE Deflator	2.4	1.6	1.5	1.5	1.1	1.3	1.3	1.4	1.9	2.4	1.7	1.3	1.9
Consumer Price Index	2.8	1.9	1.7	1.9	1.7	2.0	1.9	1.9	1.6	3.1	2.1	1.8	2.1
Industrial Production ¹	5.9	2.4	0.3	-0.5	2.1	3.5	4.1	4.1	5.4	4.1	3.6	2.0	3.8
Corporate Profits Before Taxes ²	10.3	6.7	7.5	5.0	4.8	5.2	5.4	5.8	26.8	7.3	7.3	5.3	6.5
Trade Weighted Dollar Index ³	72.7	74.5	72.7	73.3	74.0	75.0	76.0	77.0	75.4	70.9	73.5	75.5	74.5
Unemployment Rate	8.3	8.2	8.0	7.8	7.7	7.8	7.8	7.8	9.6	8.9	8.1	7.8	7.6
Housing Starts ⁴	0.71	0.74	0.77	0.87	0.90	0.96	1.02	1.08	0.59	0.61	0.78	0.99	1.17
Quarter-End Interest Rates ⁵													
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	3.95	3.68	3.50	3.35	3.40	3.40	3.45	3.50	4.69	4.46	3.68	3.44	3.80
10 Year Note	2.23	1.67	1.65	1.78	1.80	1.90	2.00	2.10	3.22	2.78	1.80	1.95	2.50

Forecast as of: January 9, 2013

¹ Compound Annual Growth Rate Quarter-over-Quarter² Year-over-Year Percentage Change³ Federal Reserve Major Currency Index, 1973=100 - Quarter End⁴ Millions of Units⁵ Annual Numbers Represent Averages

Source: U.S. Dept. of Commerce, U.S. Dept of Labor, Federal Reserve Board, Bloomberg LP, IHS Global Insight and Wells Fargo Securities, LLC

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Together we'll go far



U.S. Review

Kicking the Can Down the Road, Again!

The U.S. House voted to suspend the debt limit until May, which means the near-term threat of the Treasury missing scheduled interest and principal payments has been averted – at least temporarily. Attention will now be focused on the next two deadlines: automatic spending cuts under sequestration; and passing a continuing resolution, which provides spending authority for Federal agencies and programs to continue to operate. Both budget decisions will occur in March with sequestration set to take effect on March 1 and spending authority scheduled to expire on March 27. While the largest risk to an already sluggish pace of economic growth has been postponed—the debt ceiling—pushing the decision out further continues to increase economic policy uncertainty.

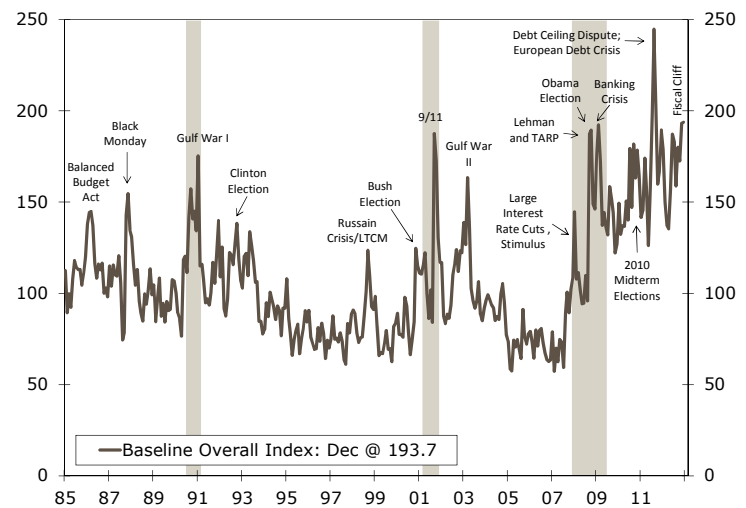
The toll of uncertainty has been documented in a recent paper written by Baker, Bloom and Davis (2013), *Measuring Economic Policy Uncertainty*. The authors find that policy uncertainty has a negative effect on industrial production (IP) and employment, hence slowing economic growth. According to their Index of Economic Policy Uncertainty, the debt ceiling debate caused the largest spike in the index (top graph). The prospect of more economic policy uncertainty down the road should cause businesses to continue to defer hiring and spending decisions and consumers to remain cautious. While we expect overall economic growth to remain positive in the first half of the year, the pace is not expected to be stellar.

One bright spot in the economy continues to be residential housing. Homebuilding remains active and improved builder sentiment suggests the boost is not short-lived. On trend, sales activity has also gained momentum. That said, existing home sales unexpectedly fell in December to a 4.94 million-unit pace due to a drop in single-family home sales. While naysayers are already calling the housing recovery into question, headline existing sales activity is only part of the story. The more important components of the existing home sales report are the mix of sales between conventional and distressed buyers and the level of inventory.

Distressed transactions accounted for 24 percent of sales in December, which is down from 32 percent a year ago suggesting more conventional sales are taking place. Fewer distressed sales mean the housing market is becoming a little healthier. Another important sign of a healing housing market is the composition of distressed sales, which is staged to include more short sales than foreclosures in the coming months. Regarding housing inventory, unusually tight inventories are helping drive prices higher, which is great news for the housing market. The optimism, however, should be tempered; as sellers become a little more confident about the housing market and put their homes on the market we could see some price volatility.

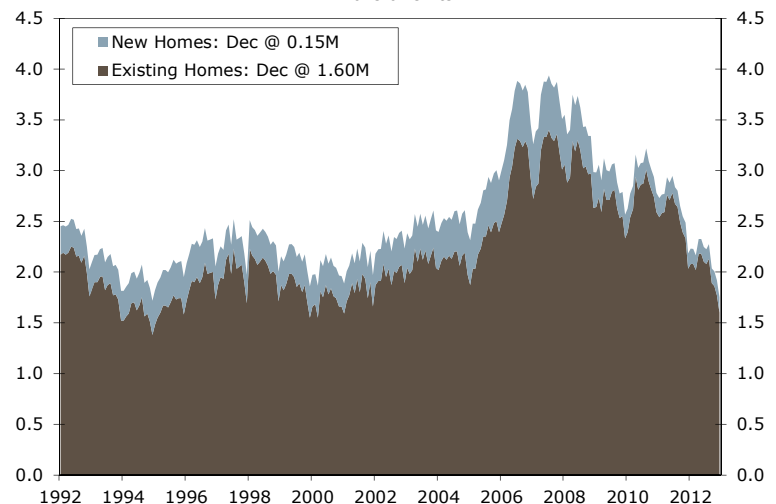
Also adding to the story of a resilient economy, initial jobless claims fell for the second consecutive week. While the trend is moving in the right direction, there could be some seasonal noise in the data.

Index of Economic Policy Uncertainty



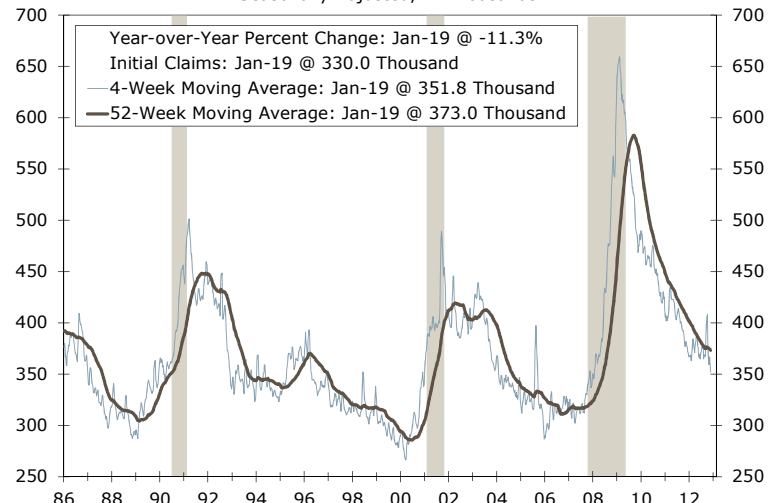
Single-Family Home Inventory

Millions of Units



Initial Claims for Unemployment

Seasonally Adjusted, In Thousands



Source: Economic Policy Uncertainty, U.S. Dept. of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

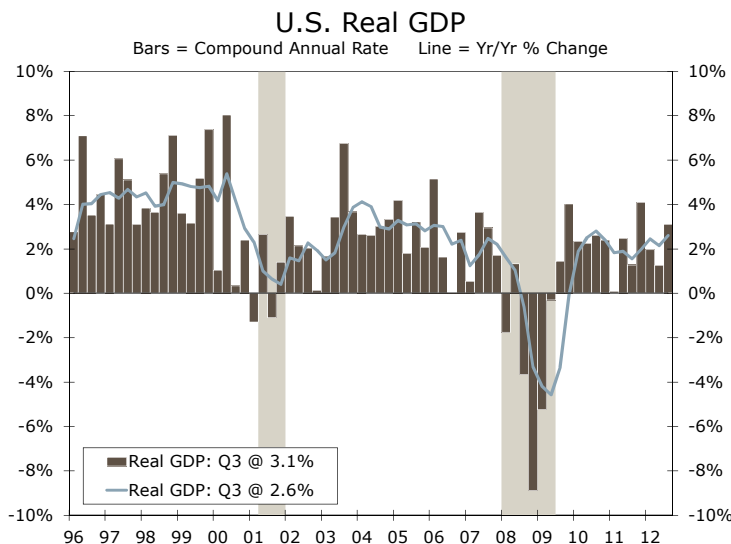
Durable Goods Orders • Monday

Durable goods orders were notably soft in the second half of 2012, but data for November showed that capital spending plans may have begun to firm. Orders increased 0.7 percent versus an expected gain of 0.3 percent and followed an upwardly revised print in October. Stripping out the volatile defense and aircraft sectors, orders posted their second straight monthly gain, which pushed the three-month average annualized rate into positive territory.

We expect to see another gain in orders in December, as early reads on the manufacturing sector show that business spending may not have retreated ahead of the fiscal cliff as much as feared. Auto sales to dealers in December continue to point to rising demand for motor vehicles, and company reports show aircraft orders rose in December. Outside the transportation sector, however, we expect orders to remain weak following feeble prints from December's PMI surveys.

Previous: 0.8% (Month over Month) Wells Fargo: 3.0%

Consensus: 1.8%



Employment • Friday

Despite worries that the approaching fiscal cliff would dampen hiring, employers added 155,000 new jobs in December. The December print was in line with the consensus and general trend for the year, where employers added an average of 153,000 jobs a month in 2012. This figure will likely be revised higher, however, with the annual benchmark revisions to the establishment survey that are to be reported with Friday's release. The initial estimate shows a 0.3 percent increase to 2012 payroll gains.

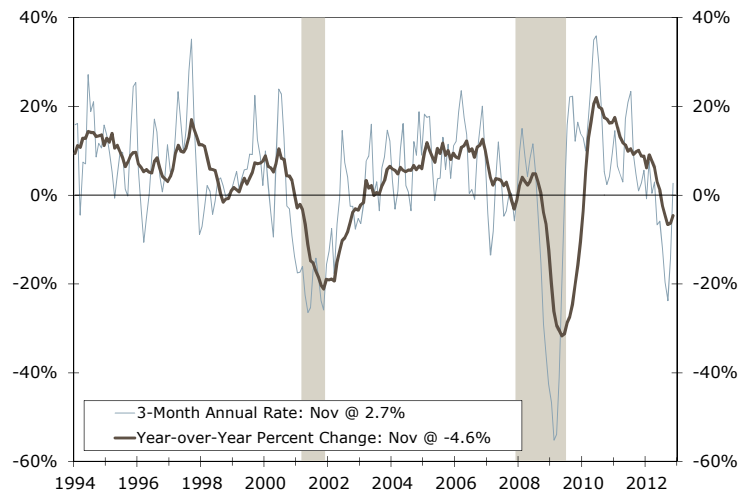
We expect the upward momentum in the labor market to continue in January. While jobless claims are subject to above-average seasonal volatility in the first few weeks of the year, readings over the past few weeks have pointed to further strength in the labor market. We expect the unemployment rate to edge down to 7.7 percent.

Previous: 155,000

Wells Fargo: 200,000

Consensus: 155,000

Nondefense Capital Goods Orders, Ex-Aircraft
Series are 3-Month Moving Averages



GDP • Wednesday

GDP growth likely softened in the final quarter of 2012, falling to 1.0 percent in Q4 from a 3.1 percent pace in Q3. The downshift will in part stem from a slowdown in government purchases. In the third quarter, government purchases rose at a 3.9 percent annualized pace, largely on the heels of an unsustainable rise in defense spending. The other major drag to growth in the fourth quarter will likely come from net exports following the substantial widening of the trade deficit in November. The 0.7 percentage point contribution from inventories in the third quarter is also likely to fade as firms aim to better align stocks with sales.

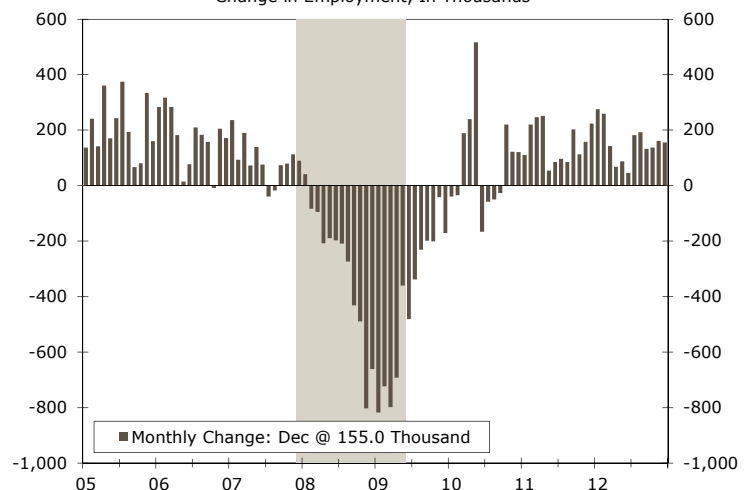
Offsetting these weaker trends will be another solid increase in residential construction. Personal consumption expenditures also look to have accelerated in the final months of the year, while business spending improved slightly.

Previous: 3.1% (Annualized) Wells Fargo: 1.0%

Consensus: 1.2%

Nonfarm Employment Change

Change in Employment, In Thousands



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

Global Review

When All the Banks Print Money, Who Wins?

Japan has been struggling to fight lackluster economic growth and chronic deflation since the 1990s. So the announcement this week of a plan to double the one percent inflation target to two percent through accommodative monetary policy and additional asset purchases is certainly bold but not shocking. The newly elected Japanese prime minister, Shinzo Abe, ran on a campaign of additional fiscal stimulus measures and increased pressure on the Bank of Japan (BoJ) to take a more stimulative monetary policy stance as well. The policy announcement this week followed the regularly scheduled BoJ meeting, but came in the form of a joint statement from the government and the bank, underscoring the fact that this initiative comes from more than just the central bank policy-makers. The plan is certainly not without its share of doubters and it is hard to say if this is a good move to take, but after roughly 15 years of deflation, policy makers there feel that it is worth trying.

Similar measures have not kept the economies of the Eurozone and the United Kingdom from slipping into a double-dip recession. That said, there have been several times in the past three years when the sovereign debt crisis in Europe nearly panicked the broader global financial system. Perhaps it was the accommodative monetary policy there that helped stave off an even worse outcome than the mild recession from which the Eurozone is now emerging.

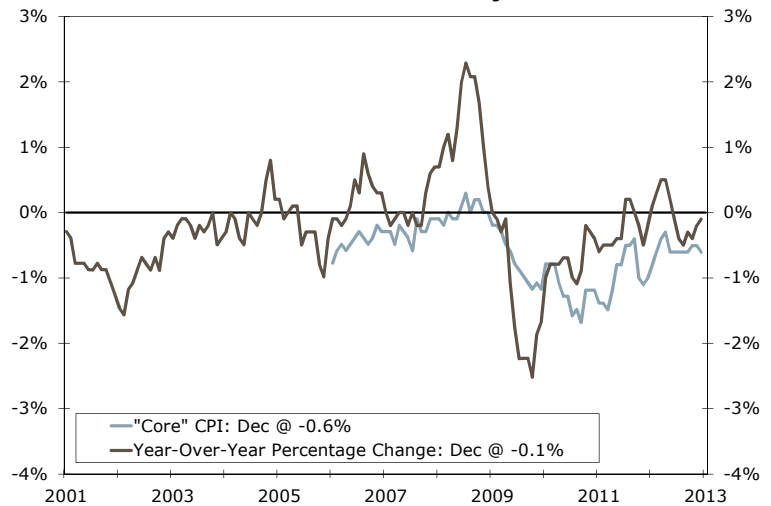
The plan in Japan is not perfect. For starters, the BoJ will not start its purchases until 2014. Perhaps policy-makers there are hoping that the mere announcement of a plan, in and of itself, will boost confidence and provide an underpinning to financial markets. Indeed, the Nikkei Index of Japanese stocks rose immediately after the announcement but then sold off perhaps as traders had a chance to see that the cavalry would not arrive for another 11 months.

Another consequence of this action is the effect it will have on the Japanese yen. As the government there increases the monetary base, there will be more and more yen chasing the same goods and services. That should lead to inflation; indeed that is the primary objective. The concern is that by increasing the global supply of Japanese yen, its value will fall when trade is conducted internationally. If realized, imported goods would become more expensive for Japanese consumers and businesses and exported goods (all else equal) would become less expensive for foreign buyers. In other words, these new policy initiatives could result in a scenario in which Japan is in effect importing inflation and exporting deflation. However, all else is not equal today. The fact that this comes at a time when other foreign central banks (including the U.S. Federal Reserve) are engaged in a similar policy suggests a geosynchronous expansion of the world's money supply.

Over time the greatest risk to the global economy is that all this printing of money could someday lead to hyper-inflation. Given the deflationary experience in Japan since the 1990s, that probably feels like a risk worth taking in Japan at the moment.

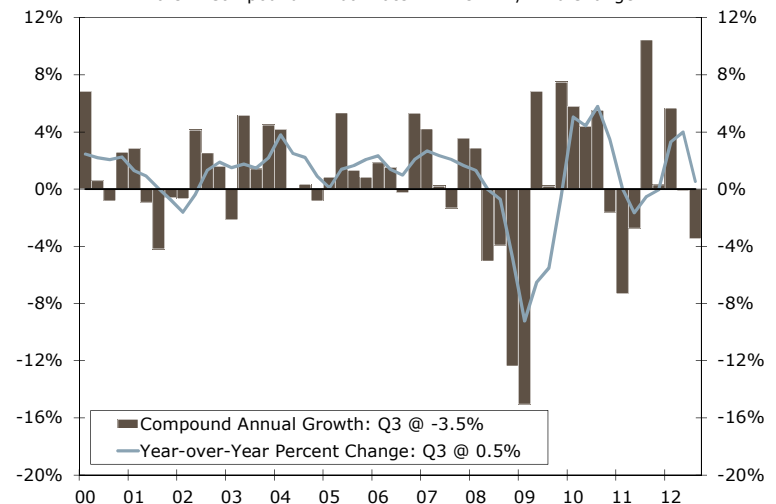
Japanese Consumer Price Index

Year-over-Year Percent Change



Japanese Real GDP

Bars = Compound Annual Rate Line = Yr/Yr % Change



Japanese Exchange Rate

JPY per USD



Source: IHS Global Insight and Wells Fargo Securities

Japanese IP • Wednesday

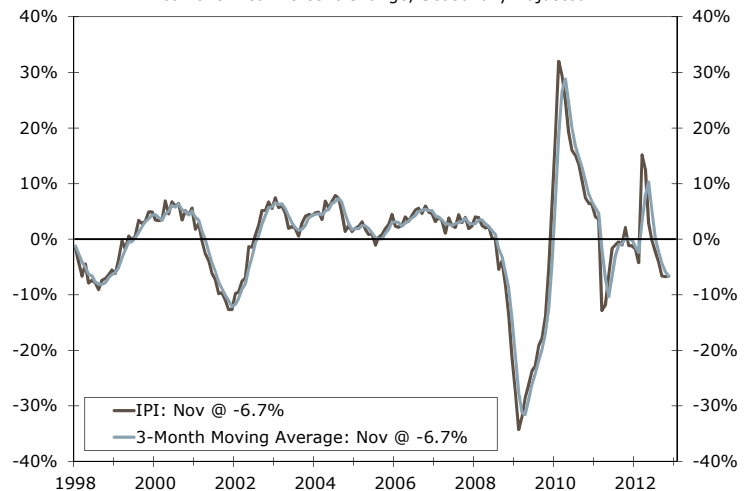
Japanese industrial production has weakened significantly this year, as global trade has slowed and as the domestic economy has slipped back into a modest recession. However, the market consensus forecast anticipates that a sharp bounceback occurred in December following the decline that was registered during the previous month. Even if the consensus forecast is realized, however, IP in Q4 would have dropped more than one percent relative to Q3, which would raise the probability that overall GDP declined for the third consecutive quarter.

Other indicators that are slated for release at the end of next week, including December data on retail spending, housing starts, and the labor market will give investors some insights into the present state of the Japanese economy. See page 4 for the analysis of the Bank of Japan's policy meeting this week.

Previous: -1.4% (Month over Month)

Consensus: 4.1%

Japanese Industrial Production Index
Year-over-Year Percent Change, Seasonally Adjusted



German Unemployment • Thursday

Unemployment in Germany fell to its lowest rate since reunification in early 2012, but it edged up a bit in the fourth quarter as the German economy started to weaken. Labor market data for January will print on Thursday and most analysts expect a small increase in the ranks of the jobless, although they also project that the unemployment rate will hold steady at 6.9 percent. Growth in German retail spending also downshifted a notch in the second half of 2012, and data for the final month of the year are scheduled for release sometime next week.

Preliminary CPI data for the Eurozone in January will print on Thursday. The “flash” estimate of the Eurozone manufacturing PMI for January that was released this week showed the index rising to its highest level since March 2012, although it remained in contraction territory. The “final” estimate will be released on Friday.

Previous: 6.9%

Consensus: 6.9%

German Unemployment Rate
Seasonally Adjusted



Brazilian Industrial Production • Friday

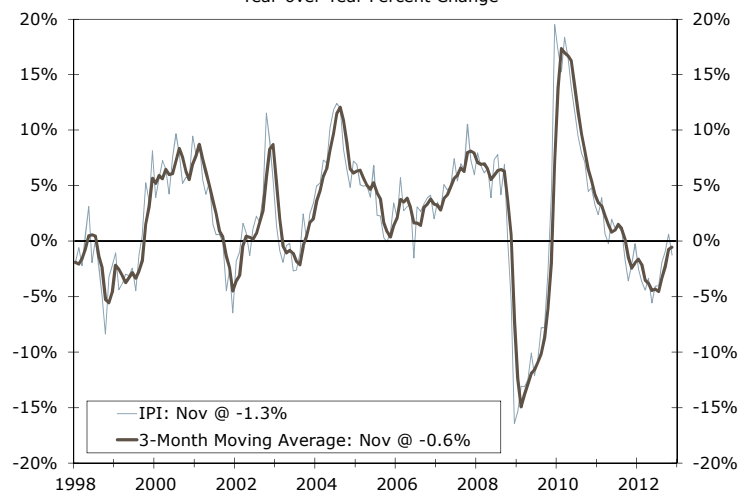
Industrial production in Brazil has been more or less flat for the past year. Growth in Brazilian IP started to slow as global trade decelerated and as growth in Brazilian domestic demand weakened due, at least in part, to policy tightening that was undertaken to slow the rate of CPI inflation in the country. There have been some tantalizing signs recently that growth in the global economy is starting to stabilize, but the consensus forecast still anticipates that Brazilian IP declined modestly in December.

Speaking of inflation, CPI data for January will print next week. Most indices of Brazilian CPI inflation have trended higher in recent months, and another increase is expected in January. The Brazilian central bank slashed its main policy rate 525 bps between September 2011 and October 2012, but it has subsequently been on hold. Rising inflation makes it hard for the central bank to justify another rate cut, even if growth remains weak.

Previous: -0.6% (Month over Month)

Consensus: -0.4%

Brazilian Industrial Production Index
Year-over-Year Percent Change



Source: IHS Global Insight and Wells Fargo Securities

Interest Rate Watch

Better Economics Suggests Modest Rise in Rates

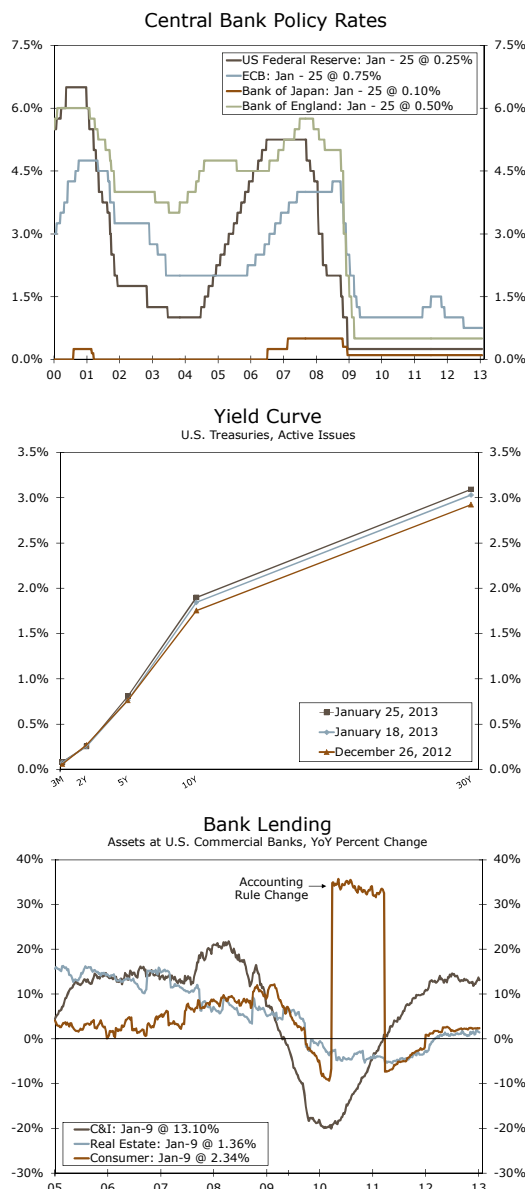
Recent economic data, such as jobless claims and housing data released this week, intimate that the economy is improving and that a rising demand for credit will lead to a modest rise in interest rates. Given continued Fed ease and low inflation, any rise in rates remains very limited compared to past economic recoveries.

After a weak fourth quarter (GDP will be released this coming Thursday and we expect a gain of just one percent) recent economic signals suggest an upswing in the economy with growth at 1.5 percent in the first half of this year and rising to 2 percent plus in the second half. We are also encouraged by the improvement in the labor market with initial and continuing jobless claims having declined over the past two months. Looking ahead to Friday, we expect a gain of 200,000 jobs for January.

Meanwhile, housing data suggest a strong demand for homes as well as mortgage credit over the past few months. Total existing home sales and prices have moved up while the month's supply (inventory) of homes has declined over the last few months. This rising demand for homes, and thereby mortgage credit, is likely to lead to rising mortgage rates over time. Moreover, as illustrated in our recent piece (*Brave New World*) home prices are rising faster than the level of mortgage rates similar to the period of the housing boom of 2004-2007 and, therefore, hints at an imbalance in the marketplace that is likely to be reconciled by rising mortgage rates.

On the credit side, the strong issuance (demand) for credit in the high-grade and high-yield bond markets suggest that there is also a bias upward in rates, as demand for credit is likely to increase rates over time.

On balance, the trend in credit demand is on the upswing and will likely lead to a modest rise in market rates. The dominant force, however, remains the Federal Reserve policy of maintaining low interest rates on benchmark federal funds and Treasury debt. So any rise in interest rates will be modest—for now.



Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities

Credit Market Insights

Mortgage Delinquencies Fall Amidst Improving Housing Market in 2012

The housing market showed signs of strength in 2012, which is good news for homeowners and the U.S. economy. Lender Processing Services (LPS) released its preliminary report for December earlier this week, reporting mortgage delinquencies fell 0.6 percentage points over the past year to 7.2 percent. This encouraging data is an indication that the housing market is strengthening. Also this week, the National Association of Realtors reported distressed sales have fallen 8 percentage points and median existing home prices have risen 12.8 percent in the past year, further corroborating evidence of a housing recovery.

Although the housing market is expected to improve in 2013, the pace of recovery will vary. Areas with elevated mortgage delinquency rates are likely to experience delayed recoveries. Elevated delinquency rates restrain the momentum of the housing recovery in part by depressing home prices. Furthermore, three of the five states with the highest percentage of non-current loans are judicial states that tend to have a longer foreclosure process, which will likely slow home price normalization. Despite these limiting factors, the rate of mortgage delinquencies for the nation as a whole should continue to fall as prices rise and the labor market improves.

Credit Market Data

Mortgage Rates	Credit Market Data			
	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.42%	3.38%	3.35%	3.98%
15-Yr Fixed	2.71%	2.66%	2.65%	3.24%
5/1 ARM	2.67%	2.67%	2.70%	2.85%
1-Yr ARM	2.57%	2.57%	2.56%	2.74%
Bank Lending	Current Assets			
	(Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	\$1,521.2	-15.24%	31.12%	13.10%
Revolving Home Equity	\$510.7	-13.61%	-11.82%	-6.79%
Residential Mortgages	\$1,617.6	-14.28%	30.75%	4.56%
Commerical Real Estate	\$1,428.0	-1.98%	7.34%	1.03%
Consumer	\$1,117.0	-13.27%	2.21%	2.34%

Source: Freddie Mac, Federal Reserve Board and Wells Fargo Securities, LLC

Topic of the Week

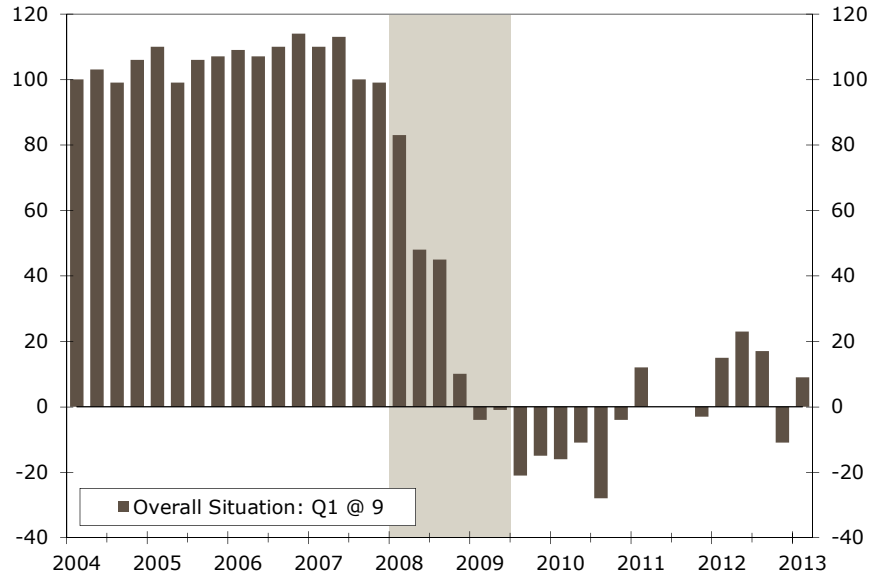
After Some Trepidation, Small Business Confidence Rebounds In the First Quarter

The Wells Fargo/Gallup Small Business Index rose 20 points in early January, as businesses expressed less concern about current business conditions and slightly more optimism about expectations for the coming year. The 20-point rise follows a 28-point drop in the fourth quarter, which was the largest quarterly decline since the fourth quarter of 2008. The partial recovery from that fourth quarter plunge suggests that worries over the fiscal cliff were likely a little overdone late last year. We noted then that most of the fourth quarter's drop was in the expectations components and that current conditions were still improving. The latest report shows improvement in both series, with the present situation series rising 8 points to -2 and the future expectations component climbing 12 points to +11.

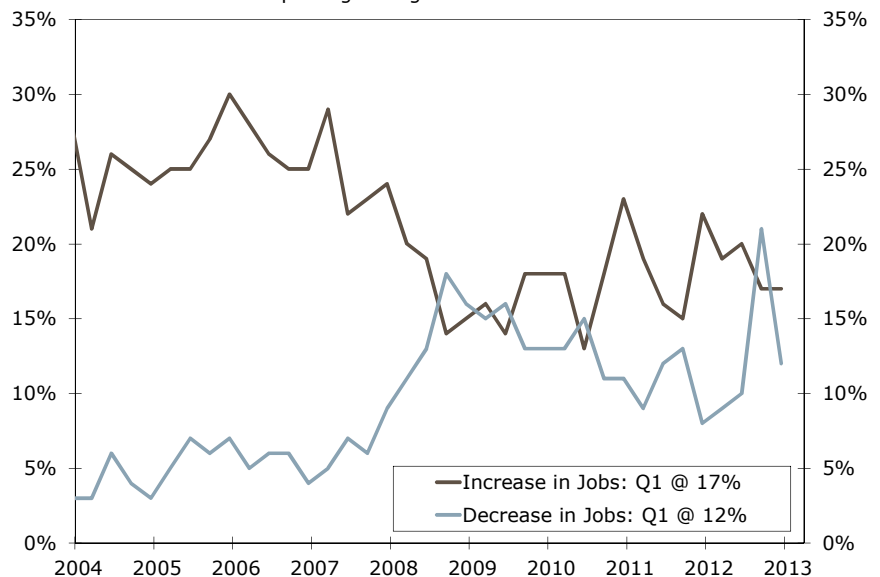
Even with the 20 point rise, the overall index remains exceptionally low, suggesting that many businesses remain concerned about changes to the tax code and the ongoing debate about fiscal policy. In this environment, businesses are likely to continue to tread lightly when it comes to investing in new plants and equipment or hiring additional workers. The trend is in the right direction, however, and this is evident across most of the survey's key components. The proportion of firms stating that they reduced their workforce during the past 12 months fell to 22 percent in the first quarter from 26 percent previously. Even fewer firms, just 12 percent compared to 21 percent a quarter earlier, stated that they intend to reduce employment over the coming year.

Because many business owners remain concerned about the recent changes to tax and regulatory policy, they are focusing intently on protecting their operating margins by controlling costs and expanding more cautiously than in the past. In this environment, capital spending and hiring will likely continue to grow modestly. For more discussion on this topic please see our recent report, *After Some Trepidation, Small Business Confidence Rebounds*, available on our website.

Wells Fargo Small Business Survey
Overall Situation



Wells Fargo Small Business Index
Percent Expecting Change in Jobs in Next 12 months



Source: Gallup, Wells Fargo Bank and Wells Fargo Securities, LLC

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 1/25/2013	1 Week Ago	1 Year Ago
3-Month T-Bill	0.08	0.07	0.04
3-Month LIBOR	0.30	0.30	0.56
1-Year Treasury	0.15	0.18	0.14
2-Year Treasury	0.25	0.25	0.22
5-Year Treasury	0.80	0.76	0.79
10-Year Treasury	1.90	1.84	1.99
30-Year Treasury	3.10	3.03	3.15
Bond Buyer Index	3.54	3.53	3.68

Foreign Exchange Rates

	Friday 1/25/2013	1 Week Ago	1 Year Ago
Euro (\$/€)	1.346	1.332	1.311
British Pound (\$/£)	1.581	1.587	1.566
British Pound (£/€)	0.851	0.839	0.837
Japanese Yen (¥/\$)	91.010	90.100	77.780
Canadian Dollar (C\$/ \$)	1.006	0.992	1.004
Swiss Franc (CHF/\$)	0.925	0.934	0.922
Australian Dollar (US\$/A\$)	1.043	1.051	1.060
Mexican Peso (MXN/\$)	12.635	12.662	13.019
Chinese Yuan (CNY/\$)	6.222	6.218	6.306
Indian Rupee (INR/\$)	53.685	54.390	50.069
Brazilian Real (BRL/\$)	2.030	2.041	1.762
U.S. Dollar Index	79.768	79.649	79.579

Foreign Interest Rates

	Friday 1/25/2013	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.14	0.14	1.09
3-Month Sterling LIBOR	0.51	0.51	1.09
3-Month Canadian LIBOR	1.22	1.23	1.38
3-Month Yen LIBOR	0.17	0.17	0.20
2-Year German	0.25	0.18	0.19
2-Year U.K.	0.37	0.38	0.42
2-Year Canadian	1.14	1.18	1.02
2-Year Japanese	0.08	0.08	0.13
10-Year German	1.63	1.56	1.95
10-Year U.K.	2.05	2.01	2.16
10-Year Canadian	1.92	1.92	2.04
10-Year Japanese	0.72	0.75	1.01

Commodity Prices

	Friday 1/25/2013	1 Week Ago	1 Year Ago
WTI Crude (\$/Barrel)	96.30	95.49	99.40
Gold (\$/Ounce)	1665.77	1684.30	1710.57
Hot-Rolled Steel (\$/S.Ton)	624.00	633.00	733.00
Copper (\$/Pound)	368.20	366.20	382.95
Soybeans (\$/Bushel)	14.49	14.45	12.13
Natural Gas (\$/MMBTU)	3.45	3.49	2.73
Nickel (\$/Metric Ton)	17,331	17,540	20,577
CRB Spot Inds.	544.88	533.82	535.39

Next Week's Economic Calendar

	Monday 28	Tuesday 29	Wednesday 30	Thursday 31	Friday 1
U.S. Data	Durable Goods Orders November 0.8% December 3.0% (W)	Consumer Confidence December 65.1 January 68.8 (W)	GDP (QoQ) 3Q F 3.1% 4Q A 1.0% (W)	Personal Income November 0.6% December 1.1% (W)	Nonfarm Payrolls December 155K January 200K (W)
	Pending Home Sales November 1.7% December 0.4% (C)		FOMC Rate Decision January 0.25% January 0.25% (W)	Personal Spending November 0.4% December 0.3% (W)	Unemployment Rate December 7.8% January 7.7% (W)
				Employment Cost Index 3Q 0.4% 4Q 0.5% (W)	Construction Spending November -0.3% December 0.5% (W)
			Japan IP (MoM) Previous (Nov) -1.4%	Canada GDP (MoM) Previous (Oct) 0.1%	Brazil IP (MoM) Previous (Dec) -0.6%
				Germany Unemployment Rate Previous (Dec) 6.9%	Eurozone PMI Manufacturing Previous (Jan) 47.5

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Anika Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Sarah Watt	Economic Analyst	(704) 410-3282	sarah.watt@wellsfargo.com
Kaylyn Swankoski	Economic Analyst	(704) 410-3276	kaylyn.swankoski@wellsfargo.com
Sara Silverman	Economic Analyst	(704) 410-3281	sara.silverman@wellsfargo.com
Zachary Griffiths	Economic Analyst	(704) 410-3284	zachary.griffiths@wellsfargo.com
Peg Gavin	Executive Assistant	(704) 410-3279	peg.gavin@wellsfargo.com
Cyndi Flowe	Administrative Assistant	(704) 410-3272	cyndi.h.flowe@wellsfargo.com

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