

# Economics Group

## MONTHLY OUTLOOK

### U.S. Overview

#### Welcome to the Recovery!

Coming off the disappointing 0.1 percent annualized growth in fourth-quarter real GDP might seem like an odd time to roll out the welcome mat to the economic recovery. After all, economic growth has seemed rather listless since the economy emerged from the Great Recession nearly four years ago, even though we have “technically” recovered all the ground lost during the downturn. Beneath the surface, however, changes are taking place that likely will produce stronger economic gains over the next few years, at least in the private sector.

Economic recoveries usually get their punch from a rebound in the most cyclical parts of the economy. Consumer spending on cars, SUVs and other big-ticket items tends to soar as worries about job security subside, hiring increases and income and household wealth rise. Once consumers are back on their feet, homebuilding and business fixed investment typically ramp back up and inventories rise in line with the higher level of economic activity.

We now see the key cyclical drivers of economic activity kicking into a slightly higher gear. Spending for motor vehicle and other big ticket items appears to have caught a tailwind from the gradual improvement in the job market, the rise in home prices and the booming stock market. Business fixed investment also appears to be on a sturdier foundation, led by strong private sector demand, a booming energy sector and stabilizing global economy. Finally, homebuilding appears to be well on its way to a self-reinforcing recovery.

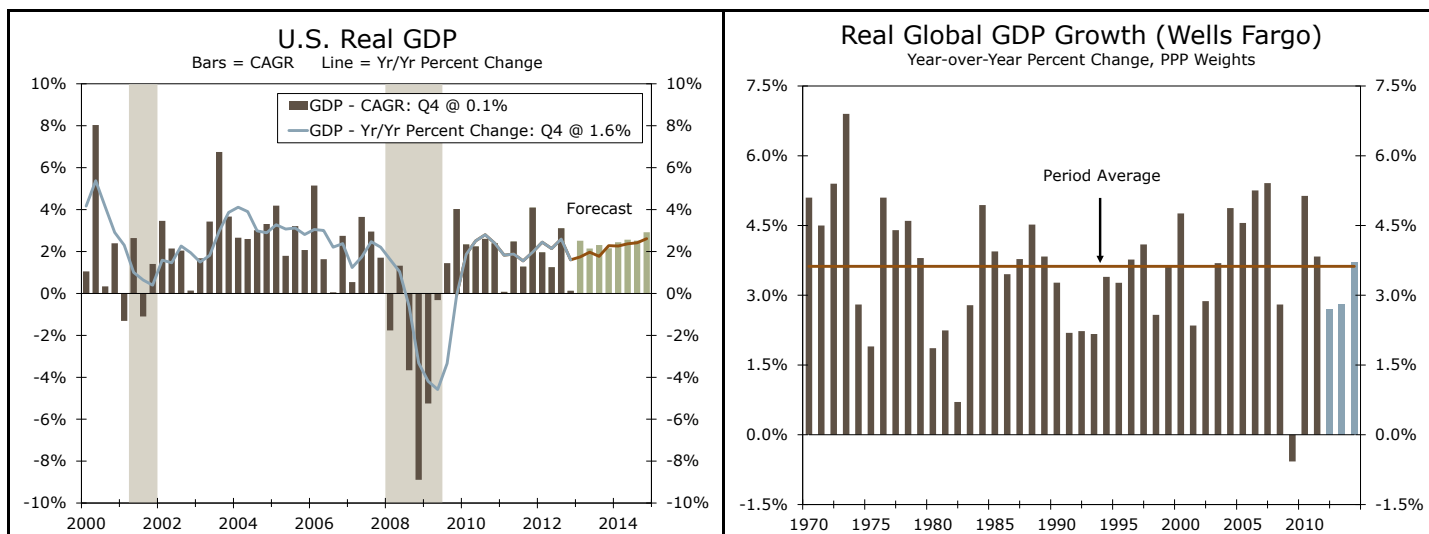
### International Overview

#### Global Economy Looking Better, at Least for Now

Real GDP in most developed economies was either essentially flat or it declined in the fourth quarter. However, growth appears to have turned positive again in many advanced economies in the current quarter, and economic activity in most developing economies likely has strengthened as well. Assuming that the global economy is not subject to a negative shock, we project that global GDP will grow in 2013 at about the same rate as it did last year before strengthening back toward its long-run average in 2014.

However, the recent inconclusive election in Italy is a poignant reminder that the European sovereign debt crisis is not completely solved and that the risk of a negative exogenous shock is not trivial. Although the Italian government does not have much of a deficit problem at present, the country does have a growth problem, making it more difficult to stabilize its debt-to-GDP ratio. If political paralysis in Italy causes a derailment of the economic reform agenda, investors may begin to question whether Italian authorities can stabilize the country's debt-to-GDP ratio.

Given their relatively small size, Greece, Ireland and Portugal can all be bailed out. However, Italy is too big to bail out. If the Italian government were unable to refinance itself, its debt would need to be restructured, which would lead to significant write-downs among financial institutions. In a worst-case scenario, another global financial crisis could ensue.



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



### The Recovery Has Not Been Sequestered

The year began amid a great deal of angst about the fiscal cliff and the federal budget sequestration. Now that both events have passed, confidence is increasing that economic growth will find a way through the clouds hanging over fiscal policy. Even the puny 0.1 percentage point rise in fourth quarter real GDP growth was not too much cause for concern. Most of the quarter's weakness was due to a 22 percent plunge in defense spending, which was at least partially tied to preparations for the sequestration originally due to take effect on January 1.

Consumers appear to have shrugged off much of Washington's latest shenanigans. Even the expiration of the 2 percentage point payroll tax holiday appears to have elicited little initial response. Consumer spending through the first two months of 2013 has held up relatively well, even with the added burden of sharply higher gasoline prices. Motor vehicle sales have been particularly strong, averaging just over a 15 million unit pace. Spending appears to have softened a bit at the lower end of the income spectrum, which is where the bite from tax increases and higher gasoline prices most likely will be felt. By contrast, spending seems to be holding up relatively well at the upper end, benefiting not only from improving labor market conditions but also the bounce-back in the stock market and rebound in home prices.

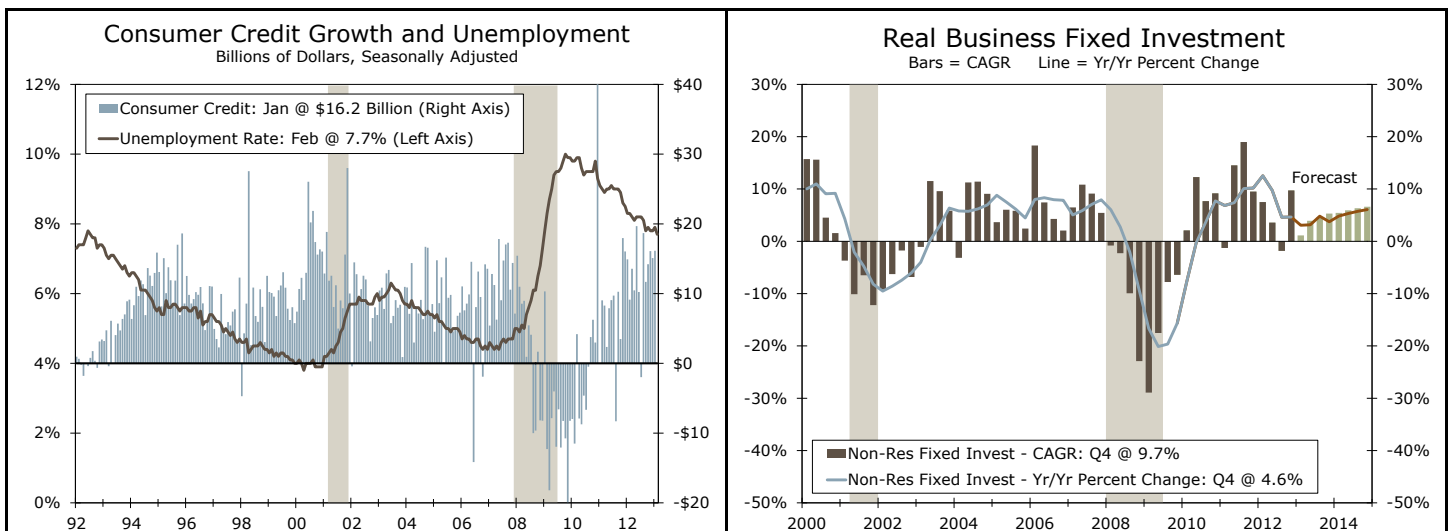
Consumers also appear more willing to take on debt. Borrowing increased at its fastest pace since the recession ended during the fourth quarter and appears to have continued to increase during the early part of 2013. The increased willingness to take on debt coincides with reduced concerns about job security. The unemployment rate has fallen to a post-recession low of just 7.7 percent, while consumers' perceptions about the labor market expressed in the consumer confidence survey have improved gradually.

While we expect consumer spending to hold up reasonably well in 2013, we also believe the higher payroll tax and higher

gasoline prices eventually will take a toll on spending. Big ticket purchases should hold up somewhat better, however, as rising home prices and the strength in the stock market encourage households to take on more debt. Moreover, rising home sales will also drive demand for services outlays.

Housing remains a key element in the broader economic rebound. Housing starts surged 15.4 percent in the fourth quarter, ending the year at a 973,000-unit pace. Both single-family starts and apartment construction improved during the quarter, and the momentum in single-family home building has carried over into the early part of 2013. The bulk of construction spending on single-family homes typically lags about 90 days behind starts, suggesting that residential investment will rise smartly in both the first and second quarters. Outlays for renovations and repairs weakened early in the year, potentially reflecting some let-up following Hurricane Sandy. There is still plenty of work to be done to recover from that storm, however, and we should see renovations and repair spending rise in the spring.

Business fixed investment should pick back up later this year. After plummeting at a 23.8 percent pace in the third quarter amid concerns about a slowing global economy, core capital goods orders surged at a 21.3 percent pace in the fourth quarter and the momentum spilled over into 2013. The latest data show a generalized slowdown in productivity, which may spur purchases of additional labor-saving technology. All the recent talk of boosting the minimum wage adds fuel to this trend. Increased investment to support the energy boom remains a more important driver for capital spending, however, particularly if final approval is given to build the Keystone Pipeline. Such a decision likely would give a green light to many other large energy projects sidelined by regulatory concerns. Inventories are also expected to add to growth over the forecast horizon, reflecting both a bounce-back from the fourth quarter's slide and a rebuild in farm inventories.



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

Wells Fargo U.S. Economic Forecast																					
	Actual								Forecast								Actual			Forecast	
	2011				2012				2013				2014				2010	2011	2012	2013	2014
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product (a)	0.1	2.5	1.3	4.1	2.0	1.3	3.1	0.1	2.5	2.1	2.3	2.2	2.4	2.6	2.5	2.9	2.4	1.8	2.2	1.9	2.4
Personal Consumption	3.1	1.0	1.7	2.0	2.4	1.5	1.6	2.1	2.1	1.7	1.7	1.9	1.9	2.0	2.0	2.2	1.8	2.5	1.9	1.9	1.9
Business Fixed Investment	-1.3	14.5	19.0	9.5	7.5	3.6	-1.8	9.7	1.1	3.9	4.6	5.3	5.4	5.9	6.3	6.6	0.7	8.6	7.7	3.7	5.5
Equipment and Software	11.1	7.8	18.3	8.8	5.4	4.8	-2.6	11.3	1.7	3.6	4.4	5.1	5.1	5.6	6.0	6.3	8.9	11.0	6.9	4.0	5.2
Structures	-28.2	35.2	20.7	11.5	12.9	0.6	0.0	5.8	-1.5	5.0	5.5	6.0	6.5	7.0	7.5	7.5	-15.6	2.7	10.1	2.7	6.5
Residential Construction	-1.4	4.2	1.4	12.0	20.6	8.4	13.6	17.4	20.0	22.0	24.0	25.0	26.0	26.0	27.0	28.0	-3.7	-1.4	12.1	19.2	25.6
Government Purchases	-7.0	-0.8	-2.9	-2.2	-3.0	-0.7	3.9	-6.9	-0.1	-3.2	-3.1	-3.8	-3.3	-2.4	-3.9	-3.4	0.6	-3.1	-1.7	-2.1	-3.3
Net Exports	-416.6	-399.6	-397.9	-418.0	-415.5	-407.4	-395.2	-387.9	-383.3	-370.4	-364.9	-364.8	-357.3	-354.9	-350.4	-343.8	-419.7	-408.0	-401.5	-370.9	-351.6
Pct. Point Contribution to GDP	0.0	0.5	0.0	-0.6	0.1	0.2	0.4	0.2	0.1	0.4	0.2	0.0	0.2	0.1	0.1	0.2	-0.5	0.1	0.0	0.2	0.1
Inventory Change	30.3	27.5	-4.3	70.5	56.9	41.4	60.3	12.0	32.0	36.0	46.0	51.0	52.0	52.0	52.0	52.0	50.9	31.0	42.7	41.3	52.0
Pct. Point Contribution to GDP	-0.5	0.0	-1.1	2.5	-0.4	-0.5	0.7	-1.6	0.6	0.1	0.3	0.1	0.0	0.0	0.0	0.0	1.5	-0.2	0.1	0.0	0.1
Nominal GDP	2.2	5.2	4.3	4.2	4.2	2.8	5.9	1.0	4.9	4.2	4.4	4.2	4.6	4.7	4.8	5.2	3.8	4.0	4.0	3.9	4.5
Real Final Sales	0.6	2.4	2.4	1.5	2.4	1.7	2.4	1.7	2.2	2.0	2.0	2.0	2.4	2.6	2.5	2.9	0.9	2.0	2.1	2.0	2.3
Retail Sales (b)	7.9	8.1	8.6	7.4	6.4	4.7	4.8	4.3	3.5	4.6	4.6	4.5	4.9	5.4	5.5	5.7	5.5	8.0	5.0	4.3	5.4
Inflation Indicators (b)																					
PCE Deflator	1.8	2.6	2.8	2.5	2.4	1.6	1.5	1.6	1.1	1.3	1.3	1.4	1.7	1.8	1.9	2.0	1.9	2.4	1.8	1.3	1.9
Consumer Price Index	2.1	3.4	3.7	3.3	2.8	1.9	1.7	1.9	1.7	2.1	2.0	2.0	2.2	2.1	2.1	2.2	1.6	3.1	2.1	1.9	2.1
"Core" Consumer Price Index	1.1	1.5	1.9	2.2	2.2	2.3	2.0	1.9	1.9	1.8	1.9	2.0	2.0	2.0	2.1	2.1	1.0	1.7	2.1	1.9	2.0
Producer Price Index	4.8	6.7	7.0	5.5	3.4	1.1	1.6	1.7	1.6	2.9	2.2	2.4	2.7	2.6	2.7	2.7	4.2	6.0	1.9	2.3	2.7
Employment Cost Index	2.0	2.2	2.0	2.0	1.9	1.7	2.0	1.9	2.1	2.0	2.0	2.0	2.8	2.3	2.2	2.3	1.3	2.6	1.9	2.0	2.4
Real Disposable Income (a)	4.4	-1.5	-1.3	-0.2	3.7	2.2	0.7	6.2	-5.0	-1.0	0.5	1.2	1.8	2.0	2.0	2.2	1.8	1.3	1.5	0.0	1.4
Nominal Personal Income (b)	6.3	5.3	4.7	4.1	2.9	3.0	3.3	5.0	1.7	1.6	1.7	1.2	3.7	3.8	3.9	3.4	3.8	5.1	3.5	1.5	3.7
Industrial Production (a)	4.4	1.2	5.6	5.1	5.9	2.4	0.5	2.6	3.5	3.5	4.1	4.1	3.5	3.8	4.1	4.1	5.4	4.1	3.8	3.0	3.8
Capacity Utilization	76.2	76.3	77.1	77.9	78.7	78.9	78.6	78.8	78.9	79.1	79.4	79.5	79.6	79.8	80.0	80.2	73.7	76.8	78.8	79.2	79.9
Corporate Profits Before Taxes (b)	4.6	10.8	4.7	9.2	10.3	6.7	7.5	5.0	4.8	5.2	5.3	5.7	6.1	6.3	6.5	6.7	26.8	7.3	7.3	5.3	6.4
Corporate Profits After Taxes	2.1	11.0	7.8	14.5	9.2	4.4	3.2	3.7	4.0	4.5	4.6	5.1	5.5	5.7	5.9	6.0	23.9	8.9	5.0	4.6	5.8
Federal Budget Balance (c)	-460.5	-141.1	-326.3	-321.7	-457.2	-125.3	-185.0	-293.3	-261.7	-165.0	-200.0	-200.0	-215.0	-175.0	-210.0	-200.0	-1294.2	-1296.8	-1089.2	-920.0	-800.0
Current Account Balance (d)	-120.0	-119.1	-108.2	-118.7	-133.6	-118.1	-107.5	-110.0	-115.0	-120.0	-125.0	-125.0	-130.0	-130.0	-135.0	-135.0	-442.0	-465.9	-469.2	-485.0	-530.0
Trade Weighted Dollar Index (e)	70.5	69.2	72.8	73.3	72.7	74.5	72.7	73.4	75.5	76.0	76.5	77.0	77.5	77.5	78.0	78.0	75.4	70.9	73.5	76.3	77.8
Nonfarm Payroll Change (f)	156.7	209.3	145.0	190.0	262.3	108.0	152.0	208.7	185.0	180.0	190.0	200.0	190.0	200.0	200.0	210.0	85.2	175.3	182.8	188.8	200.0
Unemployment Rate	9.0	9.0	9.0	8.7	8.3	8.2	8.0	7.8	7.7	7.6	7.5	7.4	7.3	7.2	7.1	7.0	9.6	8.9	8.1	7.6	7.2
Housing Starts (g)	0.58	0.57	0.61	0.68	0.71	0.74	0.77	0.90	0.90	0.96	1.02	1.08	1.12	1.15	1.20	1.23	0.59	0.61	0.78	0.97	1.17
Light Vehicle Sales (h)	12.7	12.2	12.6	13.5	14.1	14.1	14.5	15.0	15.2	15.1	15.6	15.9	16.0	15.9	16.2	16.4	11.6	12.7	14.4	15.5	16.1
Crude Oil - Brent - Front Contract (i)	105.21	116.88	111.79	108.43	118.12	108.68	109.03	109.56	113.22	113.00	115.00	116.00	118.00	120.00	122.00	124.00	80.47	110.58	111.35	114.3	121.0
Quarter-End Interest Rates (j)																					
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	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3 Month LIBOR	0.30	0.25	0.37	0.58	0.47	0.46	0.36	0.31	0.25	0.25	0.25	0.25	0.25	0.25	0.30	0.30	0.34	0.34	0.43	0.25	0.28
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Conventional Mortgage Rate	4.84	4.51	4.11	3.96	3.95	3.68	3.50	3.35	3.70	3.75	3.80	3.90	4.00	4.20	4.40	4.60	4.69	4.46	3.66	3.79	4.30
3 Month Bill	0.09	0.03	0.02	0.02	0.07	0.09	0.10	0.05	0.10	0.15	0.20	0.30	0.30	0.35	0.40	0.45	0.14	0.05	0.09	0.19	0.38
2 Year Note	0.80	0.45	0.25	0.25	0.33	0.33	0.23	0.25	0.30	0.40	0.50	0.60	0.70	0.90	1.10	1.20	0.70	0.45	0.28	0.45	0.98
5 Year Note	2.24	1.76	0.96	0.83	1.04	0.72	0.62	0.72	0.85	0.95	1.05	1.10	1.20	1.40	1.60	1.80	1.93	1.52	0.76	0.99	1.50
10 Year Note	3.47	3.18	1.92	1.89	2.23	1.67	1.65	1.78	2.10	2.15	2.20	2.30	2.40	2.60	2.80	3.00	3.22	2.78	1.80	2.19	2.70
30 Year Bond	4.51	4.38	2.90	2.89	3.35	2.76	2.82	2.95	3.30	3.35	3.40	3.50	3.60	3.70	3.90	4.10	4.25	3.91	2.92	3.39	3.83

Forecast as of: March 13, 2013

Notes: (a) Compound Annual Growth Rate Quarter-over-Quarter

(b) Year-over-Year Percentage Change

(c) Quarterly Sum - Billions USD; Annual Data Represents Fiscal Yr.

(d) Quarterly Sum - Billions USD

(e) Federal Reserve Major Currency Index, 1973=100 - Quarter End

(f) Average Monthly Change

(g) Millions of Units

(h) Quarterly Data - Average Monthly SAAR; Annual Data - Actual Total Vehicles Sold

(i) Quarterly Average of Daily Close

(j) Annual Numbers Represent Averages

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

**Global Economy Looking Better, at Least for Now**

The major economies of the world ended last year on a very weak note. The levels of real GDP in both the United States and Japan were more or less flat on a sequential basis in the fourth quarter, and the economy of the overall euro area contracted 2.4 percent at an annualized rate. However, it appears that growth has turned positive again in most developed economies in the first quarter. As shown on page 3, we project that real GDP in the United States will grow 2.5 percent in Q1-2013, and that the Japanese economy will register a modestly positive growth rate as well (page 5). Although economic activity in the Eurozone remains very weak at present, another sharp contraction like the one experienced during the fourth quarter does not appear to be occurring in the current quarter.

Economic activity in many developing economies appears to have strengthened as well recently. As represented by the pick-up in industrial production growth in China, most developing Asian economies appear to have strengthened in Q1 (bottom left chart). Brazil started the New Year on a firmer footing also as industrial production rose 2.5 percent in January. Assuming that the global economy is not subject to a negative shock, we project that global GDP will grow in 2013 at about the same rate as it did last year before strengthening back toward its long-run average in 2014 (see chart on front page).

**Europe Still Not Out of the Sovereign Debt Woods**

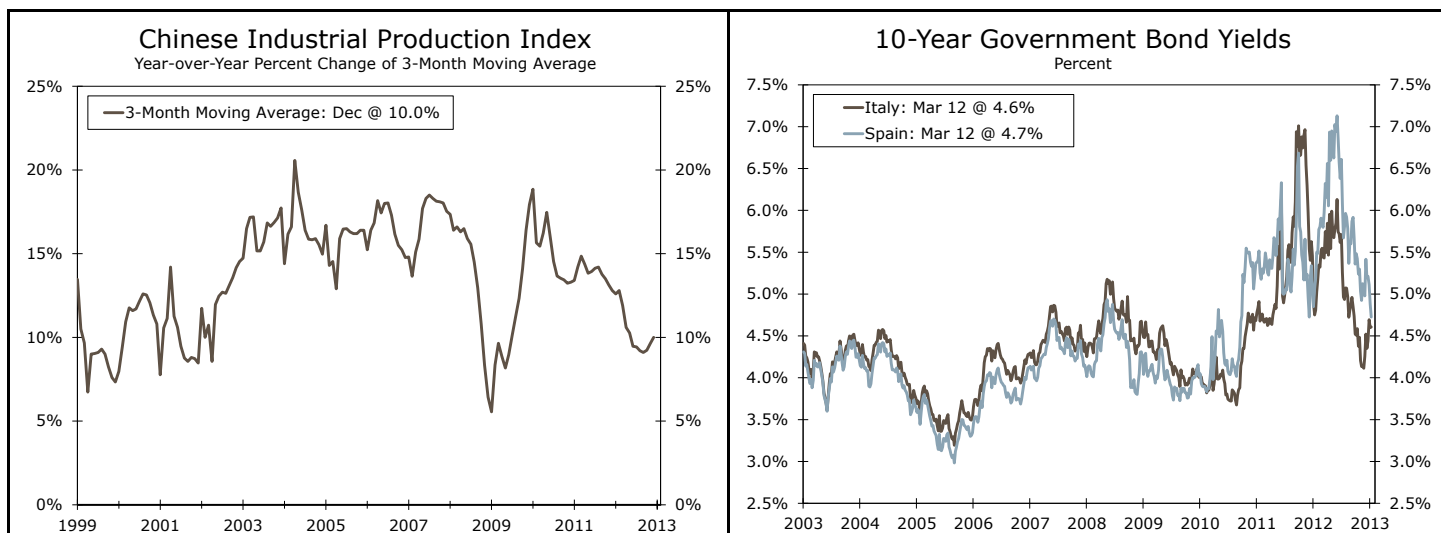
However, the recent general election in Italy, which ended inconclusively at the end of last month, serves as a timely reminder that the global economy indeed remains vulnerable to exogenous shocks. Since reaching a two-year low in January, the yield on the benchmark 10-year government bond in Italy has risen about 50 bps on balance (bottom right chart). Government bond yields in the other highly indebted countries in Europe also moved higher in the immediate aftermath of the Italian election. Although bond yields have not yet risen to levels that would seriously undermine the ability of most

European governments to stabilize their debt-to-GDP ratios, the European sovereign debt crisis may be starting to rear its ugly head again. The Italian election served as the catalyst for the reassessment of the debt crisis as voters seem to have overwhelmingly rejected the economic policies of Prime Minister Monti, the centerpiece of which were fiscal austerity and structural economic reform.

Although the Italian government has a debt-to-GDP ratio of roughly 130 percent, which is among the highest in Europe, it also has a respectable primary surplus (the budget balance less interest payments) of 2 percent of GDP. Therefore, Italy does not really have a deficit problem. What it does have is a growth problem. Real GDP in Italy is nearly 8 percent below its pre-recession (pre-depression?) peak at present. Moreover, the Italian economy has grown at an anemic pace of less than 1 percent per annum over the past two decades.

Although less fiscal austerity may help the economy grow a bit stronger in the near term, what Italy really needs is structural economic reform. However, with voters seemingly rejecting a reform agenda and with parliament now split—the center-left took the most seats in the lower house while the center-right will control the Senate—prospects of sweeping economic reforms appear to be remote. If economic growth in Italy remains weak, it will be difficult to stabilize the government-to-GDP ratio, everything else equal. And if investors have doubts about the sustainability of the debt-to-GDP ratio, the sovereign debt crisis could intensify again.

Greece, Ireland and Portugal are all small enough to bail out. However, the Italian government has about €2 trillion worth of outstanding government debt, making it too big to bail out. If the Italian government is unable to finance itself, Italian government debt will need to be restructured, which would lead to large write-downs among financial institutions. In a worst-case scenario, another global financial crisis could ensue.



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

## Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2012	2013	2014	2012	2013	2014
Global (PPP weights)	2.7%	2.8%	3.7%	4.2%	4.0%	4.3%
Global (Market Exchange Rates)	1.5%	1.6%	2.4%	n/a	n/a	n/a
Advanced Economies <sup>1</sup>	1.2%	1.1%	2.4%	2.1%	1.5%	1.8%
United States	2.2%	1.9%	2.4%	2.1%	1.9%	2.1%
Eurozone	-0.5%	-0.1%	1.8%	2.5%	1.3%	1.7%
United Kingdom	0.2%	1.1%	2.0%	2.8%	2.5%	2.1%
Japan	1.9%	0.4%	2.5%	0.0%	-0.2%	0.1%
Korea	2.1%	2.8%	4.3%	2.2%	2.6%	3.1%
Canada	1.8%	1.5%	2.6%	1.5%	1.1%	2.0%
Developing Economies <sup>1</sup>	4.4%	4.7%	5.3%	6.7%	7.0%	7.2%
China	7.7%	8.1%	8.4%	2.7%	3.0%	3.5%
India	5.0%	5.7%	6.5%	9.7%	9.0%	9.3%
Mexico	3.9%	2.7%	3.9%	4.1%	3.8%	4.4%
Brazil	0.8%	2.7%	3.6%	5.4%	6.7%	5.9%
Russia	3.5%	3.1%	3.7%	5.1%	6.5%	5.6%

Forecast as of: March 13, 2013

<sup>1</sup>Aggregated Using PPP Weights

## Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2013				2014		2013				2014	
	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q2	Q3	Q4	Q1	Q2
U.S.	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	2.10%	2.15%	2.20%	2.30%	2.40%	2.60%
Japan	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.70%	0.75%	0.80%	0.90%	1.10%	1.15%
Euroland*	0.15%	0.15%	0.25%	0.40%	0.55%	0.75%	1.55%	1.70%	1.90%	2.10%	2.40%	2.70%
U.K.	0.50%	0.50%	0.50%	0.50%	0.60%	0.70%	2.00%	2.20%	2.40%	2.60%	2.80%	3.20%
Canada	1.15%	1.15%	1.15%	1.25%	1.40%	1.50%	1.90%	2.10%	2.35%	2.75%	3.15%	3.30%

Forecast as of: March 13, 2013

\*10-year German Government Bond Yield

Source: IHS Global Insight and Wells Fargo Securities, LLC

## Wells Fargo Securities, LLC Economics Group

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