August 23, 2013

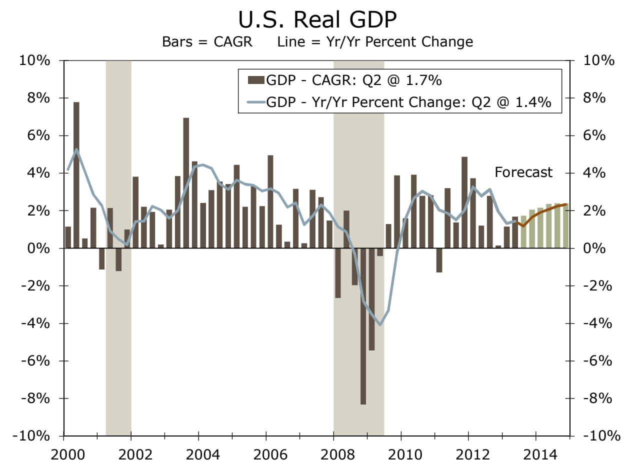
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Signals of Stronger Growth and Fed Tapering

- Existing home sales rose more than expected in July, but some of the luster was lost from when the new home sales report posted a 13.4 percent drop for the month.
- Minutes from the July FOMC meeting confirmed the timeline for the Fed to begin tapering asset purchases later this year.
- The Leading Economic Index continued to indicate stronger economic growth in the second half of the year. The overall index jumped from a flat reading in June to 0.6 percent in July.



Global Review

Mexican GDP: Fooled by Outsized Expectations

- Almost the entire spectrum of Mexican analysts was caught off-guard with the release of the country's second-quarter GDP report. In June, our 2013 forecast stood at 1.9 percent. Today, that forecast is just slightly higher at 2.0 percent. Mexican economic weakness has been clear since at least May, when we started to lower our forecast considerably.
- The good news is that this slowdown is likely temporary, and we expect the economy to resume stronger growth soon.

Wells Fargo U.S. Economic Forecast

	Actual 2012				Forecast 2013				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2010	2011	2012	2013	2014
Real Gross Domestic Product [1]	3.7	1.2	2.8	0.1	1.1	1.7	1.7	2.1	2.5	1.8	2.8	1.4	2.1
Personal Consumption	2.9	1.9	1.7	1.7	2.3	1.8	2.0	2.2	2.0	2.5	2.2	1.9	2.3
Inflation Indicators [2]													
PCE Deflator	2.4	1.7	1.6	1.7	1.4	1.1	1.3	1.3	1.7	2.4	1.8	1.3	1.9
Consumer Price Index	2.8	1.9	1.7	1.9	1.7	1.4	1.6	1.5	1.6	3.1	2.1	1.5	2.1
Industrial Production [1]	5.4	2.9	0.3	2.5	4.2	0.6	3.9	4.6	5.7	3.4	3.6	2.6	4.0
Corporate Profits Before Taxes [2]	12.8	6.9	6.3	2.7	2.1	5.2	5.3	5.7	25.0	7.9	7.0	4.6	6.4
Trade Weighted Dollar Index [3]	72.7	74.5	72.7	73.4	76.2	77.5	77.0	77.8	75.4	70.9	73.5	77.1	79.0
Unemployment Rate	8.3	8.2	8.0	7.8	7.7	7.6	7.5	7.3	9.6	8.9	8.1	7.5	7.1
Housing Starts [4]	0.71	0.74	0.78	0.90	0.96	0.87	1.02	1.04	0.59	0.61	0.78	0.99	1.12
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	3.57	4.07	4.50	4.60	4.69	4.46	3.66	4.19	4.95
10 Year Note	2.23	1.67	1.65	1.78	1.87	2.52	2.60	2.70	3.22	2.78	1.80	2.42	3.13

Forecast as of: August 7, 2013
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units
[5] 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

Inside

U.S. Review

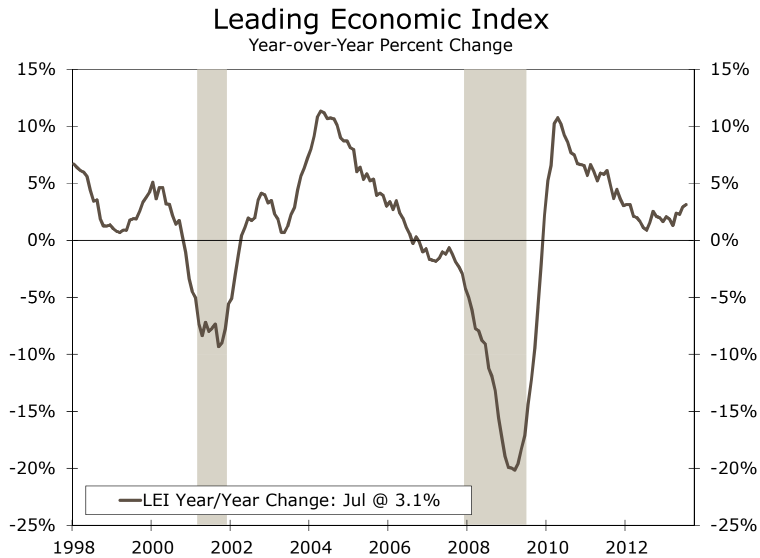
Signals of Stronger Growth and Fed Tapering

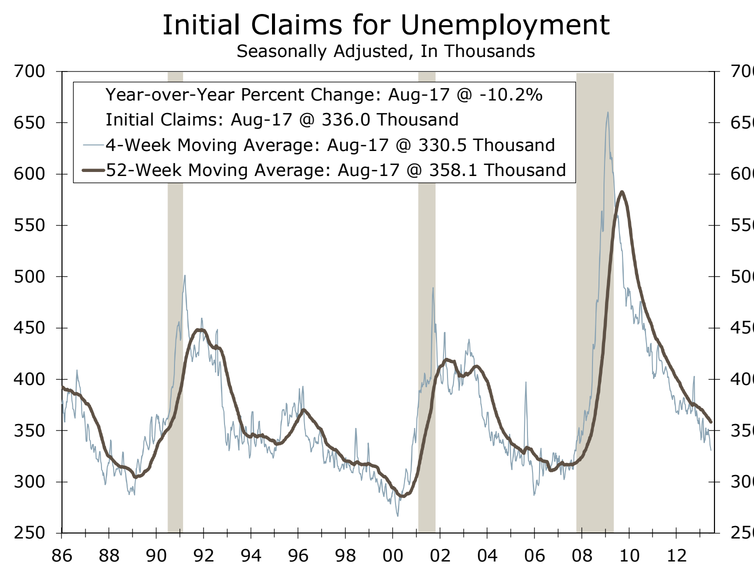
Topping the economic data this week were the minutes of the July FOMC meeting, which supported the argument for the Fed tapering its asset purchases later this year. The Leading Economic Index posted a sizable improvement in July, indicating that economic conditions appear to be poised to accelerate in the second half of the year. Initial jobless claims rose slightly for the week but remain near a five-year low. Data on the housing market continued to show improvement but reinforced our view of a somewhat slower pace in the housing market recovery over the next year.

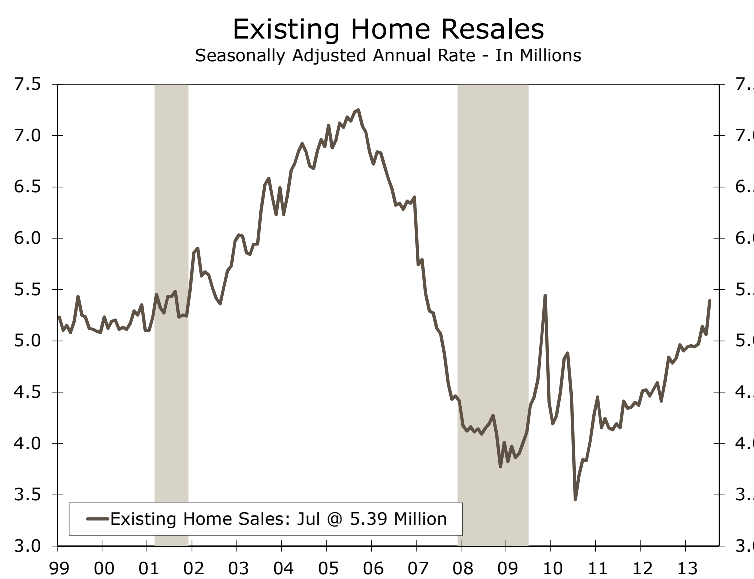
The minutes of the July FOMC meeting confirmed the Fed's timeline for a likely September announcement for a reduction in the pace of asset purchases. In particular, the minutes noted that if economic conditions continued to develop as anticipated, "the Committee would reduce the pace of purchases in measured steps and conclude the purchase program around the middle of 2014." Assuming a continued modest pace of nonfarm payroll gains in August, along with jobless claims continuing to bump along near a five-year low, there is likely enough labor market justification for the Fed to begin tapering the pace of asset purchases this fall, even in light of inflation running "persistently below its 2 percent objective," which the committee members see moving back towards its target in the medium term.

The forward-looking Leading Economic Index signaled a pick-up in the pace of economic growth in the months ahead, rising to 0.6 percent from the flat reading recorded in June. The index was driven higher through broad-based gains, including equity prices, declining jobless claims and the improvement in non-farm payrolls. The average work week for production workers and core capital goods orders subtracted from the index. A more coincident index of economic activity, the Chicago Fed's National Activity Index, posted a slightly less negative reading in July and a downward revision to June's reading. Taken together, these two metrics continue to signal somewhat stronger overall economic growth, but at a pace slower than in previous expansions.

Housing market data this week pointed toward continued improvement; however, there were signs that the pace of the housing market recovery may be slowing. Existing home sales rose 6.5 percent in July, following a 1.6 percent decline in June. Sales of single-family homes rose 6.3 percent for the month as condo and co-op sales climbed 8.6 percent. Median existing home prices slipped a bit on the month, falling to $213,500 from June's $214,000 reading. New home sales posted a disappointing 13.4 percent drop in July and June's figures were downwardly revised. Tight lending standards continue to be an obstacle for first-time home-buyers and investor purchases, which have been robust over the past year, have begun to fall over the past three months. A broader measure of home prices from FHFA rose 0.7 percent in following the trend of less than 1 percent growth the previous three months. The downshift in the pace of home price appreciation remains consistent with our outlook for continued improvement in the housing market but at a more subdued pace.







Source: The Conference Board, U.S. Department of Labor, NAR and Wells Fargo Securities, LLC

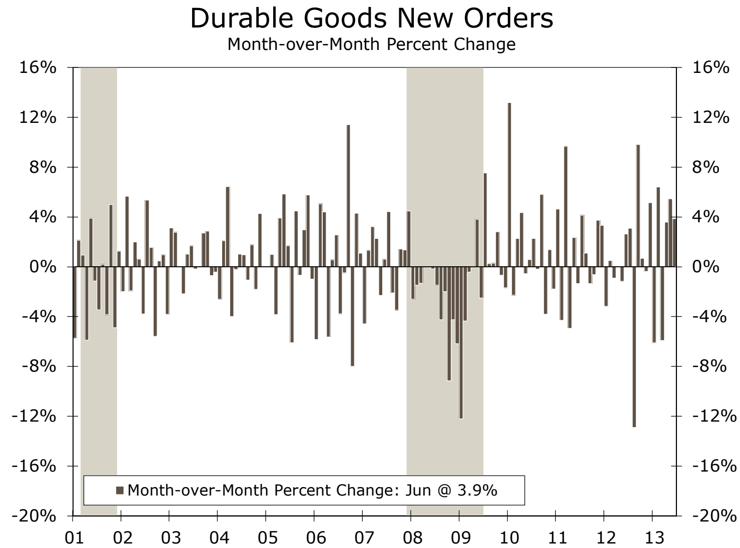
Durable Goods Orders • Monday

Orders for durable goods have risen solidly in recent months, leading the manufacturing sector out of its spring slump. Orders are now back above their pre-recession peak following three straight months of 3 percent-plus gains. This string of impressive gains looks set to end in July, however. Recent gains have been driven by the most volatile sectors in the report—civilian aircraft and defense orders. Boeing has already reported a 70 percent drop in orders for July, which should turn transportation orders negative for July, particularly as auto sales and production have eased over the past month.

Outside of transportation, durable orders should see a bounce following last month's flat reading. The ISM index showed new orders increasing at the fastest clip since 2011, which should support a continued uptrend in core capital goods orders.

Previous: 3.9% **Wells Fargo: -5.4%**

Consensus: -4.0% (Month-over-Month)



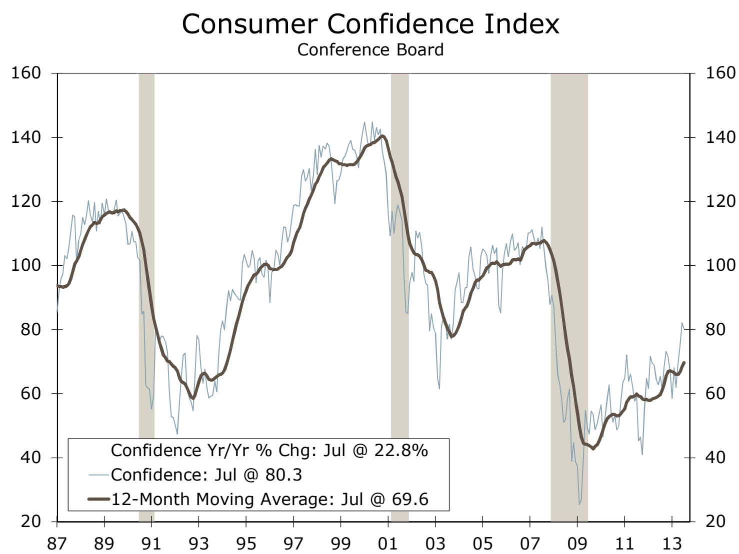
Consumer Confidence • Tuesday

Consumer confidence has improved markedly since the spring, with the index above 80 for the first time since 2008. A strengthening job market, rising equity prices and increasing home values have all supported the 15-point gain in the Consumer Confidence Index over the past year.

Some moderation looks to be in store for August. The recent pullback in the stock market will likely weigh on the most recent reading. Between the beginning of August and the end of the survey period, the S&P 500 slipped 1.8 percent. Improving labor market conditions should provide some support to consumers' assessment of the economy. Since last month's consumer confidence report, the headline unemployment rate fell 0.2 percentage points to 7.4 percent, while the four-week average for jobless claims has fallen to its lowest level since November 2007.

Previous: 80.3 **Wells Fargo: 76.2**

Consensus: 79.5



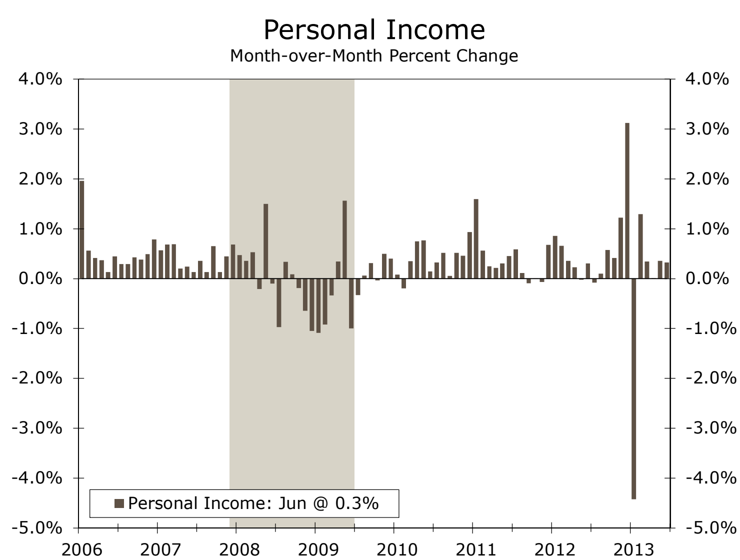
Personal Income • Friday

Personal income rose 0.4 percent in June, slightly slower than the pace set in May. Growth likely slowed again in July. After increasing 0.5 percent in June, growth in wages and salaries, the largest share of income, looks to have moderated. Data from the employment report showed weaker job growth in July. Combined with a slightly shorter workweek and a pullback in earnings, take home pay looks to have softened. Rental and asset income, along with transfer payments, should be more favorable and lift personal income growth up 0.3 over the month.

We suspect personal spending also moderated in July, increasing 0.3 percent. Retail sales growth slowed over the month, while a smaller increase in gasoline prices saved consumers from having to step up spending at the pump as much as they did the previous month.

Previous: 0.3% **Wells Fargo: 0.3%**

Consensus: 0.2% (Month-over-Month)



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

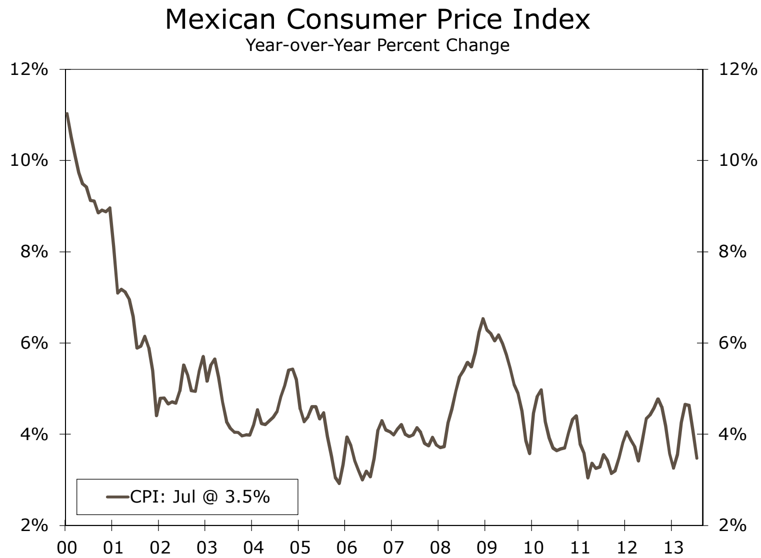
Global Review

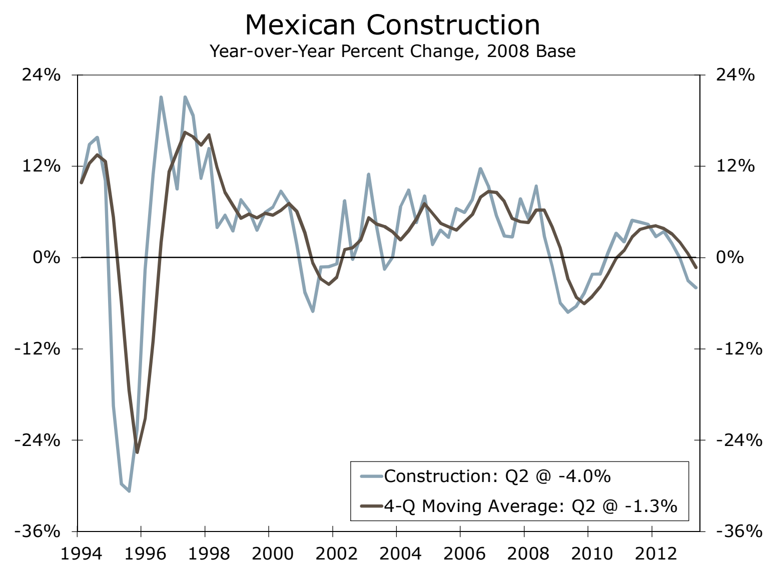
Mexican GDP: Fooled by Outsized Expectations

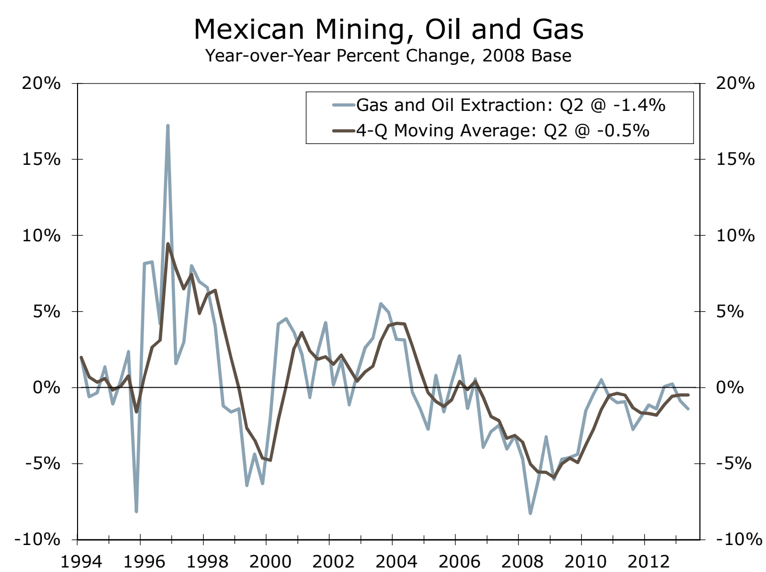
Almost the entire spectrum of Mexican analysts was caught off-guard with the release of the country's second quarter GDP report. Although GDP forecasts tend to vary during the year, we settled early on a very low rate of economic growth as the outlook started to dim. In June, our 2013 forecast stood at 1.9 percent. Today, that forecast is just slightly higher at 2.0 percent. Mexican economic weakness has been clear to us since at least May, when we started to lower our forecast considerably. We were also surprised by outsized expectations earlier in the year due to the fast pace of reforms tackled by the administration of Peña Nieto after taking office in December and bringing the PRI, which governed Mexico for more than 70 years, back to power after a 12-year hiatus. However, those expectations did not last long. On a seasonally adjusted basis, Mexican GDP dropped 0.7 percent in the second quarter with an important 1.1 percent decline in industrial activity. On a year-over-year basis, which is more reliable than the seasonally adjusted series, the economy grew only 1.5 percent after growing 0.6 percent during the first quarter, in line with our forecast. Our forecast today is for the Mexican economy to grow 2.0 percent in 2013.

However, even our below-consensus forecast of 2.0 percent GDP growth this year may be difficult to achieve. In order to hit this annual average rate, real GDP would need to grow at a year-over-year rate of 2.6 percent in the third quarter and 3.4 percent in the fourth quarter. It may be a stretch to achieve these growth rates. Therefore, the consensus GDP forecast for 2013, which currently stands at 2.7 percent, likely will be marked down significantly.

Interestingly enough, the Mexican government has argued that the slowdown in economic activity was caused by the weak international environment. That may be partially true later when it releases data from the demand side of the economy, but a close analysis from the supply side of the economy today conveys a weak domestic economy, rather than an economy affected by a weak external environment. We saw this weakness early this year when we got the release of the results for the last quarter of 2012, which showed a price deflator that increased by only 0.7 percent at a time when the economy was growing, which was the lowest percentage change in the deflator during a quarter when the economy posted a positive rate of growth since historical data has been available. Thus, it was clear that the economy was weak. After this, the central bank decreased the benchmark interest rate, acknowledging these developments. The biggest contributors to this year's slowdown seem to be the mining and construction sectors. The construction sector dropped 3.1 percent in the first quarter and 4.0 percent in the second quarter, year over year. Meanwhile, the mining sector dropped 1.4 percent in the first quarter and 2.1 percent in the second quarter. The weakness in the construction sector was not a surprise as many road construction projects in the capital of the country came to completion. The good news is that this slowdown is temporary and we expect the economy to resume stronger growth soon.







Source: IHS Global Insight and Wells Fargo Securities, LLC

German IFO • Tuesday

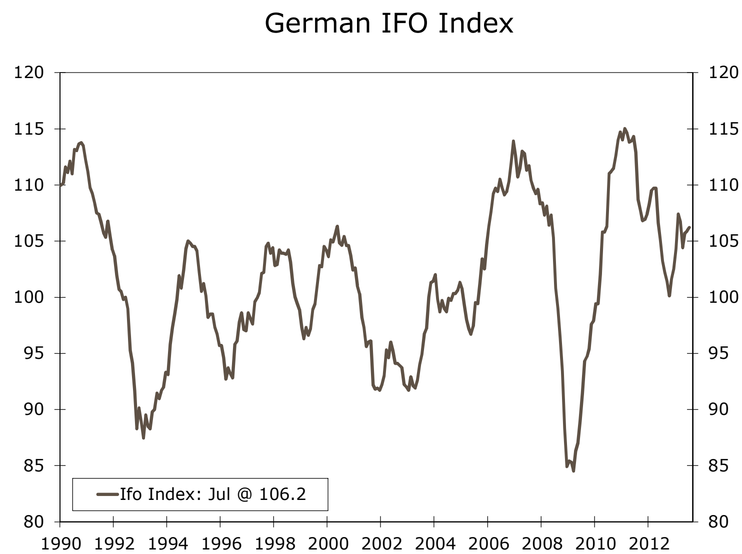
We learned this week that the Eurozone composite PMI climbed to 51.7 in August– the best print for this measure of business activity since 2011. Coming on the heels of a better-than-expected print for second-quarter GDP growth in the Eurozone, the survey raised hopes for a sustained economic recovery in Europe.

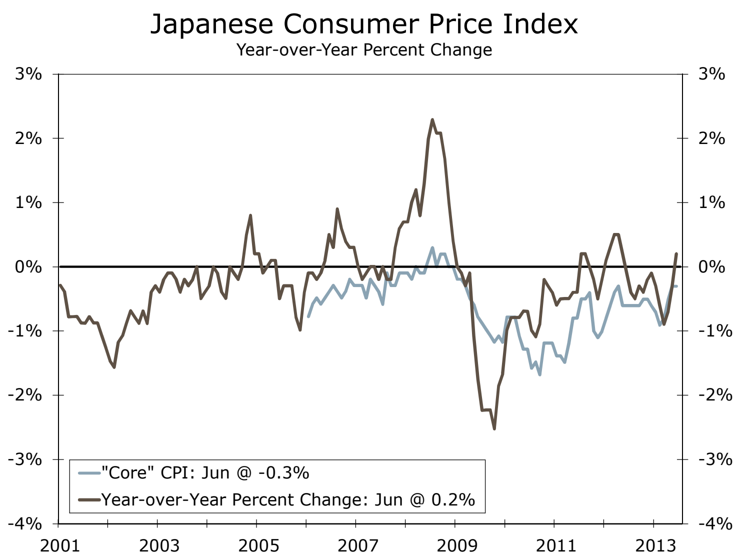
On Tuesday, the German IFO index will tell financial markets about business activity during August in the Eurozone's largest economy and manufacturing powerhouse.

Unlike much of the rest of Europe, the German expansion seems to be firmly entrenched. We certainly would like to see the prosperity in Germany spread throughout Europe, but until it does, prospects for the Eurozone depend to a large extent on continued growth in Germany.

Previous: 106.2

Consensus: 107.0





Japanese CPI • Friday

Since April, the Bank of Japan (BoJ) has been implementing what it calls Quantitative and Qualitative Easing (QQE). These bold monetary policy changes include BoJ purchases of Japanese government bonds, ETFs in Japan and other assets to increase the monetary base. In addition to stimulating the economy, the stated goal of QQE is to lift inflation to 2.0 percent within two years.

Though the year-over-year inflation rate turned positive in June, this is more of a reflection of higher fuel prices than underlying inflation trends. For more analysis on this, see our recent special report, "*Is Abenomics Working?*", on our website.

On Friday, markets will get a look at July inflation figures and learn if inflation is taking hold more broadly.

Previous: 0.2% **Wells Fargo: 0.5%**

Consensus: 0.7% (Year-over-Year)

Canadian GDP • Friday

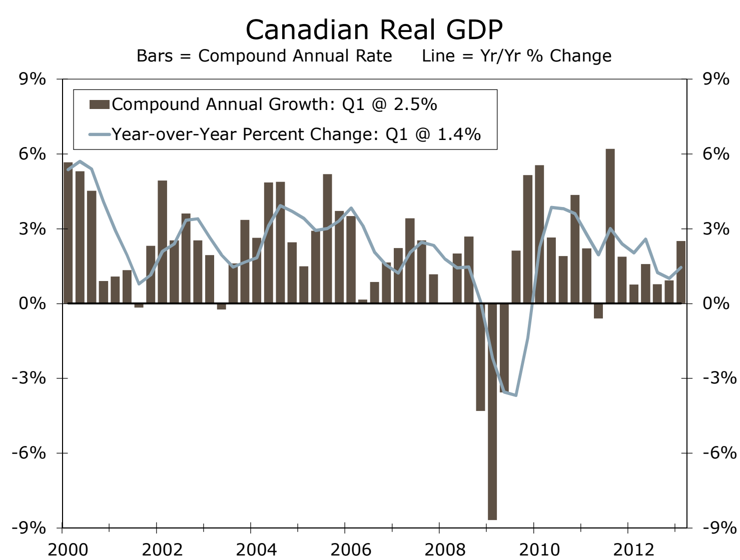
A first-quarter increase in exports and government spending were enough to offset a drag from business spending and only tepid growth in consumer spending in Canada. The 2.5 percent annualized growth rate was a bit stronger than the consensus had expected.

When second quarter GDP numbers hit the wire on Friday, we expect to see another better-than-expected number, though the growth rate will likely slow relative to the first quarter.

We expect to see a pickup in consumer and business spending and less of a boost from trade. Recent weakness in the labor market raises doubts about third-quarter spending, but retail sales increased in April and May before giving up some ground in June. Similarly, the manufacturing PMI slipped in July, but was quite strong in the second quarter months.

Previous: 2.5% (CAGR) **Wells Fargo: 1.9%**

Consensus: 1.6%



Source: IHS Global Insight and Wells Fargo Securities, LLC

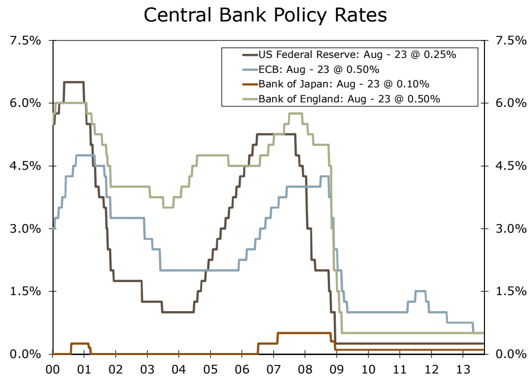
Interest Rate Watch

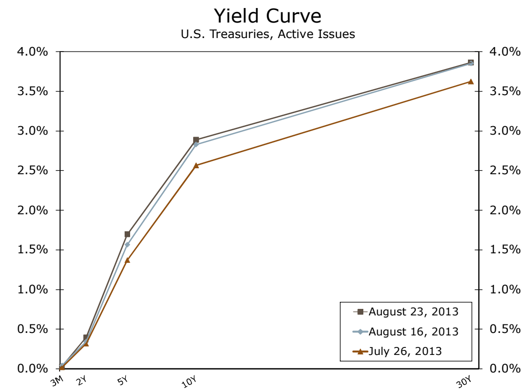
Got to Do What They Have to Do

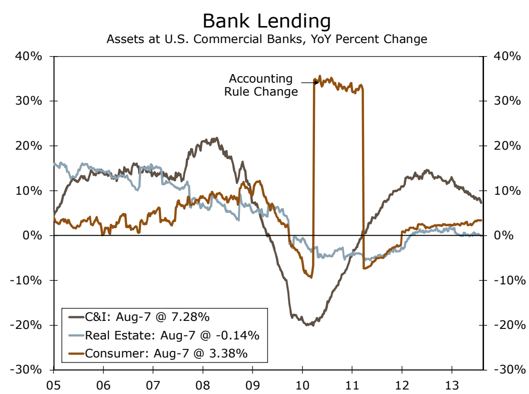
Financial markets continue to adjust in anticipation of the Fed beginning to wind down its monthly securities purchases. The general consensus is that the FOMC will announce its intentions to taper securities purchases at the Sept. 17-18 FOMC meeting and begin scaling back purchases immediately after. There is also an expectation that the FOMC will reemphasize its intention to hold the federal funds rate at its current near-zero level through mid-2015. This combination explains the steepening yield curve, which has seen the spread between the 10-year and 2-year Treasury notes widen by 66 bps over the past 12 weeks, and the spread between long-term Treasuries and T-bills widen much more.

Normally, a steeper yield curve is a harbinger of stronger economic growth. While we expect economic growth to improve, we doubt these relationships hold to the degree that they have in the past. The Fed's repeated statements about holding the federal funds rate near zero still constitute an extraordinarily easy monetary policy. Moreover, studies about the predictive power of the slope of the yield curve have tended to show that changes in short-term rates have been more important than changes in the steepness of the yield curve.

How much further long-term rates will rise is still a bit of a mystery. If yields were based solely on growth and inflation expectations, we believe the 10-year should be currently yielding somewhere around 3.40 percent. The actual yield, however, is based on much more than that, including, among many others, expectations about how fast the Fed tapers, when the markets feel the Fed will begin to raise the federal funds rate and the possibility that a potential budget showdown will disrupt the economy and financial markets. Bond yields likely overshot on the downside and may just as easily overshoot to the upside, particularly if investors get spooked about the Fed's intentions or a sudden rash of stronger economic reports. Ultimately, however, yields will reflect the underlying fundamentals, which are below trend economic growth and an inflation rate that remains slightly below the Fed's target.







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

Credit Market Insights

C&I Lending on the Downswing

Lending standards have gradually begun to loosen over the past few years following times of extremely tight credit as a result of the financial crisis. Looking at the Fed's Senior Loan Officers Survey, the net percentage of banks tightening standards for commercial and industrial (C&I) loans to large and medium firms has been negative for six consecutive quarters at this point. However, over approximately that same period of time, C&I lending at domestically chartered banks have continued to see growth slow, while consumer loan growth rates have actually been gradually increasing. The C&I loan-to-deposit ratio is off the trough of several years ago, but it still very low historically. Even though loan growth has been decelerating, the demand for C&I loans has been relatively firm for the past year and a half. So, we have standards that are loosening, and strong demand, however, C&I loan growth is continuing to fall. In order for commercial and industrial firms to begin receiving the financing they desire, it seems that lending standards will have to continue to come down so that the growing demand can be met.

Our forecast does not call for any substantial uptick in business fixed investment growth for the remainder of 2013 or into 2014. In order to see business fixed investment begin making larger contributions to GDP growth going forward, the growing demand for C&I loans needs to be met.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.58%	4.40%	4.31%	3.66%
15-Yr Fixed	3.60%	3.44%	3.39%	2.89%
5/1 ARM	3.21%	3.23%	3.16%	2.80%
1-Yr ARM	2.67%	2.67%	2.65%	2.66%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,569.9	-11.15%	6.62%	7.28%
Revolving Home Equity	$484.2	-11.51%	-11.28%	-8.91%
Residential Mortgages	$1,587.5	-22.54%	-10.18%	0.48%
Commerical Real Estate	$1,451.4	8.64%	10.40%	2.45%
Consumer	$1,144.3	3.87%	2.63%	3.38%

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

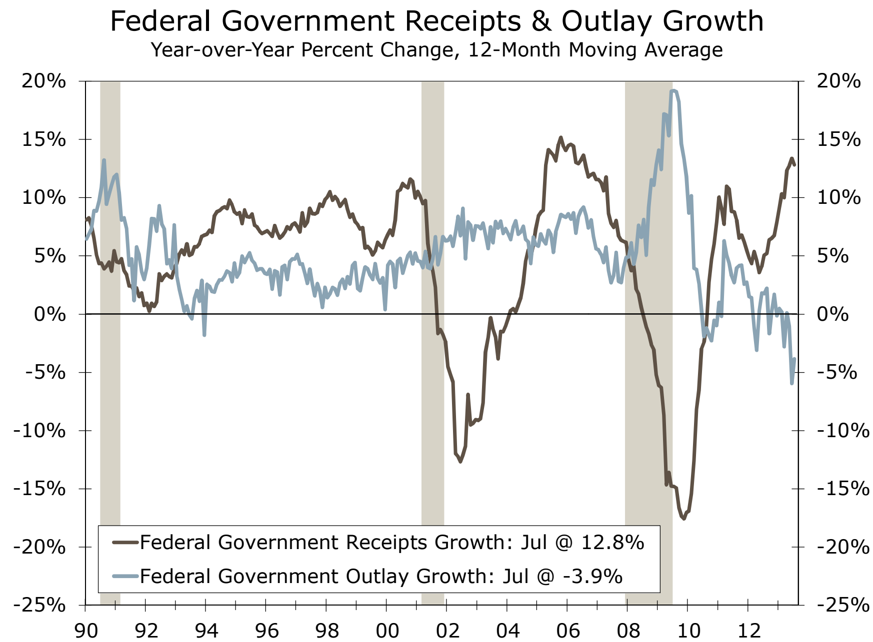
Topic of the Week

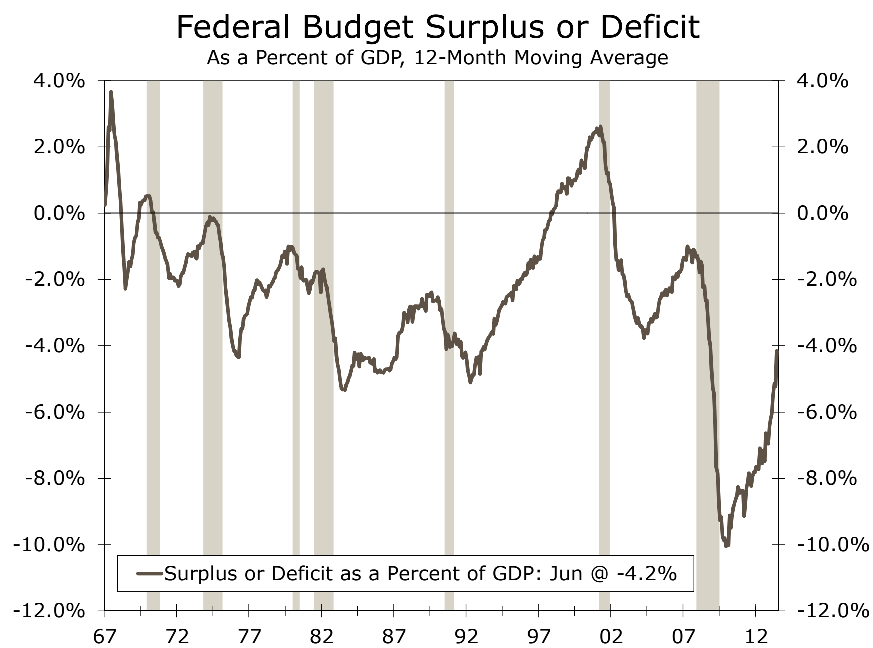
Fiscal Policy Update: More Uncertainty Ahead

It is that time, yet again, for a fall fiscal showdown. Congress faces a hard deadline, which, over the past couple of years, has been the impetus for important fiscal policy decisions to be made. The House and Senate currently stand in recess until Sept. 9, leaving only nine scheduled legislative working days in the House to come to an agreement on funding the federal government beyond Sept. 30, when the current Continuing Resolution (CR) expires. In addition, sometime in October or early November, the nation's debt ceiling will need to be increased.

One factor that may help to ease the tension in the upcoming debate is the turn-around in the budget deficit since the last major fiscal policy debate in January. As of July, federal revenues were up 13.9 percent from last year's levels thanks, in part, to higher payroll tax rates that went into effect in January combined with reimbursement payments received from Freddie Mac and Fannie Mae. In addition, the across-the-board spending cuts, known as sequestration, went into effect in March, which has reduced outlays by 2.9 percent since FY2012. These combined effects have resulted in the federal budget deficit as of June falling to 4.2 percent of GDP, from last year's 7.2 percent.

Our current expectation is that another CR will be passed that funds the government and raises the debt ceiling for a short time—likely six months or less. However, this process is not likely to take place in one step, it could involve a one- or two-month CR that keeps the government funded, while a longer-term budget and debt ceiling deal is reached. If, as is typical, this fiscal year's funding levels are carried over in a short-term resolution, the established funding level would exceed the 2014 budget sequestration limit, which could reduce the slated budget cuts for FY2014. The economic impact of budget sequestration next year would be less severe under a CR that maintains last year's funding levels. For further details see our special report, *Fall Fiscal Policy Update: More Uncertainty Ahead.*





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 8/23/2013	1 Week Ago	1 Year Ago
3-Month T-Bill	0.03	0.04	0.10
3-Month LIBOR	0.26	0.26	0.43
1-Year Treasury	0.14	0.15	0.17
2-Year Treasury	0.39	0.34	0.26
5-Year Treasury	1.70	1.56	0.70
10-Year Treasury	2.89	2.83	1.68
30-Year Treasury	3.86	3.85	2.79
Bond Buyer Index	4.91	4.80	3.76

Foreign Exchange Rates	Friday 8/23/2013	1 Week Ago	1 Year Ago
Euro ($/€)	1.335	1.333	1.256
British Pound ($/£)	1.556	1.563	1.586
British Pound (£/€)	0.858	0.853	0.792
Japanese Yen (¥/$)	99.000	97.530	78.490
Canadian Dollar (C$/$)	1.055	1.034	0.994
Swiss Franc (CHF/$)	0.925	0.927	0.956
Australian Dollar (US$/A$)	0.900	0.919	1.044
Mexican Peso (MXN/$)	13.064	12.911	13.161
Chinese Yuan (CNY/$)	6.122	6.114	6.353
Indian Rupee (INR/$)	63.353	61.669	55.255
Brazilian Real (BRL/$)	2.397	2.393	2.024
U.S. Dollar Index	81.572	81.257	81.359

Foreign Interest Rates	Friday 8/23/2013	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.15	0.15	0.18
3-Month Sterling LIBOR	0.51	0.51	0.69
3-Month Canadian LIBOR	1.17	1.17	1.31
3-Month Yen LIBOR	0.15	0.15	0.19
2-Year German	0.30	0.22	-0.01
2-Year U.K.	0.44	0.42	0.16
2-Year Canadian	1.21	1.21	1.13
2-Year Japanese	0.12	0.11	0.09
10-Year German	1.96	1.88	1.38
10-Year U.K.	2.73	2.70	1.57
10-Year Canadian	2.76	2.71	1.82
10-Year Japanese	0.77	0.76	0.83

Commodity Prices	Friday 8/23/2013	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	104.90	107.46	96.27
Gold ($/Ounce)	1371.58	1376.87	1670.60
Hot-Rolled Steel ($/S.Ton)	648.00	648.00	645.00
Copper (¢/Pound)	333.50	336.30	349.25
Soybeans ($/Bushel)	13.62	13.36	17.65
Natural Gas ($/MMBTU)	3.52	3.37	2.80
Nickel ($/Metric Ton)	14,359	14,654	16,023
CRB Spot Inds.	526.27	527.43	513.91

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	26	27	28	29	30
U.S. Data	**Durable Goods Orders** June 3.9% July -5.4 (W)	**Consumer Confidence** July 80.3 August 76.2 (W)		**GDP Annualized (QoQ)** Q1 1.7% Q2 2.1 (W)	**Personal Income** June 0.3% July 0.3% (W) **Personal Spending** June 0.5% July 0.3% (W)
Global Data	**Mexico** **Trade Balance** Previous (Jun) 856.4M			**Japan** **CPI (YoY)** Previous (Jun) 0.2% **Germany** **Unemployment Rate** Previous (Jul) 6.8%	**Brazil** **GDP (QoQ)** Previous (Q1) 0.6% **Eurozone** **Consumer Confidence** Previous (Jul) -17.4

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
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@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	Economist	(704) 410-3282	sarah.watt@wellsfargo.com
Michael T. Wolf	Economist	(704) 410-3286	michael.t.wolf@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 Burris	Administrative Assistant	(704) 410-3272	cyndi.burris@wellsfargo.com

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