December 06, 2013

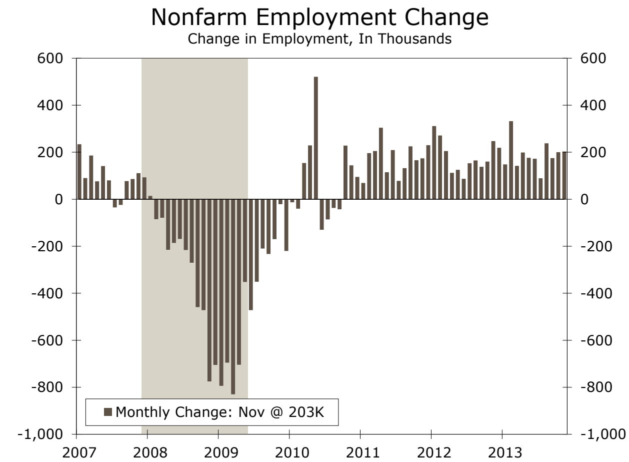
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Is Tapering on the Fed's Gift List?

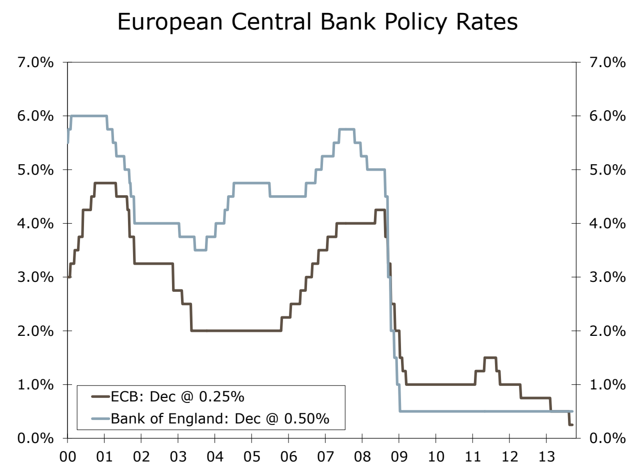
- November employment numbers were stronger than expected and the unemployment rate slid to a level once consistent with the end of quantitative easing.
- Housing market data are weaker than they were earlier in the year, but the recovery remains intact.
- The 2014 Economic Outlook Conference Call will be held Thursday, Dec. 12 at 1 p.m. EST. Please check our Website for more details.



Global Review

Global Economic Activity Continues to Expand

- The readings on the manufacturing and service sector PMIs in the United Kingdom remained at very high levels in November, suggesting that the British economy continues to enjoy solid economic growth. Real GDP growth in the Eurozone, although positive, appears to be much weaker at present. The Bank of England and the ECB decided to keep their main policy rates unchanged this week.
- Following very strong growth in Q2, real GDP in Brazil contracted modestly in Q3. A return to the boom-like conditions of 2004-2007 in Brazil does not appear to be in the cards.



Wells Fargo U.S. Economic Forecast

	Actual 2013			Forecast	2014				Actual		Forecast		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2011	2012	2013	2014	2015
Real Gross Domestic Product [1]	1.1	2.5	2.8	1.8	1.8	2.4	2.6	2.7	1.8	2.8	1.7	2.3	2.8
Personal Consumption	2.3	1.8	1.5	2.0	2.0	2.1	2.2	2.3	2.5	2.2	1.9	2.0	2.4
Inflation Indicators [2]													
PCE Deflator	1.4	1.1	1.1	1.1	1.3	1.8	1.8	2.0	2.4	1.8	1.2	1.8	2.2
Consumer Price Index	1.7	1.4	1.6	1.5	1.6	2.1	1.9	2.0	3.1	2.1	1.5	1.9	2.2
Industrial Production [1]	4.1	1.1	2.3	5.2	4.2	4.3	4.4	4.5	3.4	3.6	2.5	4.0	4.7
Corporate Profits Before Taxes [2]	2.1	4.5	6.3	5.0	4.1	5.4	6.2	5.3	7.9	7.0	4.5	5.3	5.9
Trade Weighted Dollar Index [3]	76.2	77.5	75.2	76.5	77.3	77.5	77.8	78.3	70.9	73.5	76.4	77.7	78.9
Unemployment Rate	7.7	7.6	7.3	7.2	7.1	7.0	7.0	6.9	8.9	8.1	7.5	7.0	6.7
Housing Starts [4]	0.96	0.87	0.89	0.94	1.03	1.13	1.18	1.20	0.61	0.78	0.93	1.10	1.25
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	0.44
Conventional Mortgage Rate	3.57	4.07	4.49	4.30	4.40	4.50	4.60	4.70	4.46	3.66	4.11	4.55	4.95
10 Year Note	1.87	2.52	2.64	2.60	2.70	2.80	2.90	3.00	2.78	1.80	2.41	2.85	3.25

Forecast as of: November 13, 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

Together we'll go far

U.S. Review

Payrolls Surprise to the Upside

The November jobless rate unexpectedly dropped to 7.0 percent despite an increase in the participation rate. The Fed previously indicated that 7.0 percent unemployment would be the threshold for the end of QE. However, the central bank has given itself more wiggle room as to when it will begin tapering, and the core PCE deflator, which slid to a paltry 1.1 percent in October, is not creating a sense of urgency. Nonetheless the strong employment report increases the chances of early tapering.

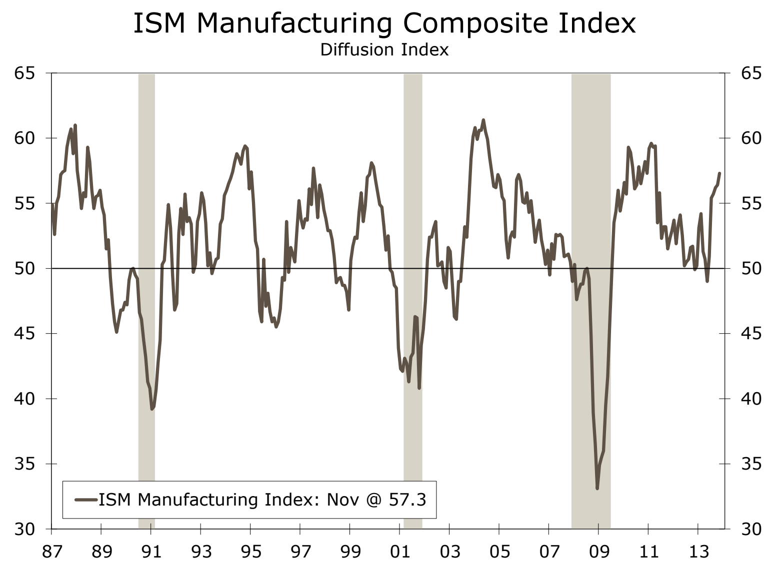
November employment gains were fairly broad-based, with only the financial activities and information industries ticking down in the month. Manufacturing employment has accelerated over the past two months, which sheds some light on the mixed messages the factory sector has been sending. The purchasing managers' survey data have been stronger, and the November ISM manufacturing index reached its highest level since 2011. However, factory orders have been weak recently. The most recent decline for October was felt across subcomponents, and non-defense, capital goods orders, ex aircraft, a strong indicator of overall business spending activity, has been consistently weak. Growing manufacturing employment through November suggests that the factory orders data may be a bit too bleak. In addition, this indicates that the large buildup of inventories seen in the most recent revision of Q3 GDP has not slowed down the sector's progress so far in Q4.

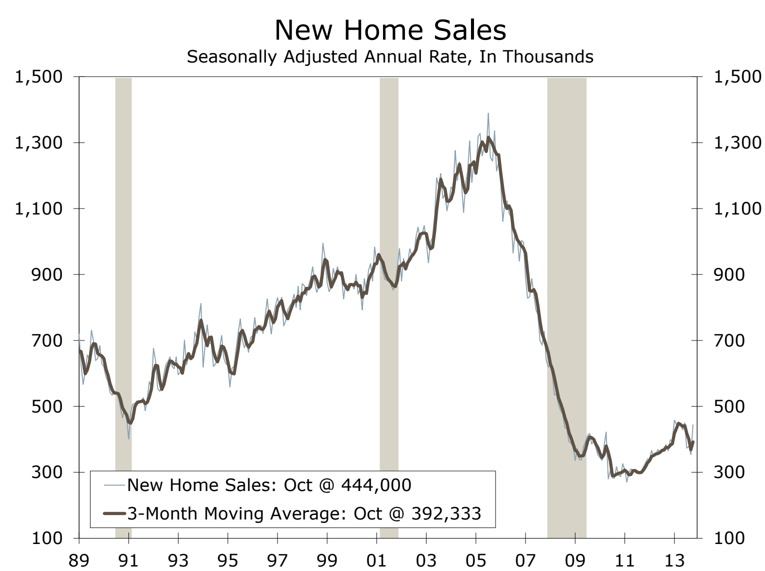
Consumers have been notably weak in the current recovery. Consumer confidence tumbled this fall, and holiday spending numbers so far have disappointed. However, average hourly earnings and weekly hours perked up in November. Despite an anomaly in farm income pushing the headline income number lower, personal spending increased more than expected for October, suggesting that consumers may not be as weak as previously thought.

Ho-Ho-Hum Housing

The momentum of the housing market recovery has slowed in recent months. Higher mortgage rates have played a role in pulling back the reins on the breakneck speed of housing metrics seen earlier in the year. Pending home sales declined for the fifth straight month in October and are even lower than they were a year ago. New home sales data, however, regained ground lost in September, though the 25.4 percent October gain was still not enough to push the headline number above the level seen in June.

Although momentum has slowed, the recovery remains intact. Residential construction spending is still 17.4 percent higher than a year ago despite declining three out the past four months. Furthermore, housing permits, a leading indicator of home construction reached a post-recession high in October. Ample housing demand has also kept year-over-year price growth in double digit territory.





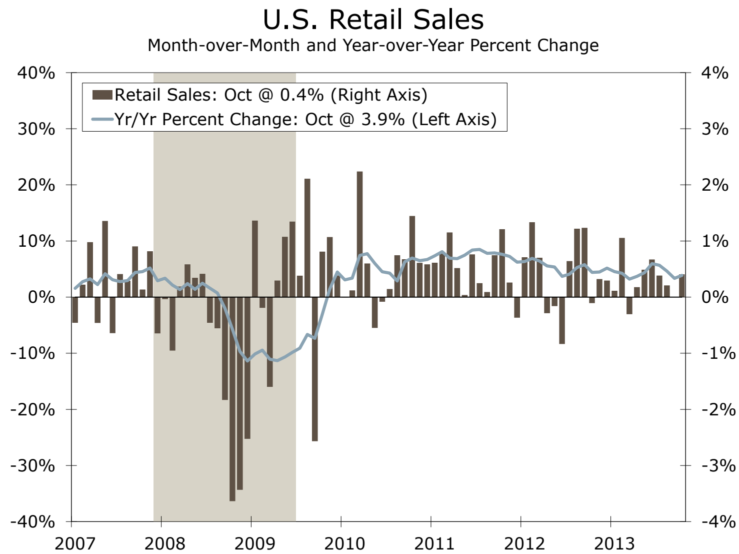
Source: U.S. Department of Labor, U.S. Department of Commerce, ISM, and Wells Fargo Securities, LLC

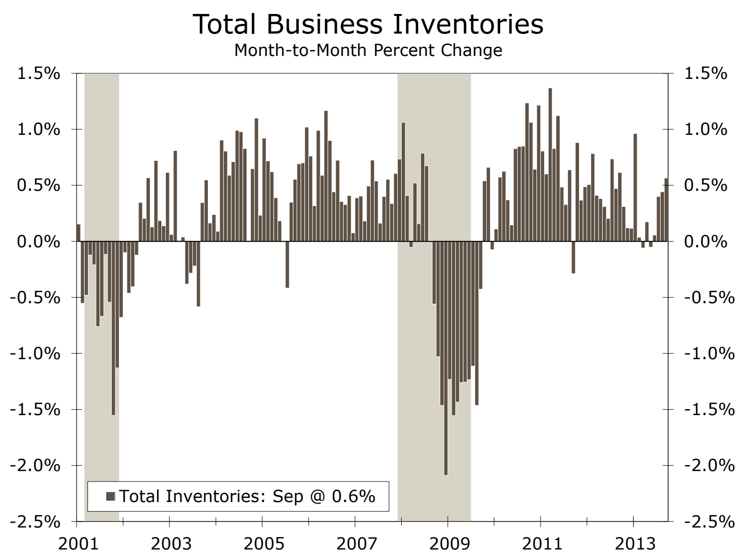
Retail Sales • Thursday

After moving sideways in September, retail sales picked up 0.4 percent in October. Despite the better-than-expected gain, the overall trend in retail sales continues to reflect a cautious consumer sector as income growth remains rather weak. Initial estimates of Black Friday sales showed consumers spending less over the weekend, but the late Thanksgiving may have pulled some sales forward as retailers started discounting earlier in the week. Autos remain a bright spot in the retail sector, however. After a decline in September and October, auto sales in November rose to the highest level in more than six years. We look for retail sales to have advanced 0.5 percent in November. Excluding autos, retail sales are likely to have registered a more tepid gain of 0.1 percent, held down by a drop in gasoline prices over the month.

Previous: 0.4% **Wells Fargo: 0.5%**

Consensus: 0.6% (Month-over-Month)





Business Inventories • Thursday

After increasing at an annualized rate of 0.5 percent in the second quarter, business inventories surged in the third quarter. According to the monthly report on inventories, firms added to their stocks at a 3.7 percent annualized rate. This boosted real GDP growth in the third quarter by a whopping 1.7 percentage points.

On Thursday we will see how firms are handling the third quarter surge in inventories. A report released earlier this week showed that manufacturers were more cautious in their stock building, increasing inventories by 0.1 percent in October compared to 0.3 percent in September. Retail inventories rose 0.9 percent in September, but after stronger sales in October, some moderation in stock building seems likely. Even with the pickup in inventories overs the past three months, stocks seem manageable. The inventories-to-sales ratio held firm at 1.29 for the fifth consecutive month in September.

Previous: 0.6% **Wells Fargo: 0.3%**

Consensus: 0.3% (Month-over-Month)

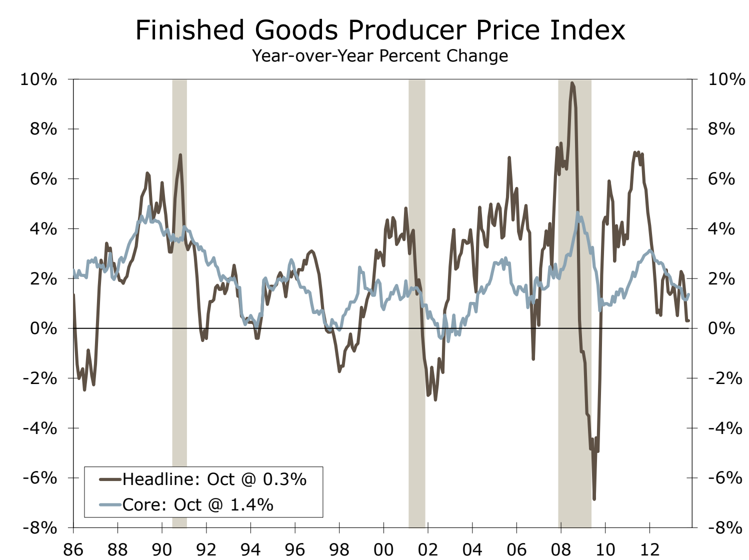
Producer Price Index • Friday

Producer prices for finished goods fell 0.2 percent in October, the second dip in two months. Lower energy prices were the primary culprit of the negative print as gasoline and residential gas prices fell. On a year-over-year basis, prices are up only 0.3 percent—the lowest rate of change in four years.

Prices for non-food and energy goods also remain modest amid sluggish demand and excess capacity in the industrial sector. Core prices rose 0.2 percent in October and are up only 1.4 percent from a year ago. With little change in energy prices over the past month and only tepid demand growth, we look for producer prices to have been little changed in November. Core price growth likely moderated over the month following a 1.7 percent increase in passenger car prices, which largely reflected the model year changeover.

Previous: -0.2% **Wells Fargo: -0.1%**

Consensus: 0.0% (Month-over-Month)



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

Global Review

Bank of England on Hold as Growth Remains Solid

This week's foreign economic data were mildly encouraging, and suggest that, on balance, economic growth in the rest of the world remains positive in the fourth quarter. Let's start with the United Kingdom, which arguably had some of the strongest data during the week.

The manufacturing PMI rose from an upwardly revised reading of 56.5 in October to 58.4 in November, which was much stronger than expected (top chart). The construction PMI rose to a 6-year high in November and although the service sector PMI fell, it remained at a very high level. British real GDP grew at an annualized rate of 3.2 percent during Q3 and, taken at face value, the PMIs point to another strong rise in economic activity in Q4.

That said, there is not yet much "hard" data from Q4 to corroborate or refute the signals sent by the PMIs. In that regard, next week's release of October industrial production data will be an important marker in determining how strong British economic growth actually is at the moment. We currently project that British real GDP will grow at an annualized rate in excess of 2 percent during Q4. Given the strong readings from the PMIs, the decisions by the Bank of England this week to keep its main policy rate unchanged at 0.50 percent and the size of its asset purchase program unaltered at £375 billion came as little surprise (see graph on front page).

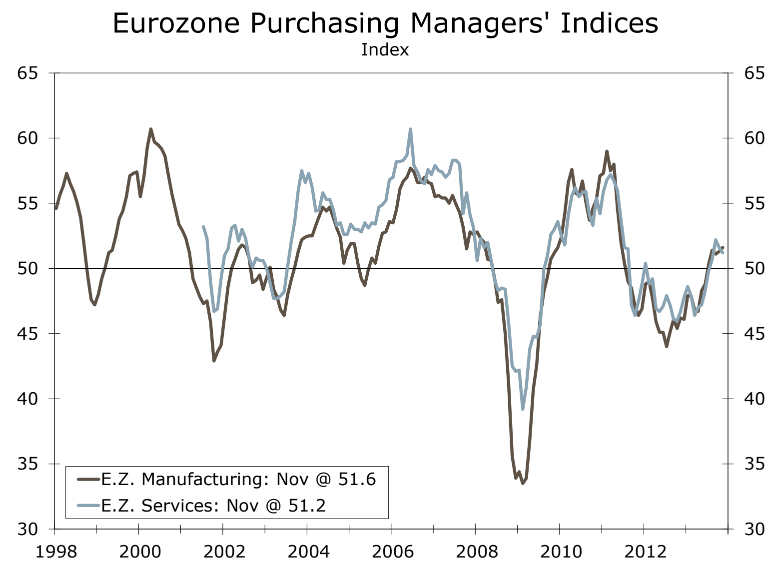
Eurozone Economic Growth Remains Slow

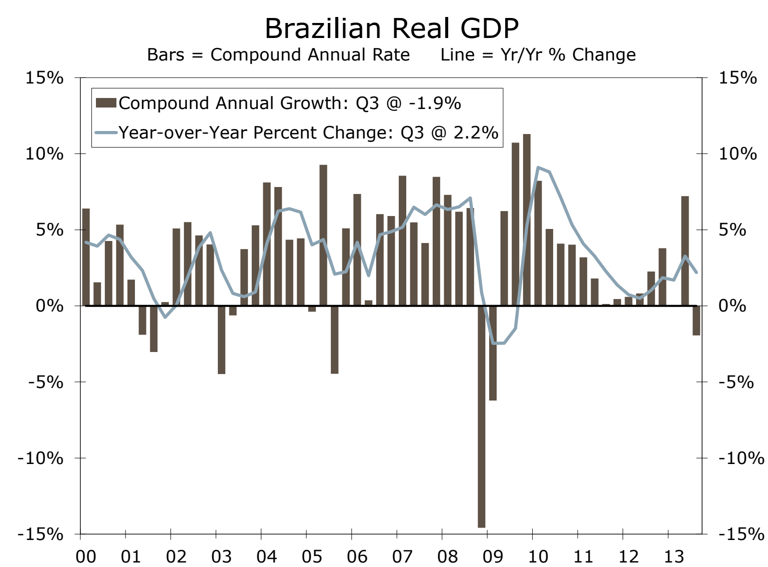
The "final" readings on the Eurozone PMIs for November more or less confirmed the "flash" estimates that were released two weeks ago. That is, both the manufacturing and the service sector PMIs remain in positive territory, but only barely (middle chart). Real GDP in the euro area has now grown for two consecutive quarters, but at sequential non-annualized rates of only 0.3 percent in Q2 and 0.1 percent in Q3 the pace of growth has been very slow. The recent readings on the PMIs suggest that real GDP growth has remained sluggish in the current quarter.

The European Central Bank (ECB) cut its refinance rate 25 bps at its policy meeting last month but, as widely expected, decided to keep that rate unchanged at 0.25 percent this week (graph on front page). That said, the ECB has a clear "bias" to ease policy further due to weak economic growth and benign inflation.

Brazilian Economy Contracted in Q3

On a disappointing note, real GDP in Brazil fell at an annualized rate of 1.9 percent in Q3-2013. That said, the contraction should be seen in the context of the strong 7.2 percent annualized growth rate that was registered in Q2. Brazilian GDP in Q3 suffered from slow growth in the rest of the world, which crimped the country's export growth, as well as a drop in fixed investment spending. Although we do not forecast that Brazil will slip back into another recession—the 0.6 percent rise in Brazilian industrial production in October is a good sign—a return to the boom years of 2004-07 does not appear likely either. (For further reading, see our special report entitled "*Brazilian Economy Weakens in Q3*" that is posted on our Website.)





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

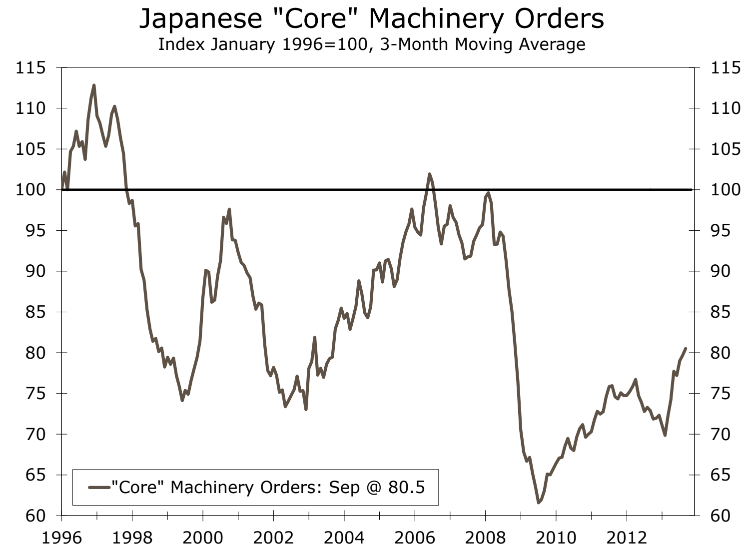
Japanese Machine Orders • Tuesday

The turnaround story in Japanese economic growth has not left the factory sector behind. With back-to-back monthly increases, manufacturing output is now up 4.7 percent relative to where it was in October of last year.

Despite a slip in September, orders figures have been rising on trend in recent months. On Tuesday, we will get a look at machine orders for October which will give an indication for future production trends. The Japanese Cabinet Office has tried to set low expectations for core machinery orders in the fourth quarter, citing seasonality issues that might result in a modest drop throughout the quarter. The warnings have not resulted in much apprehension from the consensus which expects a 0.4 percent increase when the machine orders number hits the wire on Tuesday.

Previous: -2.1%

Consensus: 0.7% (Month-over-Month)



United Kingdom Industrial Prod. • Tuesday

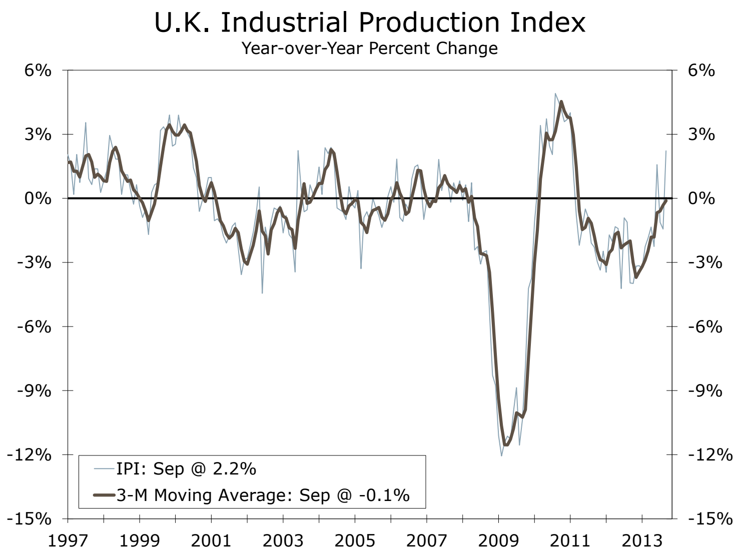
As the U.K. economy continues its recent expansion, the outlook for business spending and industrial activity is generally upbeat, but not without its challenges.

The manufacturing PMI climbed to 58.4 in November, the highest reading for this barometer of factory activity since 2011. But the "hard" data have been less convincing. Industrial production picked up in September, but the 0.9 percent monthly increase was not enough to offset the drop of 1.1 percent the prior month.

On Tuesday of next week we get a look at October output figures. The consensus expectation is for a more modest gain of three tenths of a percent which, if realized, would be consistent with our outlook for continued gradual economic growth in the United Kingdom.

Previous: 0.9%

Consensus: 0.4% (Month-over-Month)



Eurozone Industrial Production • Thursday

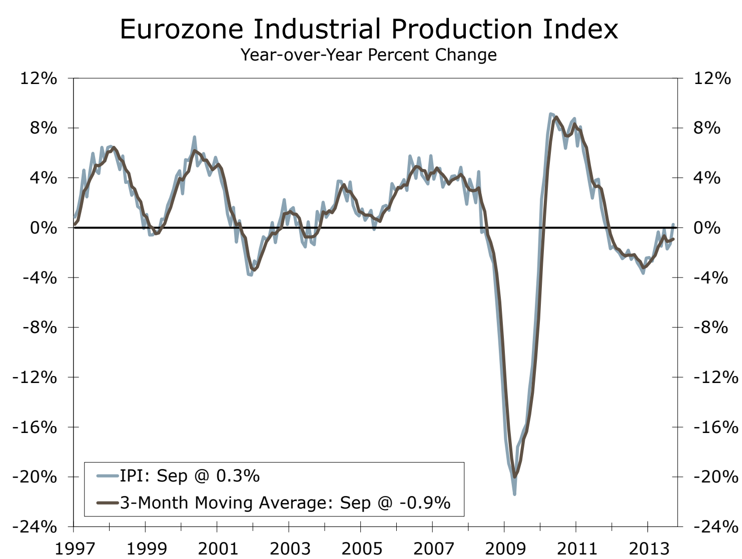
The very slow economic recovery in Europe has resulted in some modest improvement in the factories across the Eurozone. That said, the manufacturing recovery has been hit-or-miss. A saw-tooth pattern where industrial production is up one month and down the next has been in place for the past six months.

October industrial production figures are expected on Thursday of next week, and following a 0.5 percent decline in September, the consensus expectation is for the recent pattern to repeat with an increase of 0.3 percent for the month.

The survey data justify a tempered optimism. The manufacturing PMI rose modestly to 51.3 in October before climbing another notch to 51.6 in November.

Previous: -0.5%

Consensus: 0.3% (Month-over-Month)



Source: IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

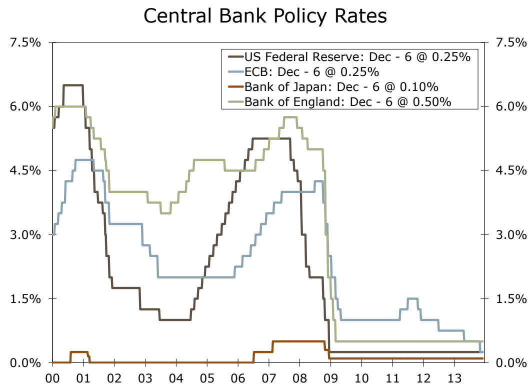
Evolution of Credit and Rates

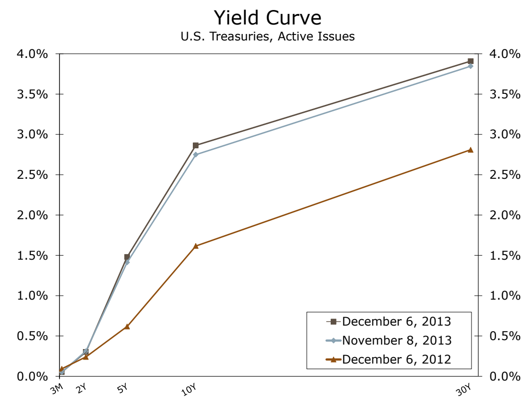
Despite some popular commentary that interest rates have not changed, the reality for investors is that over the past year, the yield curve has shifted upward (middle graph) as markets focus on growth opportunities in other assets and avoid defensive Treasury debt. Moreover, there is also the sentiment that rates will rise at some point and the longer end of the yield curve to discount that movement. Intermediate and long-term interest rates remain higher than before the tapering discussion, including interest rates on mortgage-backed securities.

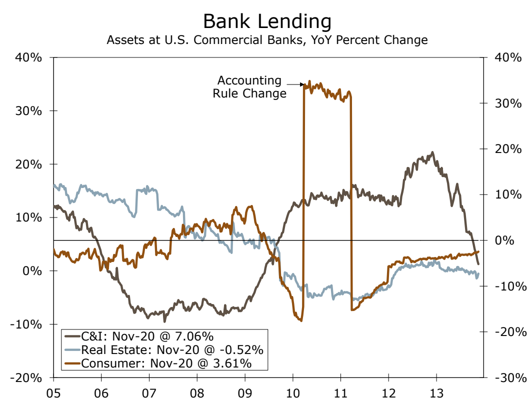
In the year ahead, we expect that long-term rates will exhibit an upward bias as the probability of Fed tapering rises. However, the extent of any increase in long rates should be modest given continued low inflation and a reduced Federal deficit. At the short-end of the yield curve, the Fed's policy of administered rates will keep the funds rate at zero to 25 basis points. This will likely mean that the yields on short-term Treasury bills and two- and three-year notes will be less than the rate of inflation and thereby yield negative real returns, even before taxes.

As for credit markets, while easy monetary policy may provide some support to the aggregate economy, the current Fed policy is clearly altering asset prices at the sector level. The Fed's purchases of mortgage-backed securities is providing a boost to homeowners, but at a cost of less credit available to renters and future homeowners who will pay the higher home prices now. Suppressed Treasury yields have pushed investors into riskier assets, such as equities, high yield corporate debt and emerging market assets, where returns may not be balanced relative to risks. The allocation of credit may therefore reflect a distortion of resource allocation and asset pricing. The large sell-off in emerging markets in anticipation of the September tapering is a good example of the global implications of Fed policy and its possible credit misallocation. As asset purchases continue against a firming economic backdrop, the debate over whether the benefits outweigh the costs will intensify pressure to wind-down QE.

For investors and business decision makers the reality is that the current level of Treasury interest rates, which serve as a basis for asset pricing, along with pricing of mortgage-backed securities, is being distorted.







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

Credit Market Insights

Black Friday Takes a Hit

While the net percent of banks tightening standards on credit card loans has been negative since early 2010 according the Fed's Senior Loan Officers survey, revolving credit growth has been negative or near zero for that same period of time. This is likely a lasting effect of the credit crunch that came as a result of the global financial crisis. And although consumer confidence has made marked gains following the recession, it is still nowhere near the levels seen during the previous recovery. With consumer confidence still subdued and credit markets remaining tight, personal consumption has not been able to break out into the major driver of economic growth that we are accustomed to. Going into the holiday season, evidence of these issues coming together may be reflected in this year's Black Friday sales figures. According to the National Retail Federation, shoppers spent an estimated $57.4 billion between Thanksgiving day and Sunday, Dec. 1. This is down from $59.1 billion in 2012, a 2.1 percent decline, which is coupled with a 4 percent drop in spending per shopper. We note that this specific data could be the result of more granular factors such as holiday shoppers starting earlier due to the late Thanksgiving holiday, and the gain in popularity that Cyber Monday has seen as a vehicle for holiday shopping. That being said, a still-hesitant consumer, with revolving credit still tight, may be showing through in this years' initial holiday sales figures.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.46%	4.29%	4.16%	3.34%
15-Yr Fixed	3.47%	3.30%	3.27%	2.67%
5/1 ARM	2.99%	2.94%	2.96%	2.69%
1-Yr ARM	2.59%	2.60%	2.61%	2.55%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,584.2	-8.73%	-5.03%	7.06%
Revolving Home Equity	$477.4	-6.74%	-5.19%	-7.69%
Residential Mortgages	$1,567.1	96.69%	0.09%	-2.31%
Commerical Real Estate	$1,477.6	7.14%	6.47%	4.12%
Consumer	$1,152.9	0.92%	5.30%	3.61%

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

Topic of the Week

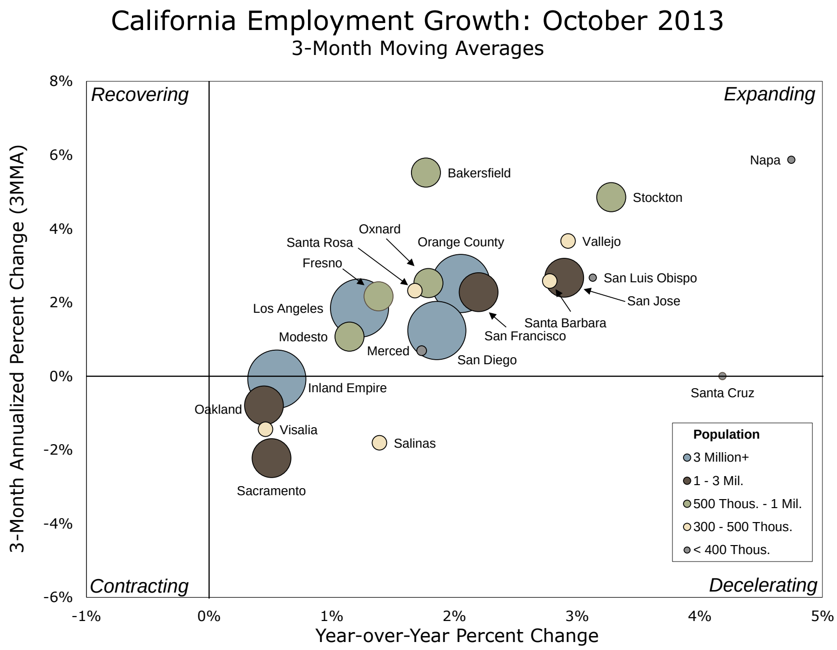
California Economic Outlook: A Bifurcated Recovery Remains in Place

The uneven nature of the economic recovery is evident across California, with the coastal areas largely enjoying stronger job gains, reduced unemployment and more robust gains in home prices. The interior parts of the state have not been as lucky, with meager job gains, stubbornly high unemployment rates and less of a rebound in home prices. Although overall conditions in the state are improving, a number of splits are evident; newer industries such as mobile devices, social media, search and cloud computing have taken off, while old mainstays such as agriculture, manufacturing and construction have struggled to regain traction.

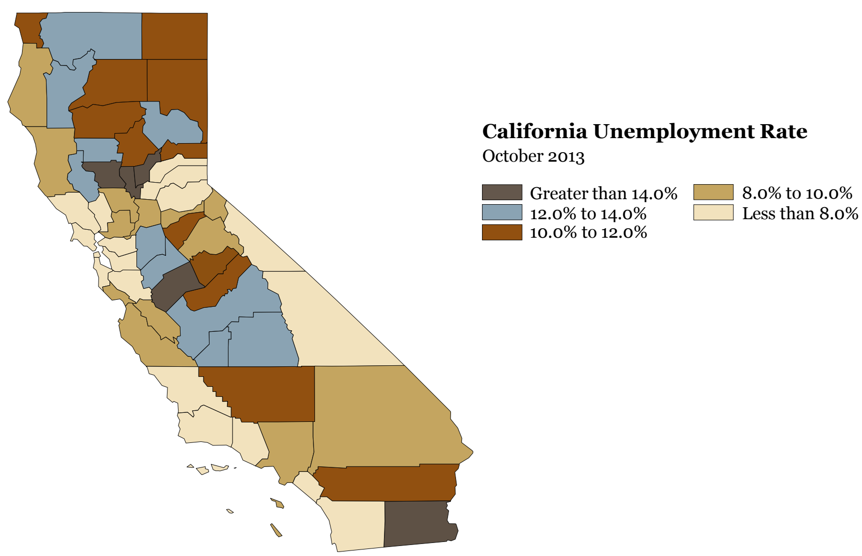
Although geography and the distinctly different industry mix are responsible for much of the split economic performance in California, the Fed's unconventional monetary policy has also played a major role. Low interest rates and the Fed's continuous monthly securities purchases have helped fuel the stock market rally, which has disproportionately benefitted California's wealthier areas and funneled billions of dollars into the state's technology sector. The tidal wave of liquidity has made its way into the housing market, as big institutional investors have bought up distressed properties and repositioned them as rentals, sending home prices soaring in many areas across the state.

California's economy will continue to recover in 2014 but will likely lose some momentum from its recent pace. Overall job growth has already shown signs of slowing amid concerns over rising interest rates and worries about another tech bubble. Although we believe these concerns are overblown, some let up seems in order given the huge run-up in equity and home prices seen over the past couple of years. The fundamentals simply have not improved as much as prices have, but prices have not risen to the point that we should be worrying about the bursting of another bubble.

For more information, see our report, *California Economic Outlook: December 2013,* available online.



California Unemployment Rate by County



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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 12/6/2013	1 Week Ago	1 Year Ago
3-Month T-Bill	0.06	0.06	0.09
3-Month LIBOR	0.24	0.24	0.31
1-Year Treasury	0.16	0.14	0.17
2-Year Treasury	0.31	0.28	0.24
5-Year Treasury	1.50	1.37	0.60
10-Year Treasury	2.86	2.74	1.59
30-Year Treasury	3.89	3.81	2.77
Bond Buyer Index	4.70	4.61	3.27

Foreign Exchange Rates	Friday 12/6/2013	1 Week Ago	1 Year Ago
Euro ($/€)	1.368	1.359	1.297
British Pound ($/£)	1.636	1.637	1.605
British Pound (£/€)	0.836	0.830	0.808
Japanese Yen (¥/$)	102.690	102.440	82.400
Canadian Dollar (C$/$)	1.065	1.061	0.991
Swiss Franc (CHF/$)	0.895	0.906	0.932
Australian Dollar (US$/A$)	0.908	0.911	1.049
Mexican Peso (MXN/$)	12.992	13.109	12.870
Chinese Yuan (CNY/$)	6.083	6.094	6.228
Indian Rupee (INR/$)	61.415	62.449	54.138
Brazilian Real (BRL/$)	2.347	2.336	2.077
U.S. Dollar Index	80.253	80.680	80.258

Foreign Interest Rates	Friday 12/6/2013	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.21	0.19	0.13
3-Month Sterling LIBOR	0.52	0.52	0.52
3-Month Canadian LIBOR	1.17	1.17	1.31
3-Month Yen LIBOR	0.15	0.14	0.18
2-Year German	0.22	0.12	-0.05
2-Year U.K.	0.50	0.46	0.26
2-Year Canadian	1.09	1.10	1.04
2-Year Japanese	0.09	0.09	0.10
10-Year German	1.86	1.69	1.30
10-Year U.K.	2.91	2.77	1.74
10-Year Canadian	2.68	2.56	1.70
10-Year Japanese	0.67	0.61	0.70

Commodity Prices	Friday 12/6/2013	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	97.66	92.72	86.26
Gold ($/Ounce)	1235.18	1253.49	1699.90
Hot-Rolled Steel ($/S.Ton)	676.00	675.00	650.00
Copper (¢/Pound)	328.75	323.05	362.70
Soybeans ($/Bushel)	13.31	13.28	14.86
Natural Gas ($/MMBTU)	4.16	3.95	3.67
Nickel ($/Metric Ton)	13,692	13,334	17,490
CRB Spot Inds.	525.27	524.15	520.28

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	9	10	11	12	13
U.S. Data		**NFIB Small Business Optimism** October 91.6 November 92.6 (C)		**Retail Sales (MoM)** October 0.4% November 0.5% (W) **Import Price Index (MoM)** October -0.7% November -0.3% (W)	**PPI (MoM)** October -0.2% November -0.1% (W)
Global Data	**Canada** **Housing Starts** Previous (Oct) 198.3K **Brazil** **CPI (MoM)** Previous (Oct) 0.48%	**China** **Retail Sales (YoY)** Previous (Oct) 13.3% **Russia** **GDP (YoY)** Previous (Q2) 1.2%	**Australia** **Unemployment Rate** Previous (Oct) 5.7%	**Eurozone** **Industrial Production** Previous (Sep) -0.5% **Japan** **Industrial Production** Previous (Sep) 0.5%	**Singapore** **Retail Sales (YoY)** Previous (Sep) -5.9%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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