January 10, 2014

Economics Group

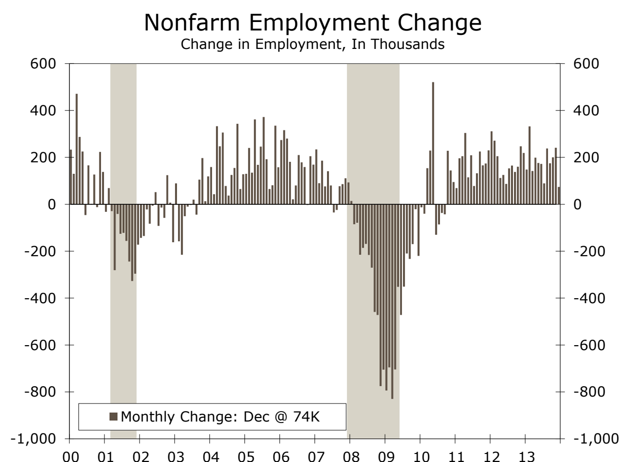
WELLS FARGO SECURITIES

Weekly Economic & Financial Commentary

U.S. Review

Employment Throws a Curve Ball After Fed Tapering

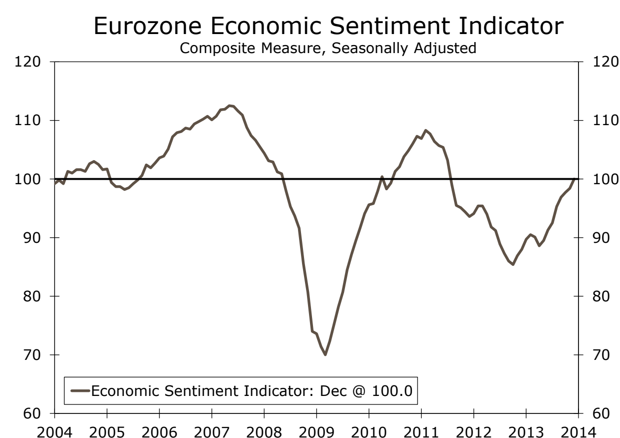
- Employment plummeted well below consensus estimates, rising by only 74,000 jobs in December compared to the survey forecast that expected almost 200,000 jobs. We believe that much of the decline is due to one-time seasonal quirks and we could see some payback in the coming months.
- The weakness in the employment report brings into question whether the Fed moved too quickly on their decision to begin tapering and may see some adjustment in the expected course in the slowing of asset purchases. While this question is on the minds of Fed watchers, the Fed left plenty of wiggle room in its language to change course if further data disappoint.



Global Review

Will The European Central Bank Ease Further?

- Amid signs that economic activity in the euro area continues to expand, the European Central Bank decided this week to keep policy unchanged. The decision was widely expected.
- However, the recovery is by no means firmly established, and CPI inflation has slipped below 1 percent. The ECB continues to maintain a "bias" to ease further, and we think there is a strong case to be made for a reduction in the ECB's main policy rate to only 0.10 percent at some point in the next few months.



Wells Fargo U.S. Economic Forecast

	Actual 2013			Forecast					Actual		Forecast		
					2014								
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2011	2012	2013	2014	2015
Real Gross Domestic Product [1]	1.1	2.5	4.1	2.5	2.0	2.4	2.8	2.9	1.8	2.8	1.9	2.6	3.0
Personal Consumption	2.3	1.8	2.0	4.0	2.1	2.1	2.2	2.3	2.5	2.2	2.0	2.5	2.4
Inflation Indicators [2]													
PCE Deflator	1.4	1.1	1.1	0.9	1.0	1.5	1.5	2.0	2.4	1.8	1.1	1.5	2.2
Consumer Price Index	1.7	1.4	1.6	1.2	1.3	1.8	1.6	1.9	3.1	2.1	1.5	1.6	2.2
Industrial Production [1]	4.1	1.2	2.3	6.2	5.2	4.3	4.4	4.5	3.4	3.6	2.6	4.4	4.7
Corporate Profits Before Taxes [2]	2.1	4.5	5.7	5.0	4.1	5.4	5.5	5.6	7.9	7.0	4.3	5.2	5.9
Trade Weighted Dollar Index [3]	76.2	77.5	75.2	76.6	77.0	78.0	79.0	79.3	70.9	73.5	75.9	78.3	79.6
Unemployment Rate	7.7	7.6	7.3	7.1	7.0	6.9	6.7	6.6	8.9	8.1	7.4	6.8	6.4
Housing Starts [4]	0.96	0.87	0.88	0.97	0.98	1.07	1.18	1.21	0.61	0.78	0.94	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	4.26	4.70	4.80	4.80	4.90	4.46	3.66	3.94	4.80	5.05
10 Year Note	1.87	2.52	2.64	3.04	3.00	3.10	3.10	3.20	2.78	1.80	2.35	3.10	3.35

Forecast as of: January 3, 2014
[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, ISM and Wells Fargo Securities, LLC

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Together we'll go far

U.S. Review

Will the Fed Stay on Course?

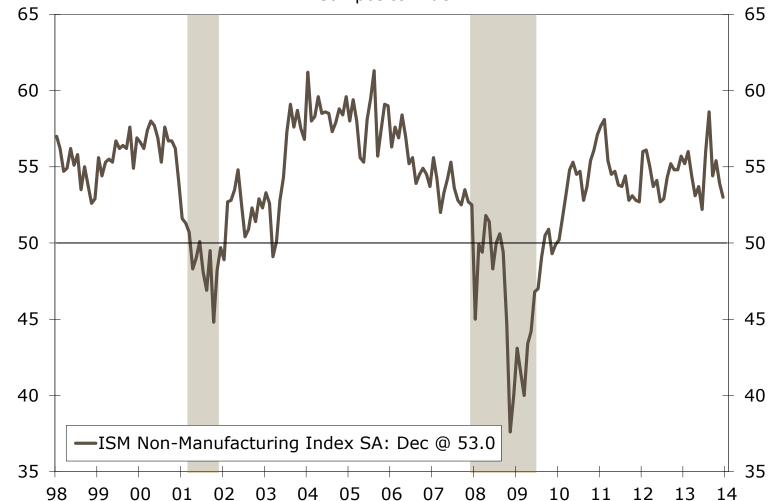
Employment plummeted well below consensus estimates, rising by only 74,000 jobs in December compared to the survey forecast that expected almost 200,000 jobs. While the unemployment rate edged lower on the month to 6.7 percent from 7.0 percent in November, the lower unemployment rate was due to a drop in the labor force. Looking at the report by sector, the drop was concentrated in construction, information, and government. According to the U.S. Department of Labor, nonresidential specialty trade contractors and motion picture and sound recording were responsible for the disappointing headline figure. For the construction sector, weather likely played a major role in the drop and suggests there could be some payback in the coming months. However, the substantial weakness in the report brings into question whether the Fed moved too quickly on its decision to begin tapering and we may see some adjustment in the expected course in the slowing of asset purchases.

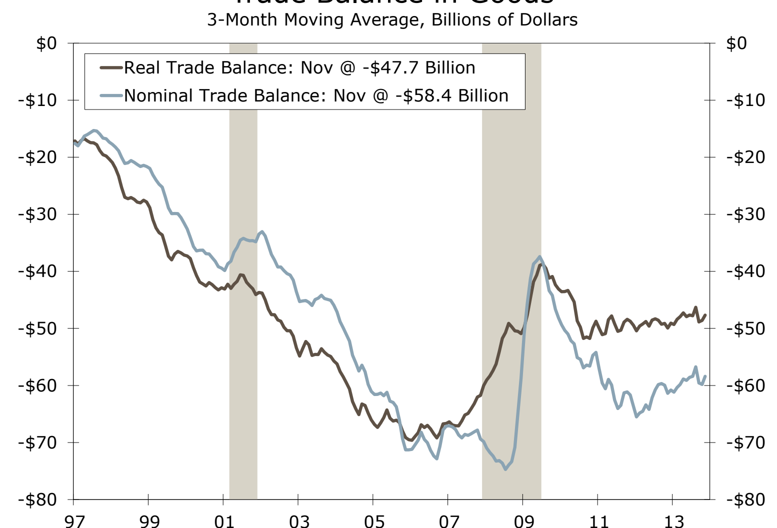
Speaking of the Fed, the highly anticipated minutes from the December FOMC meeting were released this week and the details showed that improvement in the labor market during the intermeeting period and outlook for sustained employment growth played a large role in the Fed's decision to begin slowing the pace of asset purchases. Go figure!

We expect that while the report was much lower than expected, the Fed could see December's nonfarm payroll report as an anomaly. Many of the other employment indicators, including the employment-to-population ratio, firms' hiring plans and the jobs opening rate were either unchanged or improved in recent months. However, it is important to note that while the decision to taper appeared largely consensus-driven with "most" members supporting the outcome, the Fed left a little wiggle room in its language and policy action in the event that either overall economic conditions or closely followed indicators, including the nonfarm payroll numbers, begin to show a slowing trend. The minutes made it obvious that tapering is not on a "preset course" and will be determined based on the outlook for the labor market and inflation. It is also worth noting that Boston Fed President Rosegren was the lone dissenter citing the decision was "premature" due to the still-elevated unemployment rate and below-target inflation rate.

Another indicator that suggests strange things are afoot was the ISM nonmanufacturing index, which also delivered a below consensus reading. The composite reading, which equally weights business activity, new orders, employment and supplier deliveries, declined to 53.0 in December. The pullback was the second consecutive monthly decline. More importantly, the forward-looking new orders component contracted for the first time since July 2009, falling to 49.4. Comments from respondents on the new orders component noted "funding" issues and "fewer new prospects." If the new orders component shows sustained weakness in the coming months, there could be a larger problem brewing.

In contrast to the gloomy nonfarm payrolls figure, real GDP in the fourth quarter is expected to be rise solidly. The real trade deficit narrowed significantly in October and November, and if the pace remains unchanged in December, real exports will make a significant contribution to real GDP growth in the fourth quarter.





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

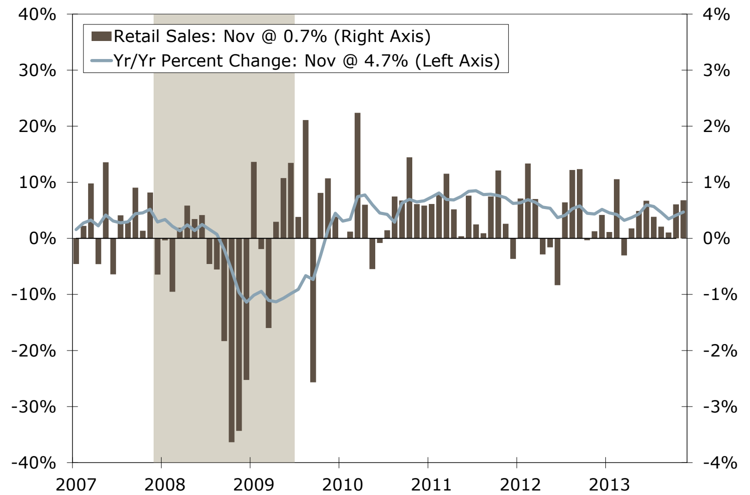
Retail Sales • Tuesday

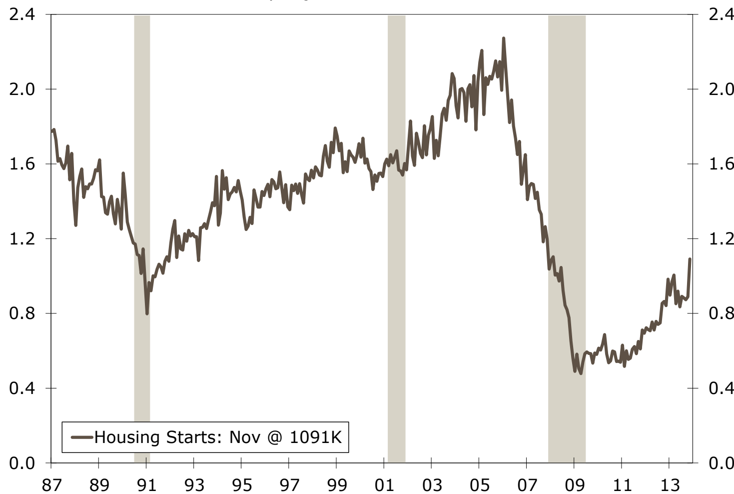
In November, retail sales grew 0.7 percent, its largest increase since June. Vehicle sales drove the headline number, but even after excluding autos, sales still jumped a respectable 0.4 percent during the month. Furthermore, October sales were revised upward, which added to the positive news for the fourth quarter.

However, sales growth in December should slow a bit. Some of the large gains in November's auto sales will be bought back in December, a trend that was evident in the most recent release of vehicle sales data. With inflation so low and only a modest uptick in gasoline prices, retail sales will not get much of a boost from rising prices in the month. To make matters worse, fierce competition led to heavy discounting among retailers, which likely kept a lid on growth in December. On the plus side, consumer confidence picked up considerably, and chain store sales posted strong growth.

Previous: 0.7% **Wells Fargo: 0.3%**

Consensus: 0.1%





Housing Starts • Friday

Housing starts surged to a 1.091 million-unit pace in November, a five-year high. Single-family and multifamily starts increased more than 20 percent. Some of this seems to be the result of an abundance of construction finally coming on line after an exceptionally rainy summer in the South, which accounts for about half of the nation's homebuilding activity. In addition, November tends to be a relatively weak month for homebuilding, so an unusual rise in the numbers may be over exaggerated by the seasonal adjustment.

After such a meteoric rise, it should come as no surprise that we expect starts to ease some in December. Construction payrolls dropped in December and housing permits and new home sales slid back some in November. However, a low supply of new homes and a growing number of consumers planning to purchase a home in the next six months should keep starts at a 986,000-unit pace.

Previous: 1,091K **Wells Fargo: 986K**

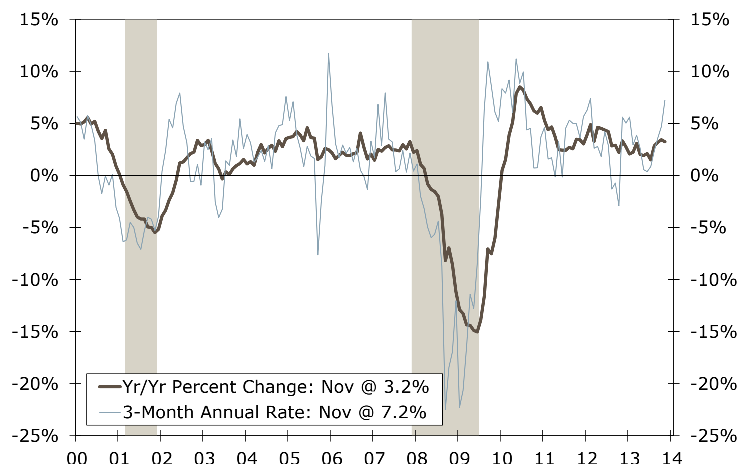
Consensus: 993K

Industrial Production • Friday

The industrial production report in November finally provided positive news after months of disappointing data. Gains in the manufacturing output component were relatively broad based, with automobiles and parts production driving the headline number. Wood products and textile mills also posted solid gains. Mining production jumped up notably in the month, though this comes after a comparable loss in the previous month. Looking ahead to December, we expect industrial production to rise 0.3 percent over the month. Although the ISM manufacturing survey remains firmly in positive territory, it did decline some in December, further indicating that November's strong gain is unlikely to be sustained. In addition, manufacturing employment growth eased in the month, and the average weekly hours of production workers ticked down.

Previous: 1.1% **Wells Fargo: 0.3%**

Consensus: 0.3%



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

Global Review

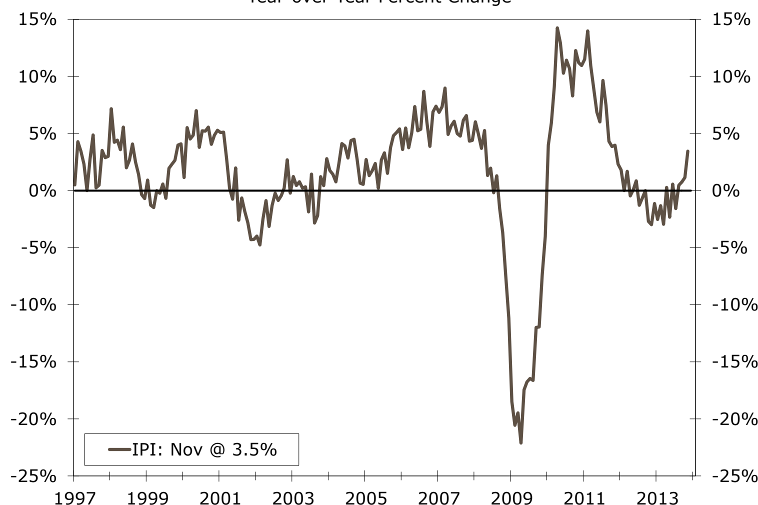
Will The European Central Bank Ease Further?

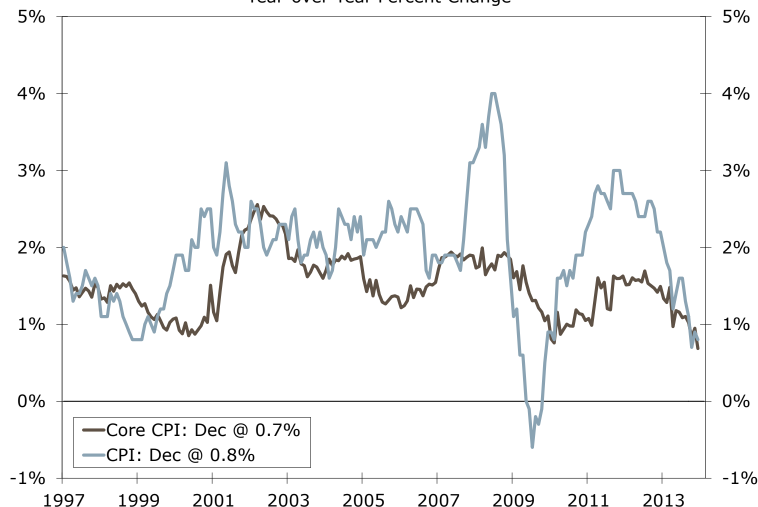
The European Central Bank held its first policy meeting of the new year this week and, as widely expected, did not make any changes to its policy stance. Most analysts had expected that the ECB would remain on hold due to recent signs that the recovery underway in the Eurozone continues, albeit at a tepid pace. The Economic Confidence index in the euro area rose for the eighth consecutive month in December, and it now stands at its highest level since mid-2011 when the Eurozone slid back into recession (see graph on front page). More importantly, "hard" data are corroborating the optimism that the survey data are indicating. Retail sales in the euro area rose 1.4 percent in November relative to the previous month. Not only was the outturn significantly stronger than the consensus forecast, but it was the largest monthly increase in four years. The 1.9 percent rise in German industrial production in November adds to the evidence that the German factory sector is gaining strength again (top chart).

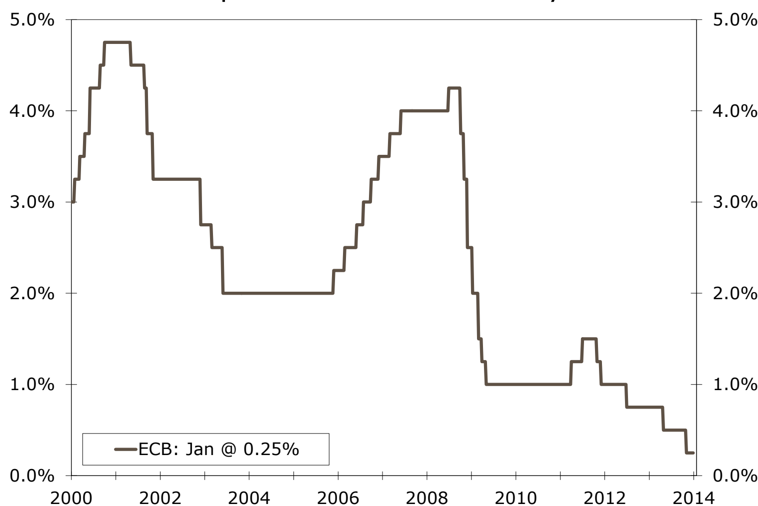
However, the ECB remains "biased" to ease policy further. In its policy statement that was released after the meeting, the ECB Governing Council reaffirmed that it expects "key ECB interest rates to remain at present or ***lower*** (emphasis ours) levels for an extended period of time." Although a recovery seems to be underway in the Eurozone, it is by no means firmly established yet. Moreover, the ECB's single policy objective is to maintain CPI inflation "below, but close to, 2 percent." With CPI inflation at both the "headline" and the "core" measures running below 1 percent at present—the "core" rate of CPI inflation fell to an all-time low of 0.7 percent in December— it is difficult to make the case that CPI inflation is "close to" 2 percent (middle chart).

Although deflation has not set in in the overall euro area, there are some countries where extremely depressed economic activity has eliminated any inflationary potential, at least in the foreseeable future. CPI inflation is more or less flat in Ireland, Portugal and Spain at present, and the consumer price index in Greece is actually 2.9 percent lower today than it was a year ago. If our forecast of stronger GDP growth in the Eurozone proves correct—we project that real GDP in the overall euro area will grow a bit more than 1 percent this year following a contraction on the order of 0.4 percent in 2013—then deflation in the overall euro area likely will not take hold.

However, we also forecast that CPI inflation will not return to 2 percent between now and the end of our forecast period (end of 2015). Therefore, we think there is a significant possibility that the ECB will cut its policy rates further at some point in the next few months. In our view, only extreme circumstances would lead the ECB to slash its deposit rate below its current setting of zero percent (i.e., taking the deposit rate into negative territory, thereby charging banks for the deposits they hold at the central bank). However, the refi rate, the ECB's main policy rate, currently stands at 0.25 percent (bottom chart). Although the ECB probably won't cut the refi rate all the way to zero percent, we think there is a strong case to be made for a cut to 0.10 percent. If so, the euro could encounter selling pressure.







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

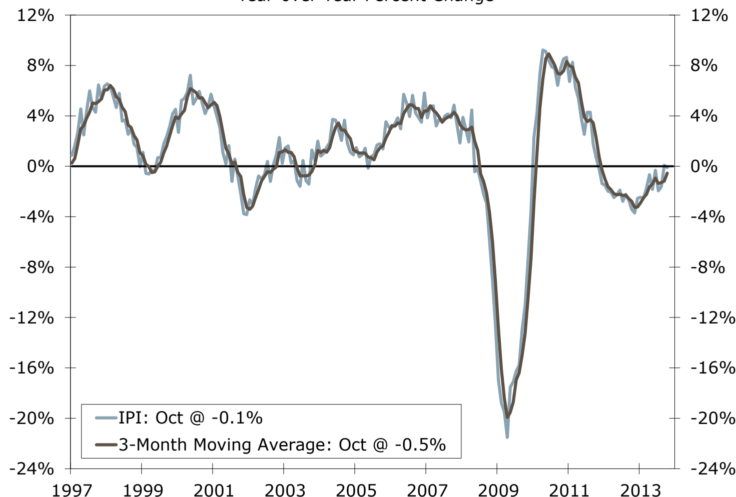
Eurozone Industrial Production • Tuesday

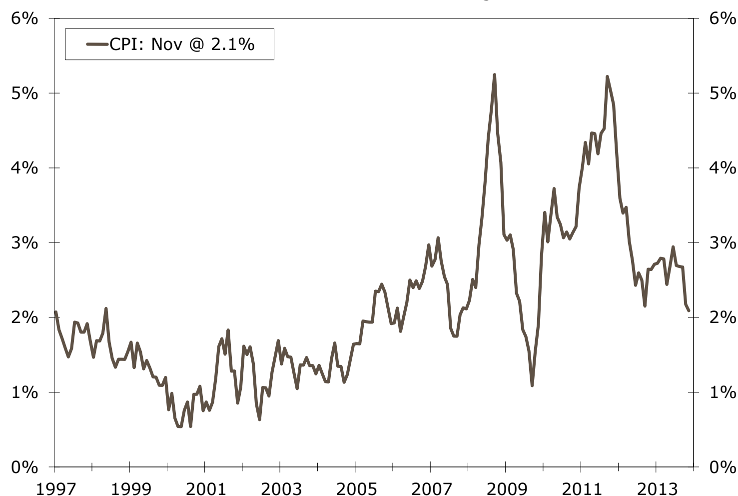
Markets are expecting to see a strong print for November's Eurozone industrial production index. Consensus expectations have industrial production increasing 1.4 percent, month-over-month, seasonally adjusted. The previous month number was down 1.1 percent, month over month, which means that while strong, a large part of the expected increase is just a recovery from a weak performance in October. The number in November could be the first positive print since August 2013. As industrial production for Germany was up a stronger–than-expected 1.9 percent, month over month, this 1.4 percent expected strong gain for the overall Eurozone is likely.

On Thursday, the consumer price index is expected to rise 0.3 percent (month-over-month) in December after a 0.1 percent decline in November. This will be a breath of fresh air for the European Central Bank as it continues to consider options for monetary policy in 2014.

Previous: -1.1%

Consensus: 1.4%





United Kingdom CPI • Tuesday

The U.K. consumer price index is expected to post a relatively strong 0.5 percent increase in December after two consecutive months of 0.1 percent. However, year over year, CPI inflation is expected to have remained stable at 2.1 percent. Meanwhile, core CPI inflation, (i.e. consumer prices excluding volatile food and energy prices), is also expected to remain stable at 1.8 percent.

Retail sales ex-auto is to be released on Friday and markets are expecting an increase of 0.5 percent. If markets are correct, this will be the second consecutive month-over-month increase and will erase the drop of 0.7 percent recorded in October. Including auto sales, markets are also expecting a 0.5 percent print after a 0.3 percent increase in November. October's retail sales including autos were down 0.9 percent, so even if the report agrees with consensus expectations the index will still be short of recovering from October's drop.

Previous: 2.1% **Wells Fargo: 2.0%**

Consensus: 2.1%

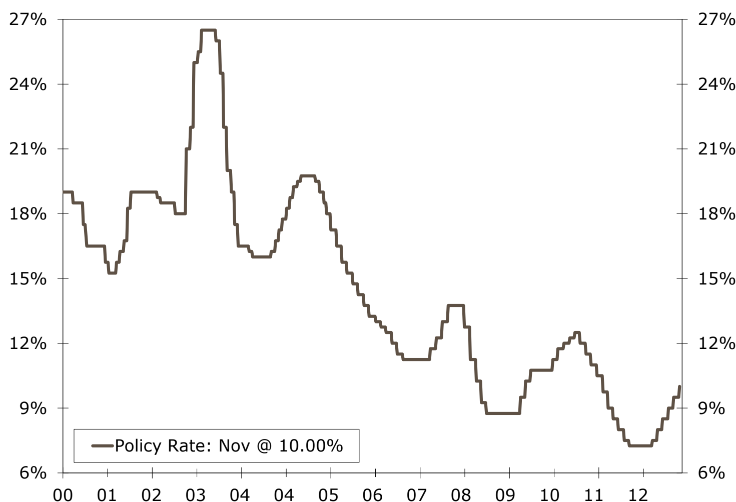
Brazil Selic Rate • Wednesday

The Brazilian central bank is expected to continue with its tightening campaign during next week's monetary policy committee meeting as markets are expecting the central bank to raise the Selic benchmark interest rate by 25 basis points, from 10.00 percent to 10.25 percent. This will be the seventh increase in the Selic rate since January 2013 when it was at 7.25 percent. However, the 25 basis point increase represents a slowdown in the central bank's tightening campaign as the previous five increases were increases of 50 basis points. Thus, markets think that the central bank is close to ending its tightening campaign in the next several months.

Meanwhile, on Thursday, the statistical institute will release retail sales data for November. Our expectation is for the number to have weakened again from the 5.3 percent year-over-year rate recorded in October.

Previous: 10.00%

Consensus: 10.25%



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

Interest Rate Watch

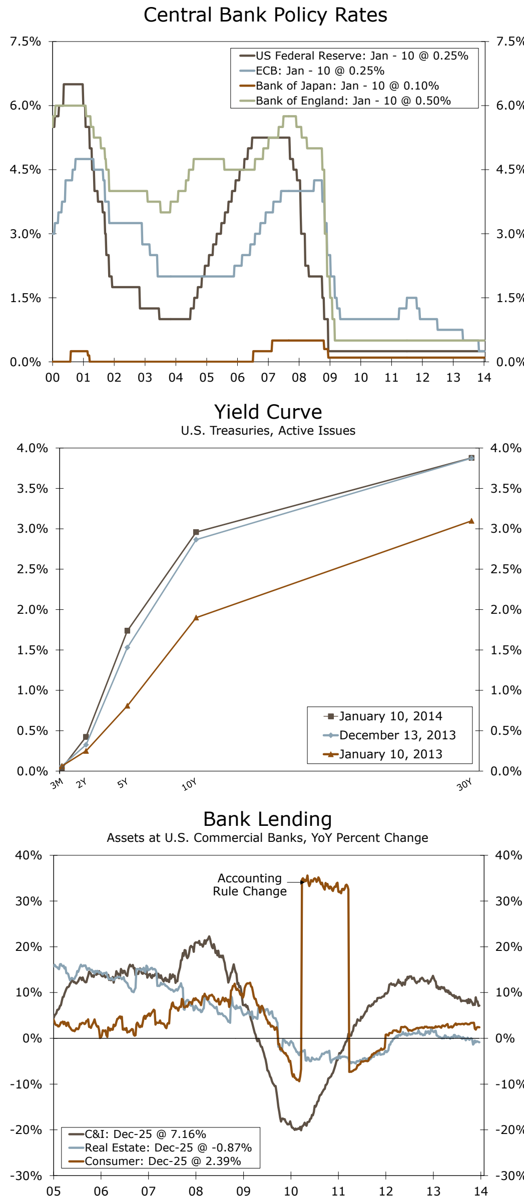
Investors Seeking Real Yields

Despite the emphasis on perceived "low" inflation in the United States, the reality is that the rate of inflation still exceeds the rate of return at the short end of the Treasury yield curve. This has two impacts. First, there is an incentive to move cash into other investments, such as real estate, equities and corporate bonds; indeed, we have seen fund flows into these areas as the outlook for the economy has improved. Second, borrowers have an incentive to finance at the short-end of the curve, as the expected rate of return for many projects will exceed the negative real rate for borrowing at the short end of the curve.

As investors have sought higher yields in corporate bonds and emerging market instruments, this also opens up the possibility of capital losses when even modest increases in interest rates on low-yielding financial instruments can have significant impacts on capital values.

Our outlook has been that benchmark 10-year Treasury yields will rise in 2014 as the Fed takes the first steps toward a more traditional policy environment. The minutes from the December FOMC meeting released this week showed fairly broad ("most") support for reducing long-term asset purchases (QE). With short-term rates left alone until the unemployment rate falls "well past" 6.5 percent, we expect a steeper yield curve with the yield on the 10-year Treasury security moving higher than 3 percent as the year progresses.

We remain cautious, however, that even modest upward moves in benchmark Treasury rates may generate a surprise decline in asset values in selected portfolios within institutions around the world. The history of interest rate shocks has been that what is perceived to be a modest interest rate move can carry with it an unwelcome surprise to a portfolio positioned the wrong way (Penn Central, Drysdale Securities, Long-term Capital Management, Bear Stearns) and the fallout from such interest rate shocks can reverberate throughout a financial system that already is undergoing additional regulatory restrictions and is sensitive to risk.



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

Credit Market Insights

Charge-Off Rates Continue to Decline

Earlier this week the Fed released its consumer credit report for November, which showed consumer credit grew by $12.3 billion, slightly below expectations. One of the bright spots of this report is the continued decline in charge-off rates. Charge-off rates at commercial banks have reached their lowest levels since Q4 2006, and the credit card charge-off rate is at the lowest rate since Q1 2006. This leaves both figures comfortably below their long-run averages and suggests that consumer balance sheets are continuing to improve. Another metric that would suggest consumers are more comfortable with their current economic standing is consumer credit as a percent of disposable personal income. This figure hit 24.5 percent in November, which is the highest reading since 2008. What this may suggest is that consumers are more comfortable making purchases with credit, because they are more confident that they will be able to pay their bills in the future. This is also evident in December's reading of consumer confidence which saw a jump to 78.1 from 72.0 in November with gains in both the present situation and future expectations components. As we receive the final economic data releases for 2013, there are many reasons to have a positive outlook for 2014 as we continue to see encouraging data in most aspects of the economy. A particular point of strength we see at the end of the year is in personal consumption, as we expect it to grow 4.0 percent in Q4.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.51%	4.53%	4.42%	3.40%
15-Yr Fixed	3.56%	3.55%	3.43%	2.66%
5/1 ARM	3.15%	3.05%	2.94%	2.67%
1-Yr ARM	2.56%	2.56%	2.51%	2.60%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,610.1	42.59%	11.57%	7.16%
Revolving Home Equity	$473.6	-1.64%	-2.26%	-7.91%
Residential Mortgages	$1,558.4	-6.08%	1.65%	-3.41%
Commerical Real Estate	$1,489.4	12.46%	5.23%	4.54%
Consumer	$1,144.0	8.00%	8.66%	2.39%

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

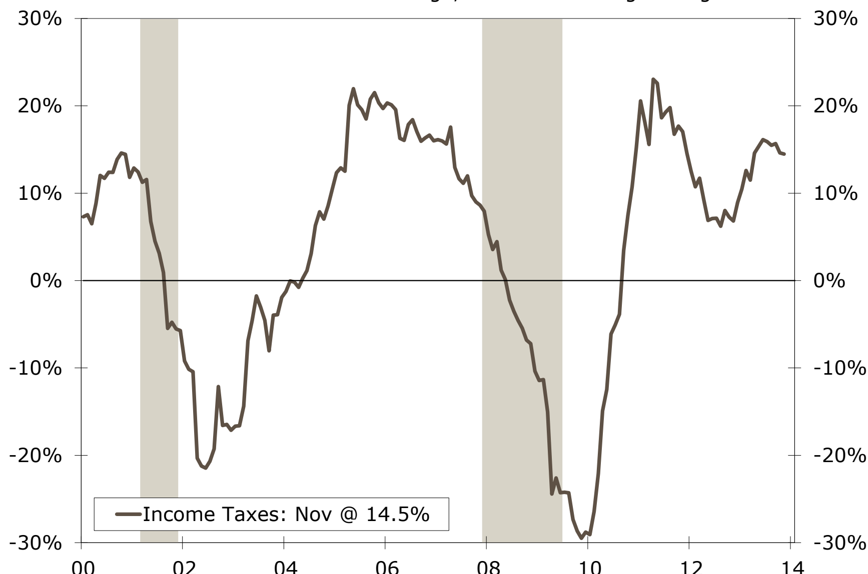
Topic of the Week

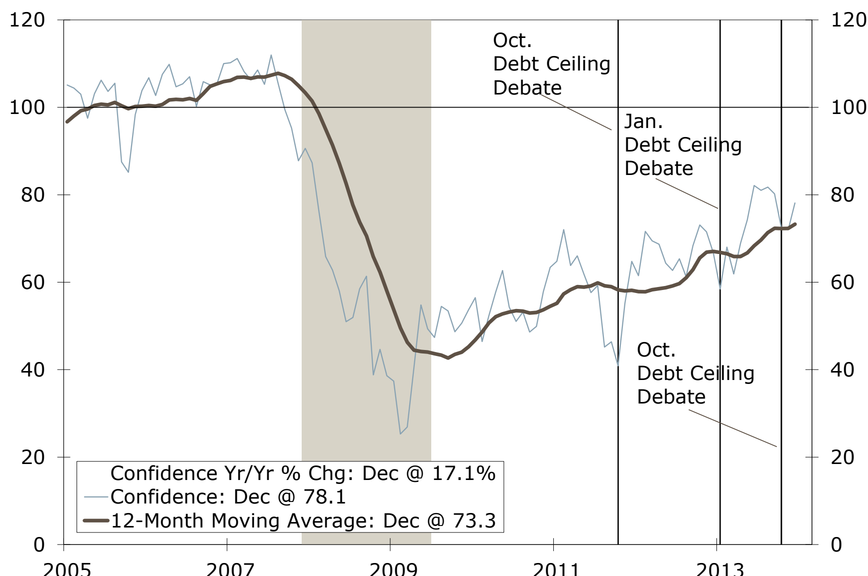
Another Debt Ceiling Deadline

As the 113th Congress returns for its second session this week, there is a laundry list of items on the agenda. First, Congress needs to complete and pass an omnibus appropriations bill before January 15th when the current continuing resolution expires. Given the bipartisan nature of the spending bill passed in December, we expect that the omnibus appropriations bill will also clear both chambers before the deadline without much incident. The second major item on the docket is the proposed extension of unemployment insurance benefits which expired on December 28th. While some form of unemployment benefits will likely be extended, the debate will likely be contentious. But the next key policy deadline is the rapidly approaching need to raise the debt ceiling.

The nation's borrowing limit is currently suspended through February 7th, after which the Department of the Treasury will begin to employ extraordinary measures to stay under the debt limit. Last month, Treasury Secretary Jack Lew sent Congressional leaders a letter signaling the need to raise the borrowing limit by late February or early March. However, the CBO estimates that through the use of extraordinary measures, the nation can stay under the debt ceiling until March or as late as June. Those individuals expecting a tax refund typically file earlier, resulting in larger federal outlays in February and March before tax collections begin to boost revenue collections (top graph). This dynamically shortens the time period for the Treasury to remain under the borrowing limit. Given that we expect timely resolutions to both the omnibus appropriation bill and the debt ceiling increase, we do not expect either of these events to affect our baseline GDP forecast. However, should the political rhetoric become heated, there is some downside risk to consumer confidence (bottom graph).

For further information see our special report entitled "*Another Debt Ceiling Deadline*" available on our website.





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 1/10/2014	1 Week Ago	1 Year Ago
3-Month T-Bill	0.04	0.07	0.06
3-Month LIBOR	0.24	0.24	0.31
1-Year Treasury	0.14	0.11	0.16
2-Year Treasury	0.42	0.40	0.25
5-Year Treasury	1.74	1.73	0.79
10-Year Treasury	2.96	2.99	1.90
30-Year Treasury	3.88	3.92	3.08
Bond Buyer Index	4.68	4.75	3.60

Foreign Exchange Rates	Friday 1/10/2014	1 Week Ago	1 Year Ago
Euro ($/€)	1.359	1.359	1.327
British Pound ($/£)	1.641	1.642	1.617
British Pound (£/€)	0.828	0.828	0.821
Japanese Yen (¥/$)	105.030	104.860	88.780
Canadian Dollar (C$/$)	1.086	1.064	0.983
Swiss Franc (CHF/$)	0.908	0.905	0.914
Australian Dollar (US$/A$)	0.889	0.895	1.060
Mexican Peso (MXN/$)	13.081	13.108	12.606
Chinese Yuan (CNY/$)	6.052	6.052	6.225
Indian Rupee (INR/$)	61.905	62.155	54.575
Brazilian Real (BRL/$)	2.393	2.377	2.029
U.S. Dollar Index	81.048	80.791	79.738

Foreign Interest Rates	Friday 1/10/2014	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.26	0.26	0.13
3-Month Sterling LIBOR	0.52	0.53	0.51
3-Month Canadian LIBOR	1.17	1.17	1.31
3-Month Yen LIBOR	0.15	0.15	0.17
2-Year German	0.21	0.21	0.10
2-Year U.K.	0.54	0.54	0.41
2-Year Canadian	1.09	1.14	1.20
2-Year Japanese	0.11	0.09	0.10
10-Year German	1.89	1.94	1.56
10-Year U.K.	2.93	3.02	2.10
10-Year Canadian	2.67	2.75	1.96
10-Year Japanese	0.70	0.74	0.83

Commodity Prices	Friday 1/10/2014	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	92.60	93.96	93.82
Gold ($/Ounce)	1233.83	1237.01	1675.45
Hot-Rolled Steel ($/S.Ton)	675.00	675.00	645.00
Copper (¢/Pound)	330.95	335.50	370.90
Soybeans ($/Bushel)	12.99	13.25	14.22
Natural Gas ($/MMBTU)	4.01	4.30	3.19
Nickel ($/Metric Ton)	13,292	13,944	17,489
CRB Spot Inds.	526.78	531.30	529.58

Next Week's Economic Calendar

	Monday 13	Tuesday 14	Wednesday 15	Thursday 16	Friday 17
U.S. Data	**Budget Statement** November -$135.2B December $44.0B (W)	**Retail Sales** November 0.7% December 0.3% (W) **Import Price Index** November -0.6% December 0.3% (W)	**PPI** November -0.1% December 0.3% (W) **Empire Manufacturing** December 0.98 January 3.50 (C)	**CPI** November 0.0% December 0.2% (W) **TIC** November $194.9B December	**Housing Starts** November 1091K December 986K (W) **Industrial Production** November 1.1% December 0.3% (W)
Global Data	**Japan** **Current Account Balance** Previous (Oct) -¥127.9B	**Eurozone** **Industrial Production** Previous (Oct) -1.1% **United Kingdom** **CPI (MoM)** Previous (Nov) 0.1%	**Australia** **Unemployment Rate** Previous (Nov) 5.8%	**Eurozone** **CPI (MoM)** Previous (Nov) -0.1% **Brazil** **Retail Sales (MoM)** Previous (Oct) 0.2%	**United Kingdom** **Retail Sales Ex-Auto (MoM)** Previous (Nov) 0.4% **Mexico** **Unemployment Rate** Previous (Nov) 4.47%

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 H. 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 J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Anika R. 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 House	Economist	(704) 410-3282	sarah.house@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
Mackenzie Miller	Economic Analyst	(704) 410-3358	mackenzie.miller@wellsfargo.com
Blaire Zachary	Economic Analyst	(704) 410-3359	blaire.a.zachary@wellsfargo.com
Peg Gavin	Executive Assistant	(704) 410-3279	peg.gavin@wellsfargo.com
Cyndi Burris	Senior Admin. Assistant	(704) 410-3272	cyndi.burris@wellsfargo.com

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