July 18, 2014

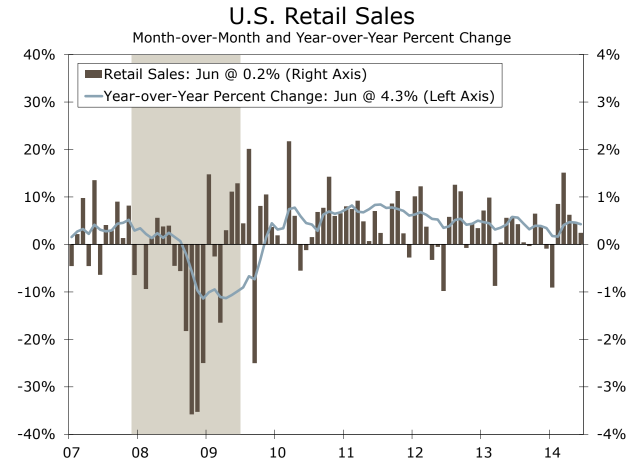
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Q2 Appears to Be Ending on a Stronger Note

- Retail sales rose a modest 0.2 percent in June, however, the details of the report were encouraging for consumer spending in the second quarter.
- June producer prices came in higher than expected, rising 0.4 percent. Import prices, however, showed some signs of easing up for the month.
- The most disappointing news of the week was June housing starts which fell 9.3 percent, marking the second month of sizable declines. The downshift in building activity was observed in both single and multifamily starts.



Global Review

Growth in China Appears to Be Stabilizing

- The year-over-year rate of real GDP growth in China edged up to 7.5 percent in Q2 from 7.4 percent in Q1. Modest relaxation in credit restrictions in recent months led to some stabilization in investment spending growth.
- We look for the rate of real GDP growth in China to edge lower in coming quarters. Although Chinese authorities may relax policy at the margin to allow some fine-tuning of the economy, they are not about to embark on a wholesale easing of policy that would delay the necessary rebalancing of the economy away from its heavy reliance on investment.

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	4.1	2.6	-2.9	2.5	2.9	2.9	1.8	2.8	1.9	1.4	2.9
Personal Consumption	2.3	1.8	2.0	3.3	1.0	2.2	2.4	2.5	2.5	2.2	2.0	2.1	2.5
Inflation Indicators [2]													
PCE Deflator	1.4	1.1	1.1	1.0	1.1	1.6	1.7	1.9	2.4	1.8	1.1	1.6	2.0
Consumer Price Index	1.7	1.4	1.5	1.2	1.4	2.0	2.1	2.4	3.1	2.1	1.5	2.0	2.3
Industrial Production [1]	4.2	1.9	2.5	4.9	3.9	5.5	3.7	4.3	3.3	3.8	2.9	4.1	4.7
Corporate Profits Before Taxes [2]	2.1	4.5	5.7	6.2	-2.2	3.6	3.8	4.0	7.9	7.0	4.6	2.4	4.3
Trade Weighted Dollar Index [3]	76.2	77.5	75.2	76.4	76.9	75.9	76.5	76.8	70.9	73.5	75.9	76.5	78.2
Unemployment Rate	7.7	7.5	7.2	7.0	6.7	6.2	6.0	5.9	8.9	8.1	7.4	6.2	5.7
Housing Starts [4]	0.95	0.86	0.88	1.03	0.93	0.98	1.06	1.07	0.61	0.78	0.92	1.01	1.18
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	0.63
Conventional Mortgage Rate	3.57	4.07	4.49	4.46	4.34	4.16	4.35	4.34	4.46	3.66	3.98	4.30	4.46
10 Year Note	1.87	2.52	2.64	3.04	2.73	2.53	2.75	2.80	2.78	1.80	2.35	2.70	3.00

Forecast as of: July 18, 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 and Wells Fargo Securities, LLC

Inside

Together we'll go far

U.S. Review

Q2 Appears to Be Ending on a Stronger Note

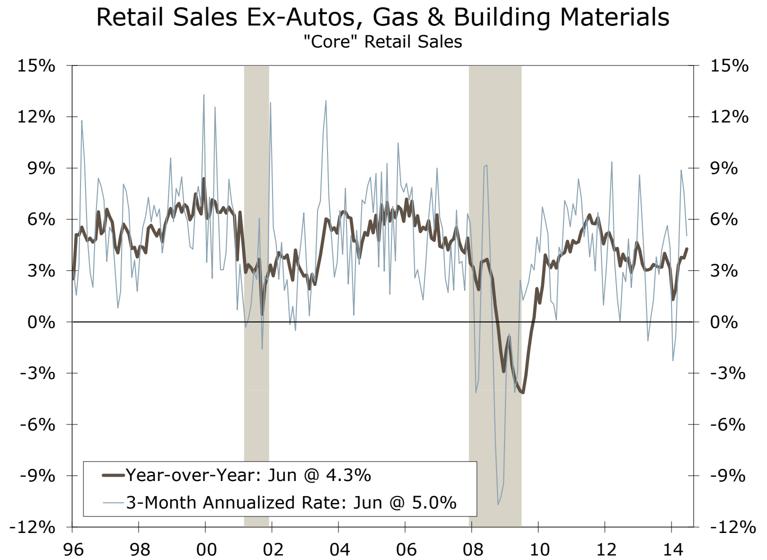
Economic data this week continued to support the case for more robust economic growth in the second quarter. Retail sales posted another improvement in June, but the underlying details of the report suggested that real consumer spending in the second quarter should come in close to our projection of 2.2 percent. Inflation pressures continued to slowly edge higher according to the producer price index. The industrial sector also posted improvement in June, ending the quarter at a 5.5 percent annualized rate. Additionally, it appears that firms are building inventories once again this quarter, suggesting that inventories will also contribute to top line GDP growth in Q2. One disappointing piece of news this week was housing starts, which declined a surprising 9.3 percent in June. Even though we maintain our view that home building will continue to improve, the pace of improvement continues to disappoint.

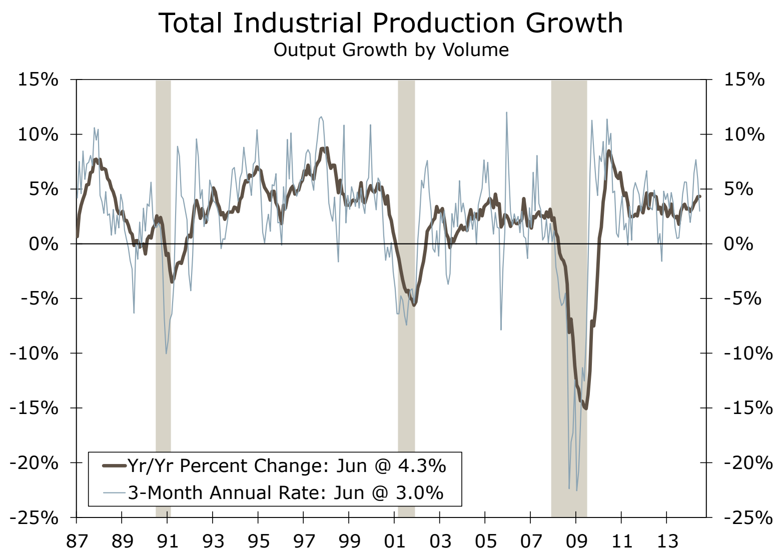
Retail sales posted a modest 0.2 percent rise in June but once automobile sales are excluded, overall sales rose 0.4 percent. In addition, prior months' data were revised higher suggesting that consumer spending was a bit stronger in the second quarter. The control group within retail sales, which feeds into the calculation of GDP, grew at a 5.4 percent annualized rate in the second quarter. The nominal retail sales numbers, however, are likely also reflecting a bit of a pick up in inflation as well.

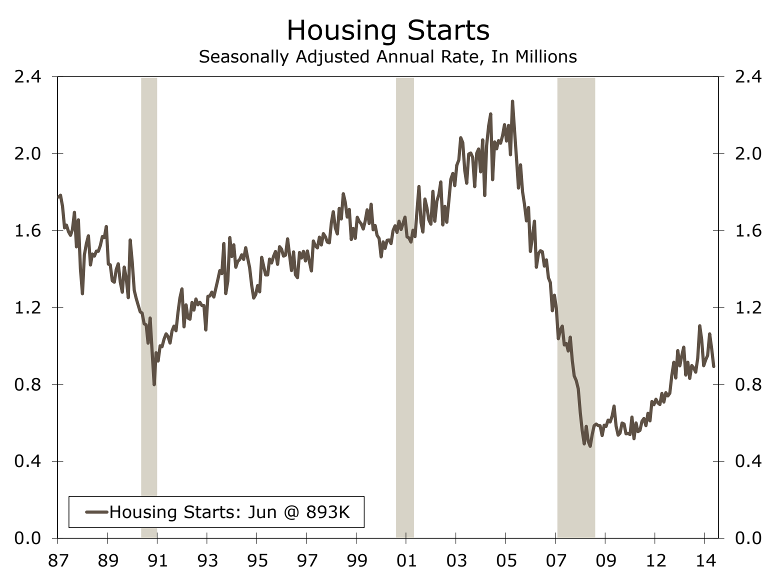
June producer prices rose 0.4 percent, taking the year-over-year rate to 1.9 percent. Higher energy prices pushed goods prices higher, while services prices rose 0.3 percent. Import prices remained soft for the month, rising just 0.1 percent. Fuel prices were the main driver of the increase. Overall, we expect the trend of modestly higher inflation in the second half of the year.

On the industrial production front, output rose 0.2 percent but net upward revisions to April and May's readings led the index to a 5.5 percent annualized rate in the second quarter. Manufacturing output rose at a modest 0.1 percent pace in the wake of two months of sizable output growth. Other surveys of the factor sector including the Philly Fed survey and anecdotal evidence from the Fed's Beige Book continued to reflect stronger manufacturing fundamentals. The continued growth in industrial output suggests that business investment is expected to improve in the months ahead. With factory output ramping up, inventory building is also picking up. May business inventory data suggested that inventories will play a role in contributing to top line GDP growth in Q2.

Housing starts posted a second monthly decline in June, raising some questions about the pace of the housing market recovery. More forward looking building permits data also slowed but remain well above the latest level of starts. Other metrics on the housing market, including the NAHB/Wells Fargo survey released this week, continue to show that builders remain confident in both current and future single family home sales activity. Although recent home building trends are a bit concerning, we still expect modest improvement in the coming months.







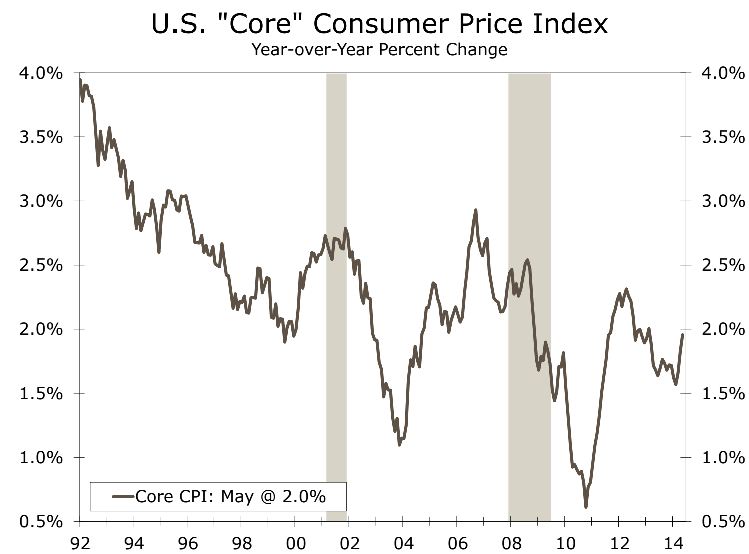
Source: U.S. Dept. of Commerce, Federal Reserve Board and Wells Fargo Securities, LLC

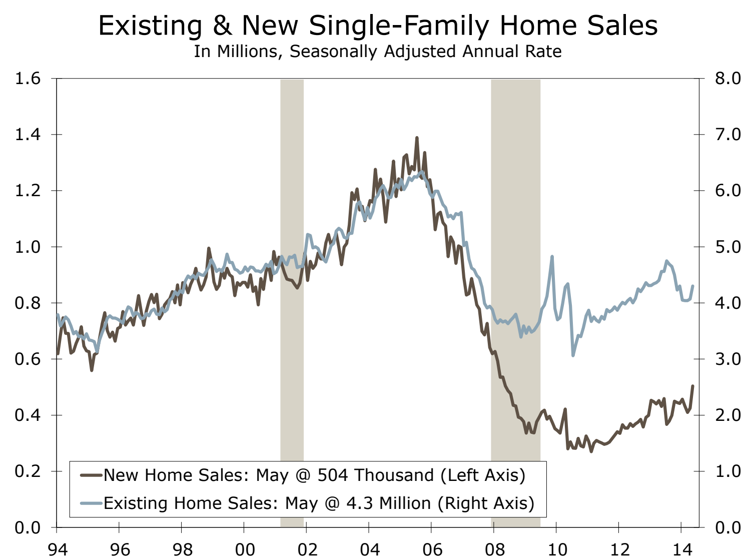
Consumer Price Index • Thursday

Headline consumer prices inched up modestly in each of the last three months to reach its largest monthly increase since May 2013, rising 0.4 percent. The year-over-year headline CPI inflation rate is now up 2.1 percent and core prices, which exclude volatile energy and food indexes, rose 2.0 percent. Although the gains were broad-based, the indexes for food, shelter, electricity, airline fares and gasoline made the largest contribution to the headline. With consumer prices continuing to accelerate, we will likely see further gains in the core PCE deflator, the Fed's preferred measure of inflation. The core PCE deflator rose 1.5 percent over the past year, which is still at the lower end of the Fed's comfort zone. However, the CPI and PCE indexes are usually correlated over time with about a 0.5 percentage point spread between the two numbers. At the current pace of consumer price growth, we could see the PCE deflator touch 2.0 percent before the end of the year.

Previous: 0.4% (Month-over-Month) Wells Fargo: 0.3%

Consensus: 0.3%





Existing and New Home Sales • Tuesday

Existing home sales have shown an upward trend in the past two months, but the gains only partly offset the weak readings earlier in the year. Although the trend is promising, the details of the report provide more insight into the health of the housing market. Distressed transactions fell to 11 percent of total purchases, the lowest share since the series began in 2008 and inventories have risen in each of the last five months. Pending home sales rose a sizeable 6.1 percent in May, the third consecutive gain which suggests existing home sales could strengthen further.

New home sales data will be released on Thursday. Recent weakness in housing starts has once again brought into question the sustainability of the housing recovery. Although builder sentiment has edged higher over the last two months, the sizeable gain in new home sales activity in May suggests some payback is in store. We expect new home sales to show a decline in May.

Previous:4.89M Wells Fargo: 5.00M

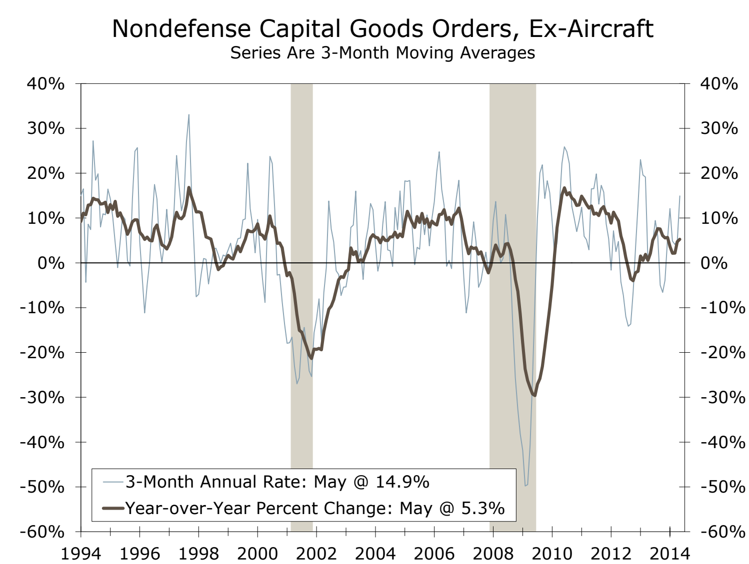
Consensus: 4.99M

Durable Goods • Friday

Following three consecutive monthly gains, durable goods orders fell 1.0 percent in May. The volatile defense component plummeted 31.4 percent after rising a similar 38.2 percent in April. Excluding defense, orders rose 0.6 percent. A purchase of U.S. Navy submarines in April could be responsible for the pullback in defense orders in May. The closely watched capital goods non-defense orders excluding aircraft measure rose 0.7 percent on the month and increased at a 14.9 percent three-month annualized rate. Shipments also edged higher in May with core capital goods shipments rising at an 8.1 percent three-month annualized pace. This gain should be a positive for equipment and software spending. With the ISM manufacturing index and new orders component firmly in expansion territory in June and regional PMIs also showing improvement, we expect durable goods orders to post a positive reading in June.

Previous: -0.9% (Month-over-Month) Wells Fargo: 0.3%

Consensus: 0.5%



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

Global Review

Growth in China Appears to Be Stabilizing

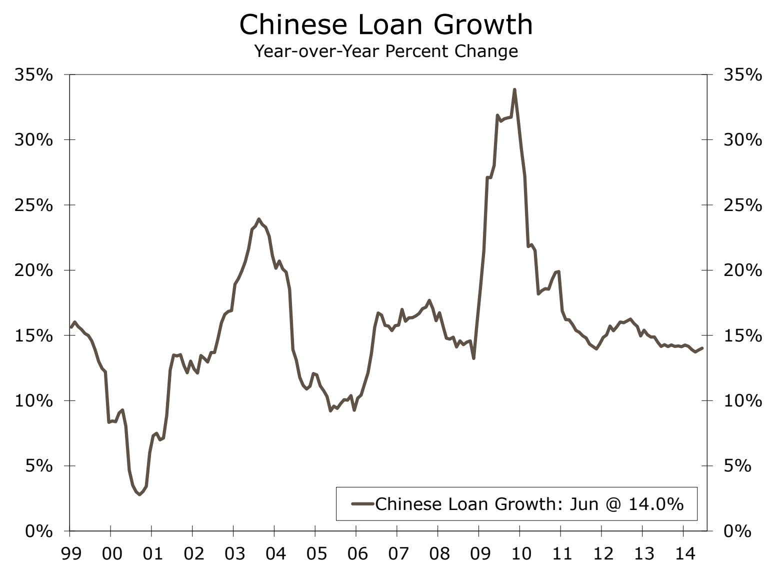
Data released this week showed that Chinese real GDP rose 2.0 percent (not annualized) on a sequential basis in the second quarter, stronger than the 1.5 percent rate registered during the preceding quarter. On a year-ago basis, real GDP growth edged up to 7.5 percent in Q2 from 7.4 percent in Q1 (see chart on front page). The stronger-than-expected output should relieve concerns, at least for the time being, that the Chinese economy is heading for a "hard landing." Indeed, real GDP growth in the world's second largest economy has largely stabilized, at least for now, in the 7 to 8 percent range.

A breakdown of second quarter real GDP into its underlying demand components is not readily available at this time. However, monthly data suggest that consumer spending remained solid as growth in the value of retail sales edged up to 12.3 percent in Q2 from 12.0 percent in Q1. In addition, it appears that net exports helped to shore up overall GDP growth as the value of exports, which fell 4.7 percent on a year-ago basis in Q1, rose 5.0 percent in Q2. On the other hand, imports decelerated somewhat in the second quarter.

Moreover, growth in fixed investment spending, which had slowed coming into the year, stabilized in the second quarter (top chart). In recent months, the Chinese government has marginally relaxed credit restrictions that were put in place last year when authorities became alarmed with runaway lending growth, especially in the so-called "shadow banking system." This marginal relaxation of policy has shown up in the stabilization in bank lending in recent months (middle chart). In addition, "total social financing," which not only includes traditional bank lending but also lending in the "shadow banking system," has strengthened modestly in recent months following its sharp slowdown in the second half of last year.

That said, Chinese authorities are not about to undertake policy easing on a massive scale as they did in the wake of the global financial crisis a few years ago. (See the spike in bank lending in the middle graph.) Any policy changes that occur in China will be marginal and of a fine-tuning nature rather than a wholesale easing of policy. Investment spending, which includes residential construction, has made an outsized contribution to real GDP growth in China over the past few decades, and the Chinese economy is now unbalanced with too much investment relative to consumer spending. As shown in the bottom chart, investment spending has accounted for roughly one-half of real GDP growth in recent years. In most other economies, the contribution of investment spending to real GDP growth would be on the order of one fourth or less. Chinese authorities are very much aware of the unbalanced nature of their economy and they are unlikely to take policy steps, such as credit relaxation on a massive scale, which would delay the necessary rebalancing of the economy.

Consequently, we look for growth in China to edge lower in coming quarters. Specifically, we forecast that Chinese real GDP growth will slow from 7.7 percent last year to 7.4 percent this year before downshifting to 7.0 percent in 2015.



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

Eurozone PMIs • Thursday

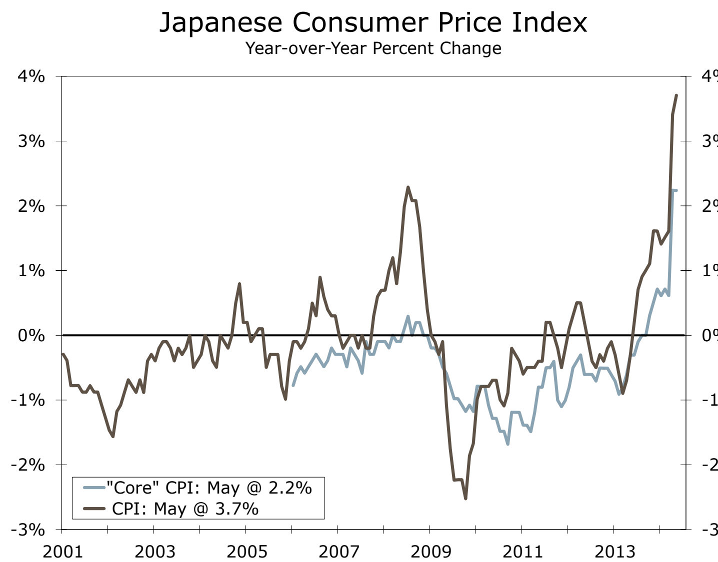
It has been roughly six weeks since the rollout of a comprehensive package of policy changes from the European Central Bank designed to spur economic growth by nudging banks to increase lending.

It is still too soon to measure the effectiveness of these policy changes on economic growth. However, on Thursday of next week financial markets will get a look at how business activity is faring in the month of July when the purchasing manager surveys for both the manufacturing and service sector are released.

Both measures lost some ground in June, though at levels comfortably above 50, both surveys are also consistent with modest expansion.

Previous: Manufacturing: 51.8, Services: 52.8

Consensus: Manufacturing: 51.7, Services: 52.7



Japanese CPI • Thursday

Even before the Japanese consumption tax went into effect in June, the year-over-year rate of CPI inflation was trending higher. There are a number of factors that have played a role in lifting consumer prices in Japan. Some credit is certainly due to the Bank of Japan and its expansion of the monetary base, though rising energy costs also have played a role. More recently, in April and May, inflation has shot up mostly because of the consumption tax.

Eventually the big boost from the tax hike will fade, especially as the year-over-year comparison become more difficult (prices began to rise in earnest in the second half of last year). On Friday of next week the CPI report for June becomes available and we expect to see the year-over-year rate slow slightly to 3.5 percent. For the near-term at least, deflation is not a problem in Japan.

Previous: 3.7% (Year-over-Year) Wells Fargo: 3.5%

Consensus: 3.5%

U.K. GDP • Friday

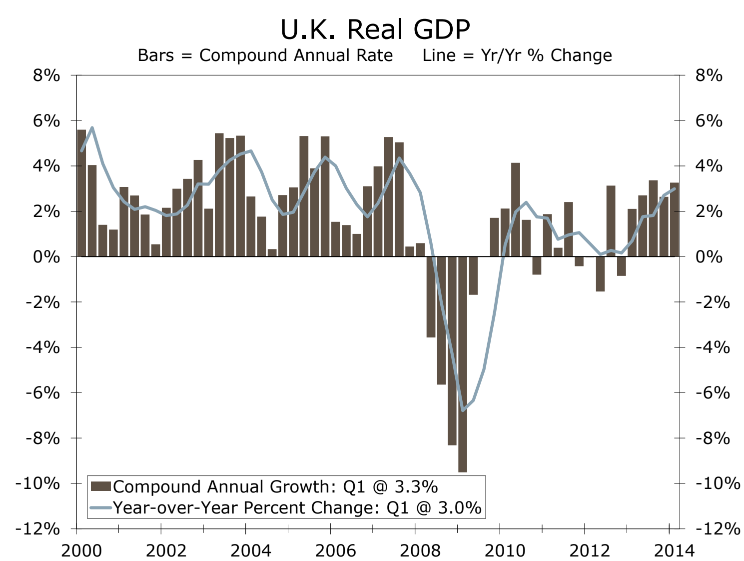
Economic growth has been steady in the United Kingdom with the annualized rate of real GDP growth coming in north of 2 percent in each of the past five quarters.

Having said that, it appears as though the U.K. economy was losing some steam in the second quarter. Retail sales slipped half a percent in May and industrial production fell seven tenths of a percent.

On Friday of next week the first look at second quarter GDP will hit the wire and we expect to see only a slight moderation in the growth rate. The Monetary Policy Committee is likely to continue its accommodative stance through this year and will likely begin tightening in the first half of 2015.

Previous: 3.3% (CAGR) Wells Fargo: 3.0%

Consensus: 3.3%



Source: IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

Economics Lead the Markets; The Markets Will Lead the Fed

At this point in the economic cycle, we believe that the path for growth, employment and inflation will lead the market to discount a Fed move in the funds rate/interest on excess reserves before the Fed actually moves in mid-2015.

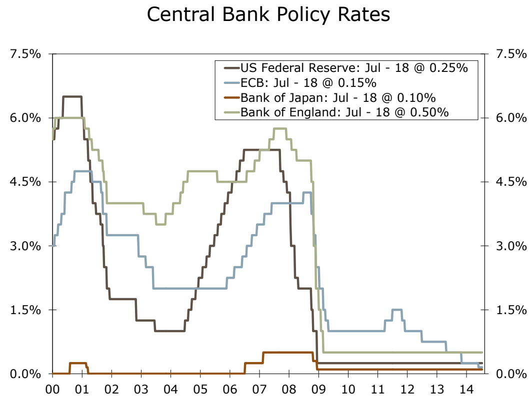
Markets are forward looking and, as result, cannot wait for the Fed to announce an increase in short-term rates. Our outlook remains that the current path of GDP growth—2.5-3.0 percent for the next five quarters—will be accompanied by a steady decline in the unemployment rate to 5.7 percent by mid-2015. In addition, we anticipate that the PCE deflator will steadily rise to a 2 percent-plus rate by mid-2015 as well.

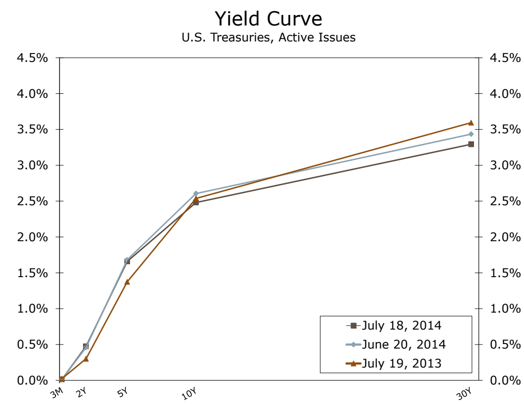
These economic fundamentals will lead the markets to discount higher short-term rates in the future and this discounting will have to occur in intermediate and long-term interest rates over the next five quarters. The rise in rates is expected to be modest by historical standards given the pressures on the global economy with weak growth in Europe as well as the political tensions that we have witnessed this past week (see Topic of the Week).

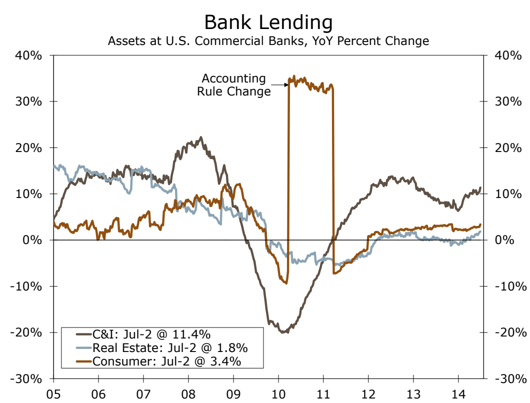
The Anchoring Bias Issue

Intellectually, there is a bias in our thinking that leads us to frame the future in ways similar to the present and thereby we fail to anticipate or allow for change. In the 1950s and 1960s, there was a comfort with rapid economic growth, low inflation and low interest rates such that investors failed to appreciate the accumulating policy contradictions and inflation of the 1970s. In the early 1980s, investors were focused on high inflation and failed to anticipate the rapid drop in the rest of that decade.

In each of the past two recoveries, there was complacency about low interest rates and slow economic growth that led to negative surprises when interest rates did move. In a similar way, we are repeating this pattern. With interest rates so low, it will not take much of an increase in rates to generate negative total returns in many bond portfolios—witness Q3-2013.







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

Credit Market Insights

Mortgage Market Misstep

Recent data from the Mortgage Bankers Association (MBA) showed a slight dip in demand in the mortgage market in June and in the first half of July. On a non-seasonally-adjusted basis, mortgage applications for new homes fell by 5 percent in June over the previous month. By type, conventional loans accounted for more than two-thirds of all applications. During the first half of July, mortgage applications and refinancing applications were lower on a week-to-week basis as well. The average application by loan size fell to $268,500–its lowest level in 5 months.

Weak data from the real estate market could be placing headwinds on mortgage growth. Housing starts dropped 9.3 percent on a month-to-month basis in June and the previous month's data were also revised downward. However, we suspect that the housing starts data overstated the extent of the weakness in June. It is likely that as the real estate market gains steam, mortgage applications will pick up as well. Next week data will be released on new and existing home sales, which should provide more color on the housing market.

Despite the weak application data seen in the past month, the mortgage market still appears to be faring well. Mortgage loans currently account for more than 70 percent of all household debt and credit, and mortgages outstanding grew 2.9 percent on a year-over-year basis in the first quarter.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.13%	4.15%	4.14%	4.37%
15-Yr Fixed	3.23%	3.24%	3.22%	3.41%
5/1 ARM	2.97%	2.99%	2.98%	3.17%
1-Yr ARM	2.39%	2.40%	2.40%	2.66%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,732.8	76.12%	35.67%	11.36%
Revolving Home Equity	$464.7	1.92%	-1.50%	-5.08%
Residential Mortgages	$1,586.9	-2.00%	11.18%	-0.93%
Commerical Real Estate	$1,554.5	22.80%	11.38%	7.25%
Consumer	$1,175.0	18.65%	10.75%	3.39%

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

Topic of the Week

Illusion of Kumbaya Has Come and Gone

At the one hundred year anniversary of World War I, the war to end all wars, the reality is that World War I did no such thing.

This week's events once again bring forth the importance to decision makers of the risks associated with non-economic events.

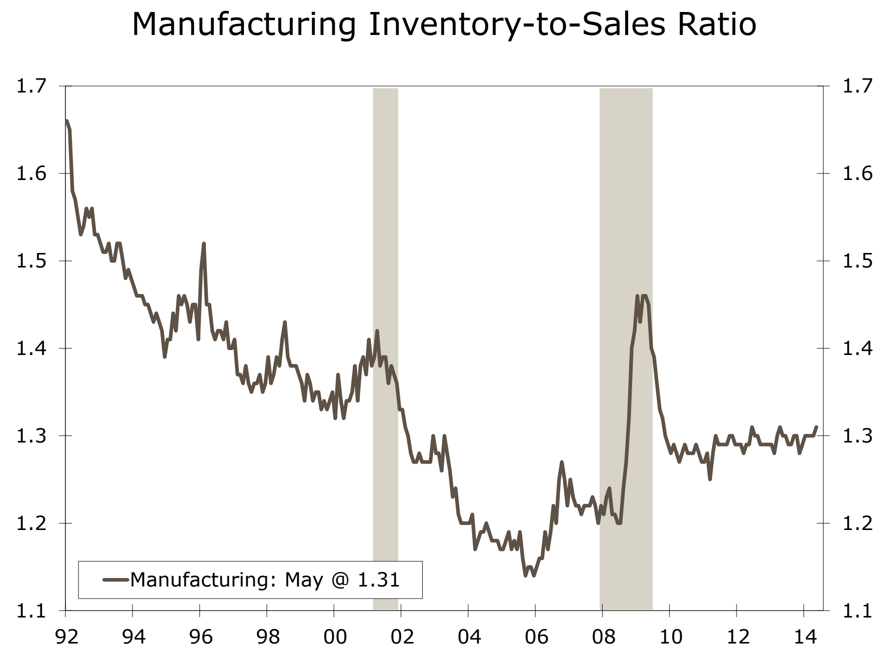
"Never, never, never believe any war will be smooth and easy, or that anyone who embarks on the strange voyage can measure the tides and hurricanes he will encounter. The statesman who yields to war fever must realize that once the signal is given, he is no longer the master of policy but the slave of unforeseeable and uncontrollable events."

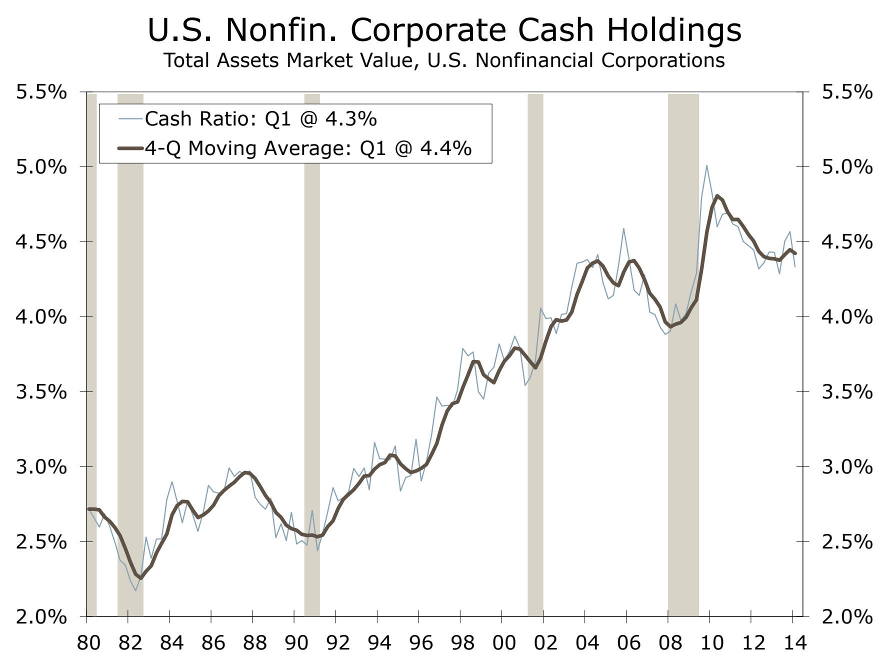
~ Winston Churchill ~

These uncertainties are the basis for manufacturing firms to keep a bit of excess inventory on hand—witness the impact on auto manufacturing of the Japanese tsunami. For service firms, there is the hoarding of labor over the business cycle. Weak final demand for a company's services does not lead to a one-to-one decline in workers since the cost to rehire many of these skilled service workers who have company specific skills is very high relative to carrying those workers through a recession.

For banks, there are excess reserves on hand. For households there is the safety of the precautionary savings account or money market fund. For non-financial companies there is the extra cash on hand to deal with an emergency—domestic or foreign.

In fact, it is the failure to allow for significant, negative, events that is the hallmark for poor decision making. So in the winter, keep that extra blanket in the car. In summer time, carry that extra water bottle with you. In business, a little extra cash is both an emotional safety valve and a source of funds to get over the small bumps. For investors, there will always be surprises on our voyage and a little extra financial protection is welcome.





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 7/18/2014	1 Week Ago	1 Year Ago
3-Month T-Bill	0.01	0.02	0.03
3-Month LIBOR	0.23	0.23	0.27
1-Year Treasury	0.16	0.17	0.08
2-Year Treasury	0.47	0.45	0.30
5-Year Treasury	1.66	1.64	1.33
10-Year Treasury	2.48	2.52	2.53
30-Year Treasury	3.29	3.34	3.63
Bond Buyer Index	4.36	4.38	4.52

Foreign Exchange Rates

	Friday 7/18/2014	1 Week Ago	1 Year Ago
Euro ($/€)	1.351	1.361	1.311
British Pound ($/£)	1.707	1.712	1.523
British Pound (£/€)	0.792	0.795	0.861
Japanese Yen (¥/$)	101.380	101.300	100.430
Canadian Dollar (C$/$)	1.074	1.073	1.038
Swiss Franc (CHF/$)	0.899	0.892	0.945
Australian Dollar (US$/A$)	0.939	0.939	0.917
Mexican Peso (MXN/$)	12.955	12.995	12.501
Chinese Yuan (CNY/$)	6.208	6.204	6.141
Indian Rupee (INR/$)	60.287	59.938	59.675
Brazilian Real (BRL/$)	2.233	2.221	2.228
U.S. Dollar Index	80.588	80.187	82.823

Foreign Interest Rates

	Friday 7/18/2014	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.17	0.17	0.14
3-Month Sterling LIBOR	0.56	0.55	0.51
3-Month Canada Banker's Acceptance	1.27	1.27	1.28
3-Month Yen LIBOR	0.13	0.13	0.16
2-Year German	0.03	0.02	0.07
2-Year U.K.	0.84	0.84	0.29
2-Year Canadian	1.08	1.11	1.10
2-Year Japanese	0.06	0.07	0.13
10-Year German	1.16	1.20	1.52
10-Year U.K.	2.58	2.60	2.26
10-Year Canadian	2.16	2.21	2.40
10-Year Japanese	0.55	0.54	0.81

Commodity Prices

	Friday 7/18/2014	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	103.15	100.83	108.04
Gold ($/Ounce)	1307.51	1338.62	1284.24
Hot-Rolled Steel ($/S.Ton)	670.00	670.00	635.00
Copper (¢/Pound)	316.20	325.85	314.25
Soybeans ($/Bushel)	11.97	12.55	15.35
Natural Gas ($/MMBTU)	3.96	4.15	3.81
Nickel ($/Metric Ton)	19,129	19,182	13,899
CRB Spot Inds.	531.52	532.08	519.15

Source: Bloomberg LP and Wells Fargo Securities, LLC

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	21	22	23	24	25
U.S. Data		**CPI (MoM)** May 0.4% June 0.3% (W) **Existing Home Sales** May 4.89M June 5.0M (W)		**New Home Sales** May 504K June 484K (W)	**Durable Goods Orders** May -0.9% June 0.3% (W)
Global Data		**Australia** **CPI YoY** Previous (Q1) 2.9%	**China** **HSBC Manufacturing PMI** Previous (June) 50.7 **Canada** **Retail Sales MoM** Previous (April) 1.1%	**Japan** **CPI YoY** Previous (May) 3.7% **Eurozone** **Markit Manufacturing** Previous (June) 51.8	**United Kingdom** **GDP YoY** Previous (Q1) 3.0%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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