August 22, 2014

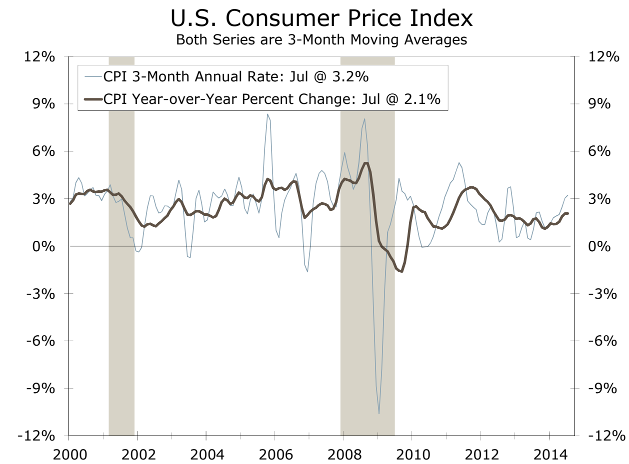
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

What Was That Noise?

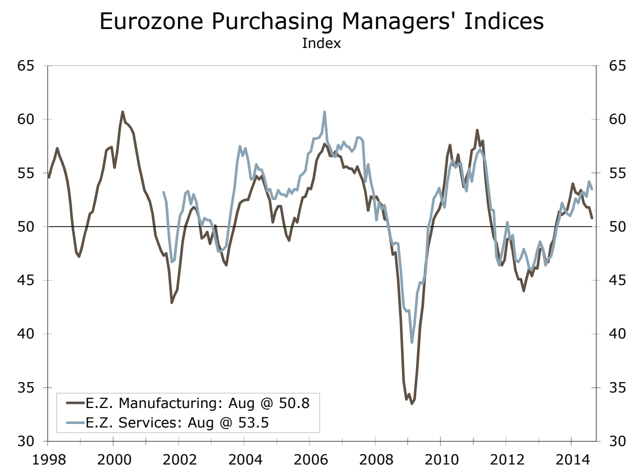
- Since Chair Yellen's comment a few weeks ago that recent price jumps were "noisy," the discussion about Fed policy has been dominated by concern about a perceived complacency on the part of policy makers. A relatively tame CPI report this week may not completely quell that concern, but it removes some urgency from it.
- It was a big week for housing with three indicators released—builder sentiment, residential construction activity and home sales. All three came in better than consensus estimates. Is the long-awaited housing market recovery finally kicking in to gear?



Global Review

Several Speeds Global Growth: Slow, Slower & Neutral.

- The story from the global economy has not changed much during the past several quarters with a very weak performance by the Eurozone and slowing economic growth in the developing world. As the Eurozone is the largest market for Chinese exports, it is no wonder that the Chinese economy has been reflecting this weakness in its economic releases.
- Mexico is, once again, taking advantage of its closeness to the U.S. market for growing its economy.



Wells Fargo U.S. Economic Forecast

	Actual						Forecast		Actual			Forecast	
	2013				2014				2011	2012	2013	2014	2015
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	2.7	1.8	4.5	3.5	-2.1	4.0	1.7	3.0	1.6	2.3	2.2	1.9	2.9
Personal Consumption	3.6	1.8	2.0	3.7	1.2	2.5	2.6	2.5	2.3	1.8	2.4	2.3	2.6
Inflation Indicators [2]													
PCE Deflator	1.4	1.1	1.2	1.0	1.1	1.6	1.7	2.0	2.5	1.8	1.2	1.6	2.1
Consumer Price Index	1.7	1.4	1.5	1.2	1.4	2.1	2.2	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]	3.1	3.9	4.9	4.7	-4.8	3.6	3.8	4.0	4.0	11.4	4.2	1.7	4.3
Trade Weighted Dollar Index [3]	76.2	77.5	75.2	76.4	76.9	75.9	77.3	77.5	70.9	73.5	75.9	76.9	78.7
Unemployment Rate	7.7	7.5	7.2	7.0	6.7	6.2	6.1	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	1.02	1.07	0.61	0.78	0.92	1.00	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	0.63
Conventional Mortgage Rate	3.57	4.07	4.49	4.46	4.34	4.16	4.35	4.35	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: August 6, 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, Bloomberg LP and Wells Fargo Securities, LLC

Inside

U.S. Review

Inflation Pressure Eases for FOMC

In July, Fed Chair Janet Yellen characterized the 0.3 percent June increase in CPI inflation as “noisy”. Given other indications of the potential for rising inflation such as the recent run-up in the prices component of many of the purchasing managers’ surveys and some indication of wage pressures—there was some concern that the Fed was being lax about inflation and that more upside surprises might portend a rate increase sooner than the Fed’s guidance might suggest.

Some of those concerns were allayed earlier this week when the CPI report for July showed a month-over-month increase of just 0.1 percent, leaving the year-over-year rate unchanged at 1.9 percent. One swing factor in recent inflation trends is energy prices. After recording strong gains in May and June, energy prices fell 0.3 percent last month as all energy components recorded modest declines.

Firming in Housing Market

A growing body of evidence is showing that the housing market, which has been largely disappointing in 2014, may have turned a corner this summer. Leading up to this week’s better-than-expected housing data, we observed that improvement could be seen on the horizon in the form of improved builder sentiment.

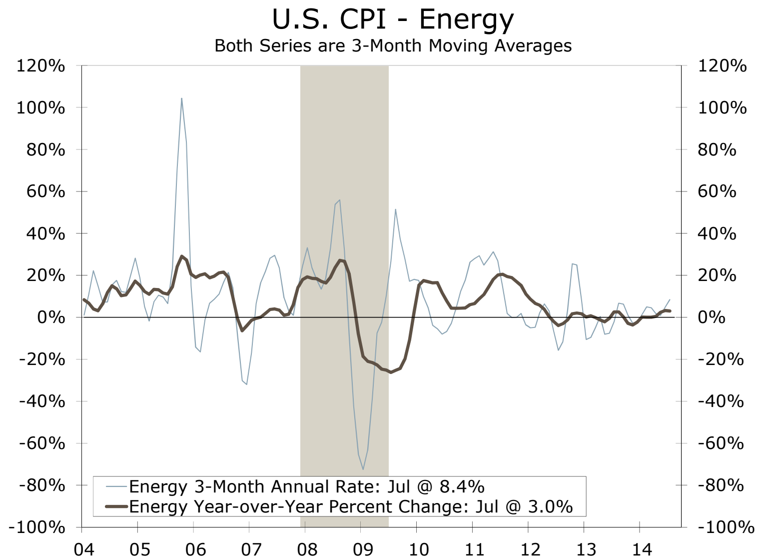
After four months in contraction territory (below 50), the National Association of Homebuilders index crested above 50 in July and climbed higher, to 55, in August. Earlier this week we also learned that July housing starts jumped to an eight-month high in a welcome affirmation of the improvement in homebuilding sentiment.

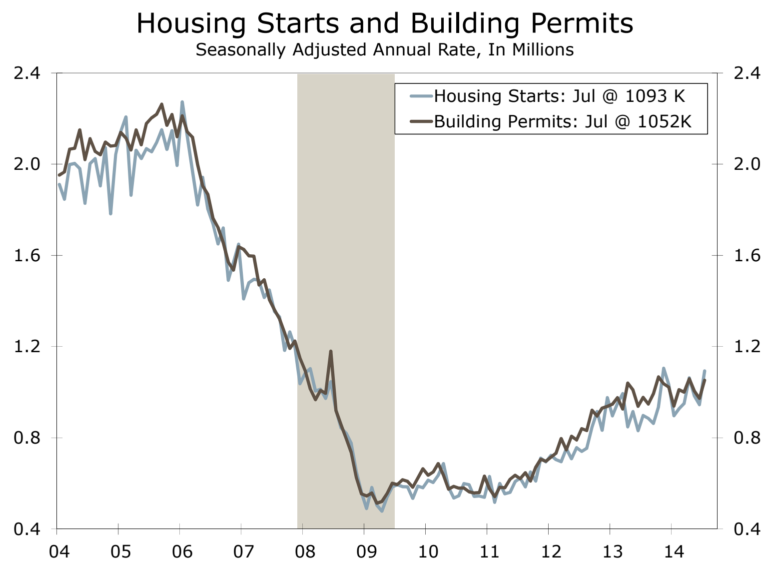
Not only did the 1.09 million annualized pace of housing starts come in faster than expected, the same report showed that builders were pulling building permits at a faster pace, indicating that the pickup is more than temporary.

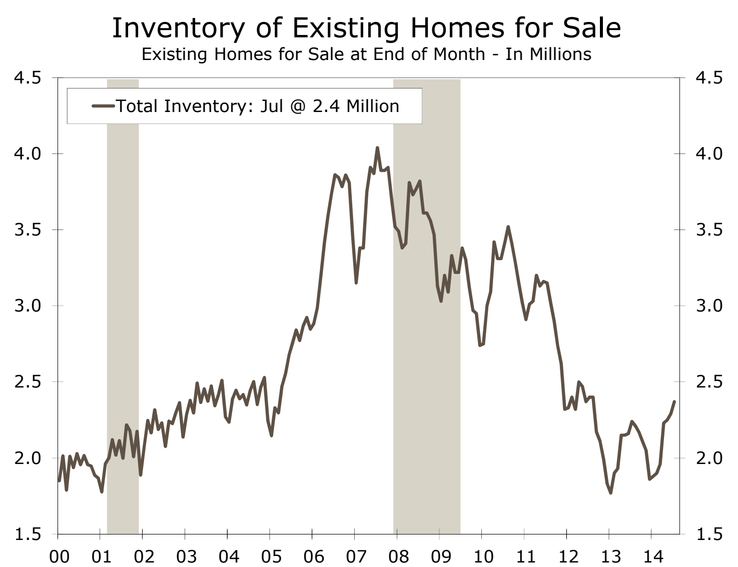
Much of the July increase in starts and permits was attributable to the volatile multi-family component. That said, single-family housing starts reversed two straight monthly declines to rise to the fastest pace reported yet in 2014.

Not only is the homebuilding market looking up, but existing homeowners are finding a more active market for selling their home this summer. In fact the number of properties listed for sale by U.S. homeowners climbed to nearly 2.4 million, the highest number of listing since August 2012. The houses are finally selling again too; the pace of existing home sales rose to a 10-month high of 5.15 million at an annualized rate.

While the housing market has made strides toward improvement, challenges still remain, which tempers our outlook somewhat. Mortgage applications are off 11 percent from a year ago. Pending home sales also slipped 1.1 percent in June, which raises concerns about deals in the pipeline for future home sales. Still, when combined with continued labor market improvement, the firming in the housing market this summer may bring some momentum into the traditionally slower months in the later part of the year.







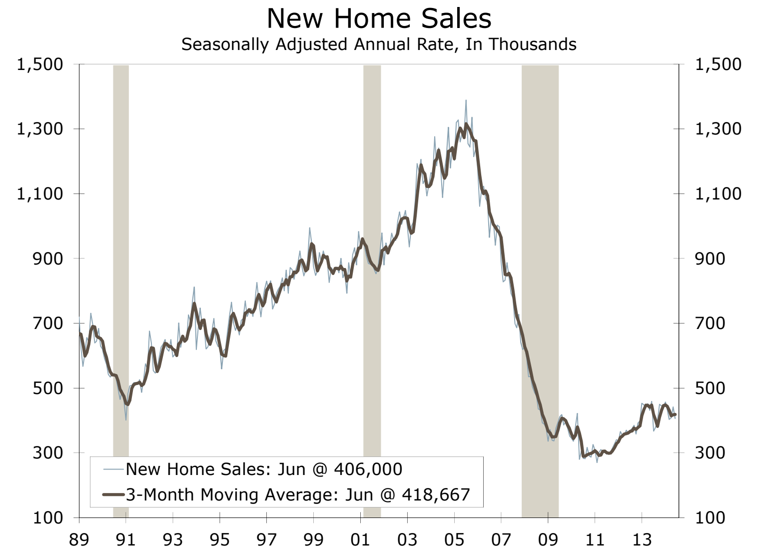
Source: U.S. Department of Commerce, U.S. Dept. of Labor, NAR and Wells Fargo Securities, LLC

New Home Sales • Monday

New home sales have struggled throughout an already sluggish housing recovery. More than all of May's gains were lost in June, when new home sales tumbled 8.1 percent to an annualized 406,000 homes. The decline was evident across all four Census regions, and revisions pushed down sales in prior months. Low household formation and rising prices have contributed to the weak demand and have kept new home sales at very low levels. New home inventory has also been tight, leaving potential buyers with few options and further restraining sales. An acceleration in hiring and rising incomes should lead to more home buying. In July, we anticipate that new home sales increased to a 430,000-unit annualized pace. Although mortgage rates are up from their post-recession lows, they still remain low enough to accommodate more home sales. Indeed, existing home sales are rebounding again, and were up 2.4 percent in July.

Previous: 406,000 **Wells Fargo: 430,000**

Consensus: 428,000

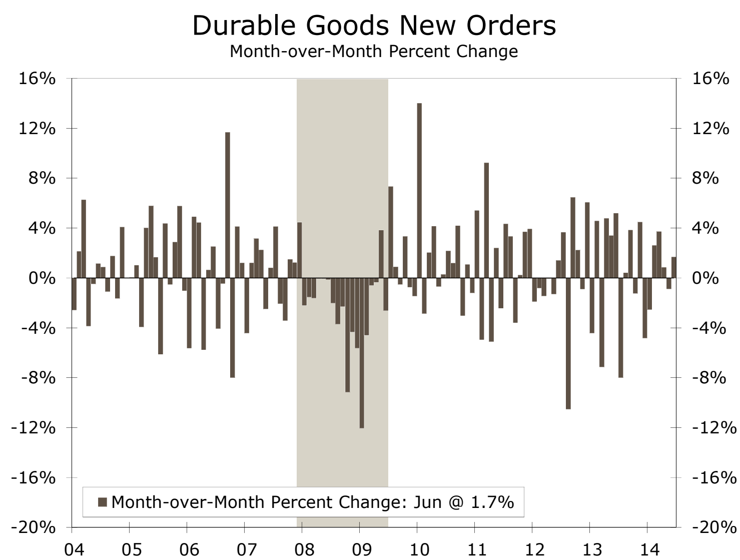


Durable Goods Orders • Tuesday

In June, durable goods orders rose 0.7 percent, regaining most of what had been lost in May. Core capital goods orders, which are important for the business investment in the national accounts, perked up 1.4 percent. Transportation orders only bounced back modestly as orders for vehicles and parts dropped 2.1 percent in the month, counteracting some of the large gains in nondefense aircraft orders. Nondefense aircraft orders are notably volatile, but in July, the sky seems to be the limit. To say that the value of orders for Boeing aircraft surged may be an understatement. There were 270 orders recorded for the 777x and another 26 orders for its 787s. We recognize that large orders like the 150 planes going to one buyer likely come at a sizable discount, but even after such consideration, we expect durable goods orders to jump 20.8 percent in July. After excluding this anomaly and transportation altogether, orders likely grew just 0.6 percent.

Previous: 1.7% **Wells Fargo: 20.8%**

Consensus: 7.6% (month-over-month)

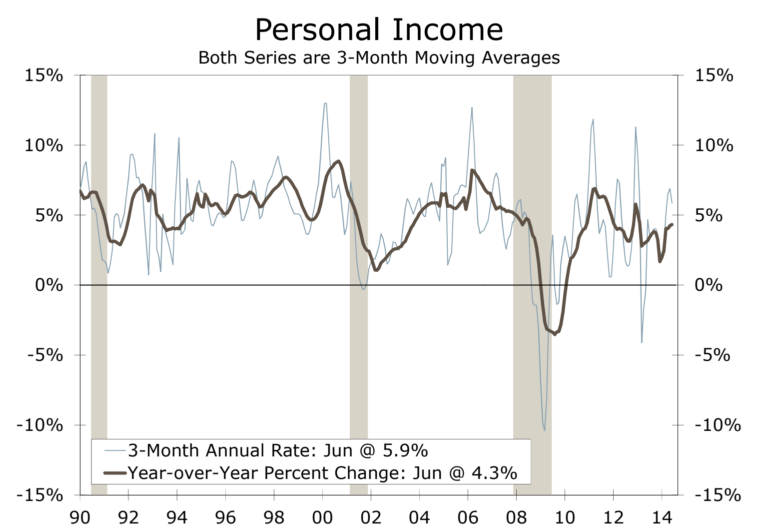


Personal Income • Friday

Personal income advanced 0.4 percent in June for the second straight month, with nominal disposable income matching that growth. However, in real terms, disposable income increased only 0.2 percent in the month, as rising prices eroded the purchasing power of Americans' income. Nevertheless, personal consumption expenditures jumped 0.4 percent in June, while May's numbers were revised higher. Personal spending also accelerated in real terms, rising 0.2 percent in June. Income growth likely maintained its current pace of 0.4 percent in July. Solid employment gains, coupled with continued advances in the financial markets, should contribute to growth in the headline number. Personal spending, however, likely moderated to 0.2 percent in the month. Retail sales increased only modestly in July, while slower consumer price growth should restrain spending in nominal terms.

Previous: 0.4% (month-over-month) **Wells Fargo: 0.4%**

Consensus: 0.3%



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

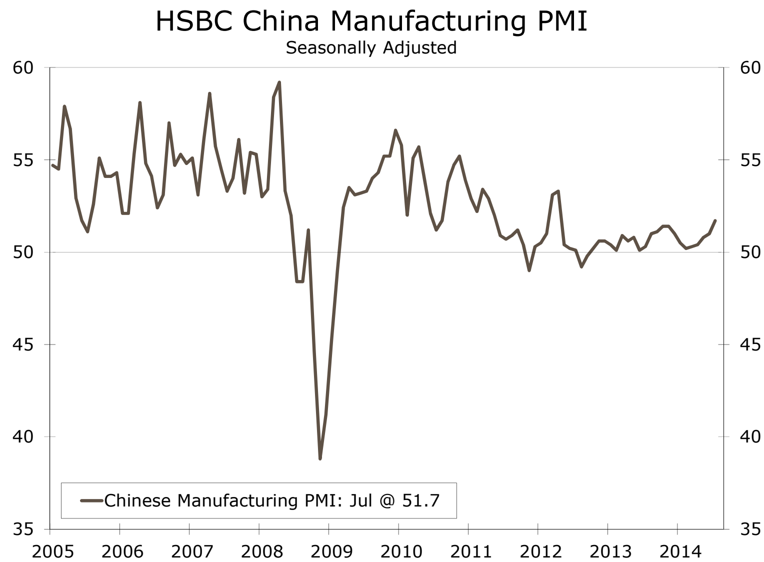
Global Review

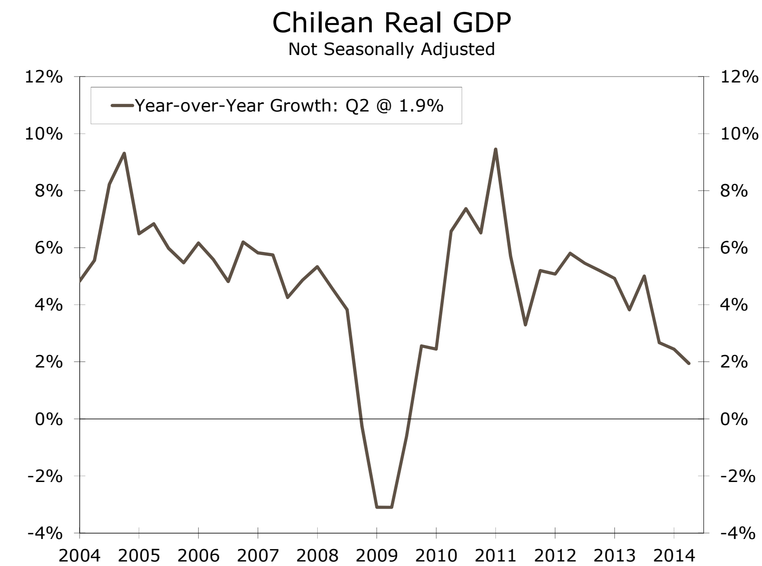
Several Speeds of Global Growth: Slow, Slower & Neutral

The story from the global economy has not changed much during the past several quarters with a very weak performance by the Eurozone and slowing economic growth in the developing world. As the Eurozone is the largest market for Chinese exports, it is no wonder that the Chinese economy has reflected this weakness in its economic releases. This week's release of the HSBC China manufacturing PMI for August showed a manufacturing sector that moved closer to the expansion/contraction demarcation line, at 50.3 from a previous reading of 51.7. Meanwhile, the Eurozone's own PMIs also have weakened in August with the manufacturing PMI going from 51.8 in July to 50.8 in August while the service PMI went down from 54.2 to 53.5. Germany, the growth engine for the Eurozone also saw marginally lower PMI numbers for August. The good news was that Germany's PMIs were higher than the market consensus expectation with the manufacturing reading going from 52.4 in July to 52.0 in August while the service reading downshifted from 56.7 to 56.4. In Latin America, the story wasn't that different with the once darling countries in the region—Brazil, Chile, and Peru—falling into hard times due to the slowing down of global growth. Chile's 1.9 percent year-over-year growth in the second quarter was the slowest performance by that country since the third quarter of 2009 when it was recovering from the global financial crisis. Meanwhile, the expectation for Peru's second-quarter GDP release next week is not very upbeat as last week's monthly economic activity index posted a 0.3 percent year-over-year growth, the slowest showing since November 2009. In Brazil, the monthly economic activity index dropped 2.2 percent in June to close a second quarter that is expected to come in negative once the GDP number for the second quarter is released at the end of this month.

Mexico's Geography Again Saves the Day

Mexico is, once again, taking advantage of its closeness to the U.S. market for growing its economy. While Mexico has recently managed its economy better than other countries in Latin America, especially Brazil, the fact remains that if the U.S. economy does well, the Mexican economy does well. And this has not materially changed. The Mexican economy grew 1.0 percent in the second quarter compared to the first, after an upwardly revised 0.4 percent print in the first quarter. On a year-earlier basis, the Mexican economy grew 1.6 percent versus an upwardly revised 1.9 percent in the previous quarter. Although the second quarter came in lower than the first, we need to remind our readers that Easter week fell in the second quarter in 2014 versus the first quarter in 2013. Thus, 1.6 percent growth in the second quarter is probably a better reading than the 1.9 percent growth rate of the first quarter. Still, the industrial sector is not out the woods with construction activity down 0.6 percent after dropping 2.6 percent rate in the first quarter, year over year, while manufacturing output grew only 2.4 percent versus a 4.4 percent growth rate in the first quarter. In this domestic environment, any slowdown in U.S. automobile demand will hurt the Mexican economy.





Source: IHS Global Insight and Wells Fargo Securities, LLC

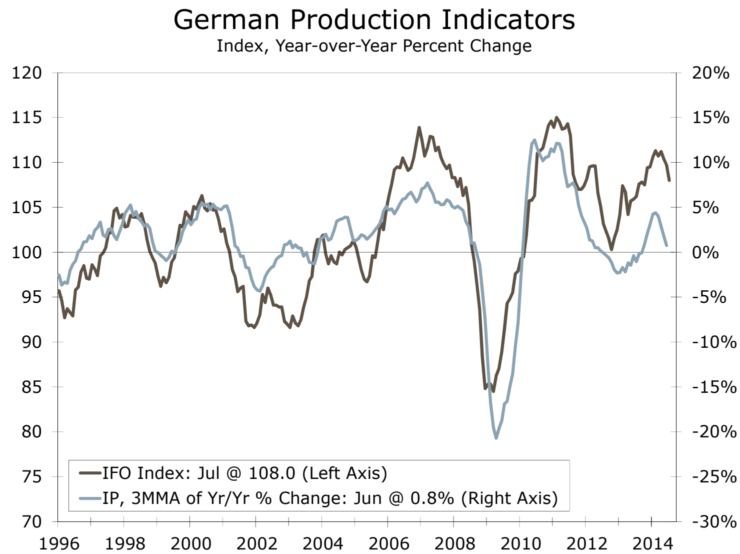
German Ifo Index • Monday

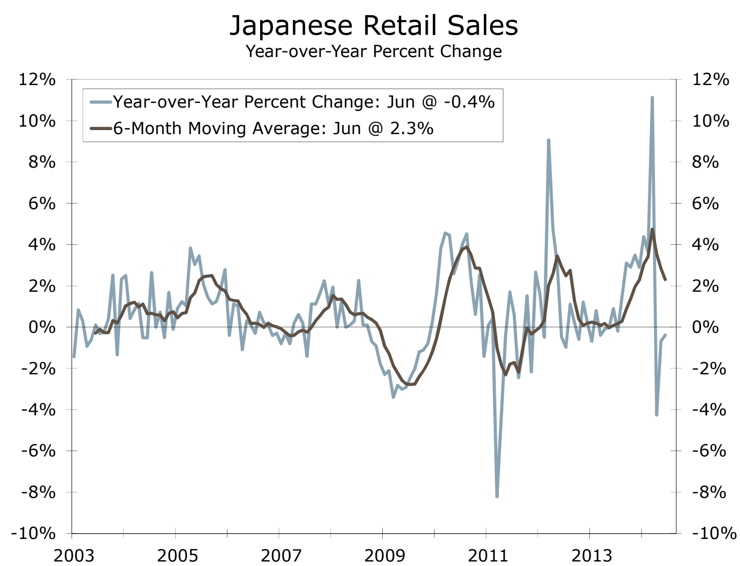
Analysts closely follow the Ifo index of German business sentiment because it is highly correlated with growth in German industrial production (IP). The decline in the Ifo index over the past three months suggests that growth in IP, which weakened sharply in the second quarter, could downshift even more in coming months. Moreover, a monthly survey of sentiment among institutional investors nosedived in early August. Maybe these investors were over-reacting to events in the simmering Russian-Ukrainian crisis or maybe their pessimism regarding the outlook for the German economy is warranted. In any event, the Ifo index will offer analysts important insights into the state of the German economy in August.

Analysts also anticipate the release of August CPI data for the Eurozone on Friday. Another weak reading—CPI inflation in July was only 0.4 percent— raises the probability that the ECB would eventually ease monetary policy further.

Previous: 108.0

Consensus: 107.0





Japanese Retail Sales • Thursday

Data released last week showed that Japanese GDP tumbled 6.8 percent at an annualized rate in Q2 relative to Q1. Analysts widely expected this nosedive, however, because it largely reflected the effects of the consumption tax hike that took effect on April 1. Consumer spending has subsequently recovered somewhat—the level of nominal retail spending in June was 5.1 percent above its April nadir—and analysts are waiting to see if this upward trend remained in place in July.

The retail sales data will be one important indicator in the usual end-of-the-month data barrage in Japan. Other indicators for July that are on the docket next week include industrial production, the labor market report, housing starts and CPI inflation. Most analysts, ourselves included, expect that the Japanese recovery resumed in Q3, and these indicators will help to validate (or not) that expectation.

Previous: 0.5% (month-over-month)

Consensus: 0.3%

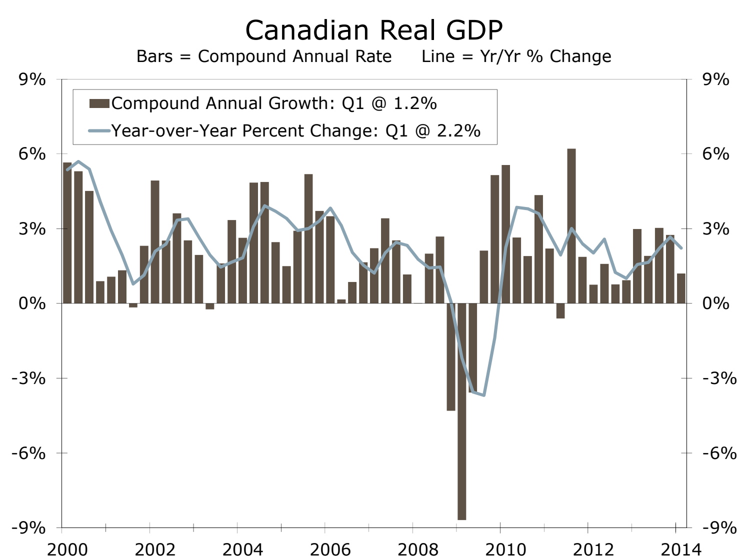
Canadian Real GDP • Friday

Canadian real GDP rose only 1.2 percent at an annualized rate in Q1 2014 relative to the previous quarter, but monthly data suggest that growth strengthened in Q2. Even if economic activity is flat in June relative to May (Canada is unique in that it releases GDP data on a monthly basis), real GDP would have risen 2.4 percent sequentially in Q2. Not only did growth in consumer spending strengthen—real retail sales surged at an annualized rate of 7.0 in Q2—but exports also have accelerated recently. Stabilization in housing starts in recent months suggests that residential investment may have exerted less drag on real GDP growth in Q2. (Real residential investment declined at an annualized rate of 6.3 percent in Q1.)

As noted above, exports have accelerated recently, but imports edged lower in May. Therefore, the current account deficit may have narrowed somewhat in Q2. Data will print on Thursday.

Previous: 1.2% (annualized) Wells Fargo: 2.9%

Consensus: 2.7%



Source: IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

Slowly I Turned, Step By Step

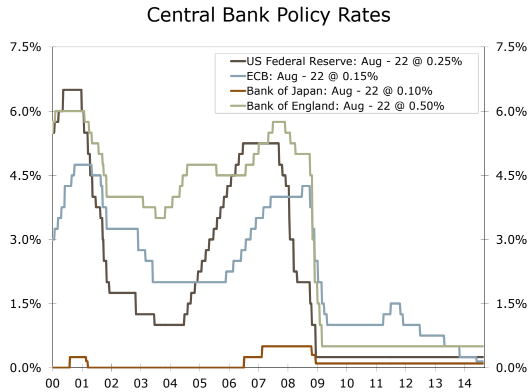
September 17th is shaping up as a key date for policy. At that time, the FOMC is scheduled to release its updated economic projections. It is those projections that may signal a reassessment in the market for the starting point for the Fed to begin raising short-term interest rates.

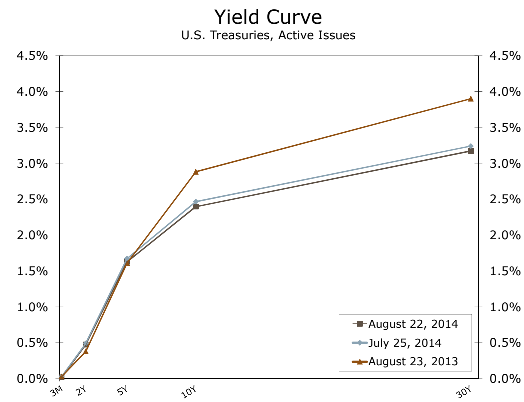
In the July 29-30 FOMC minutes, there was a signal that underlying economic conditions may have been better than previously expected and that "it might become appropriate to begin removing monetary policy accommodation sooner than currently anticipated." Our expectation remains for a rate hike in June 2015, and we will look at any changes in the FOMC economic outlook meeting in September to signal whether we need to alter our expectations. Indeed, the recent FOMC minutes revealed that "some participants" viewed progress as sufficient to call for a "relatively prompt move toward reducing policy accommodation."

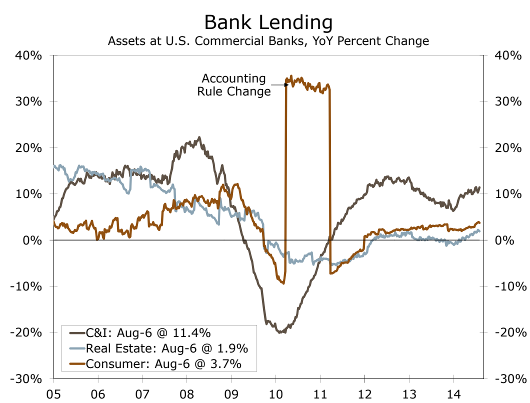
Implementation

September's meeting may also provide some guidance on the tools the FOMC will employ. The interest on excess reserves will likely set the ceiling for the target range for the federal funds rate—but only if there is such a large supply of excess reserves such that few banks actually buy any fed funds in the marketplace. Meanwhile, the overnight repo rate will likely set the floor. One issue that persists is that the liquidity in the federal funds market is much less than in the past, and, therefore, the link between short-term money market rates and the fed funds rate is diminished.

Finally, there is little sentiment to reduce the Fed's balance sheet quickly. This, along with our expectations for a very cautious move in the fed funds rate, indicates that Fed policy will remain accommodative for a while, although some members of the FOMC would move quickly. There is significant caution at the Fed not to prompt a rise in rates that could hit housing and consumer finance and weaken economic growth. Our outlook is for trend-like growth of 2.5 percent-3.0 percent for the first half of 2015 with funds at 1.0 percent at year-end 2015.







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

Credit Market Insights

Mortgages Weigh on Consumer Debt

In the recent release of the Federal Reserve Bank of New York's report on household debt and credit we learned that aggregate consumer debt fell slightly in the second quarter. The 0.2 percent decline in overall debt comes as mortgage debt fell 0.8 percent and balances on home equity lines of credit (HELOC) loans fell 1.0 percent, which more than offset gains in all other non-housing categories. This corresponds with the fall in mortgage originations, which reached the lowest level since 2000. While household debt is falling, so are foreclosures, with the new foreclosures metric reaching the lowest level ever reported. While falling mortgage debt may reflect a U.S. consumer with a healthier balance sheet, it also represents some of the difficulty the housing recovery has seen in the first half of 2014.

Student loans, credit cards and auto loans saw growth in the second quarter. Firm auto sales in the first half of the year have driven auto loan debt higher, with originations reaching the highest level since Q3 2006. Credit card balances rose, as did the aggregate credit card limit. This story is consistent with the recent uptick we have seen in revolving credit from the Fed's monthly consumer credit report. The recent gains in revolving credit and credit card debt, likely reflects a consumer that is becoming more comfortable and confident as a result of improving labor market conditions, and we expect this trend to continue.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.10%	4.12%	4.12%	4.58%
15-Yr Fixed	3.23%	3.24%	3.23%	3.60%
5/1 ARM	2.95%	2.97%	3.01%	3.21%
1-Yr ARM	2.38%	2.36%	2.38%	2.67%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$1,740.4	23.49%	6.14%	11.42%
Revolving Home Equity	$462.2	-12.31%	-4.83%	-4.88%
Residential Mortgages	$1,574.1	-33.69%	0.28%	-0.74%
Commerical Real Estate	$1,563.2	3.11%	6.72%	7.01%
Consumer	$1,182.2	-3.84%	6.13%	3.74%

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

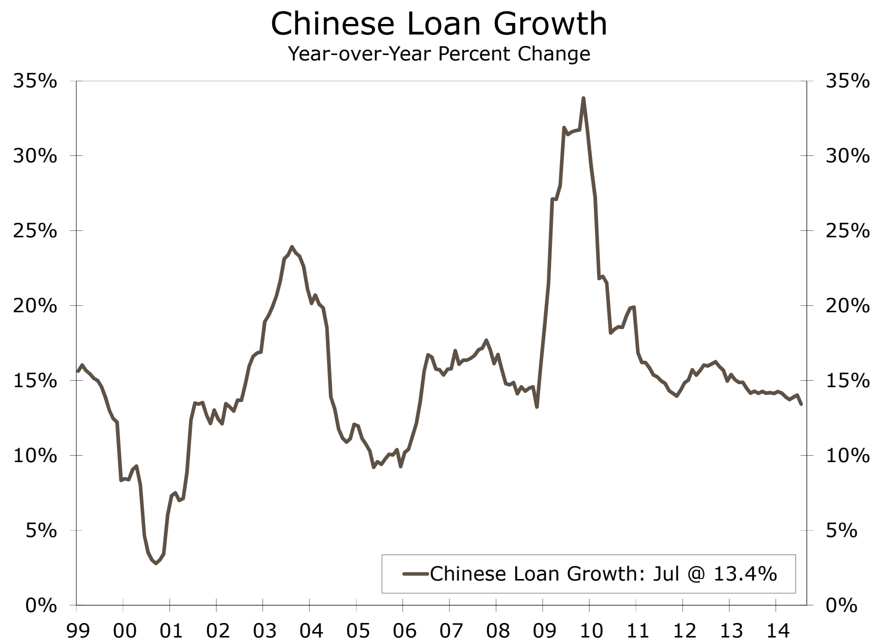
Topic of the Week

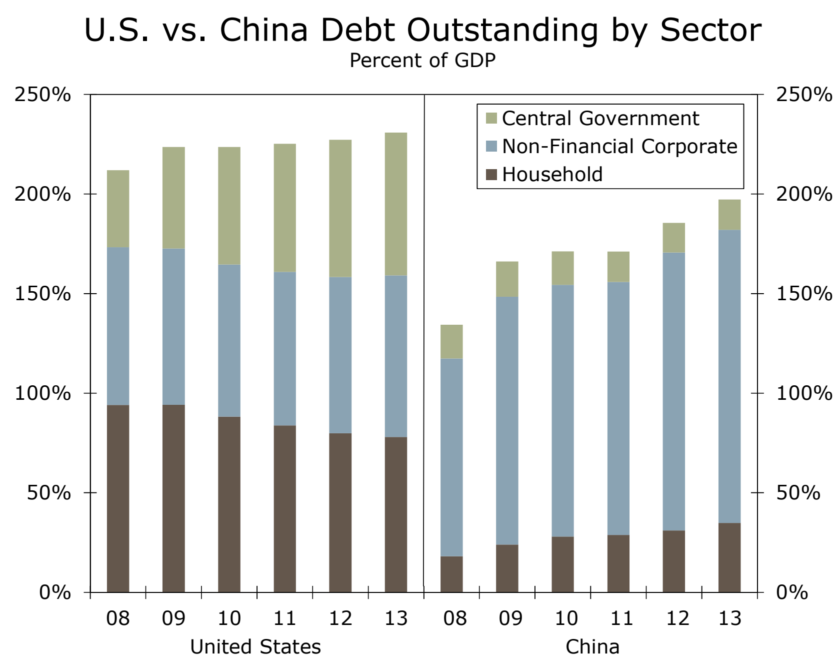
Are Debt Problems in China Bubbling to the Surface?

The Bank of China, one of China's four large state-controlled banks, reported this week that its net profit in the first half of the year rose 11 percent relative to the same period in 2013. The bank also reported that non-performing loans (NPL) edged up to 1.02 percent of total loans in June from 0.96 percent at the end of last year. Although the NPL ratio is very low, its modest increase over the past six months may again raise concerns about the debt situation in China. Does China have a debt problem?

The genesis of today's concerns about Chinese debt stems from the sharp increase in lending that occurred in the immediate aftermath of the global financial crisis when the Chinese government essentially directed banks to open the taps. At the height of the lending surge in late 2009, bank loans were growing in excess of 30 percent on a year-over-year basis (top chart). Proliferation of non-traditional lending instruments in recent years has also helped to stoke debt growth. With the rate of economic growth in China slowing, clearly not all the loans that were made over the past few years will be serviceable.

The bottom chart compares debt-by-sector between the United States and China. If there is a debt problem in China today it resides in the non-financial corporate sector where the debt-to-GDP ratio shot up from 100 percent in 2008 to nearly 150 percent last year. (The comparable ratio in the United States last year was 80 percent.) Although the profit margins of Chinese enterprises generally remain resilient at present, further slowing in the rate of Chinese economic growth could eventually lead to debt servicing problems among more businesses. There is one saving grace, however. The low debt ratio of the central government in Beijing gives it the financial ability to respond to debt problems in the private sector. For further reading see our September 23, 2013, report, *"Does China Have a Debt Problem?"* which is available upon request.





Source: CEIC, Federal Reserve Board, IHS Global Insight and Wells Fargo Securities, LLC

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/22/2014	1 Week Ago	1 Year Ago
3-Month T-Bill	0.02	0.03	0.02
3-Month LIBOR	0.23	0.23	0.26
1-Year Treasury	0.20	0.16	0.14
2-Year Treasury	0.47	0.41	0.39
5-Year Treasury	1.63	1.54	1.68
10-Year Treasury	2.39	2.34	2.88
30-Year Treasury	3.17	3.13	3.87
Bond Buyer Index	4.21	4.24	4.91

Foreign Exchange Rates

	Friday 8/22/2014	1 Week Ago	1 Year Ago
Euro ($/€)	1.327	1.340	1.336
British Pound ($/£)	1.658	1.669	1.559
British Pound (£/€)	0.800	0.803	0.857
Japanese Yen (¥/$)	103.750	102.360	98.720
Canadian Dollar (C$/$)	1.095	1.090	1.052
Swiss Franc (CHF/$)	0.912	0.903	0.923
Australian Dollar (US$/A$	0.931	0.932	0.901
Mexican Peso (MXN/$)	13.119	13.074	13.091
Chinese Yuan (CNY/$)	6.153	6.147	6.121
Indian Rupee (INR/$)	60.473	60.770	64.630
Brazilian Real (BRL/$)	2.276	2.260	2.435
U.S. Dollar Index	82.221	81.424	81.488

Foreign Interest Rates

	Friday 8/22/2014	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.15	0.16	0.15
3-Month Sterling LIBOR	0.56	0.56	0.51
3-Month Canada Banker's Acceptance	1.27	1.27	1.28
3-Month Yen LIBOR	0.13	0.13	0.15
2-Year German	0.00	-0.01	0.26
2-Year U.K.	0.71	0.65	0.41
2-Year Canadian	1.09	1.05	1.21
2-Year Japanese	0.08	0.07	0.11
10-Year German	0.98	0.95	1.92
10-Year U.K.	2.38	2.33	2.71
10-Year Canadian	2.07	2.02	2.74
10-Year Japanese	0.51	0.50	0.75

Commodity Prices

	Friday 8/22/2014	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	93.60	97.35	105.03
Gold ($/Ounce)	1279.62	1304.83	1376.17
Hot-Rolled Steel ($/S.Ton)	675.00	675.00	648.00
Copper (¢/Pound)	319.80	310.30	333.00
Soybeans ($/Bushel)	11.18	11.26	13.79
Natural Gas ($/MMBTU)	3.87	3.78	3.55
Nickel ($/Metric Ton)	18,746	18,595	14,350
CRB Spot Inds.	530.33	527.42	526.42

Source: Bloomberg LP and Wells Fargo Securities, LLC

Next Week's Economic Calendar

	Monday 25	Tuesday 26	Wednesday 27	Thursday 28	Friday 29
U.S. Data	**New Home Sales** June 406K July 430K (W)	**Durable Goods Orders** June 1.7% July 20.8% (W) **Consumer Confidence Index** July 90.9 August 87.3 (W)		**GDP (Second Revision)** Q2 4.0% Q2(2nd Revision) 4.0% (W) **Pending Home Sales (MoM)** June -1.1% July 0.5% (C)	**Personal Income** June 0.4% July 0.4% (W) **Personal Spending** June 0.4% July 0.2% (W)
Global Data	**Germany** **Ifo Business Climate** Previous (July) 108.0 **Mexico** **Retail Sales** Previous (May) 1.6%			**Japan** **Retail Sales** Previous (June) 0.5%	**Canada** **GDP (YoY)** Previous (June) 2.3% **Brazil** **GDP (YoY)** Previous (Q1) 1.9%

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
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah Watt House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Michael T. Wolf	Economist	(704) 410-3286	michael.t.wolf@wellsfargo.com
Zachary Griffiths	Economic Analyst	(704) 410-3284	zachary.griffiths@wellsfargo.com
Mackenzie Miller	Economic Analyst	(704) 410-3358	mackenzie.miller@wellsfargo.com
Erik Nelson	Economic Analyst	(704) 410-3267	erik.f.nelson@wellsfargo.com
Alex Moehring	Economic Analyst	(704) 410-3247	alex.v.moehring@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Cyndi Burris	Senior Admin. Assistant	(704) 410-3272	cyndi.burris@wellsfargo.com

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