January 09, 2014

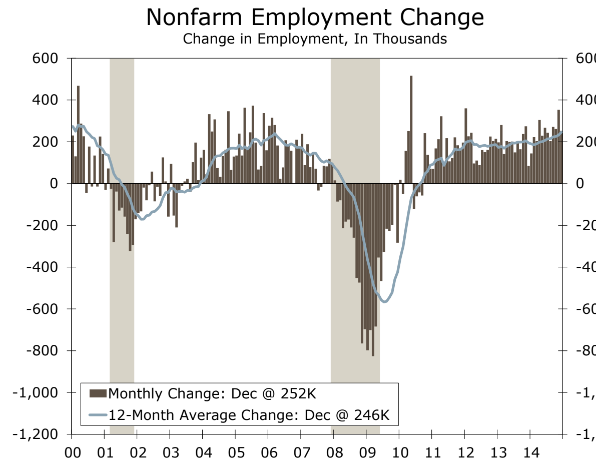
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Finishing the Year Strong

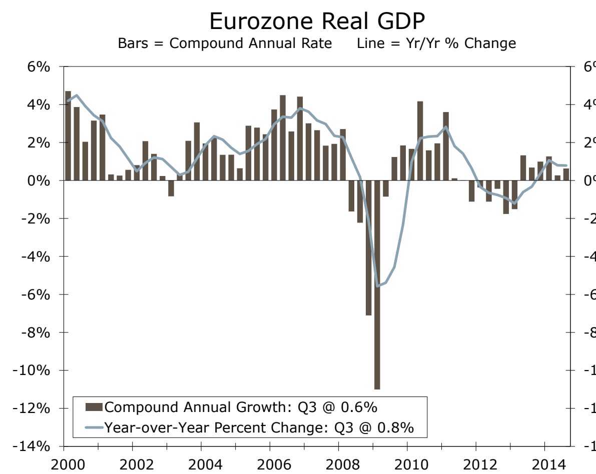
- Annual payroll gains in 2014 were the strongest since 1999. Growth was broad-based across industries, but the labor force and average hourly earnings declined in December.
- Data from the factory sector continue to send mixed signals, with factory orders dropping for the fourth straight month in November, while the ISM manufacturing index remains firmly in expansion territory.
- The trade balance narrowed significantly, thanks to a drop in imports, mostly related to lower oil prices. Exports also dropped, taking some of the optimism out of the report.



Global Review

Eurozone: New Year, Old Issues

- The Greek issue is returning to the forefront in a political process that is threatening to reignite fears of a Eurozone breakup.
- The question today is the same question the world had four years ago when this all started: how long can a country or region wait for economic growth and/or economic improvement to occur after such a severe contraction in economic activity and still maintain social stability?



Wells Fargo U.S. Economic Forecast

	Actual 2014				Forecast 2015				Actual		Forecast		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2012	2013	2014	2015	2016
Real Gross Domestic Product [1]	-2.1	4.6	5.0	2.8	2.5	2.6	2.8	2.9	2.3	2.2	2.4	3.1	3.0
Personal Consumption	1.2	2.5	3.2	4.5	2.5	2.6	2.5	2.5	1.8	2.4	2.5	3.0	2.5
Inflation Indicators [2]													
PCE Deflator	1.1	1.6	1.5	1.1	0.8	0.7	0.9	1.4	1.8	1.2	1.3	1.0	2.0
Consumer Price Index	1.4	2.1	1.8	1.2	0.7	0.5	0.8	1.7	2.1	1.5	1.6	0.9	2.4
Industrial Production [1]	3.9	5.7	4.0	6.6	6.1	4.9	3.5	3.1	3.8	2.9	4.3	5.2	3.6
Corporate Profits Before Taxes [2]	-4.8	0.1	1.4	3.2	3.7	3.6	4.1	4.6	11.4	4.2	0.1	4.0	5.2
Trade Weighted Dollar Index [3]	76.9	75.9	81.3	85.0	83.8	84.8	85.8	86.8	73.5	75.9	78.4	85.3	88.3
Unemployment Rate	6.7	6.2	6.1	5.8	5.7	5.6	5.5	5.4	8.1	7.4	6.2	5.6	5.2
Housing Starts [4]	0.93	0.99	1.03	1.03	1.06	1.13	1.21	1.24	0.78	0.92	1.01	1.16	1.26
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	0.25	0.25	0.25	0.63	2.00
Conventional Mortgage Rate	4.34	4.16	4.16	4.00	4.16	4.20	4.30	4.40	3.66	3.98	4.20	4.27	4.95
10 Year Note	2.73	2.53	2.52	2.17	2.40	2.51	2.59	2.66	1.80	2.35	2.54	2.54	3.20

Forecast as of: January 2, 2015
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units
[5] Annual Numbers Represent Averages

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

Inside

U.S. Review

Labor Market Up, Oil and Prices Down

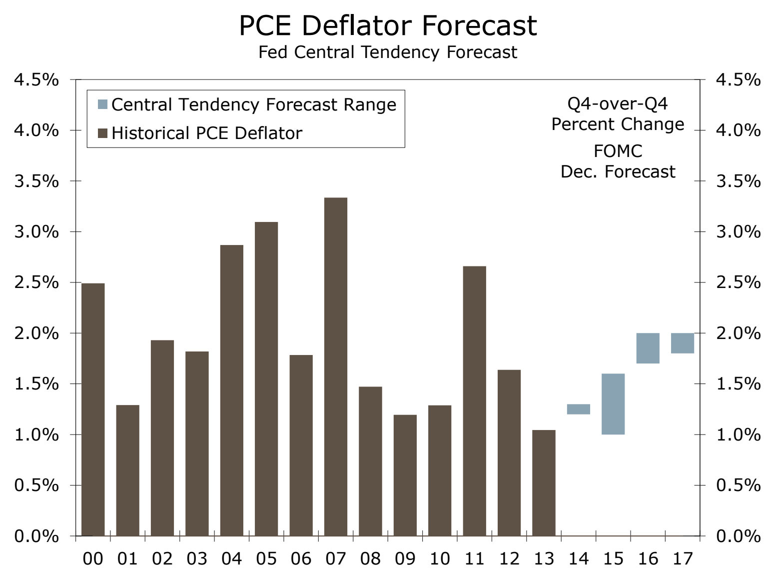
With 2,952,000 jobs added in 2014, last year posted the largest annual job gains since 1999. The labor market continued to strengthen in December, adding 252,000 jobs and showing upward revisions for the prior two already-strong months. Meanwhile, every major industry posted a net monthly gain for the last month of the year, and the unemployment rate dropped two-tenths of a percent to 5.6 percent. In addition, the number of part-time workers who would like to be full time, a key metric watched closely by the Fed, continued its descent.

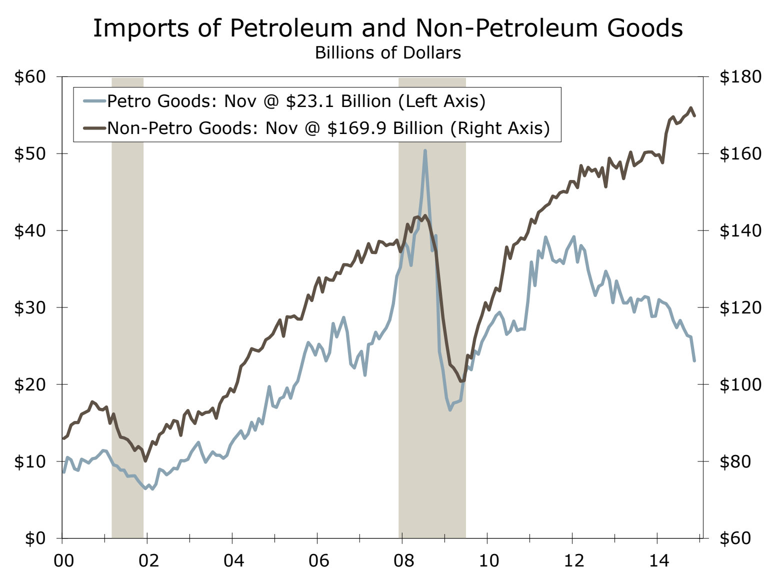
Although the labor market has clearly shown improvement and looks strong, not all of the underlying details in the December report were great. Some of the decline in the unemployment rate can be attributed to a drop in the labor force, which pushed the participation rate to its cycle low. In addition, average hourly earnings declined in December and were revised lower for November, though some of this weakness can be blamed on a sharp contraction of earnings in the mining sector.

With the U.S. economy barreling toward full employment, we maintain that the Fed is poised for liftoff in rates in the middle of this year and will likely announce its first rate hike during the June meeting. An earlier rate hike seems even more unlikely after the release of the minutes to the December meeting, which revealed that using the word "patient" indicates that the Fed would hold off raising rates "for at least a couple of months."

The largest risk to our call for the rate hike in June remains inflation, or lack thereof. With oil prices plummeting, it comes as no surprise that headline inflation has fallen considerably and could seep into core inflation as well. A stronger U.S. dollar is also keeping prices in check, and December's decline in average hourly earnings is not helping. The Fed's newest inflation projections have been revised lower for 2015 and were notched down slightly thereafter, although longer-run inflation was left unchanged. In her press conference, Chair Yellen indicated that the Fed could raise rates even if inflation remains below its 2 percent target, as long as inflation appears to be moving toward that objective. In the minutes, however, "a number" of participants voiced concern that the persistence of such low inflation could erode perception of the Fed's commitment to its 2 percent target. Such concerns could put the Fed on hold for longer than we expect if inflationary pressures do not materialize.

Oil prices have also had an outsized effect on other parts of the economy. The U.S. trade deficit narrowed to just $39.0 billion in November. Imports plunged, thanks to the lower cost of oil, but exports fell in the month as well. A stronger U.S. economy and dollar should reverse the narrowing in subsequent months. Nevertheless, the smaller deficit was unexpected and should act as a neutral contributor to GDP in Q4, as opposed to the drag we had originally expected. Falling capex spending from oil-related business has contributed to weak factory orders, which declined for the fourth straight month in November. Despite these declines, the ISM manufacturing index remains firmly in expansion territory.





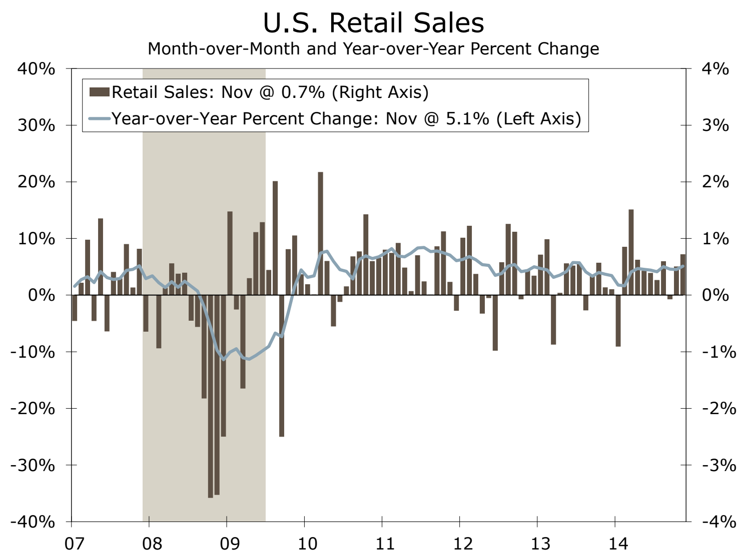
Source: U.S. Department of Labor, Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities, LLC

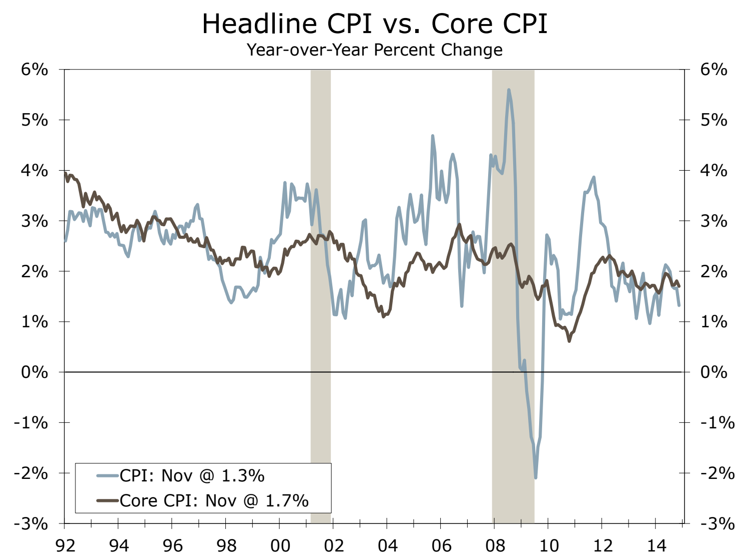
Retail Sales • Wednesday

Retail sales jumped 0.7 percent in November after rising at a 0.5 percent pace in October. Automobile sales helped to lift the headline reading for November, rising 1.7 percent. Sales growth was widespread across categories, with only miscellaneous stores and gasoline station sales posting declines for the month. The pullback in gasoline station sales likely reflects the ongoing slide in retail gas prices in the nominally reported number. So far, lower gas prices have helped to support robust consumer spending in the fourth quarter, a trend we expect continued in December. We expect that headline retail sales fell 0.1 percent in December, as consumer prices weigh on the nominal number. Even with the softer reading, fourth-quarter real consumer spending should remain robust. We expect that real spending rose 4.5 percent last quarter which, if it materializes, would be the strongest rate of real PCE growth since the first quarter of 2006.

Previous: 0.7% **Wells Fargo: -0.1%**

Consensus: -0.1% (Month-over-Month)





Consumer Price Index • Friday

CPI inflation continued to soften in November as lower energy prices pulled the headline reading down 0.3 percent for the month. Excluding the volatile food and energy categories, the measure rose a slight 0.1 percent. Headline inflation is up just 1.3 percent over last year's levels, while core prices are up 1.7 percent. While goods prices remain soft, services prices continue to put upward pressure on core prices. Looking ahead to December, we expect that the overall CPI fell another 0.4 percent, with core prices rising 0.1 percent for the month. The dominant story in the coming months will continue to be the slide in oil prices. We expect headline CPI inflation to remain tame, sliding from 0.7 percent in the first quarter to 0.5 percent for Q2. However, we expect core prices to continue their gradual upward climb, rising around 1.7 percent in the first quarter.

Previous: -0.3% **Wells Fargo: -0.4%**

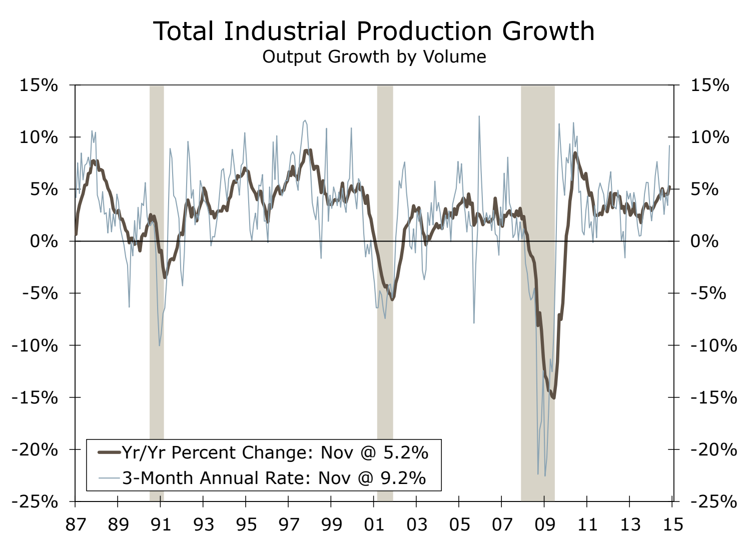
Consensus: -0.4% (Month-over-Month)

Industrial Production • Friday

Industrial production surged 1.3 percent in November, while October's previously reported declined was revised to a slight positive reading. Gains were broad-based across industry sectors. Manufacturing sector output posted a 1.1 percent increase for the month, with automobile production rising 5.1 percent. Utilities output also jumped 5.1 percent for the month as cold weather began to set in across parts of the country. The slide in oil prices did not appear to affect output in November, as crude production remained flat. We expect that December industrial production declined a slight 0.1 percent for the month. Going forward, we continue to expect industrial production to remain robust, rising in excess of 6 percent in the first quarter before moderating later in the year, reflecting the lagged effects of oil price declines on actual production activity.

Previous: 1.3% **Wells Fargo: -0.1%**

Consensus: 0.0% (Month-over-Month)



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

Global Review

Eurozone: New Year, Old Issues

As is the case in almost all aspects of life, if problems are not solved when they become apparent, they come back to haunt you in the future. This is what seems to be happening today in the Eurozone, with Greece returning to the forefront in a political process that is threatening to reignite fears of a Eurozone breakup.

The question today is the same question the world had four years ago when this all started: how long can a country or region wait for economic growth and/or economic improvement to occur after such a severe contraction in economic activity and still maintain social stability? Although the Greeks were very vocal and many times violent over the past several years due to the austerity asked of them, they seem to have taken it in stride. However, time is running out, and the new political landscape is again threatening the continuation of Greece in the union.

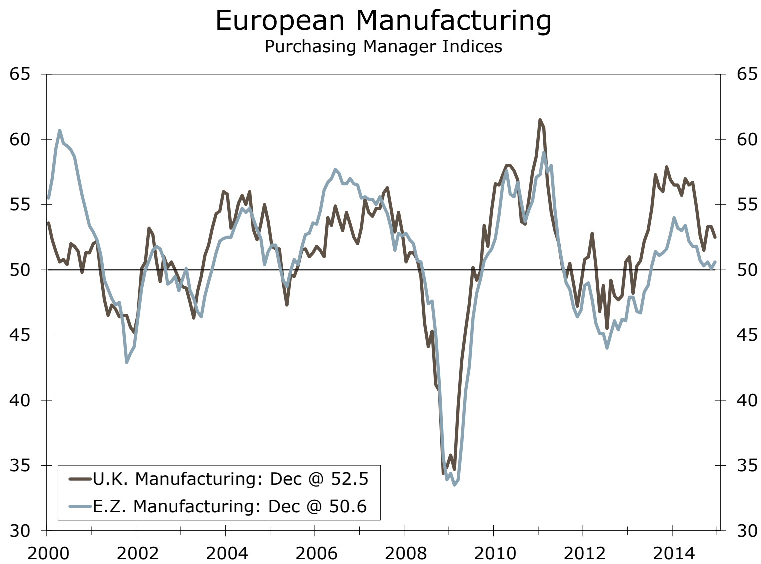
Having said this, the problem is not only Greece; it is the Eurozone in general. As it is the case for any state in any union, states benefit from growth in the rest of that union. However, the Eurozone is not showing much in terms of economic growth and this is putting further pressure on the Greek economy, which is one of, if not the weakest, members of that union.

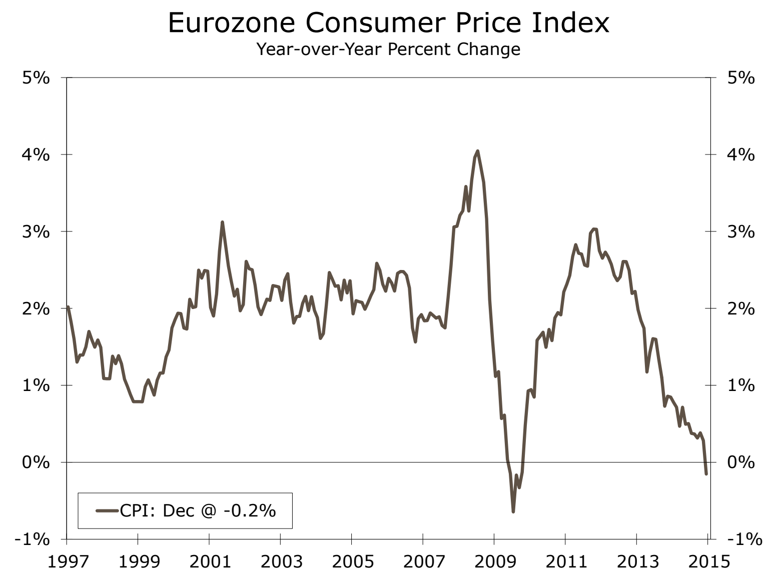
However, news has not been all bad for the Eurozone. Although economic growth is very weak, recent events will probably help the region. The collapse in the price of petroleum and in other commodities prices will help consumers and will add some important impetus to economic growth this year, especially if the drop in petroleum prices stabilizes at current levels. Furthermore, the depreciation in the euro should help the region increase its exports and, in turn, generate stronger economic growth.

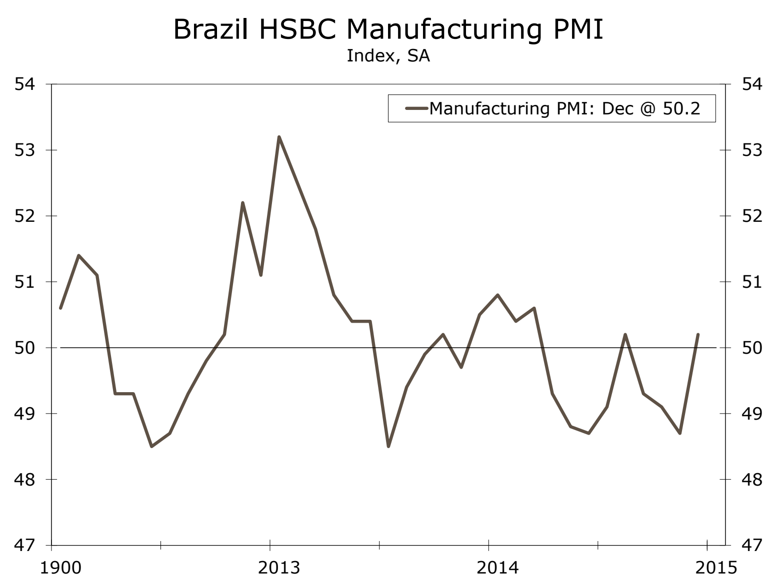
One of the biggest issues for the Eurozone today is the threat of deflation. However, for now the recent negative reading in CPI inflation has been a consequence of the drop in petroleum prices while the core inflation number came in at 0.8 percent year over year, a bit higher than the expected 0.7 percent reading. However, this does not make it much better for policymakers as the ECB will probably have to take a stance very soon on whether to move into an enhanced quantitative easing program to try to help the region in its pursuit of economic growth.

Brazil: No Relief in Sight

Brazil posted another very disappointing industrial production number for November. Industrial production dropped a more-than-expected 5.8 percent in November versus a year earlier. Industrial production dropped 0.7 percent from October versus an expectation of an improvement of 0.5 percent. The only positive from November's industrial production report was that October's month-over-month and year-over-year numbers were revised higher, from 0.0 percent to 0.1 percent and from -3.6 percent to -3.3 percent, respectively. Another positive note was the improvement in the HSBC manufacturing PMI, which rose from 48.7 in November to 50.2 in December, barely above the expansion/contraction demarcation line.







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

United Kingdom CPI • Tuesday

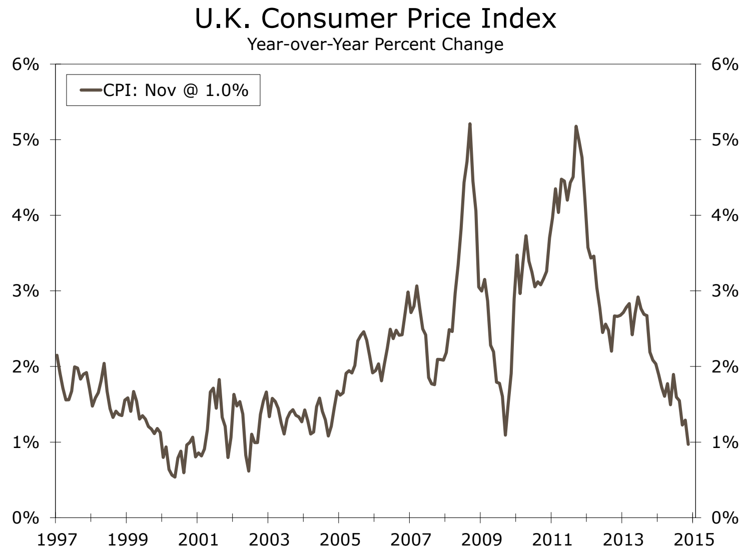
Like everywhere else in the world, lower oil prices are having an impact on inflation in the United Kingdom. The year-over-year rate of CPI inflation in November came in at just 1.0 percent in November, and the consensus expectation is that when the December figure hits the wire on Tuesday, the rate will fall well below 1.0 percent.

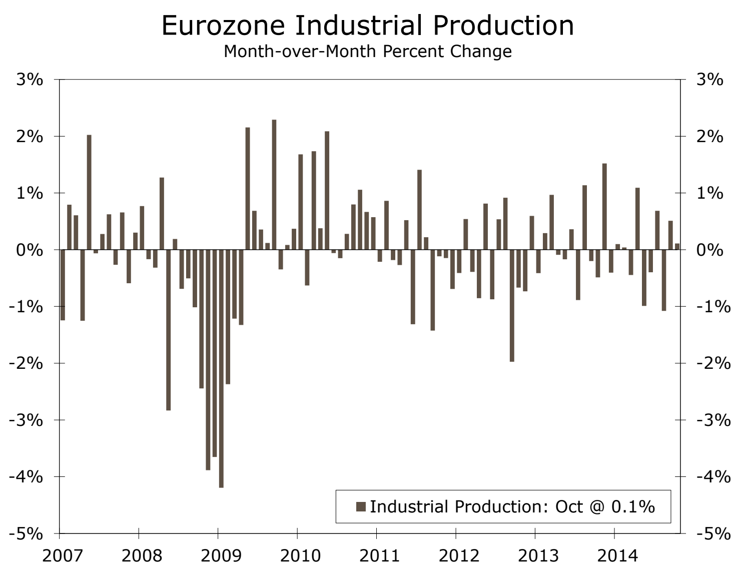
Low oil prices are starting to show up in other areas as well, and combined with recent strengthening in sterling, have resulted in rather benign core inflation. Core CPI inflation was just 1.2 percent, year over year, through November.

Just as we have been saying about the FOMC, we expect the Monetary Policy Committee to look through weaker headline prices when making any rate change decision and concentrate on core CPI inflation until oil prices stabilize.

Previous: 1.0% (Year-over-Year) **Wells Fargo: 0.6%**

Consensus: 0.7%





Eurozone Industrial Production • Wed.

Sovereign bond yields in Europe this week plumbed new record lows. Fixed income investors were reacting to more dovish comments by ECB Governor Draghi as well as the December CPI report and are betting that with outright deflation taking hold, direct purchases of sovereign bonds by the ECB is more likely.

Bond yields could be volatile again next week when industrial production figures print on Wednesday. Back in September, when the August IP report hit the wire showing a large drop, the yield on German bunds hit a then-record low.

With PMIs close to the break-even 50, most market participants expect no change in production figures for November.

Previous: 0.1% (Month-over-Month)

Consensus: 0.0%

Australian Unemployment Rate • Thursday

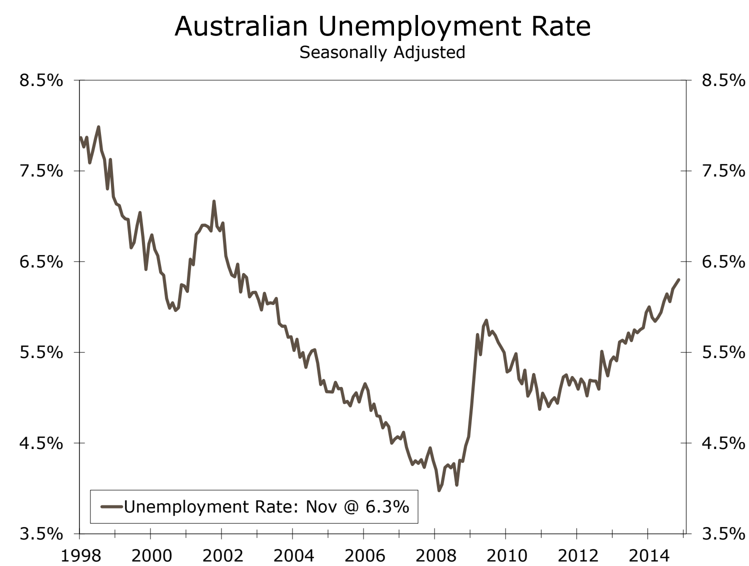
With commodities under pressure and growth in Australia's two largest trading partners either slowing (China) or turning negative (Japan), Australia's resilient economy is under pressure.

Reflecting these growing pains overseas, the unemployment rate has been grinding slowly, but relentlessly, higher over the past couple of years. In fact, the jobless rate is higher today than it was during the global downturn in 2009.

A 42.7K surge in November payrolls halted the climb in the unemployment rate, but it bears noting that most of the gains (40.8K) were in part-time jobs. The December jobs report due out on Thursday will provide a more current assessment of the state of the labor market in Australia.

Previous: 6.3%

Consensus: 6.3%



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

Interest Rate Watch

Payrolls Solid, What About Wages?

Payroll gains over the past three months have reinforced the outlook for steady economic growth in the fourth quarter and for the first half of 2015. Jobless claims and consumer confidence, both leading indicators, support this view. For economic growth, we estimate a gain of 2.6 percent in the first half of 2015.

Along with this growth, there is the anticipation of a drop in the unemployment rate. In December, the rate dipped to 5.6 percent, in part due to a drop in the participation rate, but also due to the solid gain in jobs. We expect a further drop in the unemployment rate going forward that will dip the rate into the "full employment" area, in our view.

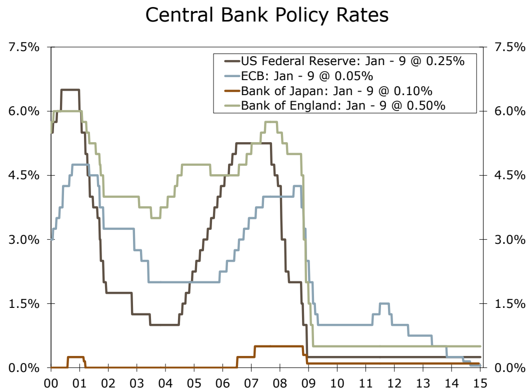
The State of Wages

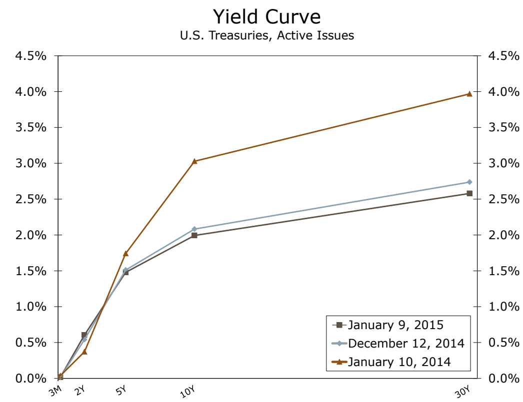
From this growth perspective, there is the case for the Federal Open Market Committee (FOMC) to raise the fed funds rate in June. However, the average hourly wage number declined in December. The FOMC watches wages closely. To declare an interest, we do not favor the wage series here as useful in tracking the overall behavior of the consumer (for more information, see our recent report, *"Hourly Earnings Underperform"*). Yet, to the extent the FOMC weighs the wage number, then the case could be made for the Fed to delay.

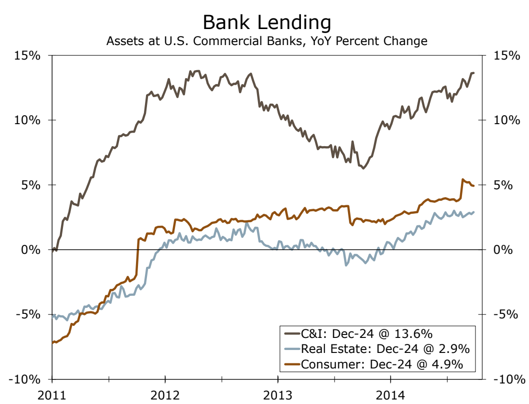
On Net, a Flatter Yield Curve

Our outlook for a flatter yield curve remains in place. This will be a significant change from the behavior of the past few years. While Fed actions will increase the short end of the curve, the continued moderate pace of inflation, limited pace of Federal debt issuance and the flight to safety from foreign investors will serve to put a lid on long-term rates.

However, we have seen a turn in credit quality, which may give rise to a wider spread on private versus public debt. Auto loan delinquencies are up and profit growth is slowing. These are signals that the credit cycle is deteriorating despite the improvement in the economy. Credit and economic growth diverge—as they do every cycle.







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

Credit Market Insights

Low Mortgage Rates to Help Refis?

Once again, mortgage rates have fallen and reached their lowest level since mid-2013. In theory, this should lead to increased refinancing activity, as borrowers seek to reduce payments or shorten the length of their loans.

It will be interesting to see if this materializes. Refinancing activity since the recession has been quite strong. Historically low interest rates led many people to refinance and lock in low rates. Fearing rising rates on the horizon, it would seem the majority of households that desired to, and were able to, refinance their mortgages likely already did so. Some individuals who were previously unable to refinance their homes because they did not qualify may now be able to access the lower rates, possibly supporting demand for refinancing activity.

Preference for Fixed Rate Mortgages

In addition, the portion of total applications that are for adjustable rate mortgages (ARM) has decreased over 2014. In fact, the ARM share fell to 5.9 percent on a three-month moving average basis from 8.1 percent at the beginning of 2014. This trend will likely continue, as historical trends show that borrowers prefer fixed rate mortgages during tightening cycles by the Federal Reserve.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.73%	3.87%	3.80%	4.51%
15-Yr Fixed	3.05%	3.15%	3.09%	3.56%
5/1 ARM	2.98%	3.01%	2.95%	3.15%
1-Yr ARM	2.39%	2.40%	2.38%	2.56%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,793.0	25.74%	16.37%	13.64%
Revolving Home Equity	$456.9	-4.99%	-2.91%	-3.38%
Residential Mortgages	$1,573.7	0.30%	2.21%	0.86%
Commerical Real Estate	$1,601.8	20.76%	12.48%	6.99%
Consumer	$1,198.6	5.98%	2.50%	4.93%

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

Topic of the Week

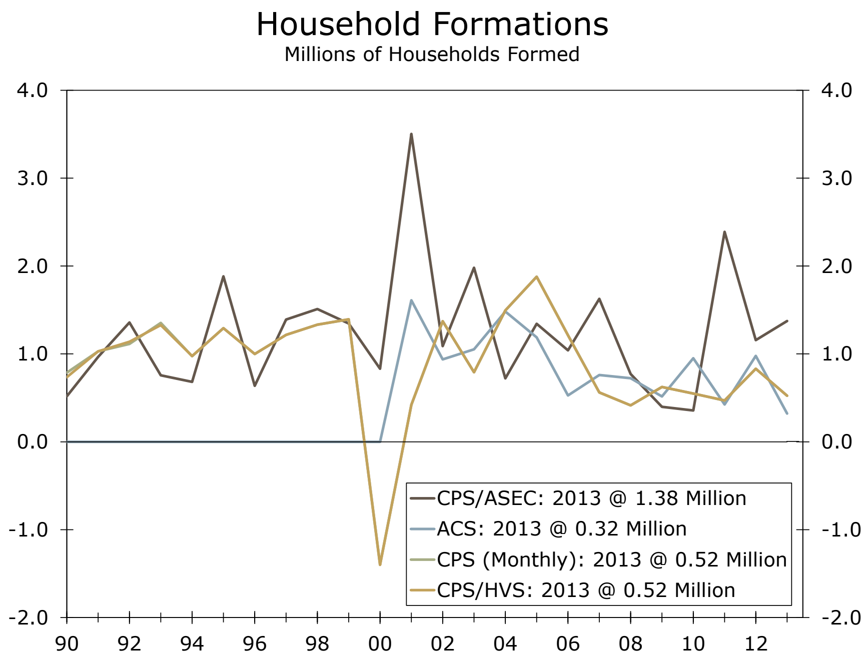
Making Sense of Household Formations

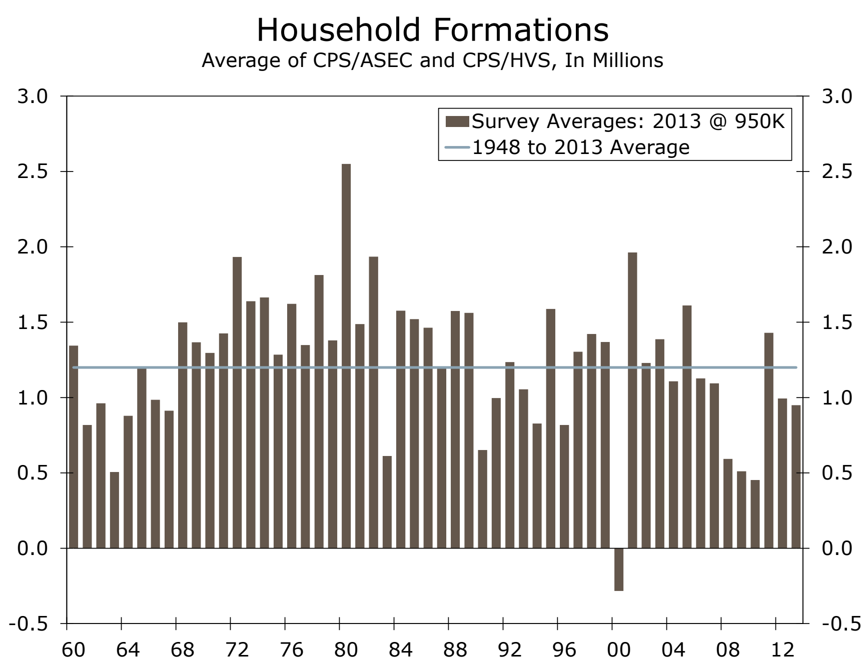
Household formation fell markedly in the wake of the housing bust and has remained low due to a variety of factors including the sluggish labor market, weak income growth, rising enrollment at colleges and trade schools and increased student loan debt. More recently, however, the Current Population Survey Annual Social and Economic Supplement (CPS/ASEC) data show household formations rebounding back to their long-run level. This apparent improvement looks suspicious, as income and labor conditions have only recently improved in a significant way. On the other hand, other measures of household formations, including the American Community Survey (ACS), the monthly CPS and Housing Vacancy Survey (CPS/HVS) remain at historically low levels and actually show a downward trend. With contradicting results, what is the best way to gauge household formations?

Which Measure Works Best?

With all four measures showing their biased results based on its underlying methodology (weights based on population or housing units), we find that averaging the CPS/ASEC and CPS/HVS provides the best estimate of household formations. That said, the level of household formations is still below its long-run trend (bottom graph), a finding that also makes intuitive sense given the ongoing concerns, by policymakers and the public in general, about job growth and the quality of jobs in particular.

However, the recent pick up in nonfarm employment growth and the drop in the unemployment rate suggest that brighter days are ahead. Based on the trend in population and the headship rate (the share of adults that head a household), especially for individuals aged 25–34, we expect the pace of household formation to pick up in the coming years. This would put net new households formed at 1.2 million in 2014. Given current trends, household formation should rise to 1.5 million in 2015, which is well above most current forecasts for housing starts for 2015. For a more detailed analysis, see "*Making Sense of Household Formations,*" available on our website or by request.





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 1/9/2015	1 Week Ago	1 Year Ago
3-Month T-Bill	0.02	0.02	0.04
3-Month LIBOR	0.25	0.26	0.24
1-Year Treasury	0.22	0.24	0.14
2-Year Treasury	0.55	0.66	0.43
5-Year Treasury	1.42	1.61	1.75
10-Year Treasury	1.96	2.11	2.97
30-Year Treasury	2.55	2.69	3.88
Bond Buyer Index	3.42	3.56	4.68

Foreign Exchange Rates	Friday 1/9/2015	1 Week Ago	1 Year Ago
Euro ($/€)	1.184	1.200	1.361
British Pound ($/₤)	1.515	1.533	1.648
British Pound (₤/€)	0.781	0.783	0.826
Japanese Yen (¥/$)	118.630	120.500	104.820
Canadian Dollar (C$/$)	1.186	1.179	1.084
Swiss Franc (CHF/$)	1.015	1.002	0.907
Australian Dollar (US$/A$)	0.819	0.809	0.890
Mexican Peso (MXN/$)	14.576	14.838	13.092
Chinese Yuan (CNY/$)	6.209	6.208	6.055
Indian Rupee (INR/$)	62.325	63.295	62.078
Brazilian Real (BRL/$)	2.641	2.694	2.391
U.S. Dollar Index	91.999	91.080	81.005

Source: Bloomberg LP and Wells Fargo Securities, LLC

Foreign Interest Rates	Friday 1/9/2015	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.05	0.06	0.26
3-Month Sterling LIBOR	0.56	0.56	0.52
3-Month Canada Banker's Acceptance	1.30	1.30	1.28
3-Month Yen LIBOR	0.10	0.11	0.15
2-Year German	-0.12	-0.11	0.21
2-Year U.K.	0.40	0.42	0.57
2-Year Canadian	0.95	1.00	1.10
2-Year Japanese	-0.03	-0.02	0.09
10-Year German	0.49	0.50	1.92
10-Year U.K.	1.60	1.72	2.98
10-Year Canadian	1.67	1.74	2.69
10-Year Japanese	0.28	0.33	0.70

Commodity Prices	Friday 1/9/2015	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	47.51	52.69	91.66
Gold ($/Ounce)	1216.43	1189.23	1227.95
Hot-Rolled Steel ($/S.Ton)	597.00	605.00	675.00
Copper (¢/Pound)	275.75	281.75	329.90
Soybeans ($/Bushel)	10.39	10.14	13.06
Natural Gas ($/MMBTU)	2.96	3.00	4.01
Nickel ($/Metric Ton)	15,486	15,074	13,464
CRB Spot Inds.	490.24	492.11	529.05

Next Week's Economic Calendar

	Monday 12	Tuesday 13	Wednesday 14	Thursday 15	Friday 16
U.S. Data		**NFIB Small Business Optimism** November 98.1 December 98.5 (C)	**Retail Sales (MoM)** November 0.7% December 0.0% (W) **Import Price Index (MoM)** November -1.5% December -2.7% (W)	**PPI (MoM)** November -0.2% December -0.4% (W)	**CPI (MoM)** November -0.3% December -0.4% (W) **Industrial Production (MoM)** November 1.3% December -0.1% (W)
Global Data	**India** **Industrial Production (YoY)** Previous (October) -4.2%	**United Kingodm** **CPI (YoY)** Previous (November) 1.0%	**Eurozone** **Industrial Production** Previous (October) 0.1% **Japan** **PPI (YoY)** Previous (November) 2.7%	**Australia** **Unemployment Rate** Previous (November) 6.3%	

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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