February 20, 2015

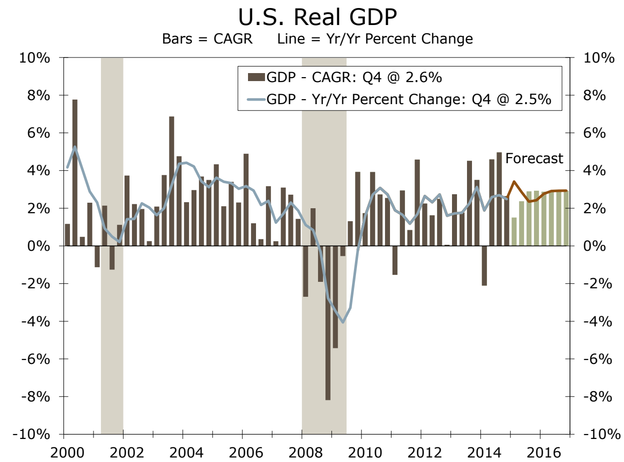
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Oil Sludge Slowing Economic Engine?

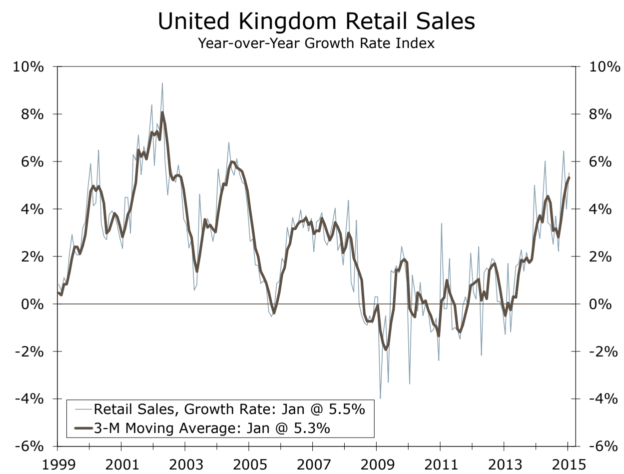
- The housing market recovery continues to plod along at a less-than-impressive pace, with housing starts and building permits falling shy of expectations in January.
- Headline PPI fell further into negative territory, decreasing 0.8 percent as energy prices continue to weigh on inflation. Even more concerning is the fact that “core” PPI flipped into negative territory as well.
- Industrial production grew modestly to begin 2015, as monthly economic indicators are pointing to a slower start to 2015, consistent with our forecast for a slowdown in GDP growth to just 1.5 percent annualized in the first quarter.



Global Review

Bank of England Put Away Its Hiking Boots, For Now

- We learned this week that inflation in the United Kingdom fell to its slowest pace in at least 25 years and although financial markets were braced for 0.3 percent drop in retail sales (ex-autos), the actual decline of 0.7 percent was sobering. Eventual rate hikes from the Bank of England are still in store, but as we discuss in this week’s International Review, the timing is now pushed back a bit.
- We also break down the fourth quarter GDP report from Japan released earlier this week and look at the brightening in the outlook for Europe.



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	2.6	1.5	2.4	2.9	2.9	2.3	2.2	2.4	2.8	2.9
Personal Consumption	1.2	2.5	3.2	4.3	3.5	2.7	2.7	2.6	1.8	2.4	2.5	3.2	2.6
Inflation Indicators [2]													
PCE Deflator	1.1	1.6	1.5	1.1	0.5	0.3	0.5	1.1	1.8	1.2	1.3	0.6	2.0
Consumer Price Index	1.4	2.1	1.8	1.2	0.2	0.0	0.3	1.2	2.1	1.5	1.6	0.4	2.4
Industrial Production [1]	3.9	5.7	4.1	4.3	3.0	4.9	3.5	3.1	3.8	2.9	4.2	4.0	3.6
Corporate Profits Before Taxes [2]	-4.8	0.1	1.4	2.2	2.6	2.7	3.5	4.6	11.4	4.2	-0.2	3.4	5.8
Trade Weighted Dollar Index [3]	76.9	75.9	81.3	85.1	88.5	89.8	91.0	92.3	73.5	75.9	78.5	90.4	94.7
Unemployment Rate	6.6	6.2	6.1	5.7	5.6	5.5	5.4	5.3	8.1	7.4	6.2	5.4	5.1
Housing Starts [4]	0.93	0.99	1.03	1.06	1.07	1.13	1.21	1.24	0.78	0.92	1.00	1.15	1.31
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	3.86	3.60	3.72	3.87	3.89	3.66	3.98	4.17	3.77	4.56
10 Year Note	2.73	2.53	2.52	2.17	1.99	2.21	2.29	2.30	1.80	2.35	2.54	2.20	2.82

Forecast as of: February 20, 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 2
U.S. Outlook 3
Global Review 4
Global Outlook 5
Point of View 6
Topic of the Week 7
Market Data 8

U.S. Review

Monthly Indicators Subdued in January

One of the more disappointing aspects of the U.S. economy in 2014 was the pace of the housing recovery. While the housing market continued to recover, it was at a slower pace than many expected going into the year. We are optimistic that the housing recovery will pick up steam this year. However, January did not mark a booming beginning for housing starts, registering a 1.065 million-unit pace. This is above the key 1 million-unit mark, but fell short of consensus expectations, and previous month's data were revised lower. Single-family starts weighed on the headline figure, falling 6.7 percent month over month, while multifamily starts grew 7.5 percent. This keeps with a theme that we have seen throughout the current recovery, with multifamily starts driving growth, as more individuals and families are looking to rent rather than buy. Building permits were also down on the month despite expectations for a decent gain, falling 0.7 percent. Some of the weakness seen for starts and permits in January may be attributable to exceptionally cold temperatures and severe winter weather.

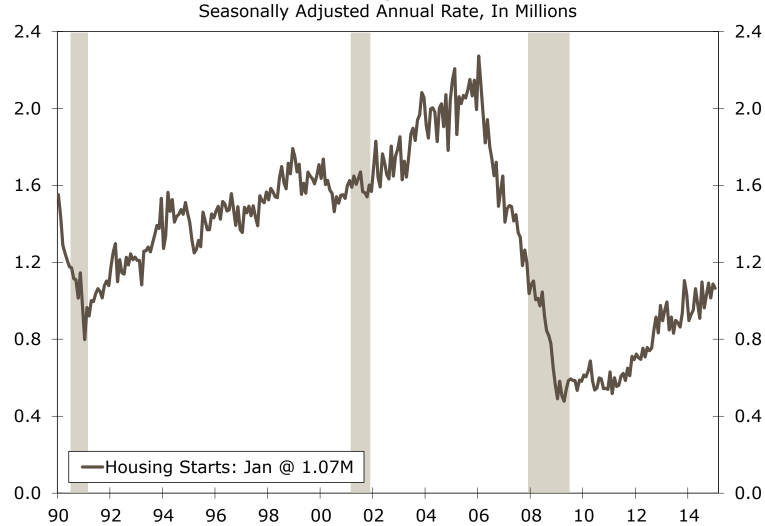
While the trend in oil prices has flattened out more recently, the effects of the recent decline continue to show up in economic data, especially when it comes to inflation. The headline reading for final demand PPI inflation fell to 0.0 percent year over year in January, the lowest reading on record. "Core" PPI (excluding food and energy) is holding up relatively well, registering a 1.6 percent year-over-year rate of growth. This is a bit more encouraging, as it seems the deceleration in overall producer prices has yet to materially leak into core readings. However, on a month-over-month basis, core PPI inflation unexpectedly fell, and the headline fell at double the pace the consensus had expected. Outside of energy, core goods prices led the decline, falling 0.2 percent on the month, as pressure on goods prices appears to be coming from domestically produced goods as well as imports.

Weak durable goods and factory orders readings appear to be showing up in more recent industrial production figures, as production grew just 0.2 percent in January. This is coming off a downwardly revised December figure. Motor vehicle & parts production fell for the fifth month out of the past six as we have seen total vehicle sales soften a bit more recently. However, this weakness was not enough to send overall manufacturing production growth into negative territory, as production grew 0.2 percent on the month. Utilities production rebounded following December's steep decline, likely as a function of the much colder weather experienced nationwide. Mining production fell on the month, as oil and gas well drilling fell 10.0 percent.

While it is widely expected that production of crude oil will be cut due to lower prices, the U.S. Energy Information Administration reported that commercial crude inventories rose 7.7 barrels last week to a record 425.6 million barrels. It seems likely that U.S. drillers are continuing to produce in order to cover the significant fixed costs of setting up a drilling operation. As far as fixed investment is concerned, we expect much of the negative effects have already occurred, with equipment spending having fallen 1.9 percent annualized in Q4.

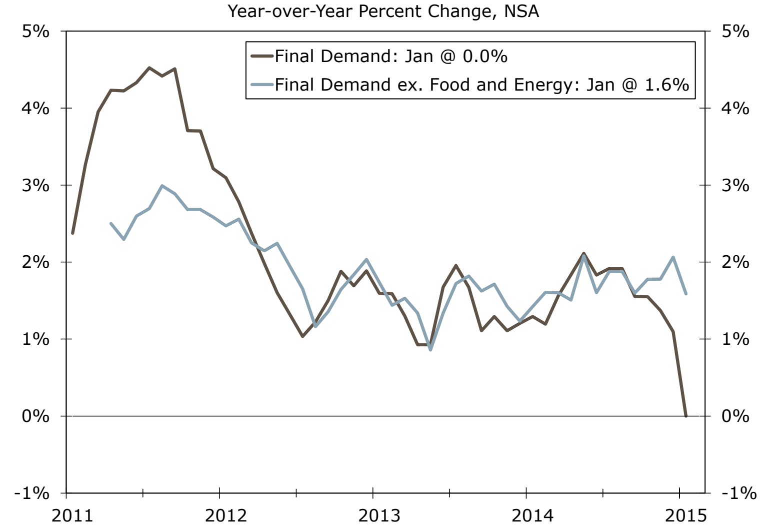
Housing Starts

Seasonally Adjusted Annual Rate, In Millions



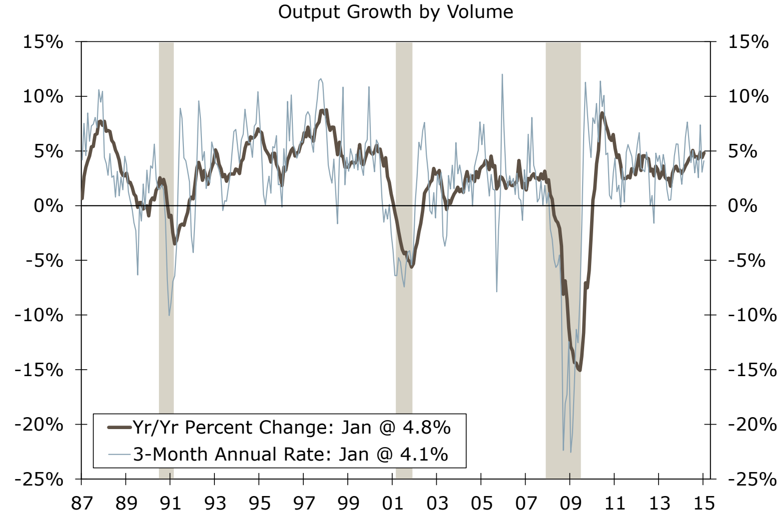
PPI and Core PPI Final Demand

Year-over-Year Percent Change, NSA



Total Industrial Production Growth

Output Growth by Volume



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

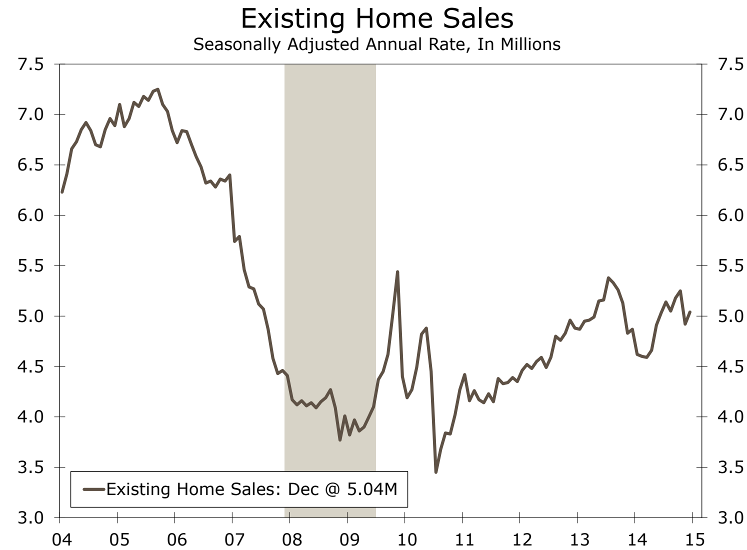
Existing Home Sales • Monday

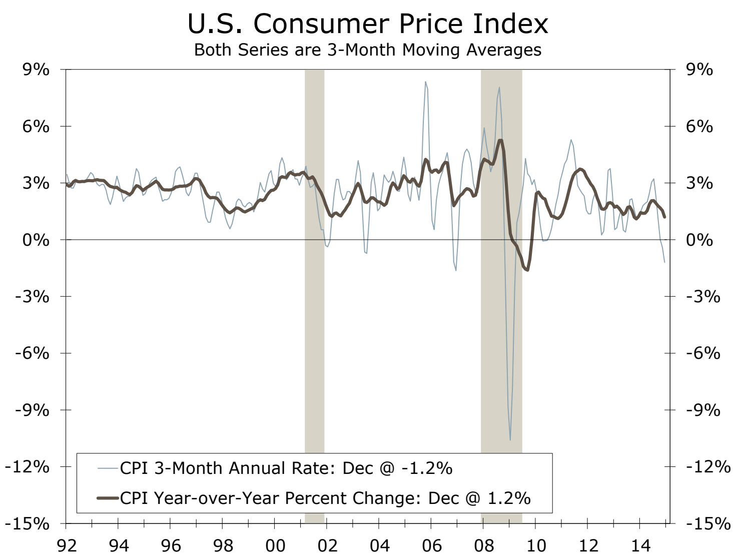
Next week, a whole host of housing market indicators will be released that will give the latest pulse on sales activity and prices. On Monday, existing home sales will likely show a moderation in resale activity in January. Harsh weather conditions already reared its head in housing starts and builder sentiment data and could have also affected sales activity. Last year, existing home sales activity was disappointing and remained below the all-important five-million mark. We suspect the pickup in labor market conditions and household formations, especially among young adults, will slowly have some bearing on overall sales activity.

The S&P Case-Shiller Index will also be released next week and is expected to show continued moderation in prices. A national index is now published along with the 10-city and 20-city reports. On a national basis, this measure is up 4.7 percent over the past year, a much slower pace than the peak of 10.8 percent recorded in 2013.

Previous: 5.04M **Wells Fargo: 5.00M**

Consensus: 4.95M





CPI • Thursday

Inflation gauges have been top of mind in recent months as energy prices have pulled headline measures much lower than originally anticipated. More importantly, Fed watchers are concerned whether the disinflation trend will eventually seep into core measures. The recent Producer Price Index (PPI) for final demand showed that fear could be coming to fruition. Core PPI in January was up only 1.6 percent over the past year compared to 2.1 percent in December. Our preferred measure of core PPI, which excludes trade services, food and energy, moderated to just a 0.9 percent year-ago increase, which shows an even more worrisome trend. Prices for consumer goods have also been weak due to the drop in energy prices. We do expect that some of the energy price drop will make its way into the core measure this month. However, steadily rising shelter and medical prices could help offset any pass through of energy prices to core consumer prices.

Previous: -0.3% **Wells Fargo: -0.8%**

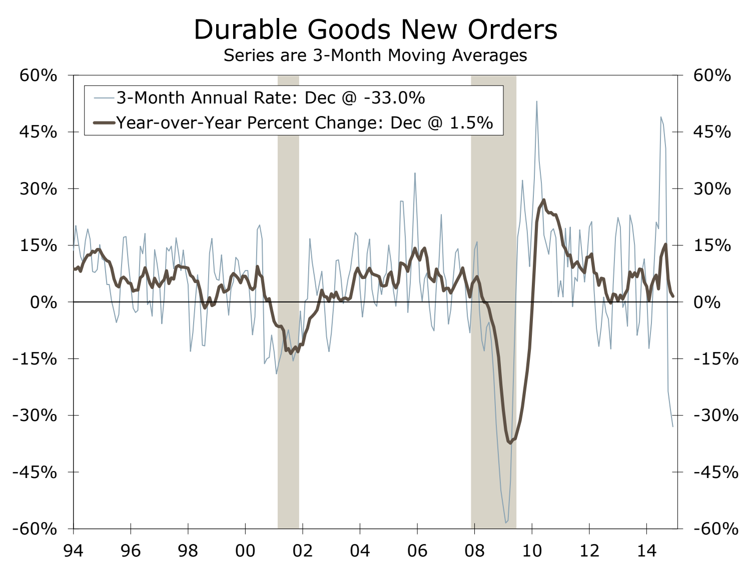
Consensus: -0.6% (Month-over-Month)

Durable Goods • Thursday

Durable goods orders have posted weaker-than-expected readings in recent months, which suggests a pullback in manufacturing activity is in the offing. New orders were negative in the last four out of five months and are up only 0.9 percent over the past year. Core capital goods orders have been even more disappointing, dropping a stark 11.4 percent on a three-month annualized basis. Even worse, core capital goods shipments, which directly feed into the GDP calculation, contracted at a 3.3 percent annualized rate. The decline in this measure intimates equipment and software spending in the first quarter is off to a slow start. At the same time, other manufacturing indicators including the ISM manufacturing index and regional PMIs corroborate a slowdown, but do not paint the same somber picture. So why the divergence? We suspect lower energy prices are playing a role as orders are reported on a nominal basis and declines in oil prices could be pulling the level even lower.

Previous: -3.3% **Wells Fargo: 0.6%**

Consensus: 1.7% (Month-over-Month)



Source: Natl. Assoc. of Realtors, U.S. Dept. of Labor, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

Global Review

Not So Big in Japan

The 2.2 percent annualized growth rate for the Japanese economy in the fourth quarter was weaker than the 3.7 percent that had been expected. Considering the fact that the Bank of Japan (BoJ) was engaged in a quantitative easing program that pumped more than ¥74 billion into the economy in 2014, the fact that full year was slightly down must come as a disappointment.

Inventories added 0.6 percentage points to the overall growth rate for the quarter and consumer spending picked up modestly. Total investment spending inched up at a scant rate of just 0.1 percent. Half of GDP growth in the fourth quarter came from trade, as net exports provided a 1.1 percent contribution to the 2.2 percent growth rate.

The BoJ's announcement of an increase in its QQE program at the end of October caused the yen to depreciate more than 10 percent versus the U.S. dollar. The weaker domestic currency for Japan helped exports, which grew at an 11.4 percent clip—more than double the 5.3 percent growth rate in imports.

BoE Rate Hikes Pushed Back as CPI Plunges in U.K.

The nosedive in oil prices has caused CPI inflation in the United Kingdom to drop sharply in recent months. Indeed, the 0.3 percent rate registered in January was the lowest year-over-year rate of CPI inflation in at least 25 years.

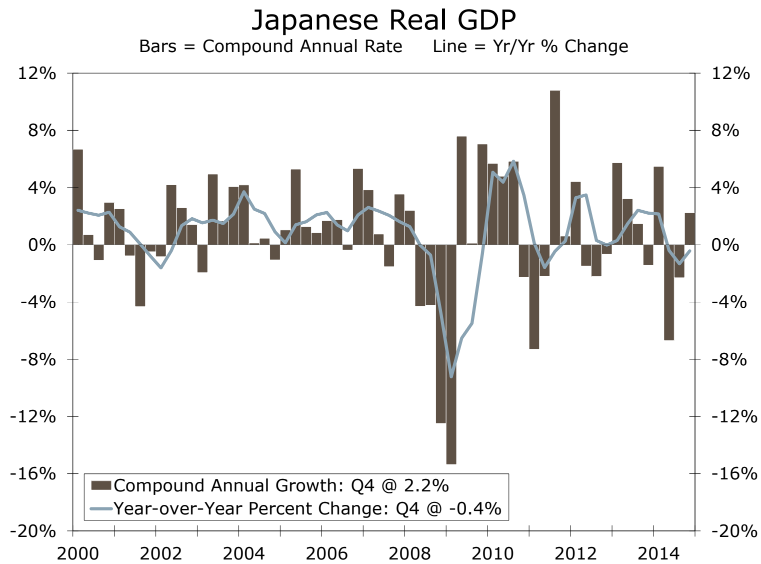
With a medium-term inflation target of 2.0 percent, the likelihood of rate hikes in the near term is no longer a realistic prospect, as even the most hawkish members of the Monetary Policy Committee have dropped their preference to increase the Bank Rate.

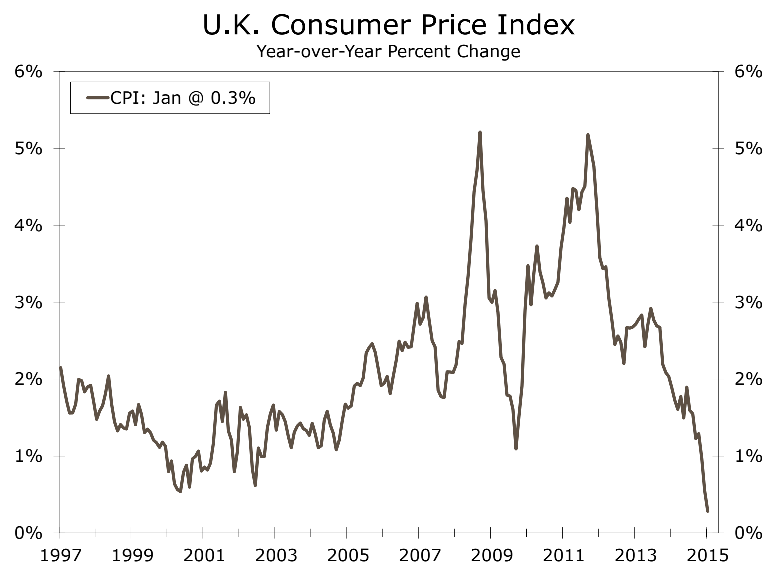
Although the official inflation target is based on headline inflation, we suspect that members of the MPC will focus more on core inflation given the precipitous decline in oil prices. On that basis, we suspect underlying core inflation to firm gradually this year, and as a result, the expected increase in the Bank Rate is postponed rather than cancelled, with liftoff most likely occurring in the fourth quarter of this year, in our estimation. This should usher in a slow process of raising interest rates that could take the U.K. main policy rate from its current 0.50 percent to 1.50 percent by the end of 2016.

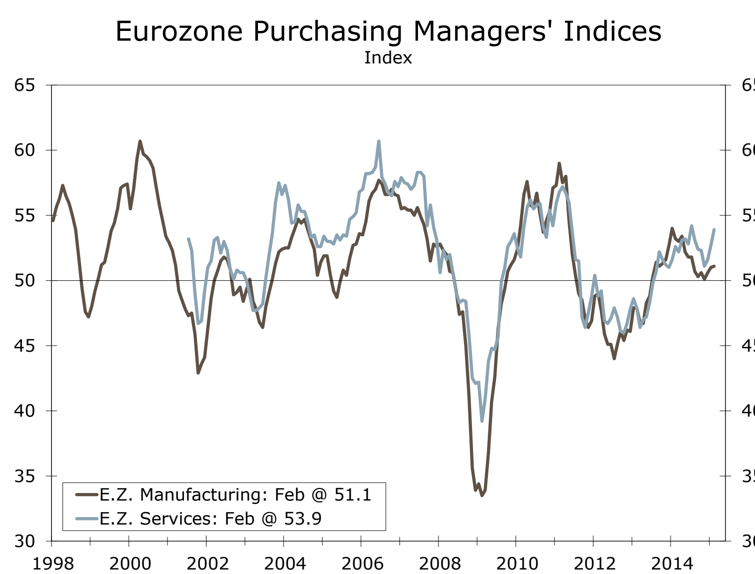
Silver Linings in Europe's Dark Clouds

Despite the hand-wringing over Greek debt negotiations and worries about Russia's end-game in Ukraine, the Eurozone economy is quietly showing signs of modest improvement. Eurozone GDP growth bested low consensus expectations in the fourth quarter, increasing 0.9 percent year over year. With the ECB beginning its own quantitative easing program, we look for further growth ahead.

New indications this week suggest that business activity is continuing to firm in the first quarter of 2015. The manufacturing PMI increased to 51.1 and the service-sector PMI rose to 53.9, which is the second strongest reading for this bellwether of business activity since 2011.







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

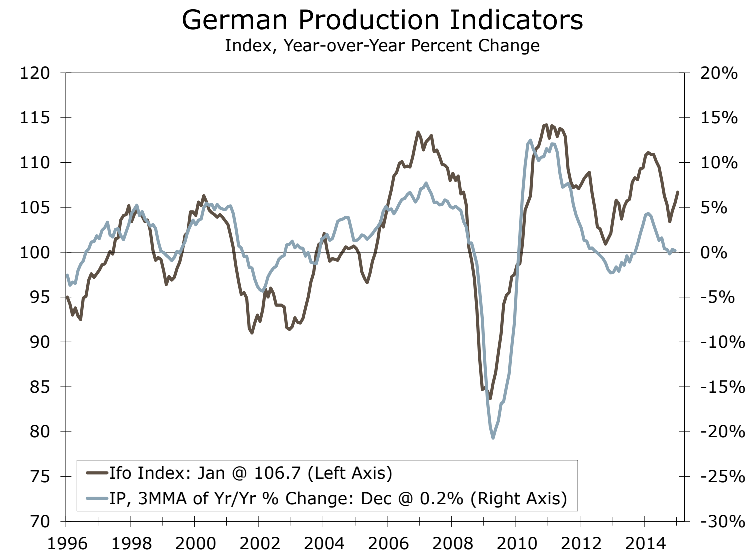
German Ifo Index • Monday

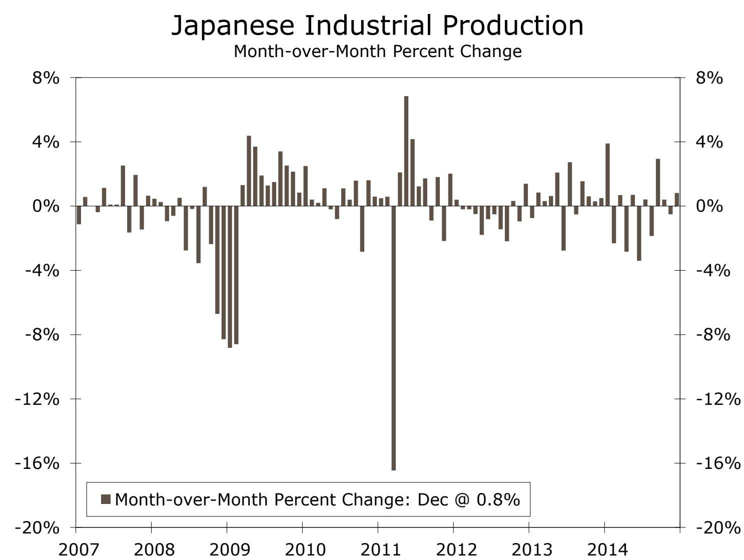
The Ifo index of German business sentiment, which has a fair degree of correlation with growth in German industrial production (IP) has risen for three consecutive months, indicating that IP in Europe's largest individual economy should be accelerating. Another increase in the Ifo index would suggest that the German economy is picking up steam in the first quarter. Data on German GDP in Q4, which are slated for release on Tuesday, will show which demand components contributed to the 0.7 percent (not annualized) sequential growth rate in Q4.

The increase in sentiment in Europe is not confined to Germany alone. The Eurozone economic sentiment indicator, which has trended higher since September, is slated for release on Thursday. Data on consumer spending in France and retail sales in Italy will show how consumers are faring in those two large Eurozone economies.

Previous: 106.7

Consensus: 107.7





Japanese Industrial Production • Thursday

The usual end-of-the month data barrage in Japan occurs next week, and data on industrial production (IP) will be closely watched by analysts. IP has followed a saw-tooth pattern in recent months. IP rose 0.8 percent on a monthly basis in December and another rise in January would suggest that the pace of economic activity in Japan may be firming somewhat in the first quarter following the disappointing 2.2 annualized rate of real GDP growth in Q4.

Also on the docket next week are January data on retail sales, housing starts and the unemployment rate as well as CPI inflation. Following the one-off jump in consumer prices last spring that was caused by the hike in the consumption tax, the rate of CPI inflation has been trending lower due, at least in part, to the sharp decline in oil prices. Another decline in the rate of CPI inflation in January, should one occur, would raise expectations of another expansion in the Bank of Japan's quantitative easing program.

Previous: 0.8% (Month-over-Month)

Consensus: 3.0%

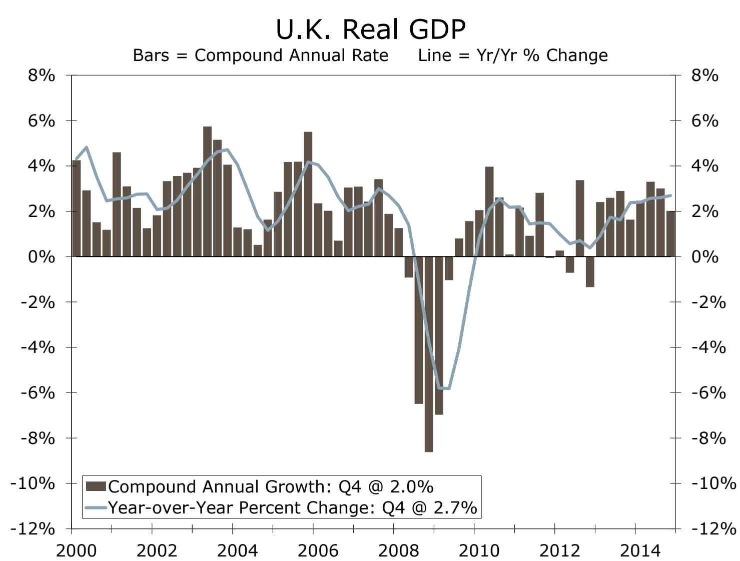
U.K. GDP • Thursday

Preliminary data released last month showed that real GDP in the United Kingdom grew 0.5 percent (2.0 percent at an annualized rate) in the fourth quarter. The demand-side components that will be released next week will help analysts identify the sources of real GDP growth in the United Kingdom at present.

A widely followed measure of British consumer confidence, which has shot sharply higher over the past two years, currently stands at a post-recession high. Another increase in consumer confidence in February, should one occur, would bode well for consumer spending in the near term. In that regard, survey data on retail spending in February will show whether or not consumers are putting their money where their mouths are. The high level of the index at present accurately measures the solid gains in real consumer spending that have occurred over the past few years.

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

Consensus: 0.5% (Quarter-over-Quarter, Not Annualized)



Source: IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

Misplaced Emphasis on Wages

Economies evolve. Unfortunately, public policy does not appear to do the same.

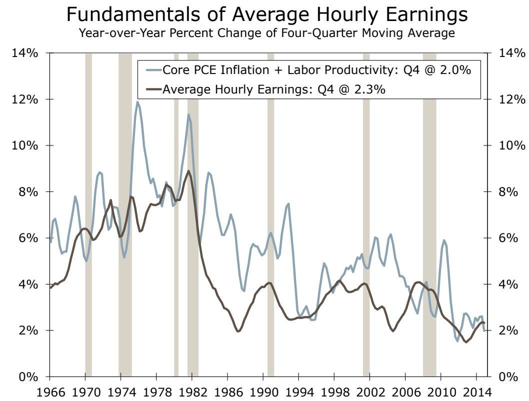
The focus on low wage growth as a benchmark for monetary policy actions is seriously misplaced in our opinion. First, we do not believe it is realistic to talk about 3.0-3.5 percent wage growth as normal. There is nothing inherent in that number to stand alone as a policy benchmark. Instead, wage growth reflects the factors of productivity and inflation. As illustrated in the top graph, the weak rate of wage growth in recent years is fairly consistent with low productivity and inflation.

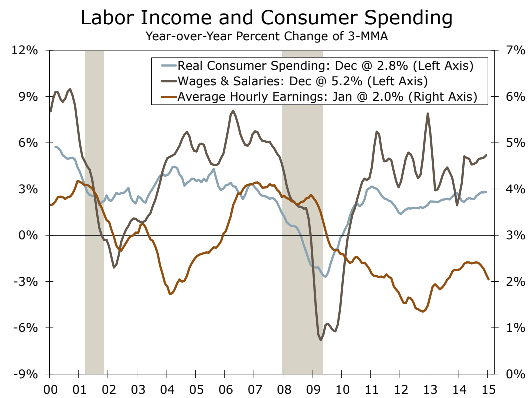
For labor income, the wages and salaries data reported in the personal income report are better correlated with consumer spending than average hourly earnings since the aggregate wages and salaries data also reflects the level of employment (middle chart). Moreover, compensation patterns have changed over the past decade, with benefits accounting for a larger share of workers' total compensation.

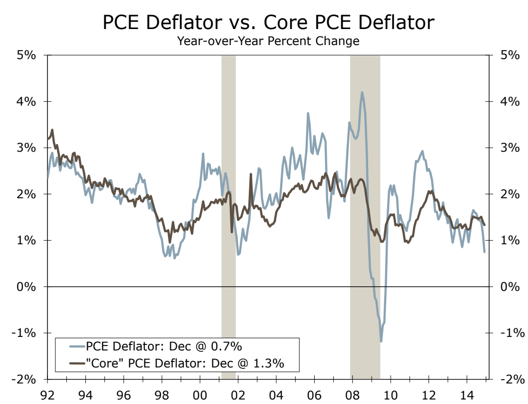
Focus on inflation is also misplaced in our view. Since 1994, the PCE deflator has averaged less than two percent (bottom chart). In prior generations, policy makers and investors would only hope for such success in achieving price stability. Ex-energy, inflation remains within a range that allows for effective decision making. Although core goods inflation is flat over the past year, inflation for core services, which account for 75 percent of core CPI, is up 2.5 percent. The global oversupply of commodities is obvious to us, as is the shortage of domestic skilled workers in the U.S.

Asset, Not Goods Inflation: Repeating the Mistake of 2004-2006

Policymakers' inability to focus on asset price inflation (expanding equity values, narrow credit spreads) as differentiated from goods inflation is a repeat of the 2004-2006 experience. It is a straw man to argue that the public and markets expect the Fed will lay out a specific plan—the problem is the model and the benchmark policy guideline.







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

Credit Market Insights

Household Debt Getting Schooled

Household debt outstanding increased by $1.2 trillion in the final quarter of 2014, according to a recent release from the Federal Reserve Bank of New York. The main contributors to the rise were mortgage lending and student loans, which increased by $39 billion and $31 billion, respectively, since the third quarter.

The number of total inquiries for new credit also saw an uptick in the fourth quarter, as 175 million households requested a loan in the last six months of 2014—up from 169 million just a year earlier. Improving economic conditions and a strengthening labor market have caused consumer demand for loans to firm, as borrowers have become more confident accruing debt.

The total level of student loan debt outstanding has risen to an all-time high of $1.16 trillion. In recent years, student loans as a share of total household debt outstanding have almost doubled—from 5 percent in 2009 to nearly 10 percent in Q4-2014.

Some worry that the high levels of student debt have kept some would-be homebuyers out of the market as they struggle to pay off loans for tuition. In fact, in our recent report, *"Millennials in the Economy VIII: Home Sweet Rental?"*, we noted that high levels of student loan debt have contributed to an increasing share of young adults living with parents and has limited a rise in homeownership rates while pushing back the age of major life events.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.76%	3.69%	3.66%	4.33%
15-Yr Fixed	3.05%	2.99%	2.98%	3.35%
5/1 ARM	2.97%	2.97%	2.86%	3.08%
1-Yr ARM	2.45%	2.42%	2.38%	2.57%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,805.1	1.27%	10.47%	12.27%
Revolving Home Equity	$455.5	-6.59%	-3.08%	-3.01%
Residential Mortgages	$1,568.6	-39.65%	1.96%	1.28%
Commerical Real Estate	$1,610.7	-0.45%	3.08%	6.65%
Consumer	$1,197.9	-1.74%	0.12%	4.68%

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

Topic of the Week

Risks in the Lending Market

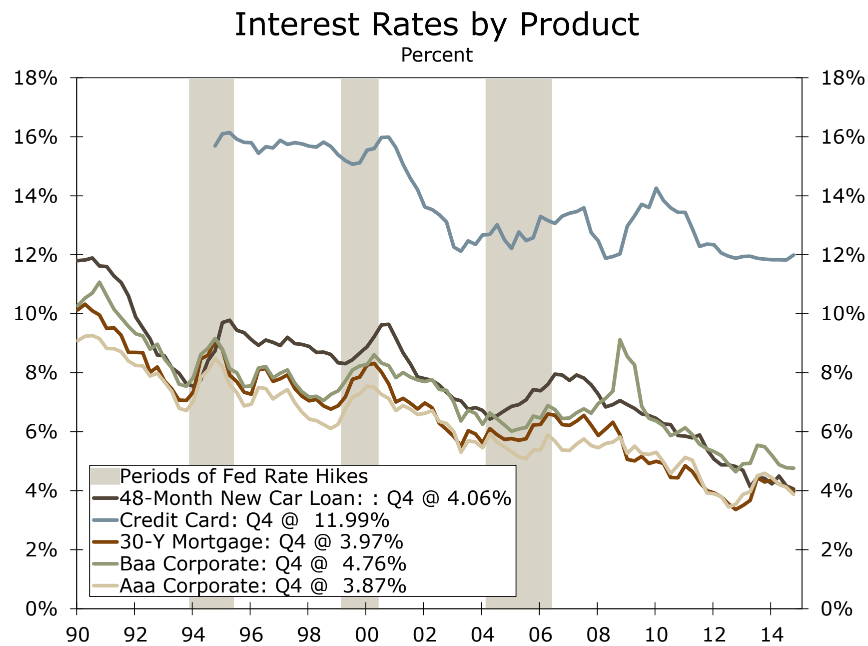
Lending standards for households and corporations have eased to the extent that they resemble the last "normal" period of lending seen in 2006. Credit has expanded rapidly in some loan categories, which has in turn boosted spending and investment. However, should interest rates rise later this year, some households and corporations may find themselves overleveraged as interest rates and borrowing costs rise.

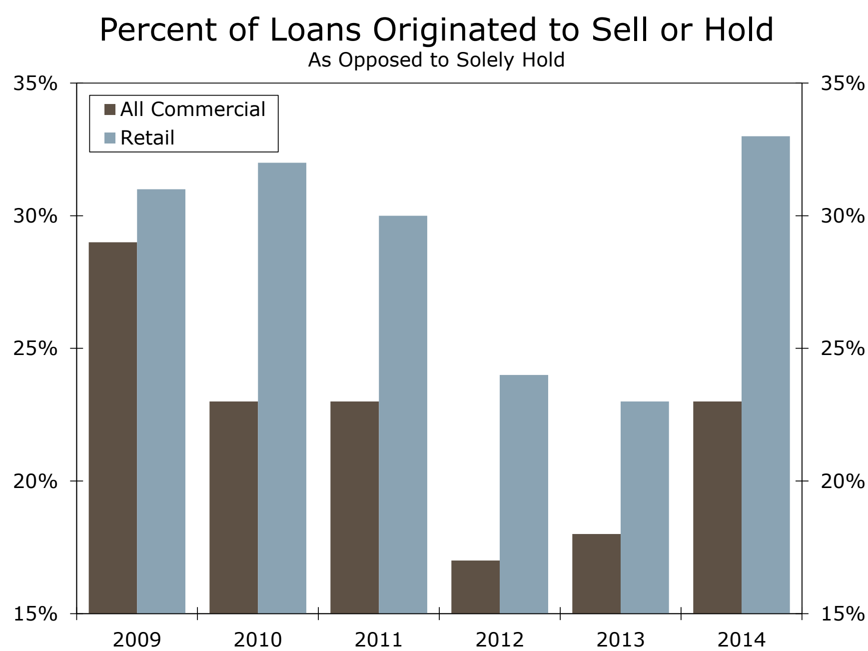
When looking at interest rate sensitivity by loan product, we see that auto loans rates are the most sensitive to changes in the fed funds target rate. In addition, we can see that for each one-percentage point rise in the fed funds rate, the interest rate on a 48-month new car loan rises 0.61 percentage points. However, it is important to note that the average duration of an auto loan has risen in recent years, and may be affected less in the next tightening cycle than in past periods of fed rate hikes. The interest rate on a 30-year conventional mortgage also has particularly high sensitivity to changes in interest rates (top chart).

Although firms continue to ease lending standards, they have perceived increased risk among some loan types. In the commercial lending category, leveraged loans, asset-backed loans and loans to large corporations have seen the largest increase in risk—as more than a third of all firms saw risk increase in these categories in 2014. Among retail loans, student and auto loans saw the largest increase in 2014, as more than 40 percent of firms reported increased risk.

As a growing share of firms has reported increased risk among loan types, some firms have chosen to adjust their intentions for lending (bottom chart). In 2014, a third of all firms originated retail loans with the intent to sell or hold the loan (as opposed to the sole intention to hold the loan). This trend indicates that some firms could be extending loans that they consider less creditworthy and could be eager to get these higher-risk loans off of their balance sheets.

For more information, see our report *"Risks in the Lending Market."*





Source: Office of the Comptroller of the Currency, Federal Reserve Board and Wells Fargo Securities, LLC

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 2/20/2015	1 Week Ago	1 Year Ago
3-Month T-Bill	0.02	0.01	0.05
3-Month LIBOR	0.26	0.26	0.24
1-Year Treasury	0.15	0.14	0.15
2-Year Treasury	0.60	0.64	0.32
5-Year Treasury	1.54	1.54	1.54
10-Year Treasury	2.07	2.05	2.75
30-Year Treasury	2.69	2.65	3.72
Bond Buyer Index	3.62	3.60	4.44

Foreign Exchange Rates

	Friday 2/20/2015	1 Week Ago	1 Year Ago
Euro ($/€)	1.136	1.139	1.372
British Pound ($/£)	1.538	1.540	1.665
British Pound (£/€)	0.739	0.740	0.824
Japanese Yen (¥/$)	118.760	118.750	102.280
Canadian Dollar (C$/$)	1.253	1.245	1.110
Swiss Franc (CHF/$)	0.944	0.932	0.890
Australian Dollar (US$/A$)	0.782	0.776	0.901
Mexican Peso (MXN/$)	15.052	14.885	13.278
Chinese Yuan (CNY/$)	6.256	6.241	6.085
Indian Rupee (INR/$)	62.221	62.196	62.230
Brazilian Real (BRL/$)	2.877	2.835	2.370
U.S. Dollar Index	94.526	94.201	80.286

Source: Bloomberg LP and Wells Fargo Securities, LLC

Foreign Interest Rates

	Friday 2/20/2015	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.03	0.02	0.26
3-Month Sterling LIBOR	0.56	0.56	0.52
3-Month Canada Banker's Acceptance	0.92	0.95	1.27
3-Month Yen LIBOR	0.10	0.10	0.14
2-Year German	-0.23	-0.22	0.13
2-Year U.K.	0.42	0.38	0.51
2-Year Canadian	0.39	0.43	1.00
2-Year Japanese	0.03	0.05	0.08
10-Year German	0.36	0.34	1.69
10-Year U.K.	1.78	1.68	2.80
10-Year Canadian	1.41	1.43	2.55
10-Year Japanese	0.39	0.42	0.59

Commodity Prices

	Friday 2/20/2015	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	50.80	51.21	102.92
Gold ($/Ounce)	1206.00	1229.43	1322.94
Hot-Rolled Steel ($/S.Ton)	530.00	535.00	655.00
Copper (¢/Pound)	261.45	260.20	327.90
Soybeans ($/Bushel)	10.03	9.80	13.57
Natural Gas ($/MMBTU)	2.97	2.71	6.06
Nickel ($/Metric Ton)	13,928	14,648	14,474
CRB Spot Inds.	471.89	469.64	529.94

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	23	**24**	**25**	**26**	**27**
U.S. Data	**Existing Home Sales** December 5.04M January 5.0M (W)	**Consumer Confidence** January 102.9 February 99.6 (W)	**New Home Sales** December 481K January 477K (W)	**CPI (MoM)** December -0.4% Janaury -0.7% (W) **Durable Goods Orders** December -3.4% Janaury 0.6% (W)	**GDP (QoQ)** Q4 (1st) 2.6% Q4 (2nd) 1.8% (W) **Pending Home Sales (MoM)** December -3.7% January 2.2% (C)
Global Data	**Germany** **IFO Index** Previous (January) 160.7 **Mexico** **Retail Sales (YoY)** Previous (November) 1.2%	**Eurozone** **CPI (MoM)** Previous (December) -0.1% **China** **HSBC Manufacturing PMI** Previous (January) 49.7		**Canada** **CPI (YoY)** Previous (December) 1.5%	**United Kingdom** **GDP (QoQ)** Previous (Q4) 0.5% **Japan** **Industrial Production (MoM)** Previous (December) 0.8%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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