March 20, 2015

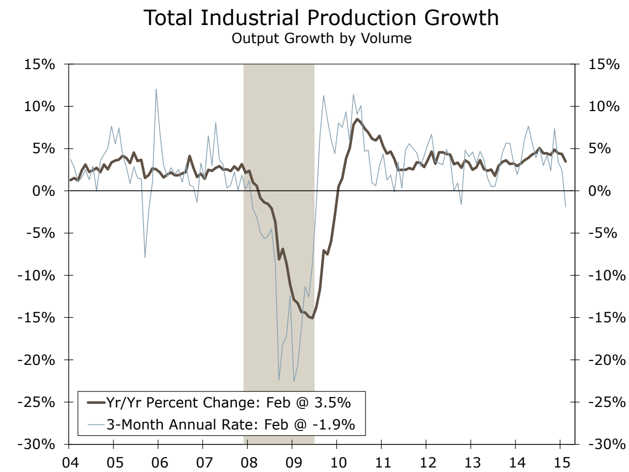
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Mixed Economic Data and A Cautious Fed

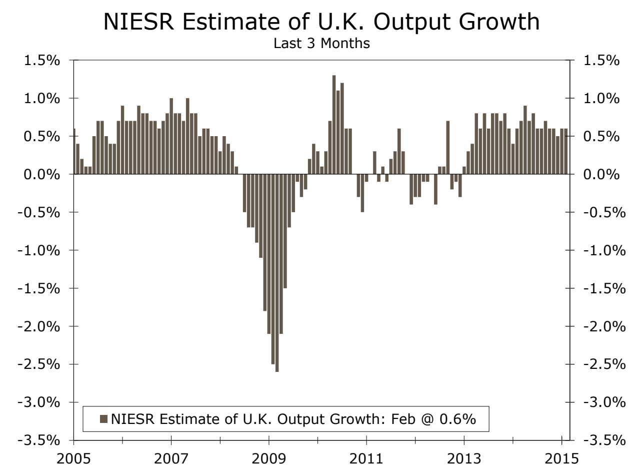
- This week's FOMC meeting statement dropped the word patient but the tone remained very dovish.
- Industrial production activity remained modest in February after posting a decline in January.
- Data on February housing starts showed a sharp decline in new construction activity; however, permitting data looked more promising for future activity.
- February's leading economic index posted another slight rise suggesting that while growth is likely to moderate in the first quarter, overall economic momentum should be maintained.



Global Review

Will Sterling Appreciation Keep BoE on Hold?

- Economic growth in the United Kingdom generally remains solid. Despite the marked decline in the unemployment rate, there are few signs of wage acceleration. Therefore, CPI inflation likely will remain below target for some time.
- The Monetary Policy Committee acknowledged in the minutes of its last policy meeting that exchange rate appreciation—sterling has risen 20 percent versus the euro since summer 2013—could continue to weigh on CPI inflation in coming months.



Wells Fargo U.S. Economic Forecast

	Actual				Forecast				Actual			Forecast	
	2014				2015				2012	2013	2014	2015	2016
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	-2.1	4.6	5.0	2.2	1.0	3.0	2.9	3.0	2.3	2.2	2.4	2.7	3.0
Personal Consumption	1.2	2.5	3.2	4.2	3.3	2.8	2.8	2.8	1.8	2.4	2.5	3.2	2.7
Inflation Indicators [2]													
PCE Deflator	1.1	1.6	1.5	1.1	0.2	0.1	0.3	0.9	1.8	1.2	1.3	0.4	2.0
Consumer Price Index	1.4	2.1	1.8	1.2	-0.2	-0.3	0.0	0.8	2.1	1.5	1.6	0.1	2.3
Industrial Production [1]	3.9	5.7	4.1	4.4	0.4	4.5	3.5	3.1	3.8	2.9	4.2	3.2	3.5
Corporate Profits Before Taxes [2]	-4.8	0.1	1.4	3.4	4.2	4.2	4.7	3.7	11.4	4.2	0.1	4.2	3.4
Trade Weighted Dollar Index [3]	76.9	75.9	81.3	85.1	91.3	92.5	93.8	95.0	73.5	75.9	78.5	93.1	97.5
Unemployment Rate	6.6	6.2	6.1	5.7	5.5	5.4	5.3	5.2	8.1	7.4	6.2	5.4	5.0
Housing Starts [4]	0.93	0.99	1.03	1.06	1.02	1.13	1.21	1.24	0.78	0.92	1.00	1.13	1.31
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	0.25	0.25	0.25	0.44	1.56
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.88	3.95	4.16	4.22	3.66	3.98	4.17	4.05	4.49
10 Year Note	2.73	2.53	2.52	2.17	2.00	2.20	2.36	2.40	1.80	2.35	2.54	2.24	2.65

Forecast as of: March 19, 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, Bloomberg, LP and Wells Fargo Securities, LLC

Inside

Together we'll go far

U.S. Review

Mixed Economic Data and A Cautious Fed

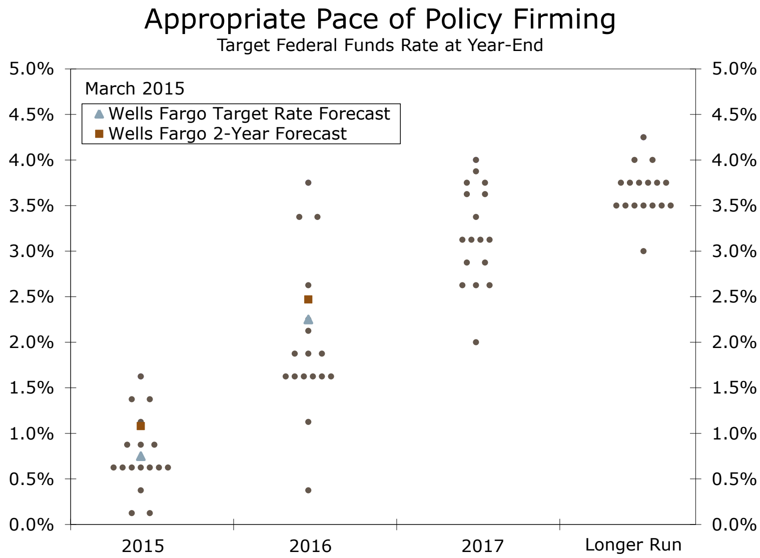
The big news this week came at the conclusion of the FOMC's two day meeting. We detail our views on the Fed policy statement and its impact on interest rates in the Interest Rate Watch section. We now expect the first fed funds rate hike in September. Industrial production data continued to reflect a softening of manufacturing activity in the first quarter. It appears that weather played an important role in housing starts as new construction activity fell 17 percent in February. The index of leading indicators signaled that momentum behind economic growth remains beyond what is shaping up to be a soft first quarter of economic growth.

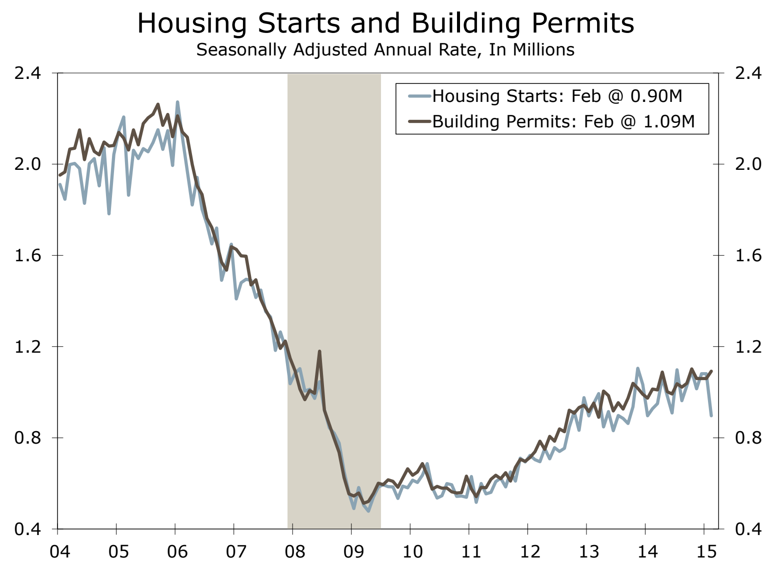
Industrial production activity remained muted in February after posting a 0.3 percent decline in January. Most of the weakness within the report came from the manufacturing side. Auto production fell 3 percent for the month, marking the third straight month of declines. One of the areas that helped to keep the headline reading in positive territory was a 7.3 percent jump in utilities output, a result of the unseasonably cold weather for the month. Regional manufacturing data from the Empire State Manufacturing and Philadelphia Fed surveys also pointed toward a downshift in activity for March. It now appears that overall industrial production activity will likely come in around 0.4 percent on an annualized basis in the first quarter, four percentage points lower than the rate recorded in the fourth quarter of last year.

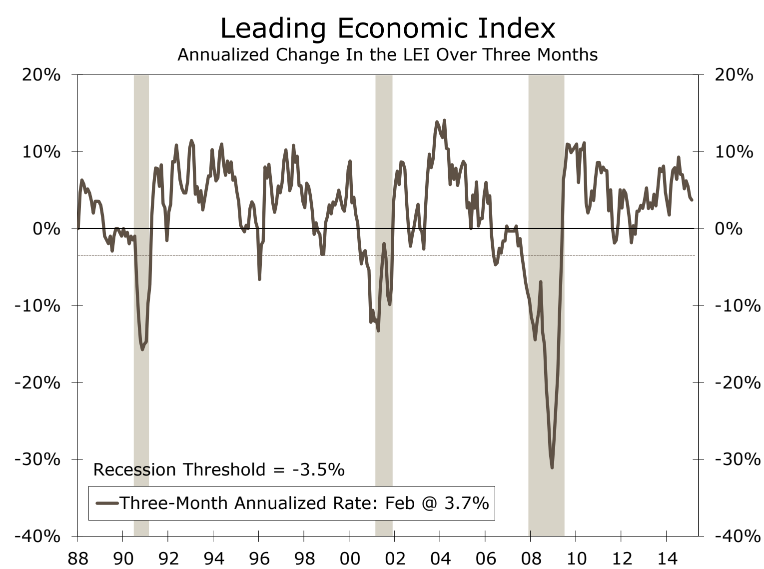
Cold weather also played a role in holding back activity in the housing market. Housing starts data for February showed a dramatic decline in the pace of new construction activity. While the volatile multi-family segment declined 20.8 percent, the more concerning aspect of the report was the 14.9 percent decline in single-family starts. As can be seen in the middle chart, the decline in starts is inconsistent with new permitting activity so we do expect some rebound in the months ahead. However, it is important to note that the pace of new construction activity continues to disappoint, a trend that is likely to continue in the months ahead. A case in point is recent data on builder sentiment, which posted a decline for the third month in a row in March.

The index of leading economic indicators rose 0.2 percent in February. The index has moderated over the past couple of months in line with a downshift in economic activity, primarily in the manufacturing sector. Average workweek, jobless claims and ISM new orders all weighed on the index in February. Even with the more modest index reading, the measure continues to point toward continued positive economic momentum.

Based on the economic data this week, we have lowered our GDP estimate for the first quarter to 1.0 percent from our previously published 1.1 percent number. The downward revision was in response to the disappointing reading for housing starts, which implied less residential investment in the first quarter.







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

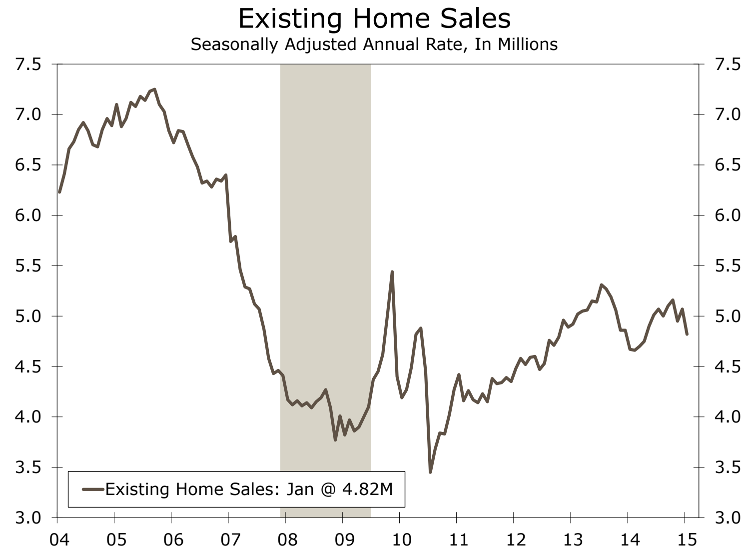
Existing Home Sales • Monday

Similar to other weather-sensitive indicators, existing home sales have been weak in recent months. Sales activity dipped in January to a 4.82 million-unit rate, the lowest level in nine months. Although the level of existing home sales gives some indication of the trajectory of resale activity, the inventory level holds the key to the true momentum. Total listed inventories have been weak in recent months, but rose a bit in January following five months of declines. Housing inventory for sale now sits at 1.87 million homes. Inventories typically follow a seasonal pattern and are low in the winter months, but the increase in January could be the first sign that sellers are getting ready for the spring home-buying season. A pick up in inventories could help overall sales activity.

New home sales will also be released this week. Here again, recent data releases have shown weak readings due to weather. We expect existing and new home sales activity to rebound in February.

Previous: 4.82M **Wells Fargo: 4.94M**

Consensus: 4.92M



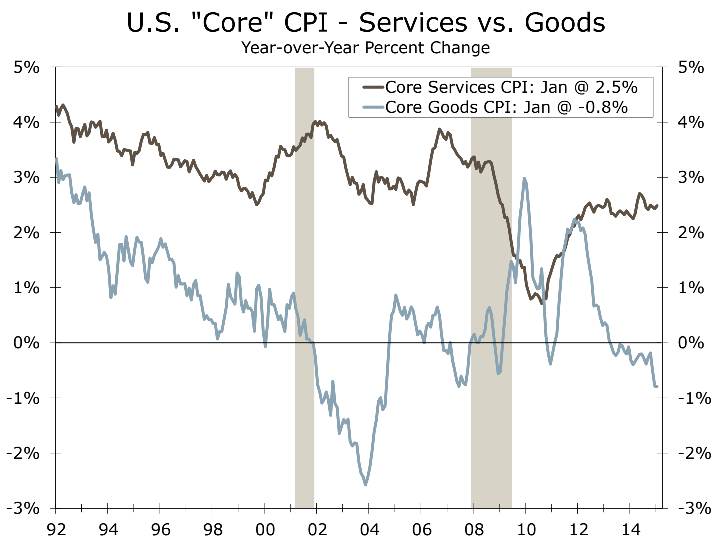
Consumer Price Index • Tuesday

The significant drop in energy prices continues to pull headline consumer prices lower. Prices paid by consumers fell 0.1 percent over the past year, the first decline in more than five years. Although the headline is now in negative territory, it is still too early to label the dip in headline prices as deflation. Deflation occurs when the decline in prices is prolonged and broad-based. In turn, a so-called “deflationary spiral” is ignited when households postpone spending for cheaper goods and services tomorrow. This typically leads to weak demand and is very difficult to turnaround. Thus far, the United States has had very few bouts of deflation.

Despite the sizeable drop in the headline, we suspect the headline weakness is largely due to temporary factors. In particular, inflation for core services, which makes up about 60 percent of the overall CPI, is up 2.5 percent over the past year. Gains in this component are more consistent with a strengthening economy.

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

Consensus: 0.2% (Month-over-Month)



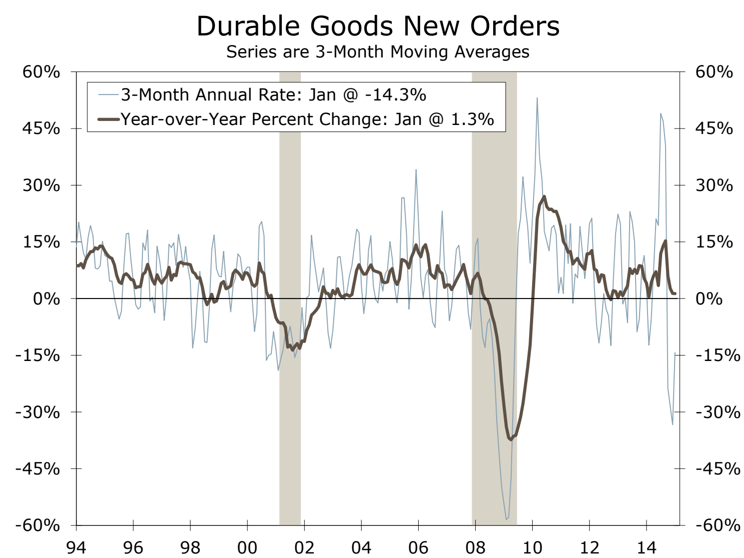
Durable Goods • Wednesday

Following two months of declines, headline durable goods orders rose 2.8 percent in January. Although the increase is welcome news and offers another positive sign the economy is still gaining momentum, much of the gain was concentrated in the volatile civilian aircraft component. With the outsized gain in aircraft orders in January, we will likely see some payback in February.

Nondefense capital goods orders excluding aircraft, which is a key measure of future business investment, increased 0.6 percent in January. The gain in this component suggests business spending is on solid footing. Although the ISM new orders component and regional purchasing manager surveys provide some forward-looking clues into the factory sector, there has been a divergence in the reports in recent months due to the drop in oil prices. Indeed, falling oil prices weigh down nominal orders figures, but have less of an impact on survey results.

Previous: 2.8% **Wells Fargo: -0.6%**

Consensus: 0.2% (Month-over-Month)



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

Global Review

Will Sterling Appreciation Keep BoE on Hold?

Real GDP in the United Kingdom grew 2.7 percent in 2014, the strongest rate of U.K. economic growth in the post-Lehman era, and recent data suggest that the British economy continues to expand at a solid pace thus far in 2015. For example, a widely-followed estimate of U.K. economic growth showed that real GDP rose 0.6 percent (not annualized) in the December-February period (see chart on front page).

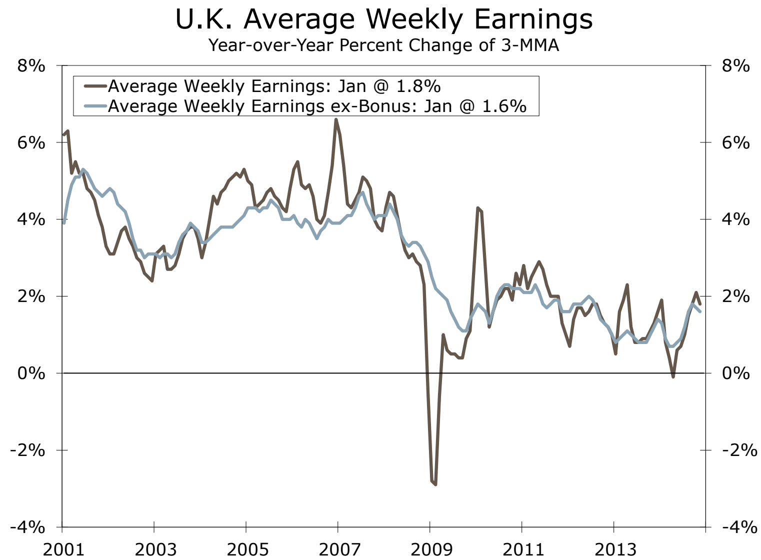
This solid economic growth over the past few years has caused the U.K. unemployment rate to fall from a peak of 8.5 percent at the end of 2011 to a seven-year low of 5.7 percent at present. As in the U.S. economy, however, this significant decline in the unemployment rate has not been associated, at least not yet, with a marked acceleration in British wages. As shown in the top chart, average weekly earnings continue to grow less than 2 percent on a year-over-year basis, whether bonuses are included or not.

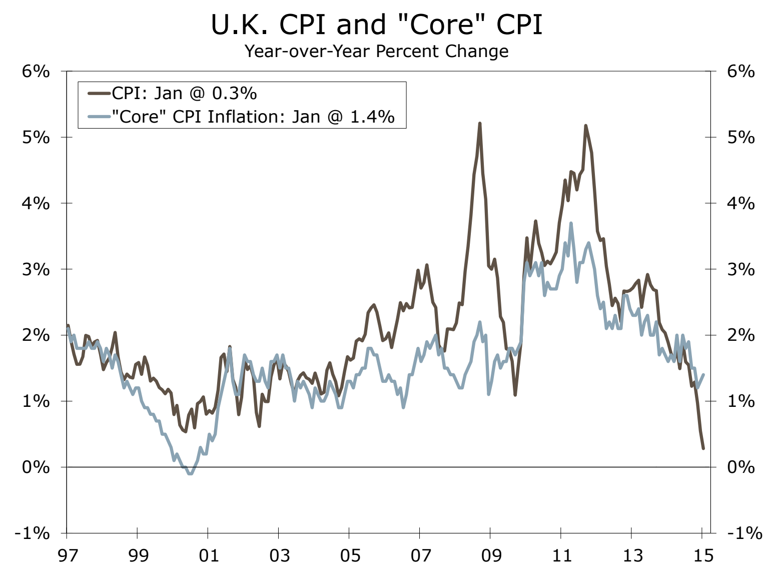
This lack of wage inflation means that CPI inflation in the U.K. economy likely will remain subdued for the foreseeable future. As shown in the middle chart, overall consumer prices were up only 0.3 percent on a year-ago basis, in January. As in many economies, this marked decline in the overall CPI inflation rate in the past few months largely reflects the collapse in petroleum prices that has occurred since last summer. That said, the "core" CPI inflation rate is only 1.4 percent at present, well below the 2 percent inflation target of the Bank of England's Monetary Policy Committee (MPC).

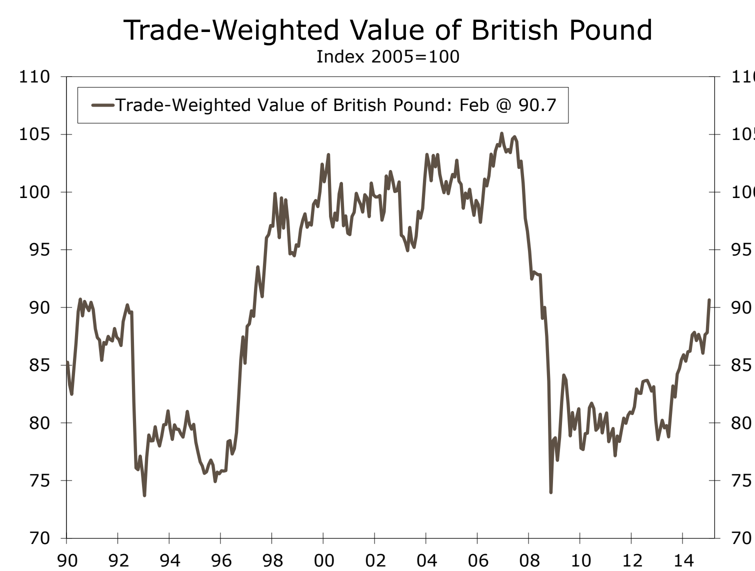
Due to this evident lack of inflationary pressures, the MPC seems to be in no hurry to tighten policy. As recently as December, two members of the nine-member MPC had been advocating a 25 bps increase in the Bank's main policy rate. In the past three MPC meetings, however, these two members have voted with the other seven members to keep policy unchanged. The minutes of the March policy meeting revealed another reason why the MPC may remain on hold for the foreseeable future. The MPC noted that exchange rate appreciation could exert downward pressure on the CPI inflation rate, keeping it below target for longer.

The trade-weighted value of the British pound has risen nearly 15 percent since summer 2013 (bottom chart). Although the value of sterling is more or less unchanged on balance against the dollar over that 18-month period, it has risen 20 percent vis-à-vis the euro since summer 2013. (The United States accounts for less than 10 percent of British trade, whereas more than 40 percent of British trade occurs with the member countries of the Eurozone.)

Although sterling is more or less unchanged versus the U.S. dollar relative to summer 2013, it has depreciated nearly 15 percent against the greenback since last July due to expectations that the Federal Reserve will hike rates sooner or more quickly than the MPC. Although the FOMC may have dialed back expectations a bit this week, we continue to believe that the Fed will tighten sooner and more quickly than the MPC. Accordingly, our currency strategy teams looks for the dollar to appreciate a bit more versus sterling in coming months.







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

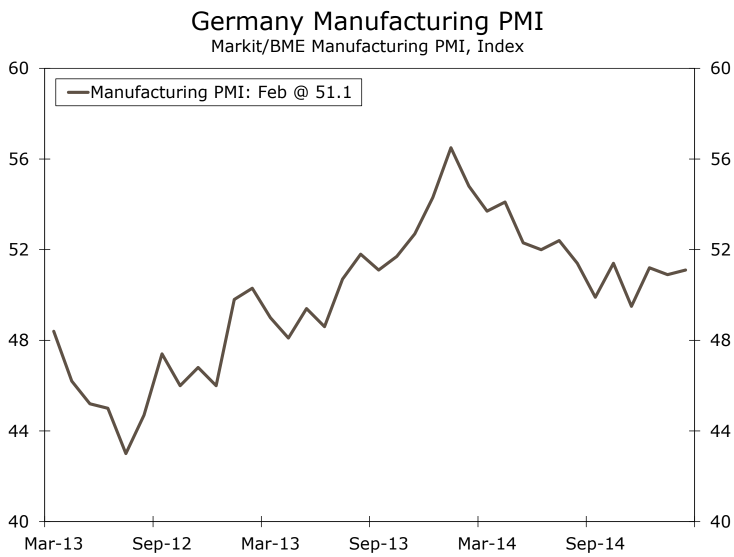
China Manufacturing PMI • Monday

Chinese economic numbers have continued to disappoint and the release on Monday of the HSBC manufacturing PMI is probably going to support that disappointment. The consensus is expecting the index to marginally decline in March with respect to the February reading, from 50.7 to 50.4.

Thus, the story from the Chinese economy will continue to be that of an economy that continues to travel the difficult path of a new economic development model based more on the internal consumption market, rather than the one we have been used to seeing over the past several decades based on investment. This is not an easy transition and it will take the country many, many years to achieve success, something that is not at all guaranteed. This means that markets should reduce their expectations for the Chinese economy during this transition.

Previous: 50.7

Consensus: 50.4



Germany Manufacturing PMI • Tuesday

We will start the week with the release of the German Markit/BME manufacturing index where markets are expecting a slightly better reading, 51.5, for March than what was recorded in February, at 51.1. Although this is not a big improvement compared to the February reading, the direction of the move continues to support a relatively better performance for the German economy and thus for the overall Eurozone economy.

On Wednesday we will also have the release of the IFO index, which could add to the improvement seen in many indicators, with relatively better news coming from this week's release of the ZEW current situation and expectations index. Once again, these changes may not seem very large, but they indicate that the German economy is moving in the right direction. The speed and the intensity may not be what markets used to expect from the German economy but it is a first step.

Previous: 51.1

Consensus: 51.5

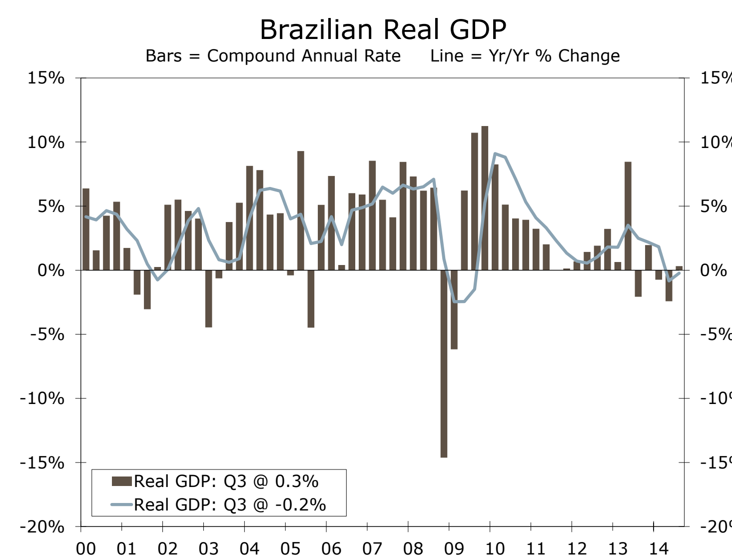
Brazil Q4 GDP • Friday

The Brazilian economy has continued to disappoint all of those that thought it had finally turned the corner. However, the last several years have clearly brought back traces of the old Brazil, a Brazil that does not show the traits needed to remain a leading member of the BRICS.

On Friday we will have a peek into the GDP results for the last quarter of 2014 and for the year as a whole and the expectations are not positive. However, the worst part is that 2014 is already old news and investors are probably looking at a very similar, or perhaps worse, environment for 2015. Although the Dilma administration has started its second term in office trying to reverse some of the decisions of her first term, the global environment facing the Brazilian economy today is not easily resolved. In addition, the internal environment is probably worse than the global environment.

Previous: 0.1%

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



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

Interest Rate Watch

The Return to Data Dependency

Following this week's meeting, the FOMC dropped its pledge to be patient in raising rates. The language change opens the door to the possibility of the Committee raising rates as early as June and brings the focus back to the economic data.

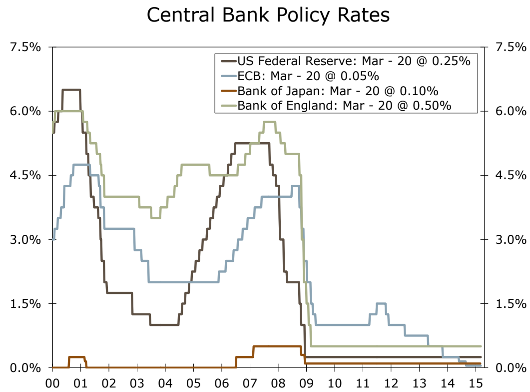
While no longer explicitly stating patience, implicitly the FOMC looks to be even more patient than when it first stated it "can be patient" in December. Updated economic projections show the committee is expecting GDP growth to be slower than previously estimated for this year, as well as in 2016 and 2017. The downgrade comes after a disappointing start to the year and weakening export growth in part due to the run up in the dollar. Inflation was also revised lower in 2015 and 2016, suggesting a later return to the Fed's 2 percent target.

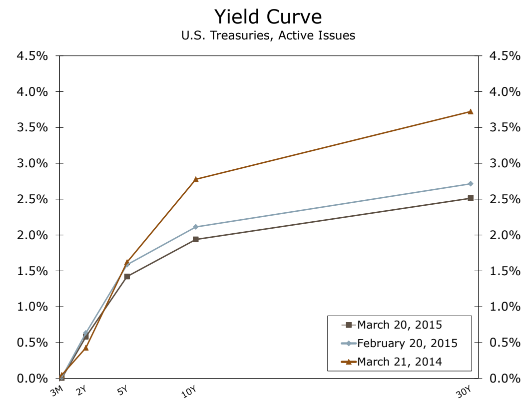
Meanwhile, the FOMC acknowledged the continued strong pace of improvement in the labor market by nudging down forecasts for the unemployment rate at the end of the year. However, with wage growth showing no clear signs of accelerating, the members also lowered estimates of longer-run employment.

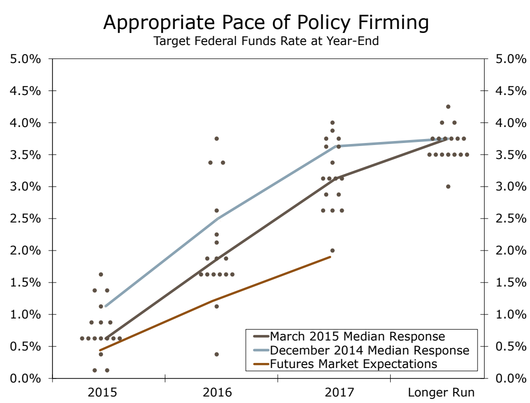
With inflation expected to take longer to return to target and full employment further away than previously thought, the median estimate for the fed funds target rate at year end fell 50 bps to a range of 50-75 bps. Expectations for 2016 and 2017 were also revised down even as the longer-run median was unchanged, suggesting a more gradual pace of tightening once the Fed begins to normalize policy.

The significantly lower rate projections for the end of the year suggest a later date for liftoff. We now expect the Fed will hold off from beginning to normalize policy until September when inflation shows surer signs of moving higher and the labor market is closer to the Fed's interpretation of full employment.

The Fed's view of the path of interest rates now looks more closely aligned with markets. We still expect the yield curve to flatten over the course of the year, but for the pace to be somewhat slower given the later date for the Fed to begin tightening.







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

Credit Market Insights

Mortgage Borrowing Costs: Less is More

Following a 17.0 percent month-over-month drop in housing starts and a weekly contraction in mortgage applications, the mortgage market may finally get some relief through a continuous downward trend in borrowing costs.

The recent Primary Mortgage Market Survey (PMMS) from Freddie Mac indicated that mortgage rates, which are already historically low, continue to trend lower. In fact, the 30-year fixed rate mortgage (FRM) currently remains at just 3.78 percent—down 0.08 points from last week and more than half a percent below the 4.32 average seen a year ago.

The average lending rate for a 15-year fixed rate and a 5-year Treasury-indexed hybrid have also fallen, at 3.06 percent and 2.97 percent from the year-ago rates of 3.32 and 3.02 percent, respectively.

The FOMC statement on Wednesday included lowered projections through 2017 for the fed funds rate. Many borrowing rates are highly correlated with the fed funds target rate—including many mortgage rates—and effects from lowered projections for the fed funds rate will likely spill over into the mortgage sector.

Lower mortgage rates and expectations for a rate hike later this year should give potential homebuyers an extra incentive to enter the mortgage market at present. This should bode well for the real estate sector and the spring home-buying season.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.78%	3.86%	3.80%	4.32%
15-Yr Fixed	3.06%	3.10%	3.07%	3.32%
5/1 ARM	2.97%	3.01%	2.99%	3.02%
1-Yr ARM	2.46%	2.46%	2.44%	2.49%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$1,840.0	42.40%	28.30%	11.92%
Revolving Home Equity	$455.3	-4.67%	-1.10%	-3.06%
Residential Mortgages	$1,582.4	-32.11%	10.69%	1.80%
Commerical Real Estate	$1,635.1	14.49%	19.51%	7.65%
Consumer	$1,198.3	7.85%	-0.08%	4.39%

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

Topic of the Week

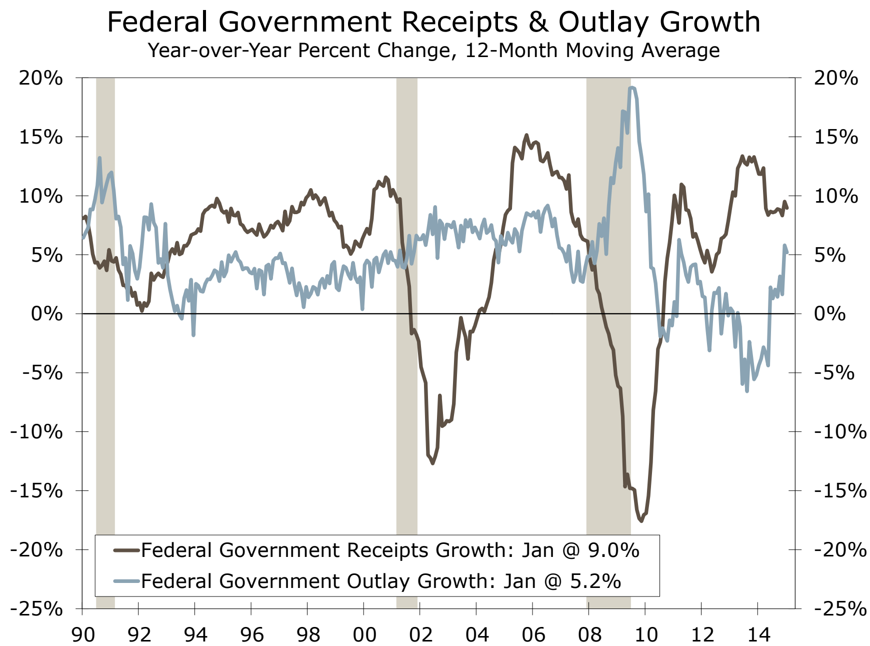
Debt Ceiling Re-Established

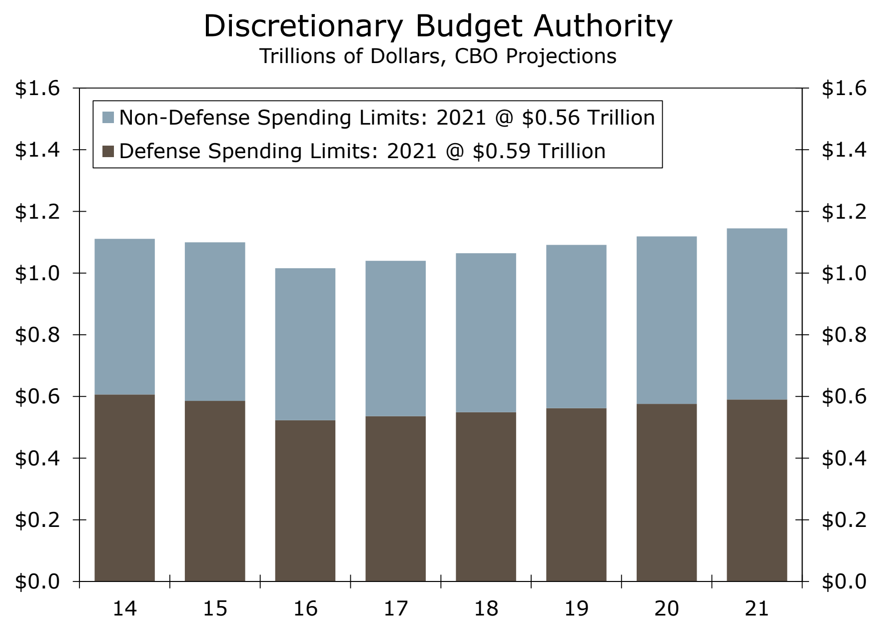
From February 2014 through March 15th, the nation's borrowing limit had been suspended under the Temporary Debt Limit Extension Act. As of Monday, the debt ceiling has been re-established at the cumulative amount of federal borrowing that was needed since the act was passed last year. Given that Congress and the administration did not lift the borrowing limit before the end of the debt ceiling suspension period, the Department of the Treasury began employing extraordinary measures to stay under the new borrowing limit. These measures include the suspension of the issuance of State and Local Government Series (SLGS) securities, which are special-purpose Treasury securities issued to states and municipalities to assist them in conforming to certain tax rules. Suspending these securities allows the Treasury to stay under the limit and buy time for Congress to act.

The use of extraordinary measures described above will allow the nation to remain under the new borrowing limit until October or November of this year, according to the Congressional Budget Office. However, it is important to note that the exact timing of when the borrowing limit will be reached is dependent on a number of factors, including tax collections and federal outlays (top graph). In addition, the October/November timeline, if it holds, would fall into the 2016 federal fiscal year. Thus, the decision of what budget level is used for the next fiscal year will also influence when the borrowing limit is reached.

Beyond the debt ceiling debate, the discussions on Capitol Hill this week revolved around the 2016 federal budget. Both the House and Senate released their budget blueprints. Both plans maintained the slated set of budget cuts known as sequestration which had been partially rolled back over the past couple of years.

For further reading see our special report *Capitol Hill Update: Debt Ceiling Re-Established* available on our website.





Source: U.S. Dept. of the Treasury, Congressional Budget Office and Wells Fargo Securities, LLC

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 3/20/2015	1 Week Ago	1 Year Ago
3-Month T-Bill	0.00	0.02	0.05
3-Month LIBOR	0.27	0.27	0.23
1-Year Treasury	0.27	0.26	0.23
2-Year Treasury	0.59	0.66	0.42
5-Year Treasury	1.43	1.58	1.70
10-Year Treasury	1.94	2.11	2.77
30-Year Treasury	2.51	2.70	3.66
Bond Buyer Index	3.52	3.62	4.51

Foreign Exchange Rates

	Friday 3/20/2015	1 Week Ago	1 Year Ago
Euro ($/€)	1.080	1.050	1.378
British Pound ($/£)	1.492	1.474	1.650
British Pound (£/€)	0.723	0.712	0.835
Japanese Yen (¥/$)	120.290	121.400	102.390
Canadian Dollar (C$/$)	1.259	1.278	1.124
Swiss Franc (CHF/$)	0.977	1.006	0.884
Australian Dollar (US$/A$)	0.776	0.764	0.904
Mexican Peso (MXN/$)	15.040	15.488	13.260
Chinese Yuan (CNY/$)	6.205	6.259	6.229
Indian Rupee (INR/$)	62.469	62.966	61.333
Brazilian Real (BRL/$)	3.221	3.249	2.328
U.S. Dollar Index	98.001	100.330	80.192

Foreign Interest Rates

	Friday 3/20/2015	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.01	0.02	0.28
3-Month Sterling LIBOR	0.57	0.56	0.52
3-Month Canada Banker's Acceptance	0.99	1.00	1.26
3-Month Yen LIBOR	0.10	0.10	0.14
2-Year German	-0.24	-0.23	0.21
2-Year U.K.	0.41	0.49	0.68
2-Year Canadian	0.46	0.55	1.07
2-Year Japanese	0.01	0.02	0.07
10-Year German	0.19	0.26	1.65
10-Year U.K.	1.53	1.71	2.77
10-Year Canadian	1.30	1.48	2.50
10-Year Japanese	0.33	0.41	0.60

Commodity Prices

	Friday 3/20/2015	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	46.00	44.84	99.43
Gold ($/Ounce)	1184.82	1158.55	1327.88
Hot-Rolled Steel ($/S.Ton)	491.00	495.00	628.00
Copper (¢/Pound)	277.90	267.85	297.60
Soybeans ($/Bushel)	9.52	9.85	14.29
Natural Gas ($/MMBTU)	2.82	2.73	4.37
Nickel ($/Metric Ton)	13,735	13,848	16,294
CRB Spot Inds.	468.48	468.42	532.92

Source: Bloomberg LP and Wells Fargo Securities, LLC

Next Week's Economic Calendar

	Monday 23	Tuesday 24	Wednesday 25	Thursday 26	Friday 27
U.S. Data	**Existing Home Sales** January 4.82M February 4.94M (W)	**CPI (MoM)** Janaury -0.7% February 0.1% (W) **New Home Sales** Janaury 481K February 470K (W)	**Durable Goods Orders** January 2.8% February -0.6% (W)		**GDP (QoQ)** 4Q (2nd) 2.2% 4Q (3rd) 2.4% (W)
Global Data	**China** **China Manufacturing PMI** Previous (February) 50.7	**Germany** **Manufacturing PMI** Previous (February) 51.1 **United Kingdom** **CPI (YoY)** Previous (January) 0.3%		**Japan** **CPI (YoY)** Previous (January) 2.4%	**Brazil** **GDP (YoY)** Previous (4Q) 0.1%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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