March 06, 2015

WELLS FARGO SECURITIES

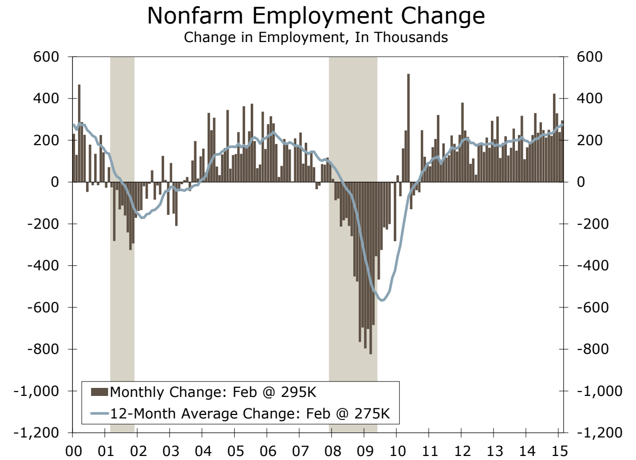
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Plenty of Momentum in the Labor Market

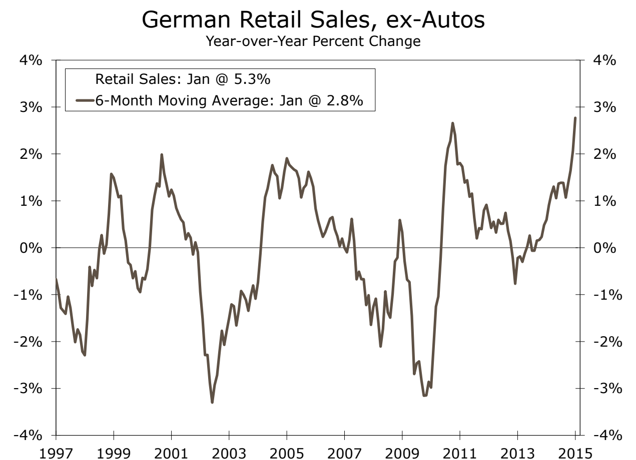
- Nonfarm payrolls added 295,000 jobs in February, while the unemployment rate dropped to 5.5 percent. Gains were broad-based, but average hourly earnings barely grew.
- The strong payroll number bodes well for consumer spending, which continued to exhibit strength in January. Meanwhile, real disposable incomes shot up, adding more to consumers' ability to spend in the coming months.
- The factory sector has been notably weaker. The ISM manufacturing index fell for the fourth straight month in February, and factory orders declined again in January.



Global Review

Small Tidbits of Stronger Demand, Still Weak Supply

- We have argued over the past several months that the decrease in petroleum and gasoline prices across the world will be a boon to the demand side of the global economy. This is desperately needed in the face of deflationary pressures across the world.
- Perhaps reflecting this slight improvement, the ECB revised its GDP forecast upward for this year and next. The ECB now expects the Eurozone to grow 1.5 percent this year (versus 1.0 percent), while expecting a 1.9 percent rate for next year.



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	2.2	1.8	2.7	2.9	2.9	2.3	2.2	2.4	2.8	2.9
Personal Consumption	1.2	2.5	3.2	4.2	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	-0.3	0.0	0.8	2.1	1.5	1.6	0.1	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 27, 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

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Together we'll go far

U.S. Review

Consumers Advance

The U.S. consumer continued to look strong into January, with real personal spending growing 3.8 percent at a three-month annualized rate. Incomes also improved in the month, with real disposable income surging 0.9 percent. These solid gains bode well for future consumer spending as well. Incomes are set to remain relatively strong into February with nonfarm payrolls adding 295,000 jobs. Job gains were relatively broad-based, with mining and logging posting the only decline of the major industry groups. In addition, the unemployment rate fell to 5.5 percent.

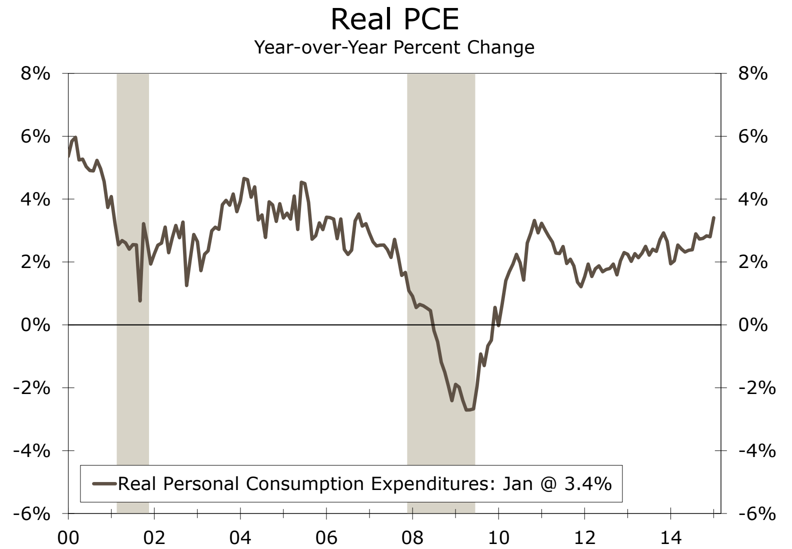
Despite the solid headline employment numbers, average hourly earnings slipped to a 2.0 percent year-over-year rate from 2.2 percent the previous month. With the unemployment rate and the number of workers who are part time for economic reasons consistently falling, more wage growth should be on the horizon. The Fed is looking for inflationary pressures to justify a rate hike while the core PCE deflator, at 1.3 percent, is well below the 2 percent mandate. Without more growth in wages, a rate hike will be difficult to justify.

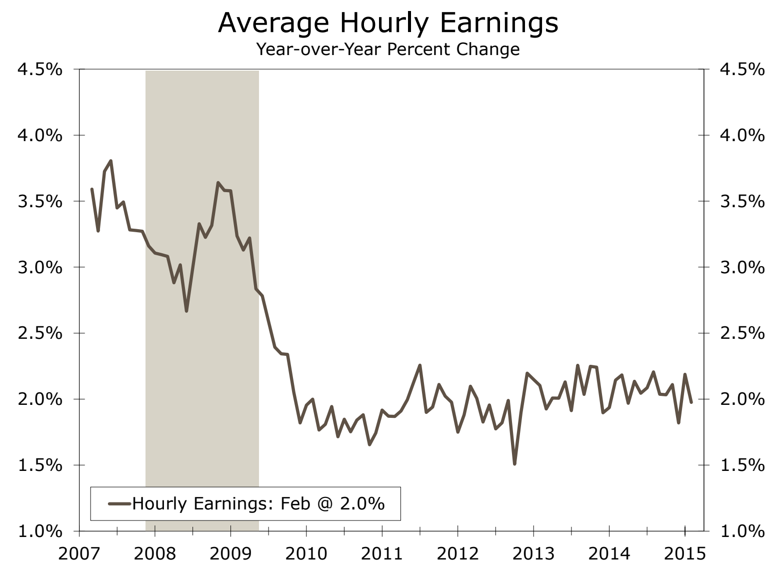
Some of the strongest gains in the employment report came from the service sector. The professional & business services and leisure & hospitality industries added 51,000 and 66,000 jobs, respectively. In addition, the ISM Nonmanufacturing Index increased for the second consecutive month.

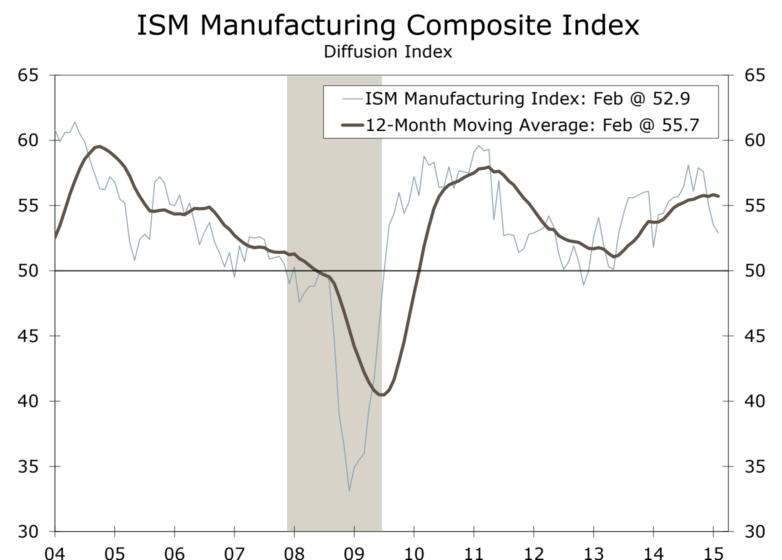
Factory Sector Retreats

Manufacturers are struggling with a stronger dollar and cutbacks from the energy industry amid low oil prices. The severity of these struggles remains uncertain as the incoming data are somewhat mixed. The ISM manufacturing index fell for the fourth straight month, though still remains in expansionary territory. New export orders fell further below the breakeven threshold of 50, pointing to manufacturers' difficulties in remaining competitive internationally with a stronger dollar. Meanwhile, the employment, production and new orders components all weakened in February as well. Factory orders had fallen 0.2 percent in January after a substantial 3.5 percent decline in the prior month. Declining orders were most prominent for nondurables, which are adversely affected by the oil price plunge; however, mining, oil field and gas field machinery managed a rebound in the first month of the year after plummeting in 2014.

The Beige Book points to an overall pick up in the factory sector. In the Dallas Fed region, which faces an outsized share of oil-related weakness, manufacturing was "flat to positive." The Beige Book also noted that some of the weakness in the construction industry this winter has been due to severe winter weather. Construction spending fell in January, while orders for construction machinery plummeted in the same month. Construction had been slow to recover before the winter storms began as household formation continues at a sluggish pace. Construction payrolls posted a solid gain in February though the increase was slower than what had been seen in the prior two months.







Source: U.S. Department of Commerce, U.S. Department of Labor, Institute for Supply Management and Wells Fargo Securities, LLC

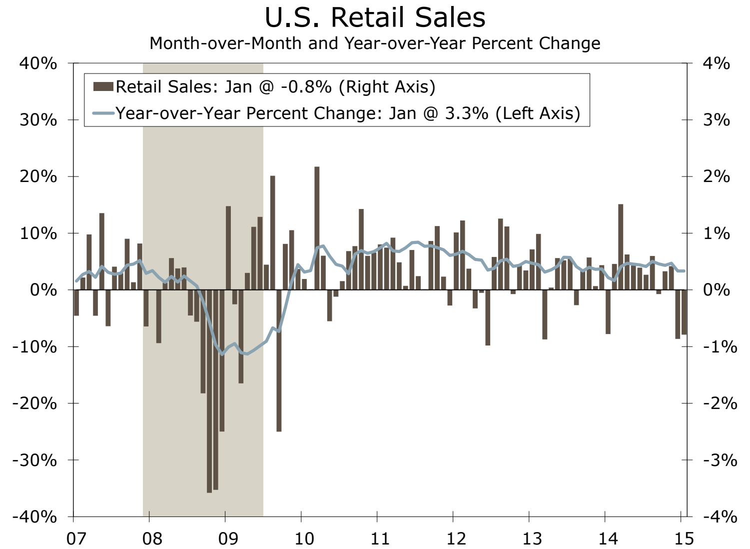
Retail Sales • Thursday

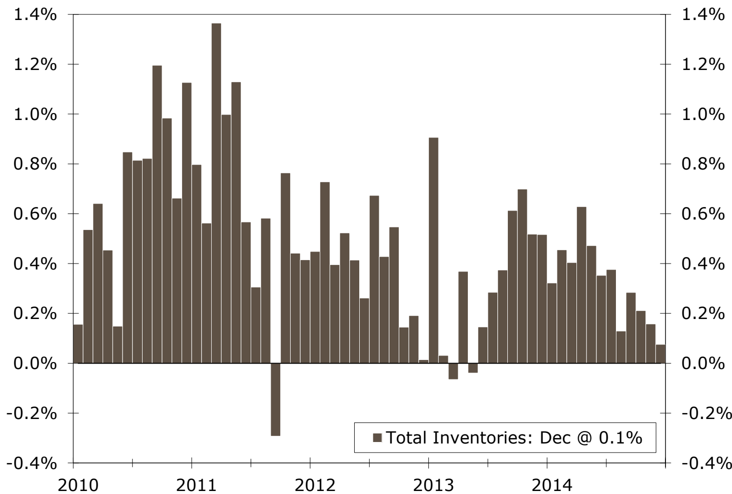
Retail sales declined for the second straight month in January on the heels of another steep drop in gasoline station sales. Retail sales are measured in nominal terms–not adjusted for price changes—and lower gasoline prices have pulled down the overall level of gasoline sales. Despite the weak headline reading, we believe that retail sales will see growth in the coming months against the backdrop of a firming labor market, particularly given that sales excluding gasoline and automobile sales increased 0.2 percent in January.

In February, we expect that retail sales saw a reversal and increased at a 0.2 percent month-over-month pace. This will be partially due to a giveback from the December and January weakness. In addition, continued cheaper oil prices have given households extra purchasing power to put toward retail sales, and consumer confidence remains firmly in positive territory.

Previous: -0.8% **Wells Fargo: 0.2%**

Consensus: 0.4% (Month-over-Month)





Business Inventories • Thursday

December saw a 0.1 percent month-over-month increase in business inventories, falling slightly short of the 0.2 percent expected increase. It is unclear whether the increase was due to increased sales expectations from businesses or an unintentional buildup as sales fell short of expectations. We suspect a combination of both, as the inventory-to-sales ratio ticked up to 1.33.

We expect that business inventories remained the same in January, with a 0.1 percent month-over-month increase. The growth in inventories may be partially due to increased sales expectations from businesses, as the six-month-ahead index of business conditions ticked up 6 points in February. In addition, a slight rise in commercial and industrial loans in January leads us to believe that some businesses may be using loans to fund additional inventories.

Previous: 0.1% **Wells Fargo: 0.1%**

Consensus: 0.1% (Month-over-Month)

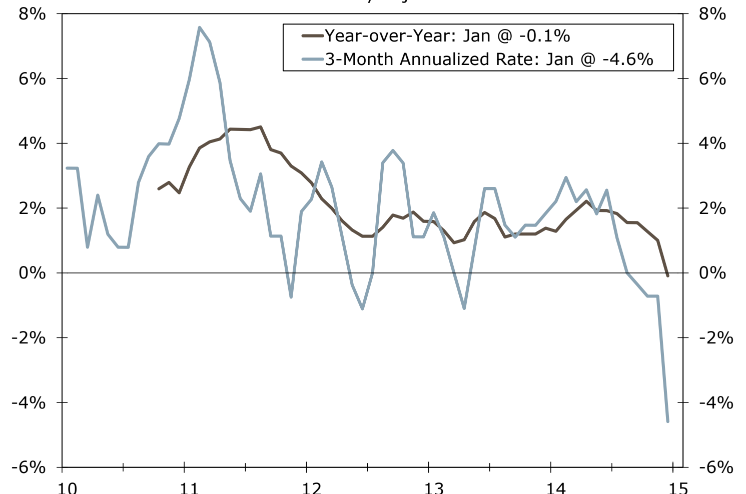
PPI • Friday

Following sharp drops in energy prices, the Producer Price Index has fallen for the past three months on a month-over-month basis. Much of the weakness can be attributed to lower energy costs, which has held down inflation growth across most major indicators. While the majority of the oil drop has been contained to the volatile energy component of inflation, January saw a spillover into prices for transportation and warehousing services, which also saw weakness. The core services index, which excludes food and energy, saw a drop in January of 0.2 percent.

In February, we suspect that prices firmed slightly as oil retraced some of its losses and other indicators of inflation (including the consumer price index) firmed. We expect a 0.1 percent month-over-month increase. Thursday will also hold the release of the import price index, which should give another indication of the state of inflation.

Previous: -0.8% **Wells Fargo: 0.1%**

Consensus: 0.3% (Month-over-Month)



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

Global Review

Small Tidbits of Stronger Demand, Still Weak Supply

We have argued over the past several months that the decrease in petroleum and gasoline prices across the world will be a boon to the demand side of the global economy, something desperately needed in the face of deflationary pressures across the world. This week we saw some small tidbits that this may be starting to happen in a region that needs help from its consumer markets. Perhaps reflecting this slight improvement the ECB revised its GDP forecast upward for this year and next. The ECB now expects the Eurozone to grow 1.5 percent this year (versus a 1.0 percent), while expecting a 1.9 percent rate for next year.

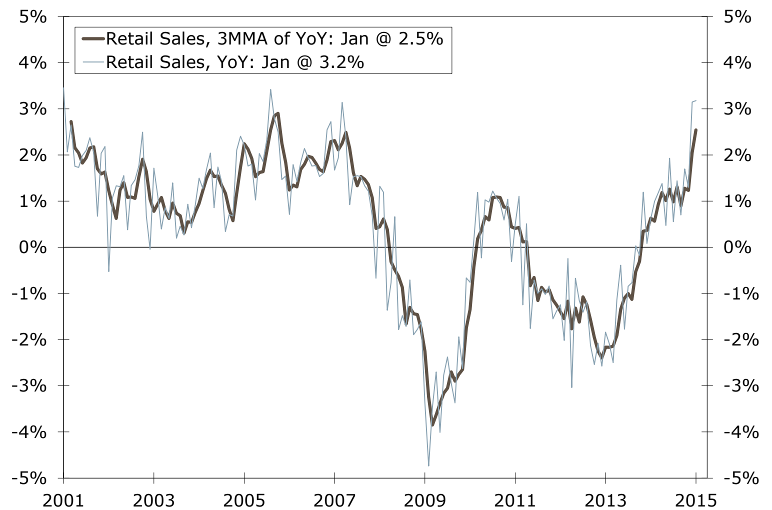
From this angle, the positive news came from German retail sales surging 2.9 percent in January versus the previous month after an upwardly revised increase of 0.6 percent in December. On a year-over-year basis retail sales were up a strong 5.3 percent, up from a 4.8 percent increase for the year ending in December. The improvement in German retail sales was probably the driver for the improvement in Eurozone retail sales, which posted an increase of 1.1 percent in January versus December and were up by 3.2 percent on a year-over-year basis.

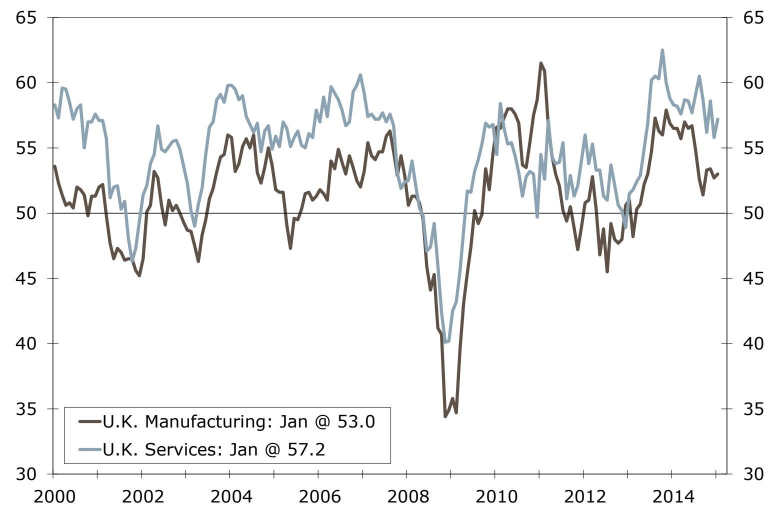
Germany also recorded a very strong industrial production number in January. According to the release industrial production increased 0.6 percent in the first month of the year while the 0.1 percent increase in December was revised up to 1.0 percent. This means that the German industrial sector has posted five consecutive months of expansion.

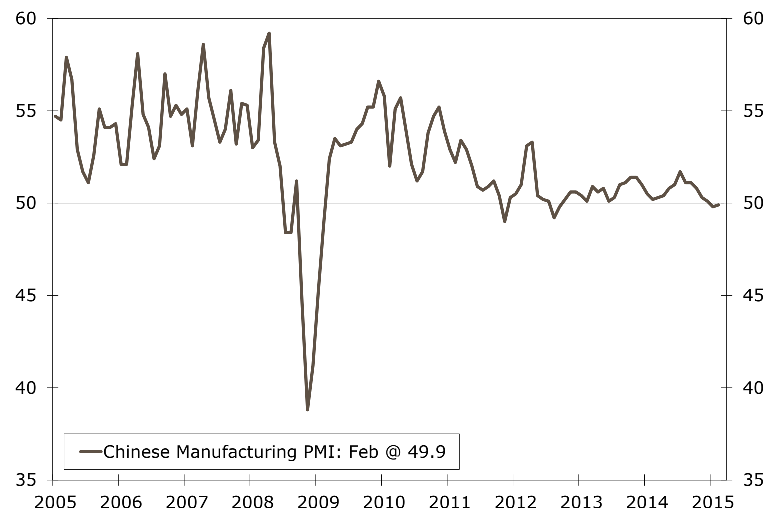
Data releases for other countries in the global economy during this week were not very upbeat on the supply side with, perhaps, the exception, once again, the U.K. The U.K. manufacturing PMI was stronger than expected in February, up from an upwardly revised 53.1 in January to 54.1. In Germany, the news was not very upbeat with respect to factory orders which dropped a more than expected 3.9 percent in January, almost reversing the 4.4 percent increase of the previous month. On the positive side, the Markit manufacturing PMI for February was a bit stronger than what originally reported, at 51.1 versus 50.9.

Meanwhile, the Chinese manufacturing sector remained stagnant in February with the official manufacturing PMI at 49.9, barely higher than the 49.8 print recorded in January. However, the private, HSBC manufacturing PMI increased a bit more, from 50.1 in January to 50.7 in February. Both indices, however, are at or close to the demarcation line between expansion and contraction, underscoring the weak economic environment of the Chinese economy. At the same time, it is worth noting that the Chinese government came out saying that their economic growth target has been dropped from 7.5 percent to 7.0 percent, still high compared to other economies of the world but low compared to what the Chinese economy grew during the past several decades.

In Brazil the country's central bank increased interest rates once again, taking the already two year tightening campaign to 550 basis points. We continue to expect the Brazilian economy to do poorly in 2015 and 2016.







Source: IHS Global Insight and Wells Fargo Securities, LLC

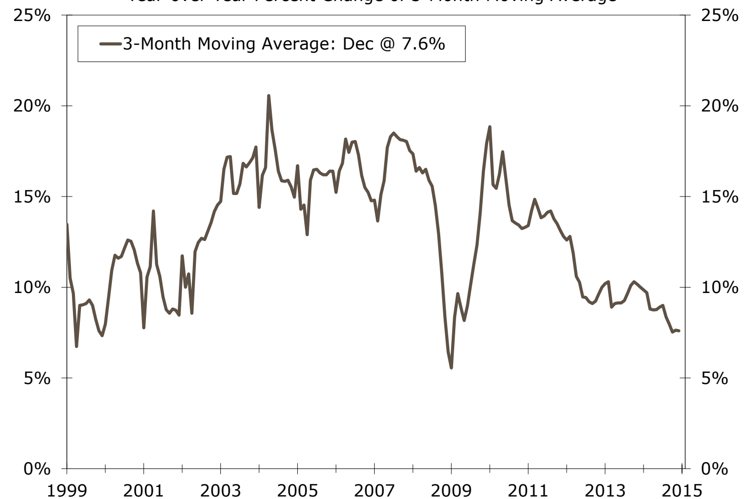
Chinese Industrial Production • Wed

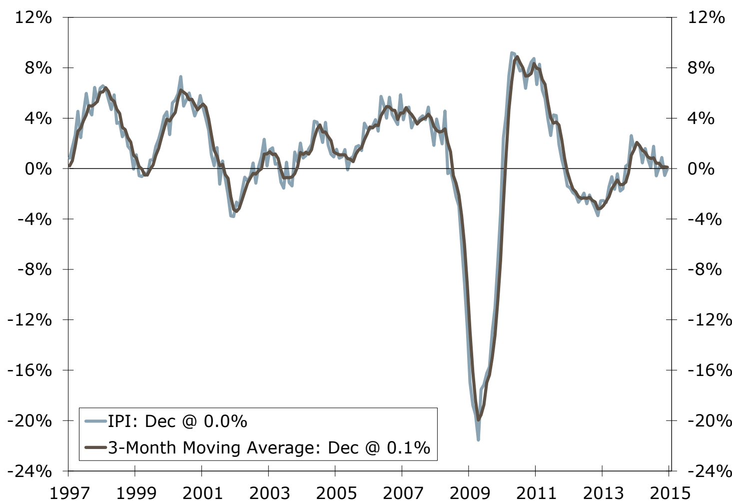
The rate of economic growth in China clearly has slowed over the past few years, and data that are slated for release next week will show how the economy is faring thus far in 2015. Arguably, the highlight of the week will be the release of IP data for the first two months of 2015, which are due out on Wednesday. (Due to the distortions that Chinese New Year can have on year-over-year comparisons, IP data for the combined January-February period are generally released every year.)

Other important indicators on the docket next week include February data on international trade and consumer prices. The overall rate of CPI inflation tumbled to a five-year low of 0.8 percent in January, which has given the central bank scope to cut its main lending rate in recent months. Data on bank lending in February will shed some light on the state of current credit conditions in China.

Previous: 7.9% (Year-over-Year)

Consensus: 7.7%





Eurozone Industrial Production • Thursday

Industrial production in the Eurozone was anemic in the fourth quarter, rising only 0.2 percent (not annualized) on a sequential basis. However, recent indicators suggest that IP may be starting to accelerate. Business sentiment indicators have trended higher in most European economies so far this year, and the 0.6 percent increase registered in German IP in January imparts a solid foundation for IP in the overall Eurozone. Indeed, the consensus forecast anticipates that IP in the overall euro area rose 0.2 percent in the first month of the year.

French business sentiment data that are slated for release on Monday will show how businesses in that country are feeling about their current prospects. "Final" CPI data in Germany should confirm that inflationary pressures in the Eurozone's largest economy remained muted in February.

Previous: 0.0% (Month-over-Month)

Consensus: 0.2%

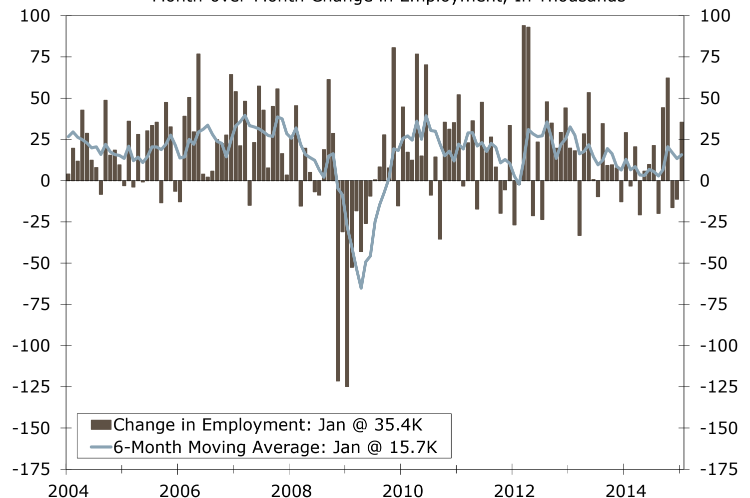
Canadian Employment • Friday

Nonfarm payrolls in Canada rose by 35,400 workers in January, reversing the declines that were registered during the two preceding months. Smoothing through the monthly volatility shows that Canadian payrolls have been growing at a modest pace in recent months. Data that will print on Friday will show how the labor market fared in February. The unemployment rate in Canada has trended lower since mid-2009, and currently stands at a six-year low of 6.6 percent.

Housing market data are also on the docket next week. After rising strongly from 2009 through 2012, housing starts in Canada have been more or less flat over the past two years. Data that will print on Monday will show how the seasonally adjusted amount of starts held up in February. A widely followed index of house prices, which has risen nearly 40 percent since 2009, will print on Thursday.

Previous: 35,400

Consensus: -5,000



Source: IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

Job Data Solidifies Fed Outlook

February's job gains of 295,000 plus the drop in the unemployment rate solidify our expectation that the Fed will raise the funds rate in June and that the yield curve will continue to flatten this year. Our 1-year and 10-year Treasury rate outlook is for 1.2 and 2.3 percent, respectively, for the fourth quarter.

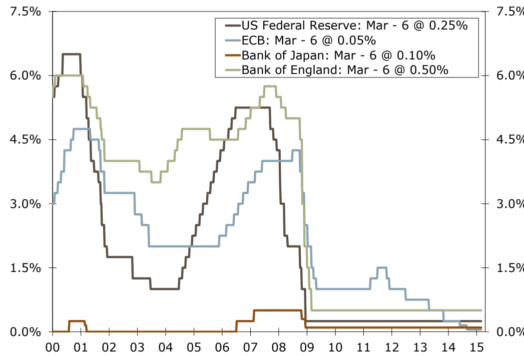
Job gains signal trend economic growth of 2.5-3.0 percent for the second half of this year. With the unemployment rate already at what we perceive as full-employment, labor costs should start to rise. For the cost side of inflation, we focus primarily on unit labor costs and we saw this week that those costs have indeed risen recently such that some upward pressures will feed through to core inflation. In fact, we suspect that the year-over-year CPI/PCE numbers will start to pick up by mid-year and those markets will react to expectations of several moves by the Fed—hence the higher 1-year Treasury rate in the fourth quarter relative to the current rate.

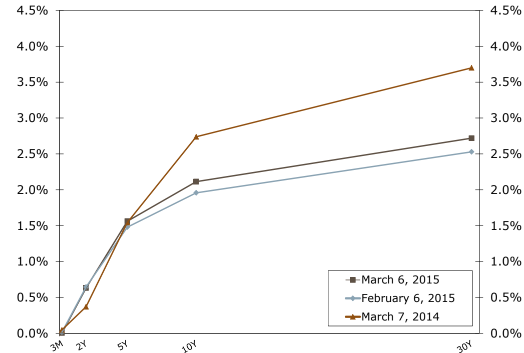
Global Easing Limits the Long End

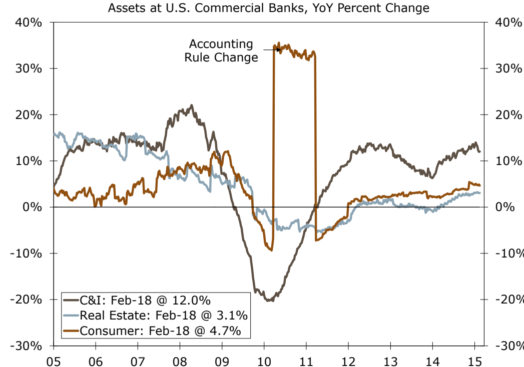
This week brought another rate cut by the PBOC along with further details on the ECB program of bond buying. Hence, despite the increase in short rates by our own central bank, the global pursuit of yield will continue to pressure long rates downward and hence our outlook for a 2.3 percent yield on the 10-year in the fourth quarter. In addition, while we do expect the inflation numbers to pick up, our long-run view is that inflation remains below 2 percent. Since 1994, the PCE deflator, the Fed's benchmark, has actually averaged below 2 percent.

The Credit Issue

Despite the modest rise in interest rates in our outlook, the problem is that any rise in rates from a small base will generate negative total returns for investors who have bought at the recent low yields. Earlier this year, there were forecasts of one percent 10-year rates. Those are now expensive expectations. Finally, the expected returns on some financial instruments, when marked to market, will be hit when rates rise—a surprise to some.







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

Credit Market Insights

Loan Performance Improves

Loan performance continued to improve in the fourth quarter of 2014. The value of loans past due fell $5.7 billion in the fourth quarter. This decline marked the ninth consecutive decline and a cycle low. The percentage of loans that are considered noncurrent fell below 2 percent for the first time of this cycle and the net charge-off rate remains at prerecession levels.

Delving into the components of noncurrent loans, we find that loans secured by real estate are the reason for the still elevated noncurrent loan rate, which has a noncurrent loan rate of 3.4 percent. While this may not seem high, it is almost four times the next highest component.

Loans secured by 1-4 family residential real estate are the reason for the elevated overall rate. This category was slow to show improvement early in the recovery, although improvement has been rapid over the past year.

An improving economy should help maintain the momentum in loan performance and new loan origination. One potential headwind could be higher interest rates when the Fed begins to raise the fed funds rate. We are forecasting for the Fed to begin tightening later this year, although we expect the yield curve to flatten as shorter rates rise faster than the long end of the yield curve.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.75%	3.80%	3.69%	4.28%
15-Yr Fixed	3.03%	3.07%	2.99%	3.32%
5/1 ARM	2.96%	2.99%	2.97%	3.03%
1-Yr ARM	2.44%	2.44%	2.42%	2.52%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$1,823.6	42.34%	15.91%	12.02%
Revolving Home Equity	$454.3	-9.36%	-4.58%	-3.07%
Residential Mortgages	$1,587.6	46.64%	4.43%	1.28%
Commerical Real Estate	$1,616.2	2.46%	5.19%	6.81%
Consumer	$1,200.0	-2.81%	2.47%	4.67%

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

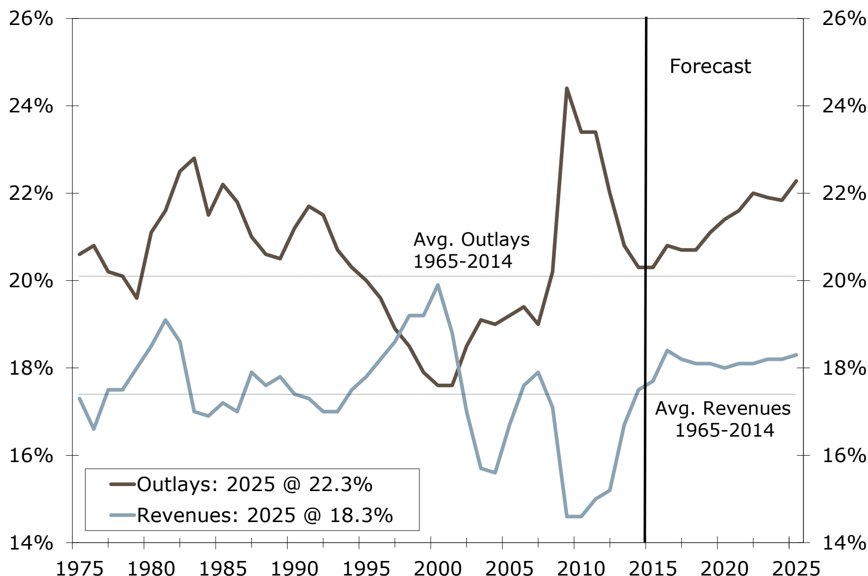
Topic of the Week

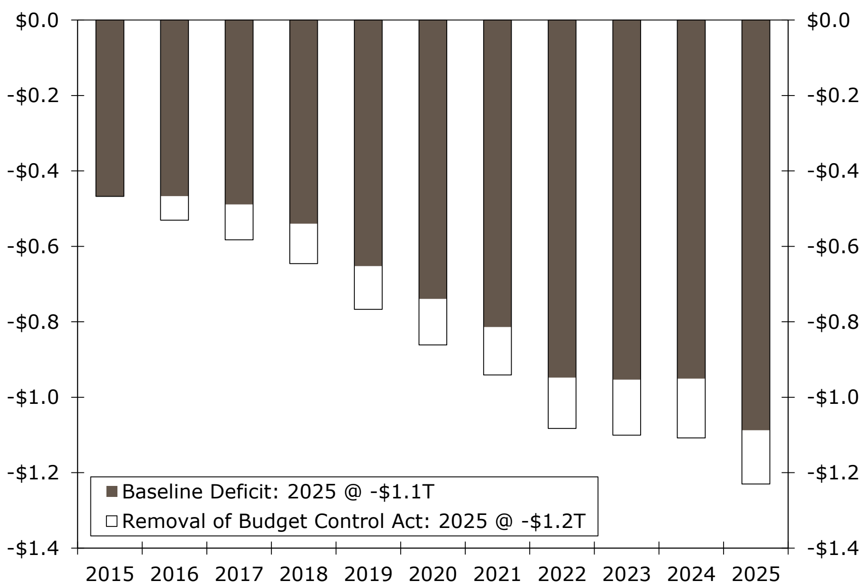
Perspectives on the Federal Budget

For investors and decision makers, the coming change in the fiscal outlook outlined by the Congressional Budget Office will be critically important to any longer run projections of market pricing and volatility. The outlook for federal revenues through 2025 indicates that federal revenues will stabilize somewhere around 18.3 percent of GDP. Federal outlays have continued to grow at a faster pace than GDP in recent years. Rising from 17.6 percent of GDP in 2000, outlays totaled 22.3 percent of GDP in 2014 (top graph). While federal revenues will stabilize over the next few years as a share of GDP, outlays will grow at a faster pace and contribute to the growing federal budget deficit. In addition, recall that monetary policy will also unlikely to be directed toward large scale purchases of Treasury assets. Foreign interest in Treasury debt remains uncertain. In addition, potential changes to the current budget baseline—such as the extension of certain tax provisions or the reversal of the budget cuts known as sequestration—could cause the deficit to grow further, weighing on the already-strained trust funds and impacting outlays for federal programs (bottom graph).

Five of the major federal trust funds pose a risk to the budget, as four of the funds continue to see outlays exceeding revenues on an annual basis. Many of these trust funds are at risk of depletion by as early as 2025, which would cause automatic reduction to the program benefits, including Social Security checks. The Highway Trust fund has been in the news recently as the current patch that Congress put in place last year is set to expire May 31 of this year. In order to keep current government programs operating at the same level of present, some changes to augment revenues and reduce outlays for these trust funds will be necessary.

For more information see our special report entitled, "*2015 Federal Fiscal Policy Outlook Part II: Outlay Growth Continues to Outpace Revenues*" available on our website.





Source: Congressional Budget Office and Wells Fargo Securities, LLC

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 3/6/2015	1 Week Ago	1 Year Ago
3-Month T-Bill	0.01	0.01	0.05
3-Month LIBOR	0.26	0.26	0.24
1-Year Treasury	0.25	0.15	0.15
2-Year Treasury	0.63	0.62	0.34
5-Year Treasury	1.56	1.50	1.57
10-Year Treasury	2.11	1.99	2.74
30-Year Treasury	2.72	2.59	3.69
Bond Buyer Index	3.68	3.62	4.41

Foreign Exchange Rates	Friday 3/6/2015	1 Week Ago	1 Year Ago
Euro ($/€)	1.098	1.120	1.386
British Pound ($/₤)	1.519	1.544	1.674
British Pound (₤/€)	0.723	0.725	0.828
Japanese Yen (¥/$)	119.940	119.630	103.070
Canadian Dollar (C$/$)	1.246	1.252	1.099
Swiss Franc (CHF/$)	0.976	0.954	0.881
Australian Dollar (US$/A$)	0.784	0.781	0.909
Mexican Peso (MXN/$)	15.180	14.950	13.152
Chinese Yuan (CNY/$)	6.263	6.269	6.119
Indian Rupee (INR/$)	62.171	61.755	61.755
Brazilian Real (BRL/$)	2.994	2.841	2.324
U.S. Dollar Index	96.687	95.293	79.663

Source: Bloomberg LP and Wells Fargo Securities, LLC

Foreign Interest Rates	Friday 3/6/2015	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	1.01	0.97	1.27
3-Month Yen LIBOR	0.09	0.10	0.14
2-Year German	-0.20	-0.23	0.17
2-Year U.K.	0.57	0.43	0.63
2-Year Canadian	0.62	0.47	1.05
2-Year Japanese	0.01	0.02	0.08
10-Year German	0.36	0.33	1.65
10-Year U.K.	1.85	1.80	2.77
10-Year Canadian	1.53	1.30	2.51
10-Year Japanese	0.40	0.34	0.62

Commodity Prices	Friday 3/6/2015	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	51.06	49.76	101.56
Gold ($/Ounce)	1196.00	1213.22	1350.85
Hot-Rolled Steel ($/S.Ton)	500.00	503.00	627.00
Copper (¢/Pound)	265.95	271.60	327.55
Soybeans ($/Bushel)	9.80	10.20	14.20
Natural Gas ($/MMBTU)	2.84	2.73	4.66
Nickel ($/Metric Ton)	14,140	14,323	15,240
CRB Spot Inds.	471.56	473.12	535.86

Next Week's Economic Calendar

	Monday 9	Tuesday 10	Wednesday 11	Thursday 12	Friday 13
U.S. Data		**NFIB Small Business Optimism** January 97.9 February 99.0 (C) **JOLTS** December 5028 January 5028 (C)		**Retail Sales (MoM)** January -0.8% February 0.2% (W) **Import Price Index (MoM)** January -2.8% February -0.4% (W)	**PPI Final Demand (MoM)** January -0.8% February 0.1% (W)
Global Data	**Mexico** **CPI (MoM)** Previous (January) -0.1%	**Japan** **PPI (YoY)** Previous (January) 0.3%	**China** **Industrial Production (YoY)** Previous (December) 7.6% **Australia** **Unemployment Rate** Previous (January) 6.4%	**Eurozone** **Industrial Production (MoM)** Previous (December) 0.0%	**Canada** **Unemployment Rate** Previous (January) 6.6%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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