October 25, 2013

WELLS FARGO SECURITIES

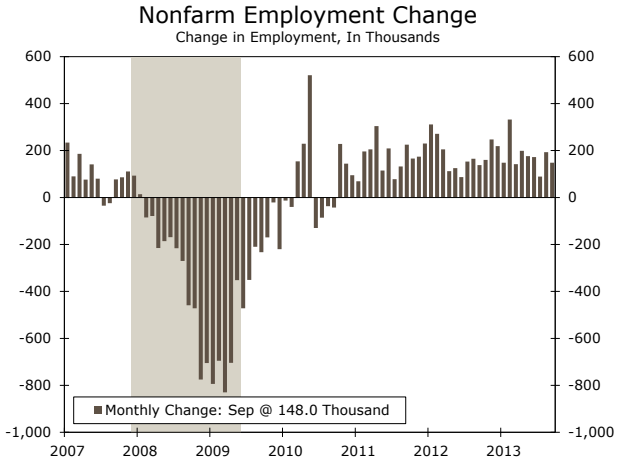
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Modesty Is Quite Unbecoming in the Recovery

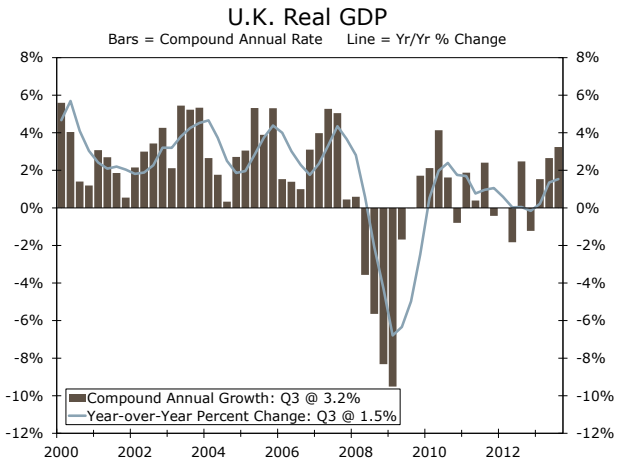
- September's employment numbers were once again underwhelming, with more than two years of modest payroll growth continuing into the autumn months.
- Residential construction bounced back in August, reflecting better weather conditions. Construction spending improved in August, and a surge in existing home sales over the summer more than made up for the small drop in September.
- Aircraft and defense orders fueled the rebound in durable goods orders, but otherwise, the report was relatively weak. In addition, a dearth of global demand kept the trade deficit relatively stable in August.



Global Review

Faster Global Growth; Bank of Canada Turns Dovish

- There were some encouraging signs this week of improving growth in some of the advanced economies of the world. Third quarter GDP figures bested expectations in the United Kingdom and South Korea. For detailed analysis of those GDP reports, please see our recent special commentary on our website.
- In this week's Global Review on page 4, we dig into the latest developments in Canadian monetary policy. Although the Bank of Canada kept its policy rate steady, the official statement points to a change in the bank's bias for the future.



Wells Fargo U.S. Economic Forecast

	Actual 2013 1Q	2Q	Forecast 2013 3Q	4Q	Forecast 2014 1Q	2Q	3Q	4Q	Actual 2011	2012	Forecast 2013	2014	2015
Real Gross Domestic Product [1]	1.1	2.5	1.8	2.1	2.2	2.2	2.4	2.4	1.8	2.8	1.6	2.2	2.6
Personal Consumption	2.3	1.8	1.7	2.1	2.1	2.2	2.4	2.4	2.5	2.2	1.9	2.1	2.5
Inflation Indicators [2]													
PCE Deflator	1.4	1.1	1.2	1.2	1.4	1.9	1.9	2.1	2.4	1.8	1.2	1.8	2.2
Consumer Price Index	1.7	1.4	1.5	1.4	1.6	2.1	1.9	2.0	3.1	2.1	1.5	1.9	2.2
Industrial Production [1]	4.1	0.7	2.0	4.6	4.2	4.3	4.4	4.5	3.4	3.6	2.4	3.8	4.7
Corporate Profits Before Taxes [2]	2.1	4.5	6.3	5.0	4.1	5.4	6.2	5.3	7.9	7.0	4.5	5.3	5.9
Trade Weighted Dollar Index [3]	76.2	77.5	75.2	75.3	76.0	76.3	76.8	77.3	70.9	73.5	76.1	76.6	77.9
Unemployment Rate	7.7	7.6	7.3	7.2	7.1	7.0	7.0	6.9	8.9	8.1	7.5	7.0	6.7
Housing Starts [4]	0.96	0.87	0.94	1.04	1.08	1.14	1.20	1.23	0.61	0.78	0.95	1.14	1.30
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Conventional Mortgage Rate	3.57	4.07	4.49	4.30	4.40	4.50	4.60	4.70	4.46	3.66	4.11	4.55	4.95
10 Year Note	1.87	2.52	2.64	2.60	2.70	2.80	2.90	3.00	2.78	1.80	2.41	2.85	3.25

Forecast as of: October 25, 2013
[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. Dept. of Commerce, Bloomberg LP, Federal Reserve Board, U.S. Dept. of Labor 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

Together we'll go far

U.S. Review

New Data, but Still the Same Old Story

The employment numbers for September were finally released this week, perpetuating the same modest growth in the labor market seen since the recovery took hold. Nonfarm payrolls added a less-than-expected 148,000 jobs for the month, though net revisions bumped total employment up 9,000 for the prior two months. In addition, the decline in the unemployment rate to 7.2 percent from 7.3 percent was largely due to a rounding anomaly. Although the headline numbers were a continuation of the status quo, changes in some of the underlying components were unusual. Transportation & warehouse employment posted a large gain, which seems to be a seasonal adjustment issue with the return of school bus drivers at the start of the school year. Furthermore, government payrolls jumped 22,000 for the month despite another drop in federal government employment amid persistent budget issues. State governments were the largest contributor to the upside, although September was the seventh straight month that local government employment increased.

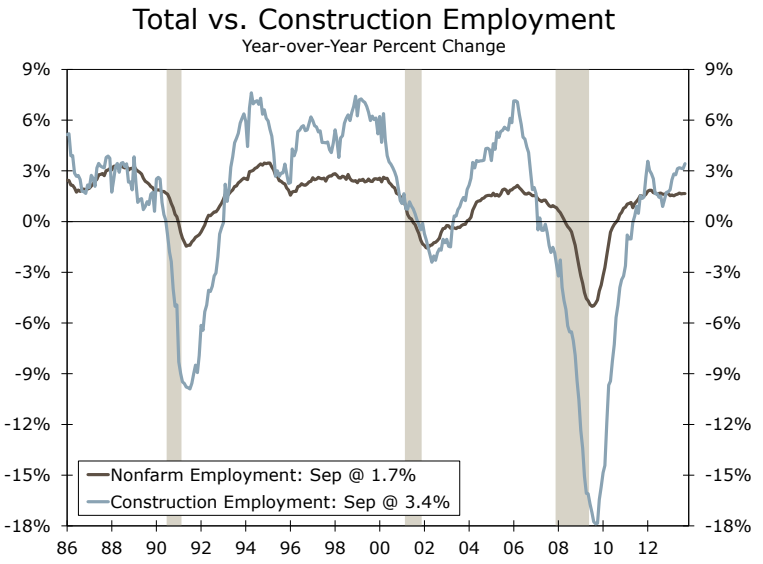
Construction Activity is Picking Up

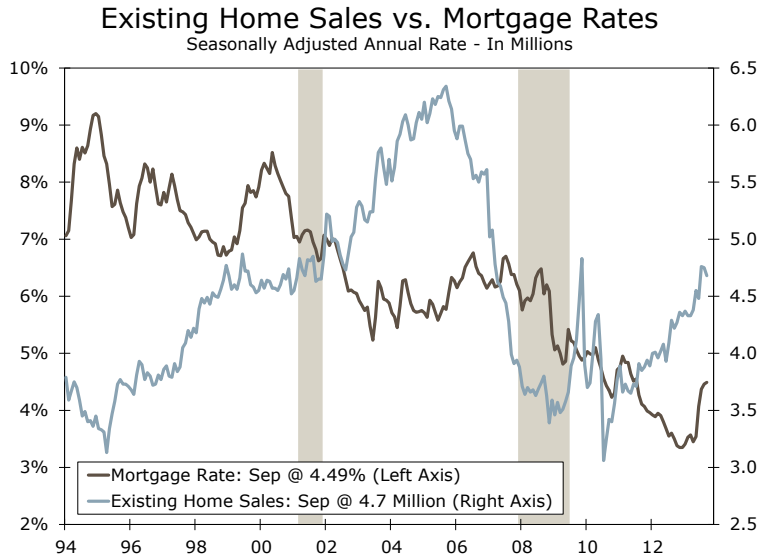
Construction spending also continued its upward trajectory in August. New single- and multifamily construction growth continued to ramp up, even if it was somewhat slower than the breakneck speeds seen earlier this year. Construction spending is an input to the structures component of GDP, and the strong upward revision to July's numbers should also provide a slightly better-than-expected reading for Q3 GDP. Despite the drop in existing home sales in September, our housing outlook continues to call for continued gradual improvement. Existing home sales were bound to come down from the huge gains made in July. Furthermore, sales still are up more than 10 percent from a year ago. Inventories remain tight, which should leave plenty of upward pressure on home prices.

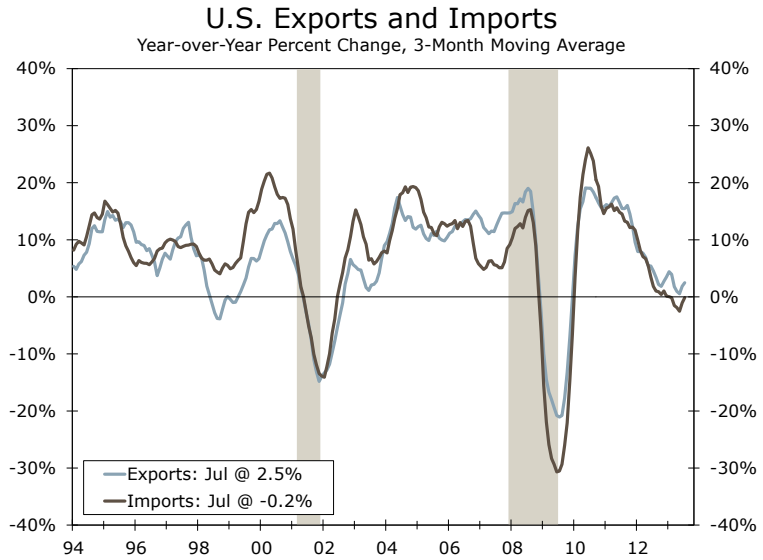
The improvement in construction activity appears to have carried over into September, when an additional 20,000 workers were added to construction payrolls. The rebound likely reflects new projects finally coming on line after an unusually rainy spring and summer in the South. However, financial activities employment declined slightly for the second straight month as higher mortgage rates erode the mortgage refinancing business.

Demand for Goods Is Not Great

A decline in goods imports and exports in August is indicative of the weak global economy. Overall, the trade balance has been relatively steady in Q3 and should have little effect on GDP for the quarter. Typically petroleum exports have been on the rise, but even this component dropped considerably in the month. Durable goods orders rebounded strongly in September, with nondefense aircraft and defense orders leading the headline number. However, these volatile subcomponents were weak over the summer, and after excluding transportation, new orders fell for the third straight month. On the other hand, shipments were up across a wide array of industries, and the longer-term trend in the report has been a positive one.







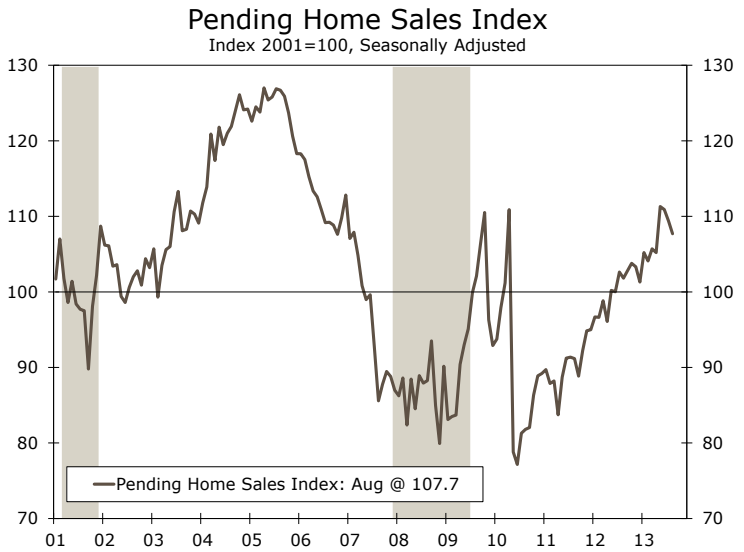
Source: U.S. Department of Labor, National Association of Realtors, U.S. Department of Commerce and Wells Fargo Securities, LLC

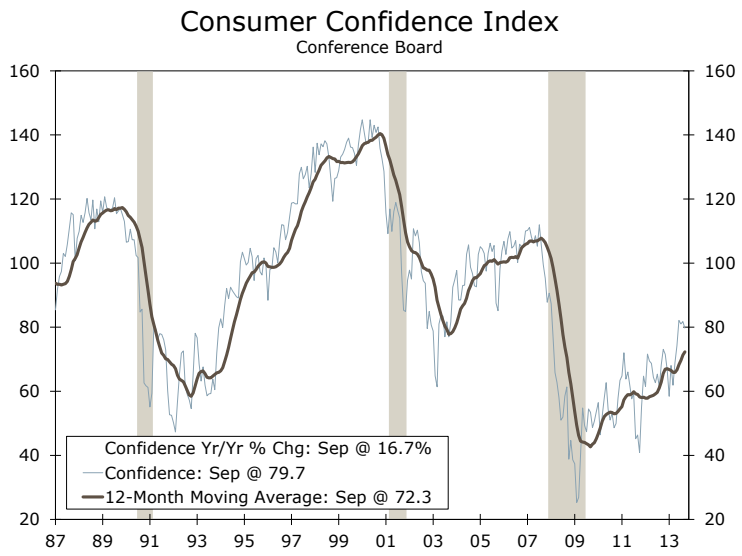
Pending Home Sales • Monday

Pending home sales fell 1.6 percent in August, marking the third straight month of declines. While pending sales activity over the past several months has been disappointing, the slowdown comes on the heels of a very strong 5.8 percent reading last May. In addition, the index remains up 5.8 percent on a year over year basis. Regionally, the Northeast was the only region with a positive reading as sales declined in the Midwest, South and West. The gradual rise in interest rates likely played a role in slowing sales in August and likely will keep the bounce back in pending sales restrained in September. Going forward, many analysts will be watching the existing housing market indicators now that interest rates are beginning to drop again. The short-term pull back in rates could help to support slightly better sales numbers in the coming months.

Previous: -1.6%

Consensus: 0.0%





Consumer Confidence • Tuesday

Consumer confidence declined 2.1 points in September to 79.7 as consumer's view of future economic conditions weakened. The survey was taken in the early part of the month and thus likely reflects domestic concerns over possible intervention in Syria. Consumers' views of current economic conditions posted an improvement for the month; however the slide in the future expectations component pulled the headline reading lower. Our expectation is that consumer confidence fell again in October as the federal government shutdown and debt ceiling fight began to weigh on consumers. This erosion in consumer confidence would be consistent with the drop in confidence after the last debt ceiling debate in August 2011. Over the next few months we expect the pace of consumer spending to downshift slightly given the gradual erosion in consumers' expectations about future conditions.

Previous: 79.7 **Wells Fargo: 71.5**

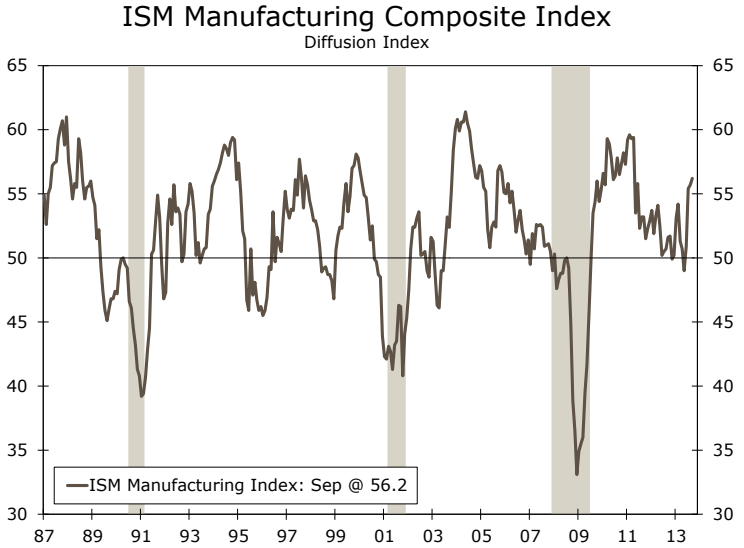
Consensus: 75.0

ISM Manufacturing • Friday

The ISM Manufacturing Index rose in September to 56.2 with the key components of production, employment and new orders remaining in expansion territory. Within the new orders component, several industries reported increases in order activity. The only potentially concerning aspect of the report was the somewhat higher prices paid component which indicated some modest input cost pressures that could squeeze profits. We expect the index to pull back slightly in October to 55.2, as the government shutdown, along with fears around the debt ceiling debate, begin to weigh on business confidence and thus new order activity. While we still expect industrial output to increase in the current quarter, the upside potential likely has been limited by the fiscal policy uncertainty of the past few weeks. This uncertainty is expected to continue given the short-term nature of the deal to end the federal shutdown.

Previous: 56.2 **Wells Fargo: 55.2**

Consensus: 55.1



Source: NAR, The Conference Board ,Institute for Supply Management and Wells Fargo Securities, LLC

Global Review

Bank of Canada: From Avant-Garde to Being on Guard

As the Canadian economy outpaced the rest of the developed world during the recovery following the global recession of 2009, the Bank of Canada (BoC) was at the vanguard of policy tightening among the world's central banks. Along with the Reserve Bank of Australia, the BoC acted early to increase its main policy rate. However, after three rate increases in 2010 which lifted the overnight rate to 1.0 percent, the BoC has been on hold, although it has maintained a hawkish stance (a bias to begin raising rates) for most of that period.

On the surface then, there was little that was different about the call from Canada's monetary policymakers this week when the decision was made to keep rates on hold. With the overnight rate at 1.0 percent for more than three years now, this was not much of a development. What was something of a change is clear move to a more dovish policy stance.

This pivot was evident in two major changes in the communication from the BoC. The first change was the complete removal of language about how over time the eventual removal of monetary policy support would become appropriate. Maintaining this language during periods of only tepid economic growth always struck us as curious. ("Bank of Canada Weighs Rate Hike…Beg Your Pardon?" July 20, 2012)

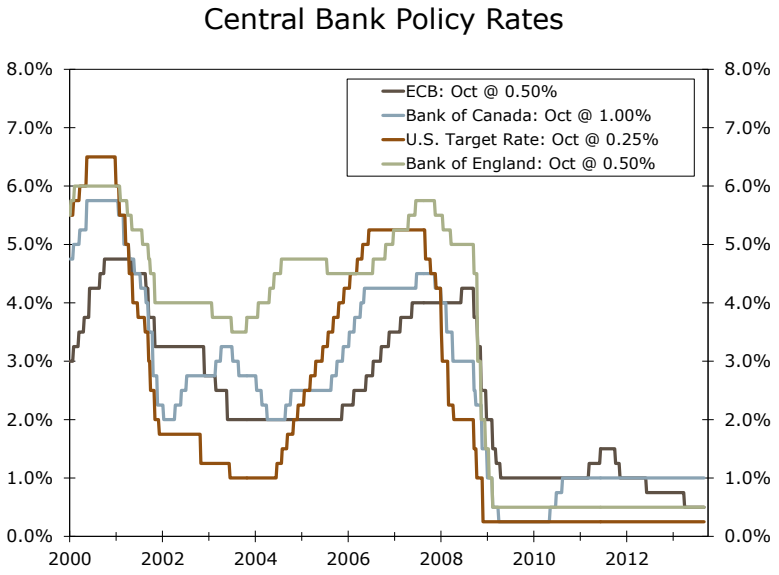
The second key shift was to identify downside risks to the inflation outlook. The official statement noted that "[c]ore inflation has softened by more than the Bank had expected, with more muted price pressures across a wide range of goods and services…total CPI inflation has also been lower than anticipated…"

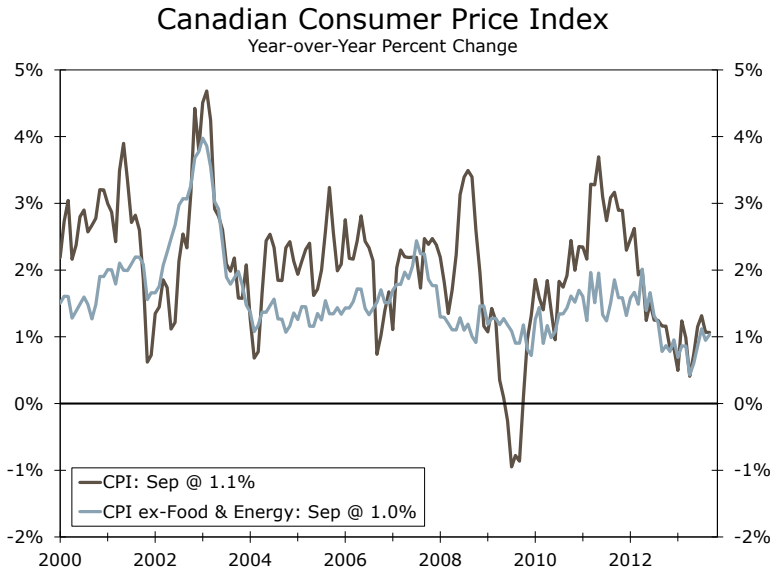
The BoC now expects total CPI inflation to remain close to 1.0 percent in the near term before picking up gradually to something closer to its 2.0 percent target in the second half of 2014. This is based on the premise that the Canadian economy will return to full capacity and inflation expectations stay in check. This revision would put the official outlook from Canada right in line with our CPI inflation forecast of 1.0 percent this year and 1.8 percent in 2014.

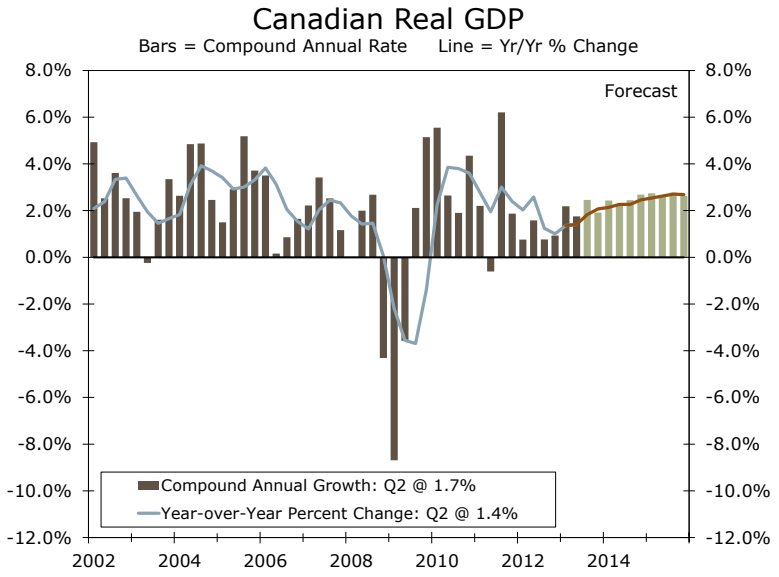
The BoC's statement pointed to headwinds south of the border, even making specific reference to U.S. congressional dysfunction contributing to an environment of uncertainty that is restraining the economic expansion in the United States.

The official growth forecast was dialed back a bit, and the BoC now expects the Canadian economy to grow 2.0 percent this year and 2.7 percent in 2014. We are less optimistic about these prospects, but we share the same idea in terms of the trajectory improving. Our full-year growth forecast is for 1.7 percent GDP growth in Canada this year and 2.3 percent in 2014.

In the next few weeks we will publish our longer 2014 Canadian Outlook report that will consider the Canadian economy's prospects in greater detail. The bottom line is that while the economy is improving, the growth outlook will probably not justify real tightening from the Bank of Canada until 2015.







Source: IHS Global Insight, Bloomberg L.P. and Wells Fargo Securities, LLC

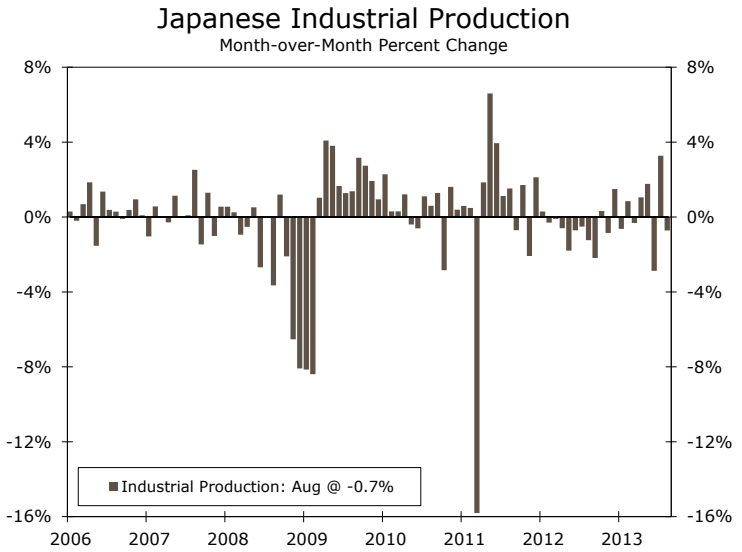
Japanese Ind. Prod.• Wednesday

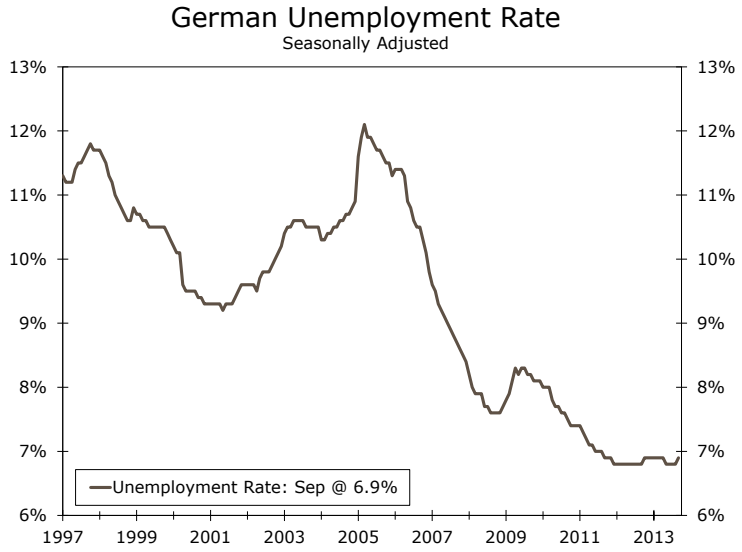
The usual end-of-the-month Japanese data barrage covering the month of September, will occur next week. The consensus forecast anticipates that industrial production (IP), which fell 0.9 percent in August, more than made up for that decline by jumping nearly 2 percent in September. If the consensus forecast is realized, IP will have risen at an annualized rate of 8.0 percent in the third quarter, which should translate into a solid rate of overall real GDP growth during Q3.

Retail spending data are also on the docket next week (Tuesday). The consensus forecast looks for a 0.4 percent increase in retail sales following the strong rise of 0.9 percent in August. The CPI inflation data will also be interesting now that the BoJ has set a target for a 2.0 percent inflation rate. The consensus forecast anticipates that the CPI inflation rate in September will be unchanged from the 0.9 percent rate registered in August.

Previous: -0.9% (month-over-month)

Consensus: 1.8%





Canadian GDP • Thursday

Canada provides data on overall GDP on a monthly basis, and the August estimate is slated for release on Thursday. In July, GDP rose 0.6 percent relative to the previous month, which offset the 0.5 percent decline that occurred in June. Smoothing through the monthly volatility shows that the underlying rate of real GDP growth in Canada is roughly 1-½ percent at present. Although we look for this rate to strengthen in coming quarters, the 2.3 percent GDP growth rate that we forecast for 2014 would not be considered to be "stellar" by most analysts.

Lackluster economic growth has been associated with some weakness in the labor market. The unemployment rate is hovering around 7.0 percent and average weekly earnings are up only 1.3 percent on a year-ago basis. Earnings data for August will print on Thursday.

Previous: 0.6% (month-over-month)

Consensus: 0.2%

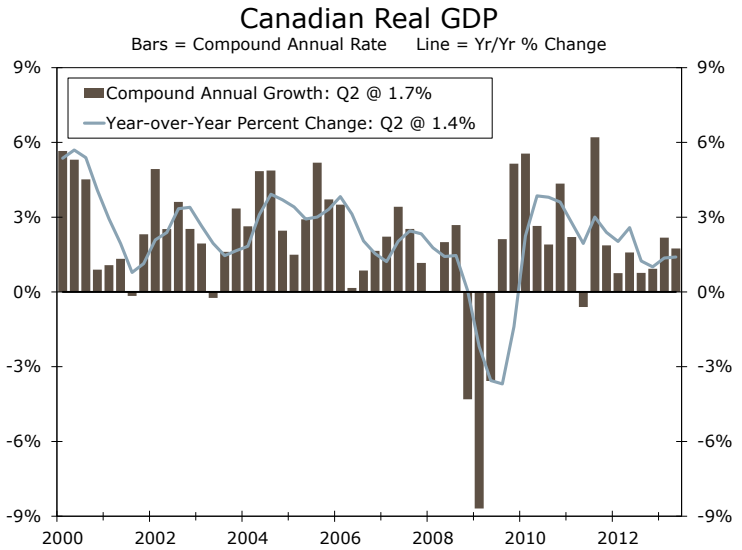
German Unemployment • Wednesday

The strong performance of the German economy over the past few years has caused unemployment to decline to rates that have not been experienced since East and West Germany were reunified in 1991. Little wonder then that consumer confidence continues to strengthen. (The GfK index of German consumer confidence is on the docket on Tuesday.) Despite the increase in consumer confidence, retail spending in Germany is essentially flat on a year-ago basis at present. Retail spending data for September are slated for release next week.

The Eurozone economic confidence indicator, which has trended higher since the spring, will be released on Wednesday. Most analysts expect another solid increase in confidence in October. The "final" estimate of October CPI inflation data will print on Thursday. The "flash" estimate showed that inflation dropped to a three-year low of only 1.1 percent this month.

Previous: 6.9%

Consensus: 6.9%



Source: IHS Global Insight, Bloomberg L.P. and Wells Fargo Securities, LLC

Interest Rate Watch

Reassessing the Policy Mix

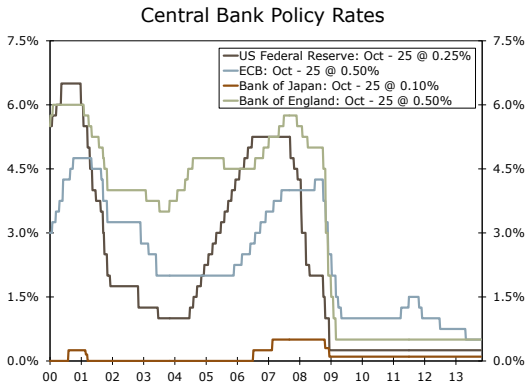
September's weak jobs report has cast further doubt on the Fed's timetable for winding down its securities purchase program. While the headline numbers in the report were only modestly softer than expected, with 148,000 new nonfarm jobs added during the month, the gain was helped along by the hiring of teachers and school bus drivers, gains that likely will not be repeated in October. The report suggests the economy had less momentum going into the government shutdown.

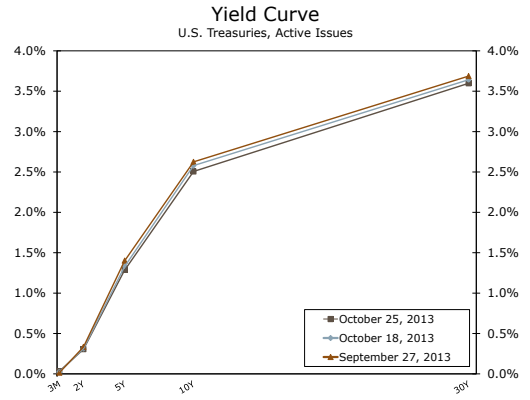
The Council of Economic Advisors devised a new weekly economic index from high-frequency private reports, which showed overall economic activity slowing substantially in October. While the bulk of the deterioration of the index appears to have been tied to an exaggerated swing in weekly jobless claims, several other indicators weakened significantly during the month, including retail sales, hiring plans, consumer confidence and mortgage applications. The weakness coincides with the period covered by the October employment report due on November 8.

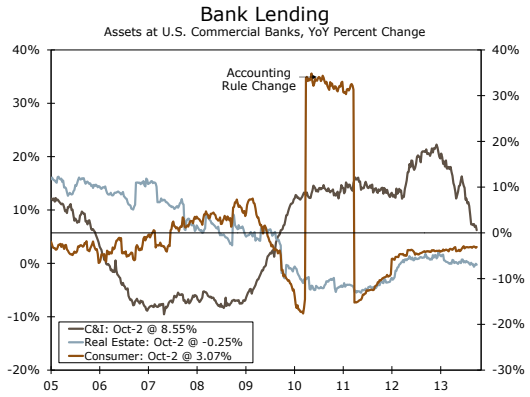
The combination of the disappointing September jobs figures, weaker high-frequency data and still to be resolved budget and debt ceiling issues has likely pushed the Fed's planned tapering of securities purchases out to at least March, which creates an entirely new set of concerns. A March tapering would likely send mortgage rates higher just as the peak spring home buying season begins. This raises the odds that the Fed may reduce Treasury purchases faster than they rein in mortgage-backed securities.

An earlier taper is still possible. However, if the Fed goes this route we would expect it to reduce securities purchases by only a small amount, perhaps $5 billion a month. Such a track would get the job done sooner and might prove less disruptive to the financial markets. We see the odds of this as fairly small, however, given the heightened uncertainty about the economy's underlying momentum.

The financial markets love the prospects of keeping QE around for a while longer. The 10-year Treasury yield fell to 2.50 percent, as the markets priced in additional securities purchases through the spring.







Credit Market Insights

Recent Housing Data Suggest Moderation in the Housing Recovery

Earlier this year, data showed a blossoming recovery in housing, particularly with regard to the rapid acceleration in home prices; however, the mood has dampened somewhat, as recent market metrics have been less encouraging. Although, mortgage rates have come off this year's highs, we are currently seeing declines in mortgage applications for purchase and refinancing compared to year-ago levels. In addition, even with the brief pickup in mortgage rates earlier this year, rates have remained quite low compared to historical standards. With the Fed likely on hold until next year, mortgage rates should remain in place around their current levels.

Last week, we saw homebuilder sentiment pull back for the second straight month, as previously felt excitement has moderated somewhat. This week we saw continued softness as existing home sales fell 1.9 percent in September, although they are still up over 10 percent on a year-over-year basis. Residential construction spending numbers provided a bright spot in the midst of recent lackluster data, as spending rose 1.3 percent in August and is up over 18 percent over the past year. Low inventories have been termed as a major reason for the slowdown in home sales, so rising spending on new construction is a particularly favorable sign. As mortgage rates remain low and new construction comes on line, the housing market should sustain its recent upward trajectory.

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

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.13%	4.28%	4.32%	3.41%
15-Yr Fixed	3.24%	3.33%	3.37%	2.72%
5/1 ARM	3.00%	3.07%	3.07%	2.75%
1-Yr ARM	2.60%	2.63%	2.63%	2.59%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,589.5	-14.53%	16.06%	7.95%
Revolving Home Equity	$481.0	2.39%	-3.97%	-7.90%
Residential Mortgages	$1,561.2	-29.56%	-14.43%	-1.67%
Commerical Real Estate	$1,467.0	10.01%	9.97%	3.50%
Consumer	$1,145.3	2.32%	2.85%	3.06%

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

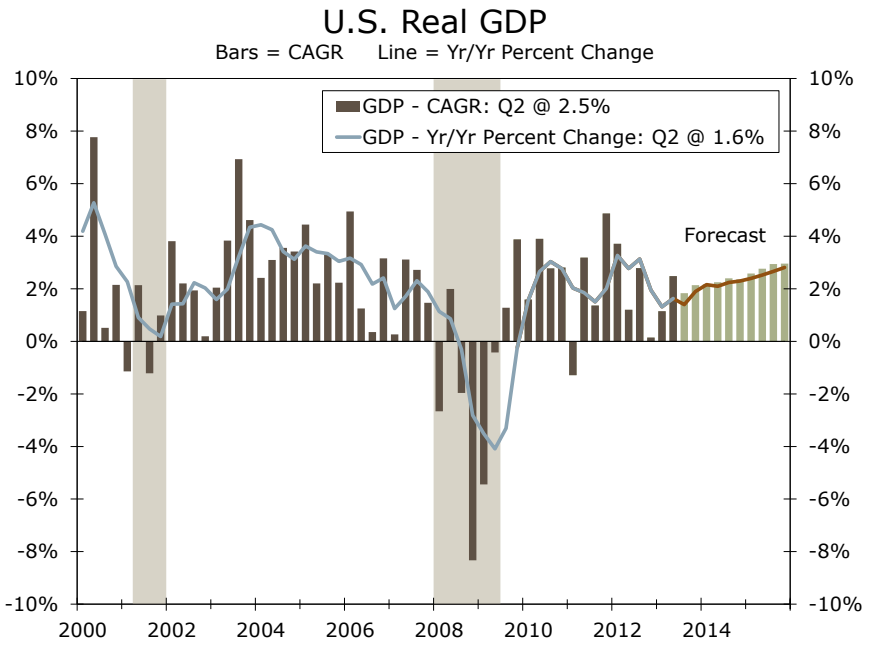
Topic of the Week

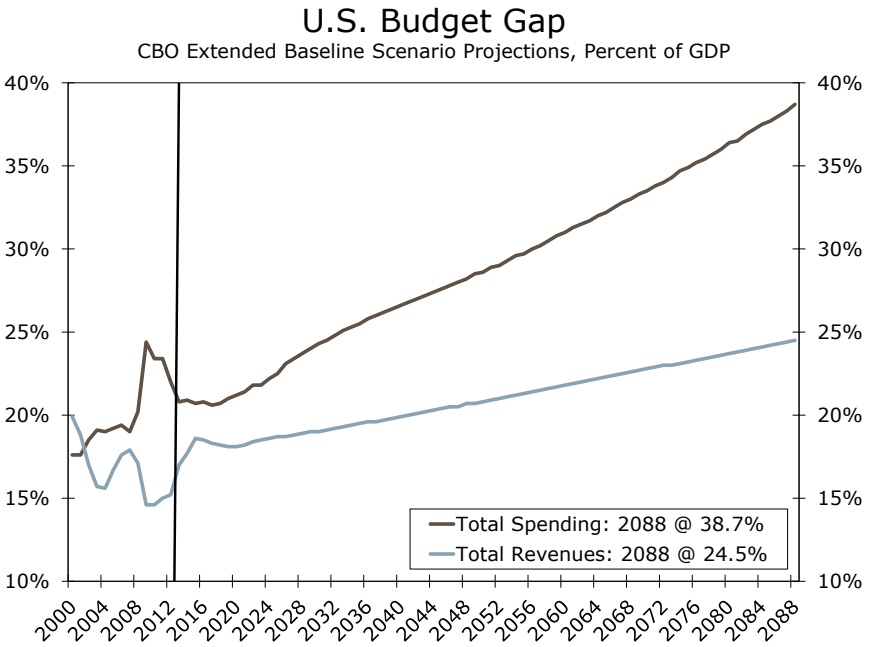
Shutdown Showdown Finale

On October 16th, a deal emerged to reopen all of the federal government and avert a possible November federal government default. The deal consists of four main provisions. First, the federal government was immediately reopened and funded at last year's budget level of $986.3 billion through January 15, 2014. Second, the act suspended the debt ceiling until February 7, 2014, and continued to allow the Secretary of the Treasury to take "extraordinary measures" to stay under the debt ceiling beyond the 7th. Third, the act provides back pay to federal workers furloughed during the government shutdown. While a fourth provision of the deal was not included in the actual bill's text, the House and Senate agreed to appoint representatives to a joint budget conference to work out a budget for the rest of the 2014 fiscal year. The joint budget conference has the option to address longer-term budget challenges; however the bill that was enacted last week in and of itself does not address the long-run budget issues (entitlement program costs) facing the nation. In essence the act is merely a short-term bridge to the next budget and debt ceiling crisis.

While the partial government shutdown and near breach of the debt ceiling likely did little to directly affect economic growth in the fourth quarter, the increased uncertainty will weigh on consumer and business confidence in the near term. Given that the short-term nature of the deal described above simply extends the current environment of political uncertainty, we expect to downgrade our outlooks for consumer spending and business investment in the fourth quarter of 2013 and the first quarter of 2014. On net, we expect lower near-term economic activity based on the continued extreme political uncertainty and the failure to address longer-term budget challenges.

For further information on how the fiscal policy debates have affected our outlook see our special report, "*Shutdown Showdown Finale: A Short-Term Bridge to the Next Crisis*" available on our website.





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 10/25/2013	1 Week Ago	1 Year Ago
3-Month T-Bill	0.03	0.02	0.11
3-Month LIBOR	0.24	0.24	0.31
1-Year Treasury	0.12	0.16	0.16
2-Year Treasury	0.30	0.31	0.31
5-Year Treasury	1.28	1.33	0.82
10-Year Treasury	2.51	2.58	1.82
30-Year Treasury	3.60	3.64	2.98
Bond Buyer Index	4.56	4.68	3.68

Foreign Exchange Rates

	Friday 10/25/2013	1 Week Ago	1 Year Ago
Euro ($/€)	1.379	1.369	1.293
British Pound ($/£)	1.619	1.617	1.612
British Pound (£/€)	0.852	0.847	0.802
Japanese Yen (¥/$)	97.310	97.720	80.300
Canadian Dollar (C$/$)	1.044	1.029	0.995
Swiss Franc (CHF/$)	0.895	0.902	0.935
Australian Dollar (US$/A$)	0.960	0.968	1.035
Mexican Peso (MXN/$)	12.959	12.858	13.009
Chinese Yuan (CNY/$)	6.084	6.096	6.242
Indian Rupee (INR/$)	61.460	61.265	53.575
Brazilian Real (BRL/$)	2.183	2.170	2.026
U.S. Dollar Index	79.249	79.654	80.044

Source: Bloomberg LP and Wells Fargo Securities, LLC

Foreign Interest Rates

	Friday 10/25/2013	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.17	0.17	0.13
3-Month Sterling LIBOR	0.52	0.52	0.53
3-Month Canadian LIBOR	1.17	1.17	1.31
3-Month Yen LIBOR	0.14	0.14	0.19
2-Year German	0.19	0.17	0.08
2-Year U.K.	0.44	0.47	0.26
2-Year Canadian	1.08	1.18	1.14
2-Year Japanese	0.10	0.11	0.10
10-Year German	1.76	1.83	1.58
10-Year U.K.	2.63	2.72	1.91
10-Year Canadian	2.42	2.53	1.89
10-Year Japanese	0.62	0.62	0.78

Commodity Prices

	Friday 10/25/2013	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	97.49	100.81	86.05
Gold ($/Ounce)	1344.35	1316.25	1712.10
Hot-Rolled Steel ($/S.Ton)	651.00	650.00	590.00
Copper (¢/Pound)	324.75	329.90	355.05
Soybeans ($/Bushel)	13.12	12.98	15.79
Natural Gas ($/MMBTU)	3.65	3.76	3.43
Nickel ($/Metric Ton)	14,598	13,947	16,336
CRB Spot Inds.	513.84	515.41	505.75

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	28	**29**	**30**	**31**	**1**
U.S. Data	**Industrial Production (MoM)** August 0.4% September 0.3% (W)	**PPI (MoM)** August 0.3% September 0.2% (W)	**CPI (MoM)** August 0.1% September 0.0% (W)		**ISM Manufacturing** September 56.2 October 55.2 (W)
U.S. Data	**Leading Indicators** August 0.7% September 0.7% (W)	**Retail Sales** August 0.2% September 0.0% (W)	**FOMC Rate Decision** September 0.25 October 0.25 (W)		**Total Vehicle Sales** September 15.21M October 15.40M (W)
Global Data	**Eurozone** **Consumer Confidence** Previous (Aug) -14.5	**Japan** **Industrial Production (MoM)** Previous (Aug) -0.9%	**Germany** **Unemployment** Previous (Sep) 6.9%	**Canada** **GDP (MoM)** Previous (Jul) 0.6%	**United Kingdom** **PMI Manufacturing** Previous (Sep) 56.7
Global Data	**Japan** **Jobless Rate** Previous (Aug) 4.1%			**Australia** **PPI (QoQ)** Previous (Q2) 0.1%	**Brazil** **Industrial Production (YoY)** Previous (Aug) 0.0%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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