May 09, 2014

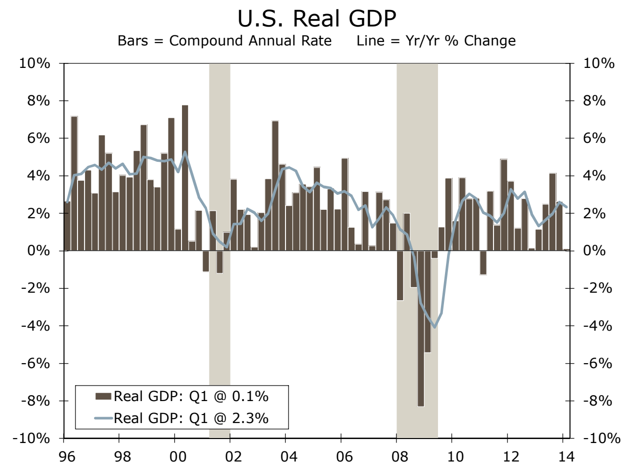
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

From Bad to Worse: A Contraction in Q1 GDP Growth?

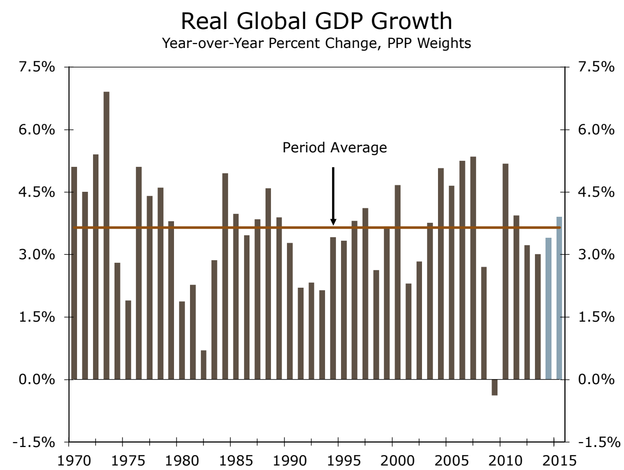
- The trade balance data this week, for March, showed that the trade deficit was $40.4 billion, suggesting that all else equal, there will likely be a downward revision to the already-soft 0.1 percent GDP growth in Q1.
- The ISM Non-Manufacturing index indicated that the service side of the economy continued to expand in April with business activity and new orders rising for the month.
- In the wake of the soft Q1 GDP growth, productivity declined 1.7 percent for the quarter, while unit labor costs jumped 4.2 percent.
- However, we maintain our expectations for better growth the rest of 2014.



Global Review

The ECB Stays Put; Mixed Results for Brazil and Chile.

- As expected, the ECB kept its benchmark interest rate unchanged at 0.25 percent during its latest meeting while it continues to gauge the need to move in the future as the economy dictates.
- Meanwhile, Brazilian industrial production was better than expected in March. However, these data points are noisy, as Easter and Carnival impact the readings. At the same time, the Chilean economy slowed down further in March.



Wells Fargo U.S. Economic Forecast

	Actual 2013				Forecast 2014				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2011	2012	2013	2014	2015
Real Gross Domestic Product [1]	1.1	2.5	4.1	2.6	0.1	3.0	2.7	3.1	1.8	2.8	1.9	2.3	3.1
Personal Consumption	2.3	1.8	2.0	3.3	3.0	4.0	2.4	2.6	2.5	2.2	2.0	2.9	2.7
Inflation Indicators [2]													
PCE Deflator	1.4	1.1	1.1	1.0	1.1	1.6	1.6	1.8	2.4	1.8	1.1	1.5	2.0
Consumer Price Index	1.7	1.4	1.5	1.2	1.4	1.9	1.9	2.1	3.1	2.1	1.5	1.8	2.2
Industrial Production [1]	4.2	1.9	2.5	4.8	4.4	6.9	4.1	4.3	3.3	3.8	2.9	4.5	4.9
Corporate Profits Before Taxes [2]	2.1	4.5	5.7	6.2	3.5	3.6	3.8	4.0	7.9	7.0	4.6	3.7	4.3
Trade Weighted Dollar Index [3]	76.2	77.5	75.2	76.4	76.9	76.5	76.5	76.5	70.9	73.5	75.9	76.6	78.1
Unemployment Rate	7.7	7.5	7.2	7.0	6.7	6.3	6.2	6.1	8.9	8.1	7.4	6.3	5.9
Housing Starts [4]	0.96	0.87	0.88	1.01	0.92	1.05	1.14	1.16	0.61	0.78	0.92	1.03	1.19
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	0.44
Conventional Mortgage Rate	3.57	4.07	4.49	4.46	4.34	4.53	4.72	4.96	4.46	3.66	3.98	4.64	5.42
10 Year Note	1.87	2.52	2.64	3.04	2.73	2.88	3.07	3.31	2.78	1.80	2.35	3.00	3.77

Forecast as of: May 7, 2014
[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, International Monetary Fund, IHS Global Insight and Wells Fargo Securities, LLC

Inside

U.S. Review

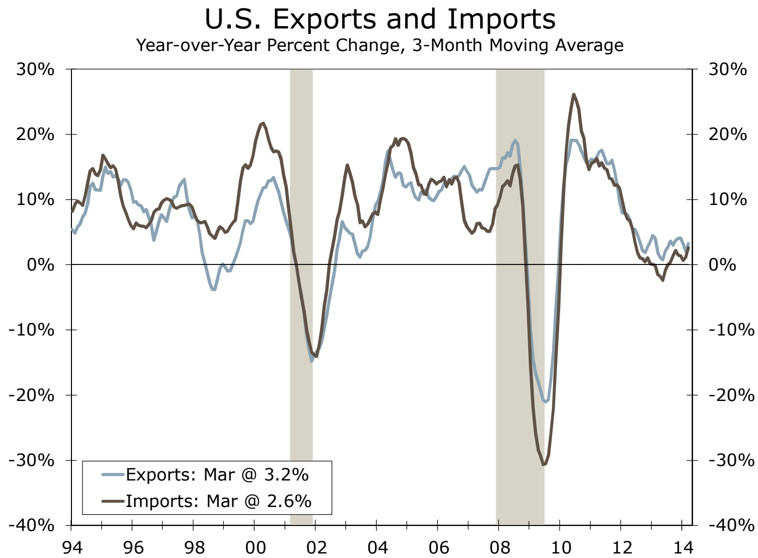
From Bad to Worse: A Contraction in Q1 GDP Growth?

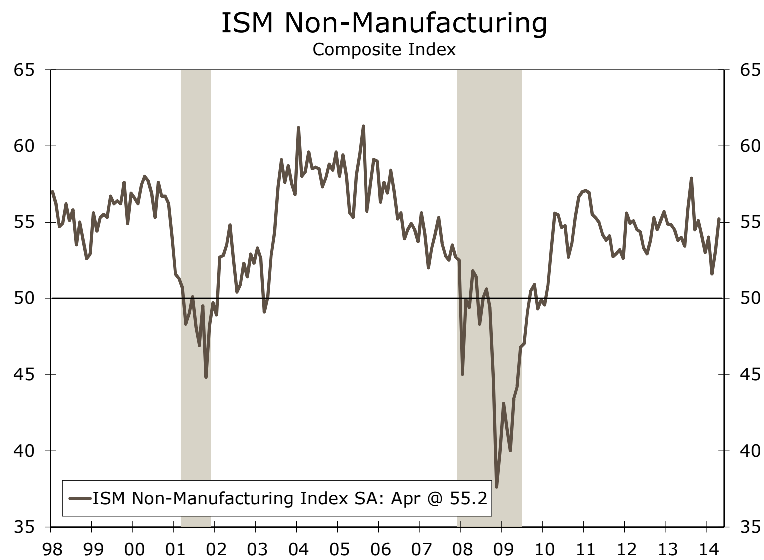
It was a relatively light week for U.S. economic data; however, the news this week signaled that Q1 economic activity was likely weaker than first thought. International trade data showed a slight narrowing of the trade deficit in March as exports grew faster than imports. The April ISM Non-Manufacturing index pointed towards continued momentum in the service side of the economy, although the growth in the employment component softened a bit on the month. Productivity and cost data in Q1 was just as disappointing as the paltry 0.1 percent headline GDP growth number with productivity declining while unit labor costs jumped. After accounting for the backward looking data in the final month Q1, we expect that the sluggish pace of growth in Q1 will be revised lower to show a contraction in economic activity.

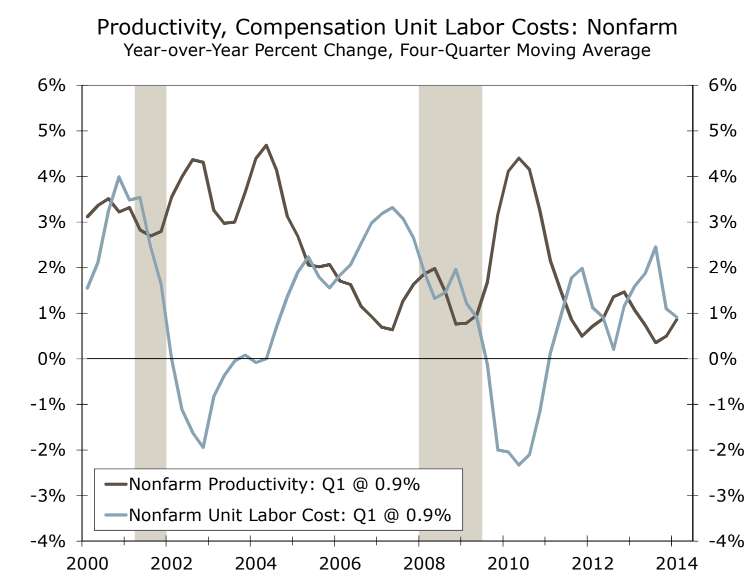
The trade balance for March narrowed a bit from the revised February deficit. Export activity rose 2.1 percent for the month following a 1.3 percent decline in February, led by a sizable increase in capital goods and automotive goods. In real terms, goods exports rose 2.3 percent for the month. Import activity also rose in March, posting a 1.1 percent increase led by a sharp rise in food and beverage goods. The key take away from the report was that the trade deficit was wider than originally estimated by the Bureau of Economic Analysis, which when combined with last week's construction spending report, suggests that the slight positive reading to Q1 GDP will likely be revised to a negative reading in a few weeks when the second look at Q1 GDP is released.

Meanwhile, the ISM Non-Manufacturing survey rose to an eight-month high in April with the current activity, and the more forward looking new orders activity, showing some acceleration. The report also added further evidence of price pressures building, as the prices paid index rose to an 18-month high. Employment activity continued to expand on the month, however, the pace downshifted slightly. In general, the strong April reading for the service sector continues to support the case for much more robust economic activity in Q2, as the economy shakes off the effects of the severe winter weather from the first three months of the year.

First-quarter productivity and costs posted disappointing readings, further adding to the already bad news from the GDP report. Nonfarm productivity fell 1.7 percent for the quarter after posting two quarters of positive growth. The large drop in output in Q1, again attributed to the effects of winter weather, was in part, responsible for the pullback. Unit labor costs jumped 4.2 percent for the quarter, marking the largest monthly gain since 2012. Real compensation rose 0.5 percent for the quarter, marking the second quarter in a row of improvement. The continued growth in real compensation provides some signal that real income growth should continue to improve in the months ahead, supporting our view of stronger consumer spending this year.







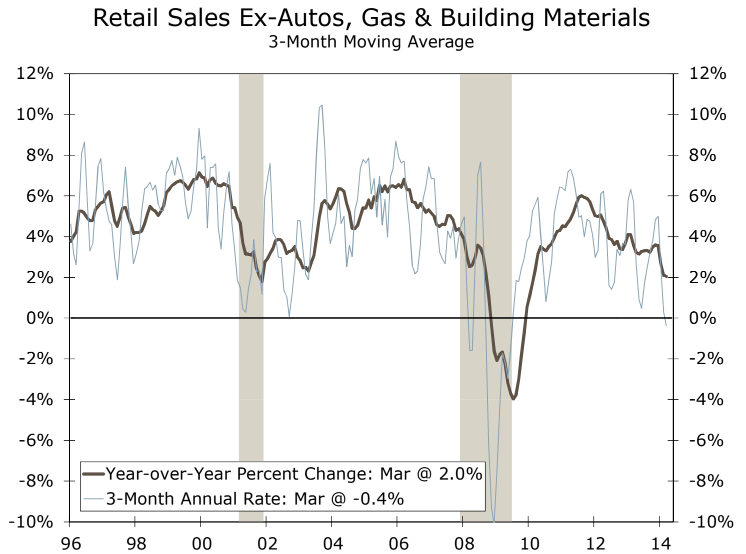
Source: U.S. Dept. of Commerce, Institute for Supply Management, U.S. Dept. of Labor and Wells Fargo Securities, LLC

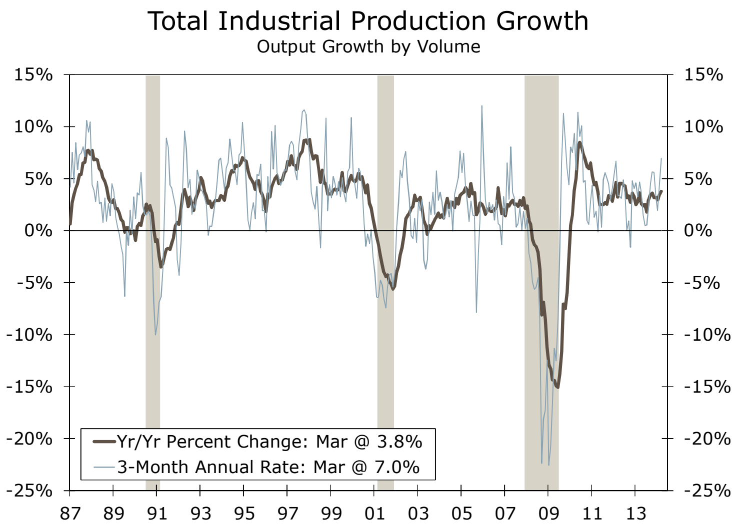
Retail Sales • Tuesday

Rebounding from slower activity in December and January, retail sales rose for the second consecutive month in March. Gains were broad-based with motor vehicles making the largest contribution to the headline. Excluding autos, retail sales were up 0.7 percent on the month and are up one percent over the past year. Consistent with recent gains in single-family starts, housing-related components of the report, including furniture and building materials, increased on the month and are up 1.0 percent and 6.2 percent over the past year, respectively. The trend in housing-related components is further evidence that the housing recovery remains on track. The retail sales control group, which excludes autos, building materials and gasoline and feeds into the real GDP calculation, rose 0.9 percent in March and is up 1.5 percent on a year-ago basis. With much of the winter payback now behind us, retail sales will likely show a more modest gain in April.

Previous: 1.2% **Wells Fargo: 0.4%**

Consensus: 0.4% (Month-over-Month)





Industrial Production • Thursday

Industrial production rose 0.7 percent in March with broad-based gains across manufacturing, utilities and mining. Manufacturing output, which makes up the lion's share of industrial production, rose for the second consecutive month and the rebound in February and further gain in March suggests continued momentum in Q2. Other manufacturing indicators including the ISM manufacturing survey and regional purchasing managers' surveys support further gains in manufacturing output. However, factory production hours worked, also a leading indicator for manufacturing output, slowed in April. Taking cues from gains in oil, natural gas and coal, mining production rose on the month and should continue to show improvement. On the other hand, although utilities output rose in March, strength was due to the unseasonably cold winter weather. With weather conditions normalizing, utilities will likely show weakness in April.

Previous: 0.7% **Wells Fargo: 0.3%**

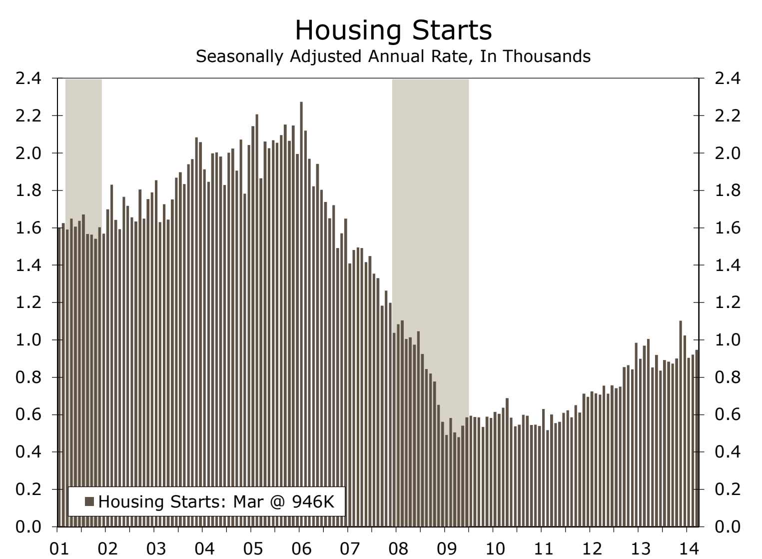
Consensus: 0.0% (Month-over-Month)

Housing Starts • Friday

Alleviating fears the housing recovery has stalled, housing starts posted a second monthly gain in March, increasing 2.8 percent to a 946,00-unit pace. However, the gain was concentrated in single-family starts, which are gradually edging back toward its high-water mark reached in December when the level remained above the one million mark for the second consecutive month. Following a 30 percent jump in November, multifamily starts fell in three of the past four months nearly erasing all of November's monthly gain. The deceleration in the pace of multifamily starts mirrors the moderation in apartment demand. Although apartment demand remains robust, we expect the pace to continue to slow in the coming quarters. Forward-looking permits fell 2.4 percent on the month, but the decline was once again concentrated in multifamily. With the unusually harsh winter weather conditions now beyond us, starts should continue to improve.

Previous: 946,000 **Wells Fargo: 988,000**

Consensus: 985,000

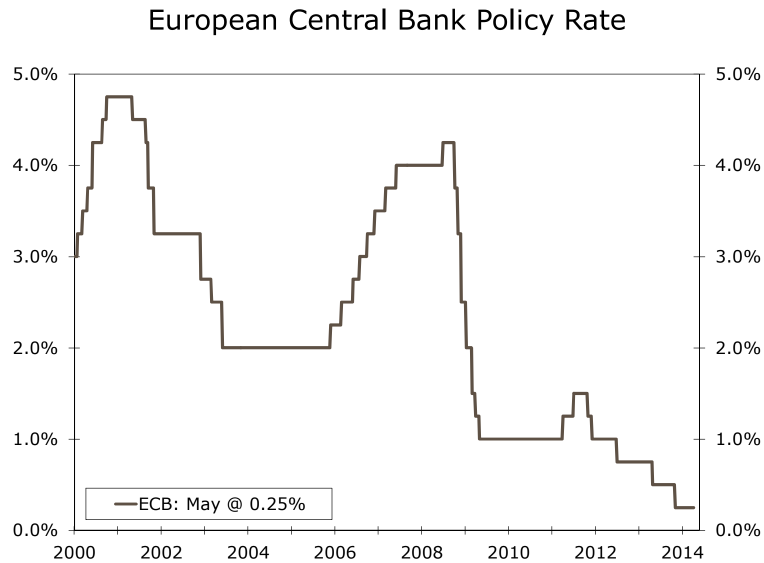


Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities, LLC

Global Review

The ECB Stays the Course but…

As expected, the ECB kept its benchmark interest rate unchanged at 0.25 percent during its latest meeting, while it continues to gauge the need to move in the future as the economy dictates. Actually, Mario Draghi, the ECB president said to reporters that the Governing Council is "comfortable with acting next time," which markets are interpreting as more monetary policy easing to be announced during June's meeting (see our Weekly Economic Financial Commentary published on May 5, 2014, for a discussion on what those alternatives may be). The widely expected move came during a week where retail sales came in higher than expected, at 0.3 percent versus expectations of -0.2 percent, but just because February's growth rate was downshifted to 0.1 percent versus an originally published growth rate of 0.4 percent. At the same time, the April Eurozone Markit Retail PMI moved into expansionary territory by posting a 51.2 reading versus 49.2 for March. Meanwhile, readings for both the Markit Services PMI and Composite PMI remained unchanged for its final reading in April, at 53.1 and 54.0, respectively.

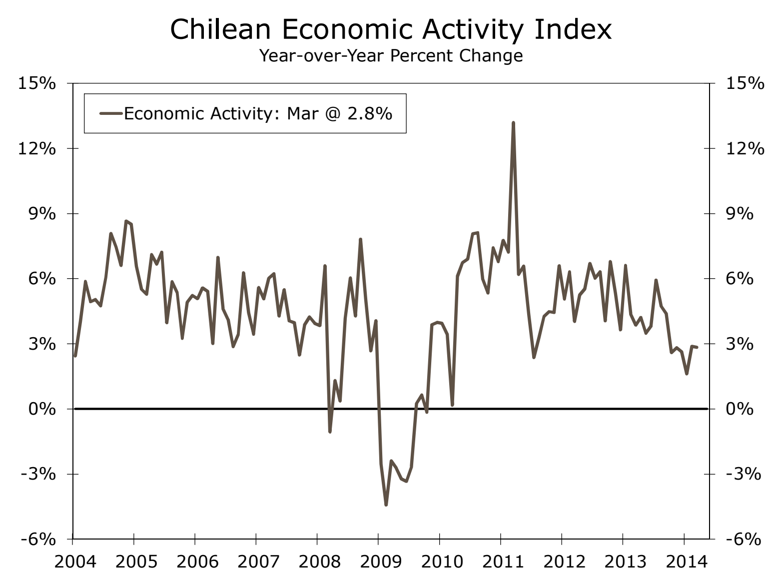


Better Industrial Production Numbers in Brazil

After a better-than-expected economic activity index in February, the Brazilian economy surprised markets again with a better-than-expected industrial production index for March. Markets were expecting a decline of 2.4 percent for the month-over-month index, while the actual number was a more modest drop of 0.5 percent. However, the statistical institute revised the February number to flat from an original print of 0.4 percent. Furthermore, the year-over-year index, which was expected to come in at -3.0 percent, dropped "only" 1.0 percent after increasing a downwardly revised 4.4 percent year-over-year in February. As we said in last week's outlook, these numbers are extremely noisy due to seasonal factors like Easter and Carnival so any conclusion from looking at these numbers should be taken cautiously. Brazil is still negotiating with Argentina on its automobile trade sector and this has continued to affect the Brazilian automobile manufacturing sector. However, better prospects coming from the Eurozone should help that sector in the coming quarters.

Chile's Economic Slowdown Continues

The Chilean economy has continued to feel the pressure coming from the slowdown in economic activity affecting the Chinese economy. Prices for its largest export product, copper, have come down considerably. March's index of economic activity slowed down further to 2.8 percent year-over-year and -0.2 percent compared to February. Meanwhile, the central bank is faced with increasing prices due to the recent depreciation of the Chilean peso as well as large increases in some of the commodities it imports, especially petroleum. Thus, inflationary pressures have increased lately and this may put any talk of further easing by the central bank on hold. However, during its April monetary policy meeting the central bank said that it was ready to help more in the future if economic conditions granted such a move as inflationary expectations remain, for now, anchored.



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

U.K. Unemployment • Wednesday

In an effort to provide guidance on monetary policy, the Bank of England's Monetary Policy Committee had previously stated that it would not raise rates until the unemployment rate fell below a threshold rate of 7.0 percent. The MPC had to walk back that guidance when the unemployment rate subsequently fell much faster than expect. In February, the guidance language from the MPC was revised to state there is "scope to absorb spare capacity further" before it begins raising rates.

On Wednesday of next week March unemployment figures for the United Kingdom will be released and while this indicator is no longer the vital statistic that it was when it was the primary threshold for MPC decision-making, it remains a consequential input for monetary policy and a gauge for slack in the labor market.

Previous: 6.9%

Consensus: 6.8%

Japanese GDP • Thursday

On Thursday of next week Q1 GDP numbers for Japan are likely to show an increase in the headline growth rate. In fact it might be the fastest rate of expansion in three years.

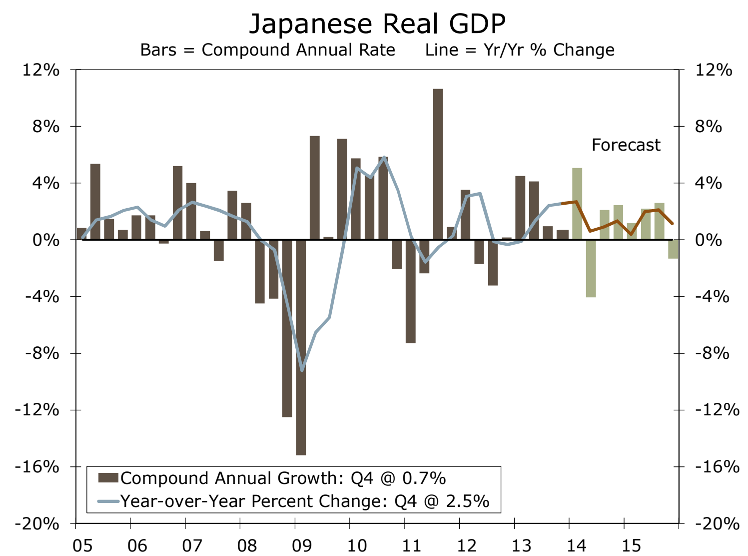
The reason for the faster GDP growth is attributable to the April increase in the consumption tax. It is likely that at least some demand was brought forward, as consumers rushed to get in final purchases before the tax hike.

We are a bit ahead of consensus expectations, a view that we feel is justified based on indications of a spending surge like the 6.3 percent monthly spike in retail sales.

The payback will come in Q2 when consumers dial back purchases as they absorb the burden of the higher tax rate.

Previous: 0.7% **Wells Fargo: 5.1%**

Consensus: 4.2% (CAGR)



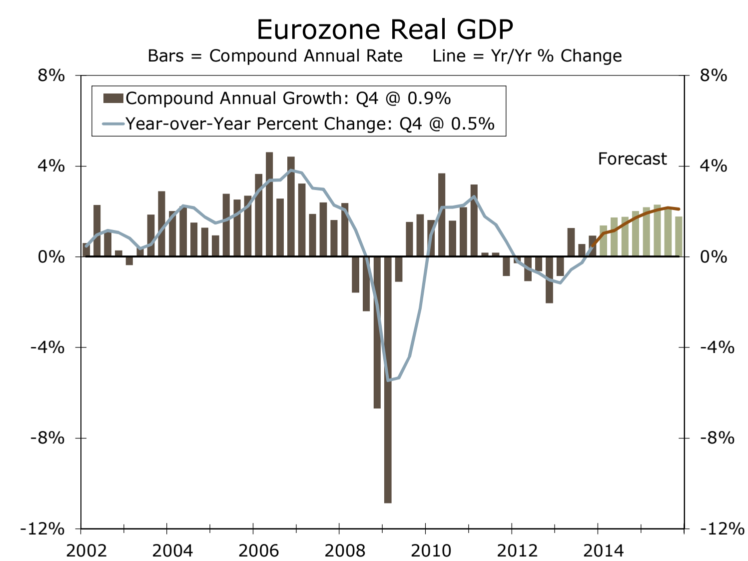
Eurozone GDP • Thursday

Despite three consecutive quarters of expansion, the Eurozone economic expansion is hardly self-sustaining at this point. At its policy meeting this week the ECB governing council opted to keep rates on hold but ECB President Mario Draghi telegraphed future accommodative moves perhaps as soon as the June meeting. The ECB has struggled to keep inflation close to its 2.0 percent target. The year-over-year rate of CPI inflation has been below 1.0 percent since October 2013.

First-quarter GDP figures are due out on Thursday of next week. We expect that real GDP growth will pick up modestly but the 1.4 percent annualized growth rate that we expect for Q1 would not likely be robust enough to assuage ECB concerns about spare capacity and chronic low inflation. The first estimates for May CPI inflation are not due out until the first week of June.

Previous: 0.9% **Wells Fargo: 1.4%**

Consensus: 1.7% (CAGR)



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

Interest Rate Watch

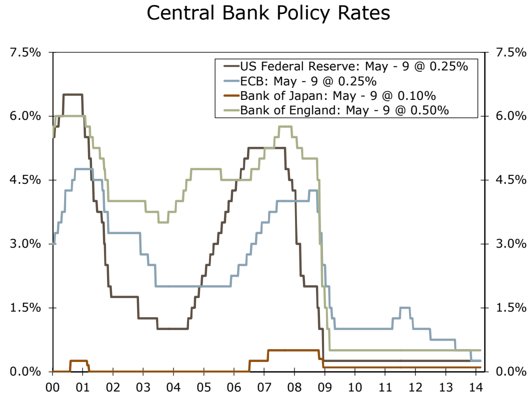
A Lack of Faith?

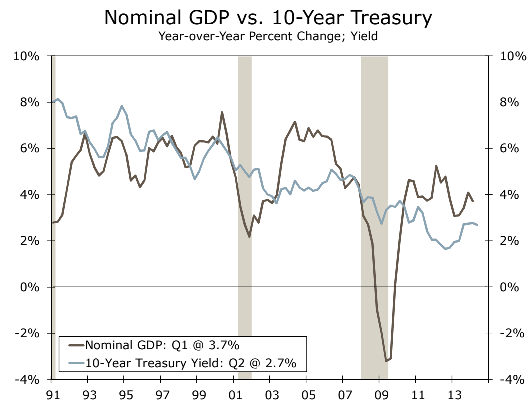
The recent slide in the yield on the 10-year Treasury note has brought about a great deal of discussion about what is behind the slide and what it means. The 10-year note ended 2013 at 3.04 percent and the general consensus was that interest rates would rise as the economy gained momentum and the Fed wound down its monthly security purchases. But interest rates did not follow this script. The yield on the 10-year quickly fell back to 2.70 percent in mid-January and more or less remained there until it drifting down toward 2.60 percent more recently.

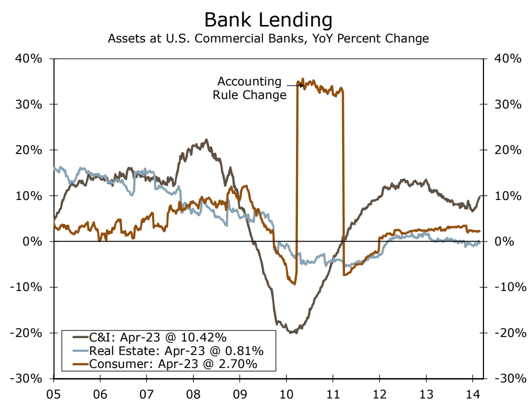
What exactly is behind the recent slide in long-term rates is a bit of a mystery. Changes in the Fed's guidance on short-term interest rates do not seem to be the culprit. If anything, the Fed's statements about when and how quickly the Fed would begin raising short-term interest rates would have been supportive of higher long-term rates, even Yellen backing away a bit from her 'six months' gaff made earlier.

Many explanations have been posited; including stepped up buying of long-term bonds by pension funds, the sudden drop in long-term interest rates in the Eurozone, particularly in the more troubled periphery countries; worries about and increased concerns about a possible pullback in the stock market.

We would add another. For the past five years the economy has often appeared to be on the cusp of stronger economic growth, only to see hopes dashed due to some exogenous event, such as the Japanese earthquake and tsunami, or simply the housing sector's inability to handle even a modest rise in interest rates this past year. Put simply, the decline in the yield on the 10-year Treasury may simply reflect a lack of faith that U.S. economic growth will pick up all that much over the next few years and that inflation will continue to run at the lower end of the Fed's comfort zone. With estimates of the economy's potential growth rate dipping below 2 percent and inflation running at 1.5 percent, a 2.60 percent 10-year note yield is not out of line with where it has traded relative to nominal GDP in recent years.







Source: U.S. Department of Commerce, IHS Global Insight, Bloomberg LP and Wells Fargo Securities, LLC

Credit Market Insights

Business Lending Sees Improvement

The Q2-2014 Senior Loan Officer Opinion Survey released this week was a ray of sunshine in an otherwise fairly cold season for economic indicators. Loan demand has remained positive among most loan types and will begin to pick up even more quickly as banks start easing lending standards even further. The biggest story this quarter comes from businesses, as they have seen increased lending activity in supply and demand. Consumers remain cautious but continue to gain confidence in the economic recovery as they start borrowing again on credit cards and for autos. The one sour note comes from residential mortgage lending that has slowed down by more than 4 percent over the past year.

Business lending picked up in Q1-2014, up 9 percent since last year, and looks to continue to do so. Banks say they are relaxing their standards for C&I loans as competition and a more optimistic outlook on the economy have pushed up demand. Businesses should help contribute to our forecast of 2.3 percent GDP growth in 2014.

While consumer loans have started to pick up slightly, standards remain roughly unchanged from the previous quarter. However, consumer loans are expected to accelerate throughout the year with increased consumption in the coming months. On the other hand, as predicted by recent weak housing data, demand for residential loans remains sluggish and some banks are still tightening their standards for lending in this space. This remains the biggest question for 2014.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	4.21%	4.29%	4.34%	3.42%
15-Yr Fixed	3.32%	3.38%	3.38%	2.61%
5/1 ARM	3.05%	3.05%	3.09%	2.58%
1-Yr ARM	2.43%	2.45%	2.41%	2.53%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,686.3	-11.70%	12.17%	10.42%
Revolving Home Equity	$467.2	-2.85%	0.42%	-6.18%
Residential Mortgages	$1,573.0	30.77%	5.15%	-2.32%
Commerical Real Estate	$1,531.2	15.64%	11.72%	6.75%
Consumer	$1,159.4	10.76%	12.99%	2.70%

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

Topic of the Week

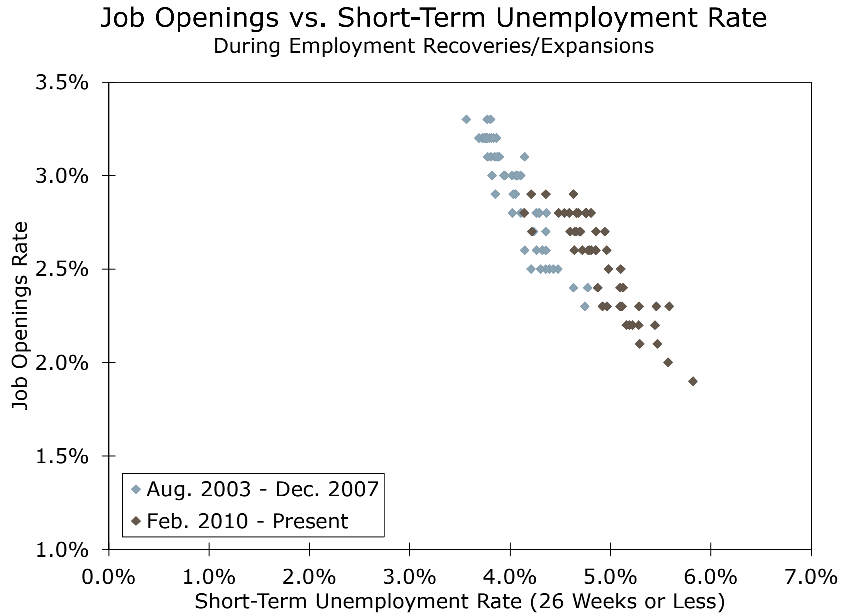
Short-Term and Long-Term Unemployment

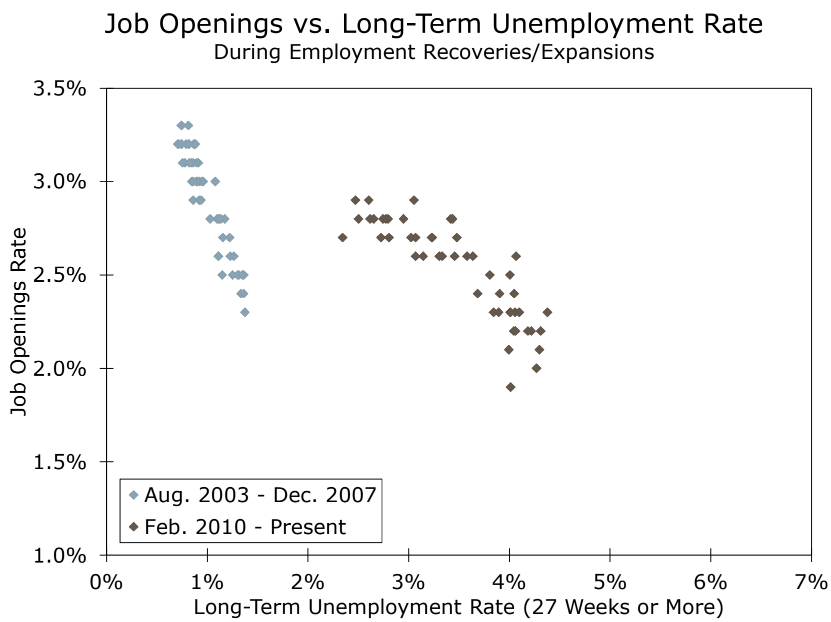
Persistent long-term unemployment has been a defining characteristic of the current expansion. The jobless rate for workers unemployed 27 weeks or more stood at 2.2 percent in April, which is significantly higher than the 1.0 percent average for the 1980-2007 period. In contrast, short-term unemployment is at 4.1 percent, below its longer-term average of 5.1 percent. This dichotomy leads to two different pictures of structural unemployment in the economy. As evidenced by the top chart, the short-term unemployment rate is consistent with the rate of job openings in the economy, indicating a fairly normal degree of frictional unemployment. However, the long-term unemployment rate remains high relative to the availability of jobs in this expansion, suggesting a greater degree of skills and locational mismatch (bottom chart).

Two important issues are raised by these results. As long-term unemployment remains elevated, the risk rises that the slow cyclical recovery results in longer lasting structural unemployment. Evidence shows that as unemployment spells lengthen, the unemployed become less likely to find work as their skills are perceived to have deteriorated.

Second, a debate has risen recently as to what extent wage pressures reflect the relative influence of short-term or long-term unemployment. If employers are dismissive of the long-term unemployed within their candidate pool, the short-term unemployment rate would be a more relevant indicator of slack in the labor market. Viewing the long-term unemployed as part of the candidate pool, however, would indicate substantially more slack in the labor market and lower wage pressures.

While the evidence is mixed as to the degree that each group matters for future wage inflation, we do know that wage growth has remained modest given the recent decline in the headline unemployment rate. This suggests that perhaps the long-term unemployed are still exerting a significant influence on wage setting.





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 5/9/2014	1 Week Ago	1 Year Ago
3-Month T-Bill	0.03	0.02	0.04
3-Month LIBOR	0.22	0.22	0.28
1-Year Treasury	0.09	0.12	0.13
2-Year Treasury	0.39	0.42	0.22
5-Year Treasury	1.64	1.66	0.75
10-Year Treasury	2.62	2.58	1.81
30-Year Treasury	3.45	3.37	2.99
Bond Buyer Index	4.31	4.33	3.67

Foreign Exchange Rates	Friday 5/9/2014	1 Week Ago	1 Year Ago
Euro ($/€)	1.379	1.387	1.304
British Pound ($/£)	1.686	1.687	1.545
British Pound (£/€)	0.818	0.822	0.844
Japanese Yen (¥/$)	101.750	102.200	100.590
Canadian Dollar (C$/$)	1.090	1.097	1.007
Swiss Franc (CHF/$)	0.884	0.878	0.948
Australian Dollar (US$/A$	0.936	0.928	1.009
Mexican Peso (MXN/$)	12.977	13.015	11.997
Chinese Yuan (CNY/$)	6.228	6.259	6.131
Indian Rupee (INR/$)	60.025	60.163	54.245
Brazilian Real (BRL/$)	2.222	2.221	2.013
U.S. Dollar Index	79.737	79.516	82.793

Source: Bloomberg LP and Wells Fargo Securities, LLC

Foreign Interest Rates	Friday 5/9/2014	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.30	0.31	0.12
3-Month Sterling LIBOR	0.53	0.53	0.51
3-Month Canada Banker's Acceptance	1.27	1.27	1.28
3-Month Yen LIBOR	0.14	0.14	0.16
2-Year German	0.12	0.13	0.01
2-Year U.K.	0.75	0.70	0.28
2-Year Canadian	1.06	1.07	0.97
2-Year Japanese	0.09	0.09	0.11
10-Year German	1.46	1.45	1.27
10-Year U.K.	2.68	2.64	1.78
10-Year Canadian	2.37	2.35	1.80
10-Year Japanese	0.61	0.61	0.60

Commodity Prices	Friday 5/9/2014	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	100.58	99.76	96.39
Gold ($/Ounce)	1291.14	1299.62	1458.25
Hot-Rolled Steel ($/S.Ton)	684.00	684.00	583.00
Copper (¢/Pound)	309.05	308.15	334.15
Soybeans ($/Bushel)	14.84	14.82	14.48
Natural Gas ($/MMBTU)	4.53	4.67	3.98
Nickel ($/Metric Ton)	19,383	18,298	15,334
CRB Spot Inds.	542.04	543.31	527.90

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	12	13	14	15	16
U.S. Data	**Monthly Budget Statement** March $112.9B April $114.0B (W)	**Retail Sales** March 1.2% April 0.4% (W) **Import Price Index** March 0.6% April 0.3% (W)	**PPI** March 0.5% April 0.1% (W) **CPI** March 0.2% April 0.3% (W)	**Capacity Utilization** March 79.2% April 79.2% (W) **Industrial Production** March 0.7% April 0.3% (W)	**Housing Starts** March 946K April 988K (W) **Building Permits** March 997K April 1015K (C)
Global Data	**Australia** **Home Loans MoM** Previous (Feb) 2.3% **Mexico** **Industrial Production YoY** Previous (Feb) 0.7%	**China** **Retail Sales YoY** Previous (Mar) 12.2%	**United Kingdom** **Jobless Claims Change** Previous (Mar) -30.4K **Japan** **GDP SA QoQ** Previous (Q4) 0.2%	**Eurozone** **GDP SA YoY** Previous (Q4) 0.5% **Canada** **Manufacturing Sales MoM** Previous (Feb) 1.4%	**Japan** **Industrial Production MoM** Previous (Feb) 0.3%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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