

# Economics Group

## Weekly Economic & Financial Commentary

### U.S. Review

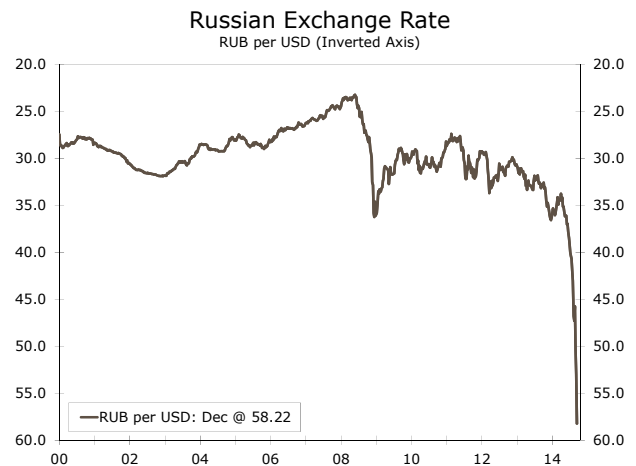
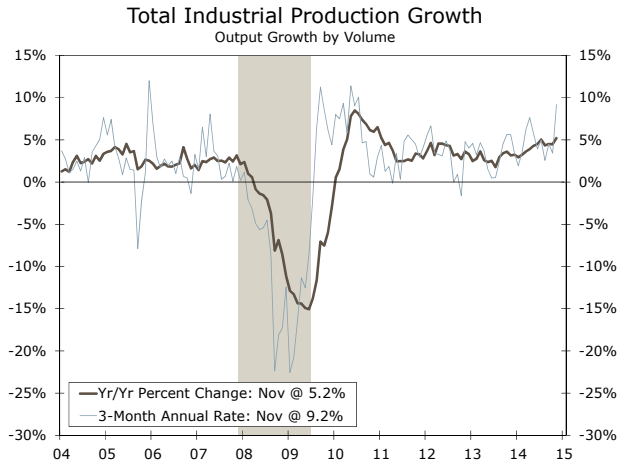
#### A Busy Week for Fiscal and Monetary Policy

- With three dissenters, the FOMC slightly tweaked its language describing the period of time between the end of the QE program and when the first rate hike would take place.
- November industrial production data showed an impressive pace of industrial output for the month, while October's data were revised higher.
- Housing starts fell a surprising 1.6 percent in November after posting a 1.7 percent increase in October.
- Consumer prices slid in November, declining 0.3 percent with energy prices pulling the headline index lower. Core prices edged higher a slight 0.1 percent for the month.

### Global Review

#### With Ruble in Freefall, CBRF Pulls the Elevator Brake

- Under pressure from falling oil prices and feeling the pinch of economic sanctions, the Russian ruble has lost about 40 percent of its value on balance since September. When the rate of decline picked up speed this week, the Central Bank of the Russian Federation intervened by lifting its main lending rate 650 bps to 17.00 percent.
- In this week's Global Review we discuss the CBRF's response, we consider Russia's next move and how the collapse in the ruble might play out for Russia and its neighbors.



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 <sup>1</sup>	-2.1	4.6	3.9	1.8	2.6	2.6	2.8	2.9	2.3	2.2	2.2	2.8	3.0
Personal Consumption	1.2	2.5	2.2	2.8	2.5	2.6	2.5	2.5	1.8	2.4	2.3	2.5	2.5
Inflation Indicators <sup>2</sup>													
PCE Deflator	1.1	1.6	1.5	1.4	1.4	1.2	1.4	1.8	1.8	1.2	1.4	1.5	2.0
Consumer Price Index	1.4	2.1	1.8	1.6	1.6	1.4	1.7	2.2	2.1	1.5	1.7	1.7	2.4
Industrial Production <sup>1</sup>	3.9	5.7	3.3	3.4	5.0	4.9	3.5	3.1	3.8	2.9	4.0	4.2	3.6
Corporate Profits Before Taxes <sup>2</sup>	-4.8	0.1	0.4	3.2	3.7	3.6	4.1	4.6	11.4	4.2	-0.2	4.0	5.2
Trade Weighted Dollar Index <sup>3</sup>	76.9	75.9	81.3	83.8	83.8	84.8	85.8	86.8	73.5	75.9	79.5	85.3	88.3
Unemployment Rate	6.7	6.2	6.1	5.8	5.7	5.6	5.5	5.4	8.1	7.4	6.2	5.6	5.2
Housing Starts <sup>4</sup>	0.93	0.99	1.03	1.00	1.06	1.13	1.21	1.24	0.78	0.92	1.01	1.16	1.26
Quarter-End Interest Rates <sup>5</sup>													
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	4.14	4.16	4.20	4.30	4.40	3.66	3.98	4.20	4.27	4.95
10 Year Note	2.73	2.53	2.52	2.30	2.40	2.51	2.59	2.66	1.80	2.35	2.52	2.54	3.20

Forecast as of: December 10, 2014  
<sup>1</sup> Compound Annual Growth Rate Quarter-over-Quarter  
<sup>2</sup> Year-over-Year Percentage Change  
<sup>3</sup> Federal Reserve Major Currency Index, 1973=100 - Quarter End  
<sup>4</sup> Millions of Units  
<sup>5</sup> 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

A Busy Week for Fiscal and Monetary Policy

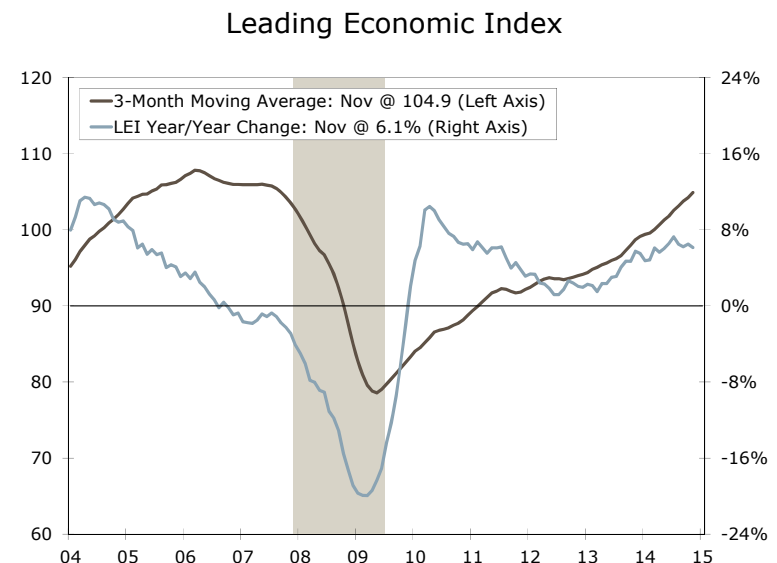
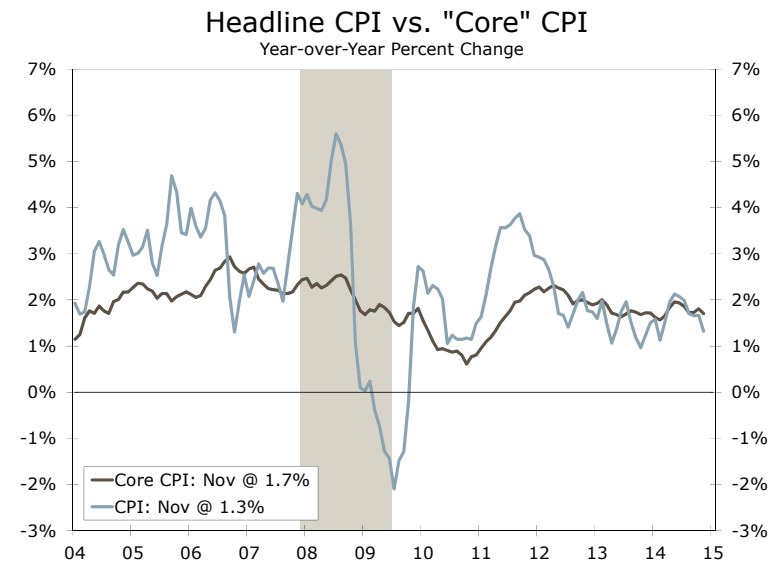
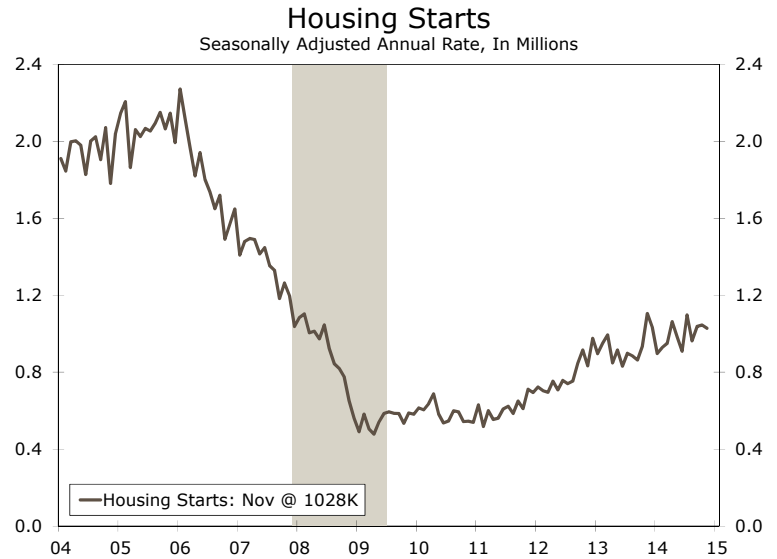
It was a busy week for both fiscal and monetary policy. After last week's cliff hanger vote in the House of Representatives, the Senate took up and passed legislation to keep the federal government funded through the end of the current fiscal year in September. The Department of Homeland Security was the only department that was funded under a short-term continuing resolution through February 27. On the monetary policy front, the FOMC slightly tweaked the language in its policy statement, indicating that the committee will be "patient" in its decision to raise interest rates next year. Economic data this week were a bit mixed overall. Industrial production posted an impressive gain in November, while housing starts dropped a surprising 1.6 percent for the month. Consumer prices pulled back in November as the slide in oil prices weighed on the headline inflation reading.

November's industrial production report showed that output rose an impressive 1.6 percent in November, the largest monthly increase in more than four years. October's reading was revised higher from a slight decline to a slight positive reading. Manufacturing output rose 1.1 percent for the month with broad-based gains across industries. Utilities output also helped to push the industrial production reading higher as output jumped 5.1 percent due in part to winter weather.

Housing starts data this week were a bit of a disappointment with starts falling 1.6 percent in November. The decline was concentrated in the single-family sector, which fell 5.4 percent during the month. Multifamily starts climbed 6.7 percent for the month. In addition to the soft starts reading, new permitting activity also declined during the month for both single and multifamily. Even with the softer reading for the month, overall housing starts remained above the key 1-million mark for the third month in a row. We continue to expect home construction to pick up slightly over the next year to a 1.16 million-unit pace.

Consumer price data continued to indicate softer prices for consumers in November. The CPI declined 0.3 percent in November as the dramatic fall in oil prices affected the measure. Energy prices fell 3.8 percent for the month with retail gasoline prices plunging 6.6 percent. The headline CPI reading now stands at 1.3 percent on a year-over-year basis. Core inflation also remained soft, rising just 0.1 percent. Core prices are up at a 1.7 percent pace over last year. Going forward, we suspect oil prices will help to keep inflation in check through the first half of 2015. We suspect headline CPI will rise 1.7 percent in 2015, while core prices will post a 1.9 percent increase over 2014 levels.

After posting a downwardly revised 0.6 percent rise in October, the Index of Leading Economic Indicators climbed another 0.6 percent in November. The interest rate spread, stock prices and ISM new orders had the strongest contribution to the reading. The trend in LEI continues to indicate further momentum in the economy and supports our view for GDP growth in the 2.5 to 3.0 percent range in the first half of 2015.

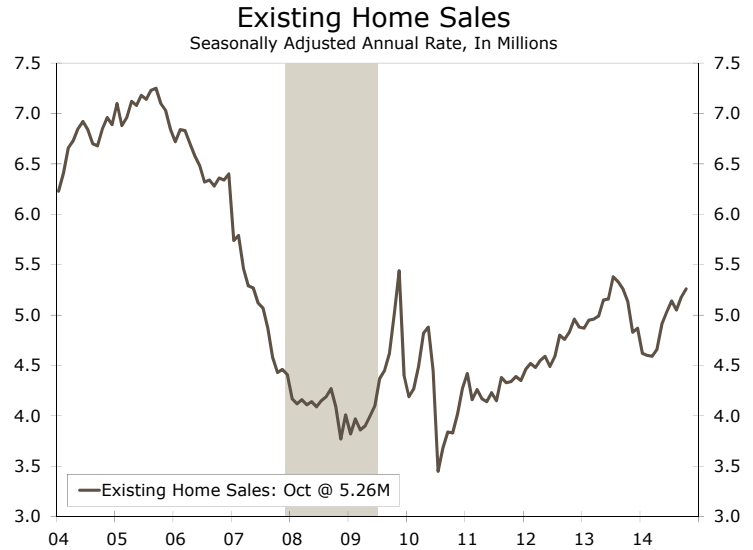


Source: Federal Reserve Board, U.S. Dept. of Commerce, U.S. Dept. of Labor, Conference Board and Wells Fargo Securities LLC

**Existing Home Sales • Monday**

Existing home sales are finally on the mend after being punished by higher mortgage rates and investors pulling out of the market. In October, sales perked up to an annualized 5.26 million-unit pace, with gains seen in both the single-family and condo market. Despite the rebound in sales, the housing recovery remains a slow one. Existing home sales are still below their recent high seen in July 2013 and sales have been skewed toward higher-priced homes. Similarly, the recovery in new home sales has been relatively lackluster, with October's improvement being offset with sizable downward revisions to previous months. The longer-run trajectory is one of slow and steady improvement in home sales as mortgage rates remain reasonably low, while the labor market continues to improve. November's existing home sales, however, are expected to slip slightly to a 5.17 million-unit annualized pace, as pending home sales have come down recently.

**Previous: 5.26 Million**      **Wells Fargo: 5.17 Million**  
**Consensus: 5.20 Million**

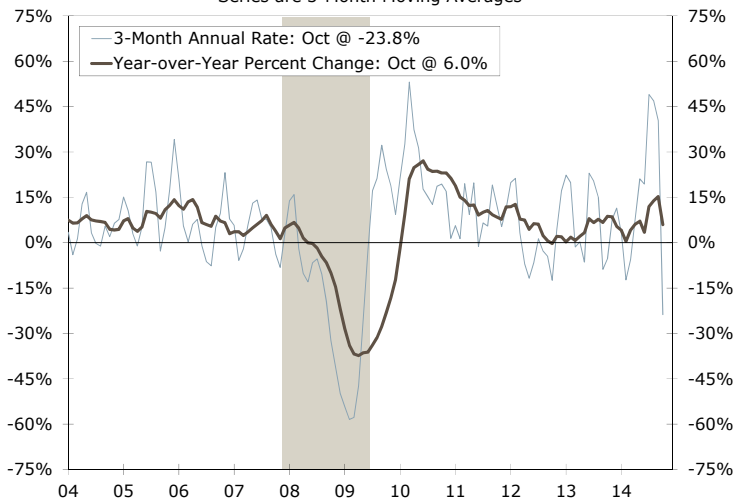


**Durable Goods Orders • Tuesday**

After considerable volatility seen this summer due to a huge boom in aircraft orders, durable goods orders should continue their otherwise upward trend. In October, new orders bumped up 0.4 percent to remain 5.4 percent higher than a year earlier. Capital goods orders have been particularly strong, thanks to additional defense spending. Most signs point to continued growth for durable goods orders in November. Manufacturing production jumped a sizable 1.1 percent in the month, while capacity utilization also picked up. The number of workers employed in manufacturing continues to grow as their workweek lengthens. In addition, the number of orders for Boeing aircraft have also picked up in November, which should give another boost to the headline number. As a result, we look for durable goods orders to increase 3.2 percent in November, but after excluding transportation they should rise 1.3 percent.

**Previous: 0.3%**      **Wells Fargo: 3.2%**  
**Consensus: 3.1%**

Durable Goods New Orders  
Series are 3-Month Moving Averages

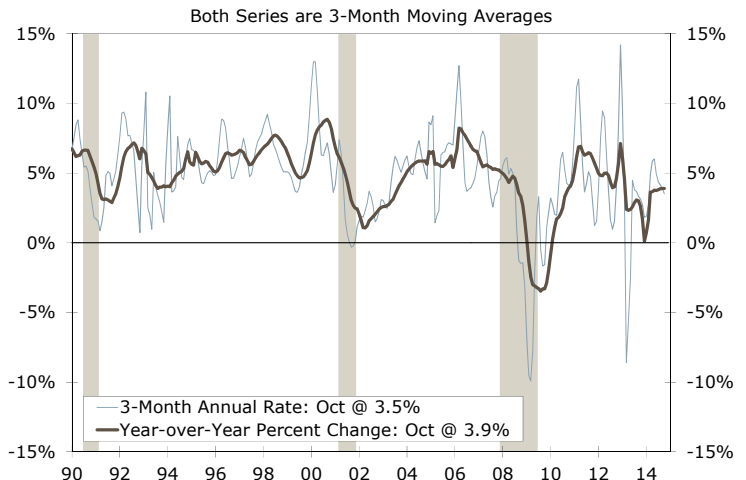


**Personal Income • Tuesday**

Personal income grew 0.2 percent in October and has been posting consistent gains throughout the year. Wages and salaries were even stronger in the month, gaining 0.3 percent. Spending also grew in line with incomes. Several factors point to a pickup in both income and spending. First, there was a huge surge in employment in the month, with the economy adding 321,000 jobs. In addition, the workweek got a little longer and hourly earnings increased. If the employment report is any indication, incomes should have posted a sizable increase in the month. In terms of spending, the boost to income should play a role in the expected rise in consumer expenditures. Falling gas prices should also help to boost real spending, as less pain at the pump should translate into more dollars that can be used for holiday purchases. Such recent trends intimate that both personal income and spending should have increased 0.5 percent in November.

**Previous: 0.2%**      **Wells Fargo: 0.5%**  
**Consensus: 0.5%**

Personal Income



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

**Global Review**

**Russian Central Bank Acts to Stop Ruble's Fall**

The ongoing situation in Russia has snowballed into the greatest financial crisis that the economy has faced since the devaluation of the ruble and the default on Russian government bonds in 1998.

In a special report last week, we wrote about Russian debt in the context of the ruble's collapse and said that further monetary policy tightening was likely. (For more on our findings from that report see "Topic of the Week" on page 7) The Central Bank of the Russian Federation (CBRF) did not make us wait long. In an unscheduled meeting this week, the CBRF hiked its main policy rate 650 bps to 17.00 percent in a dramatic measure intended to stanch a run from rubles into foreign currencies. The initial reaction was even more deterioration in the currency, but prices eventually stabilized—at least on a relative basis.

The government has officially ruled out capital controls. Whether or not that promise holds has a lot to do with whether the ruble experiences another downdraft. Meanwhile, the drop in oil prices, if sustained, puts Russia's oil-driven economy on an almost certain course for recession. Measures taken by CBRF this week also have negative implications for the Russian economy. A 17 percent borrowing rate may help stabilize the currency in the short run, but it is an added burden to an already bad situation.

**Implications for the Global Economy?**

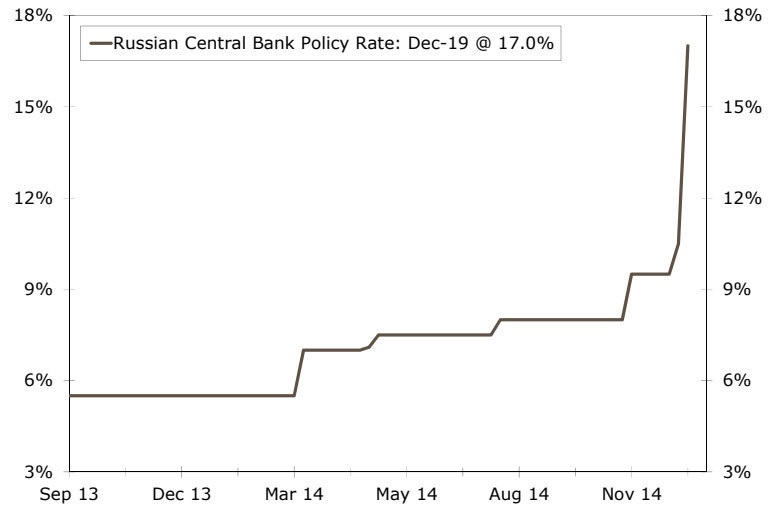
As we said in our report last week, a repeat of 1998 in the form of another default by the Russian government is unlikely in our view; the same may not be true for Russia's private sector. The ruble's steep decline makes it more expensive for Russian companies and banks to finance the portions of their external debt that are denominated in foreign currency.

The Russian banking sector is particularly vulnerable in this regard as more than 80 percent of its external debt is owed in foreign currency. The non-banking private sector is also rather exposed, owing more than 75 percent of its external debts in foreign currency. So while a government default is not a high probability event in our view, we would certainly not rule out one-off bank failures or corporate bankruptcies.

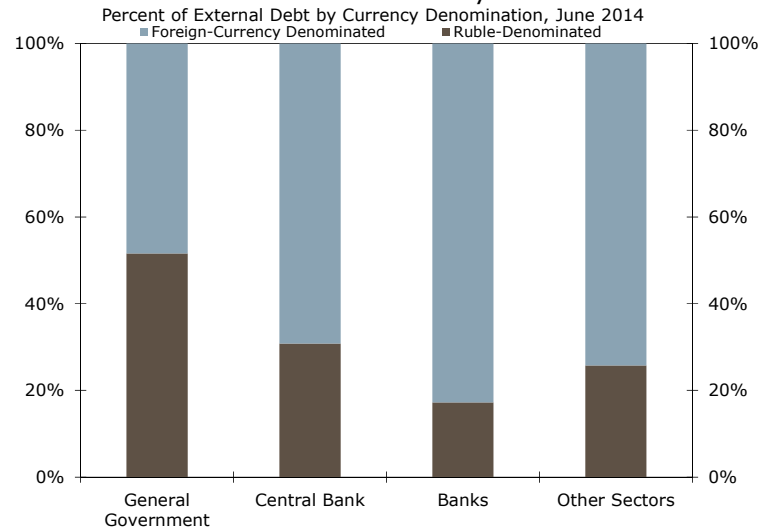
When these loans are not repaid, the banks that lent the money will be stuck with the loss. This underscores the risk of cross border contagion, particularly in Europe. In addition to the direct effects of diminished trade between Russia and Europe that would likely result in the event of a Russian recession, the banking sector in Europe would certainly feel the effects of the lending problems in Russia.

According to the Bank for International Settlements, total foreign bank loans to Russia totaled \$235.5 billion as of June 2014. Three quarters of that total (\$174.8 billion) was owed to European banks. As a share of European banking sector's roughly \$18 trillion foreign loan portfolio, Russia's accounts for less than 10 percent. So widespread private-sector defaults in Russia (should they occur) would not be good for Europe's financial institutions, but that alone would not likely break Europe's banks.

Russian Central Bank Key Policy Rate



Russian External Debt by Sector



Russian Real GDP



Source: IHS Global Insight, Bloomberg LP, the Central Bank of Russia and Wells Fargo Securities, LLC

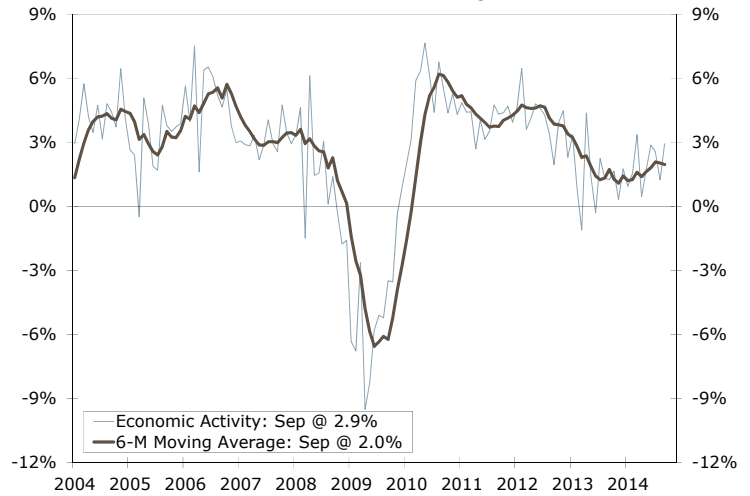
**Mexico Economic Activity • Tuesday**

According to the Mexican economic activity index, the third quarter of the year ended on a “high-note” when the index posted a relatively strong year-over-year rate of 2.9 percent after a meager 1.2 percent reading for August. The release of the index for the first month of the last quarter of the year will help us figure out if the strengthening seen in September has some staying power into the last quarter of the year.

We do not hold great expectations for the number as we have already seen some slight slowdown in October’s industrial production index and recent events in the country may also be affecting the overall performance of the economy. The good news is that the U.S. economy, and particularly U.S. consumption, is booming and that at least suggests that the external sector will remain strong in the last quarter of the year. The domestic economy is a different story.

**Previous: 2.93%**

Mexican Economic Activity Index  
Year-over-Year Percent Change



**Japan CPI • Thursday**

Japan will release its year-over-year November consumer price index on Thursday and the expectation is for the index to continue its disinflationary trajectory and post a 2.4 percent rate. Our forecast calls for 2.4 percent. But the important, and worrisome, development is that after an initial surge due to Abenomics and the April increase in the sales tax, inflation seems to have returned to its normal behavior of overall weakness. Since the economy is back in recession, then this weakness is probably going to persist and make policymakers revisit all the options to try to inject some life back to economic activity.

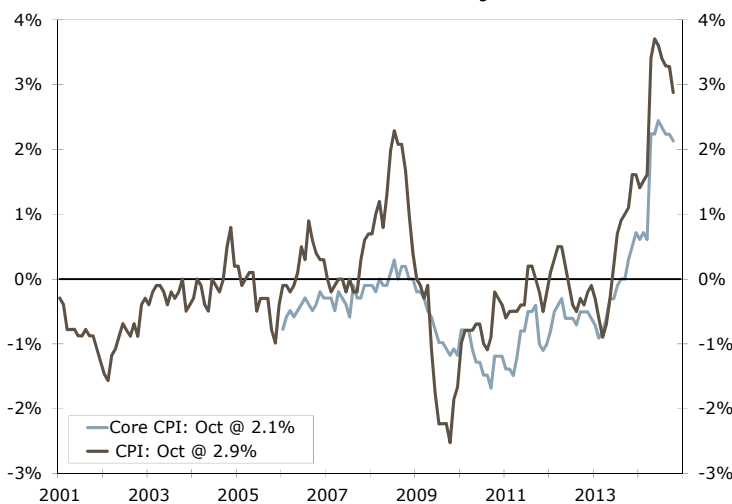
On Thursday, we will also have the release of industrial production and retail sales for November. Both indices will give us some sense of the direction the economy has taken in the last quarter of the year after such a bad performance in the third quarter.

**Previous: 2.9%**

**Wells Fargo: 2.4%**

**Consensus: 2.5%**

Japanese Consumer Price Index  
Year-over-Year Percent Change



**Germany Retail Sales • Week of 12/29**

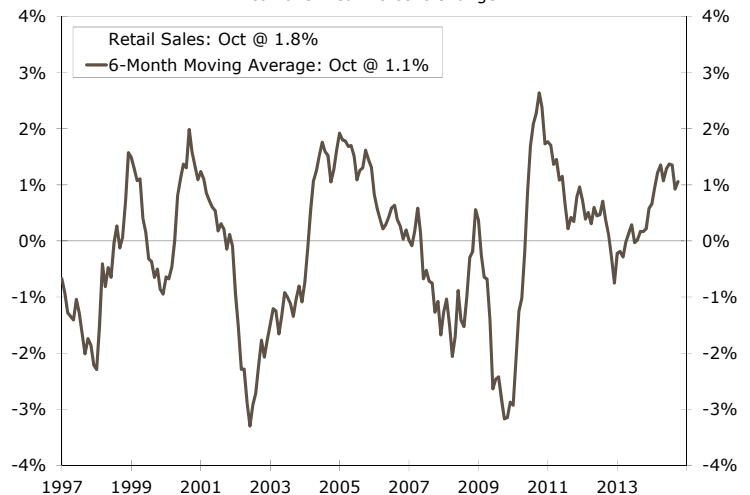
German real retail sales for November will be released during the week of December 29. Real retail sales have been hit-and-miss during 2014 as a large increase in retail sales has been normally followed by another large or even larger drop the following month. The potentially good news for the November release and for following months is that the large decrease in the price of petroleum and of gasoline should help to support growth in German consumer spending.

Although Germany depends heavily on foreign demand for its production a better domestic market will come in handy and help improve the overall conditions of the economy even if external demand remains constrained. Longer term, the sharp decline in petroleum prices will generate some more demand from Germany’s export markets and will improve economic conditions across the region.

**Previous: 1.6% (Month-over-Month)**

**Consensus: -0.3%**

German Retail Sales, ex-Autos  
Year-over-Year Percent Change



Source: IHS Global Insight and Wells Fargo Securities, LLC

**Interest Rate Watch**

**The Janus Report: Looking Back**

It was a good year. Our fundamental economic outlook held true. Real growth for 2014 appears it will come in at 2.2 percent for the U.S. compared to our forecast of 2.4 percent. Our CPI inflation forecast was right on the mark for 1.7 percent. As a result, we did not expect any Fed move in the federal funds rate in 2014 and anticipated the earliest funds rate increase to occur in June 2015, an outlook we have held throughout the year.

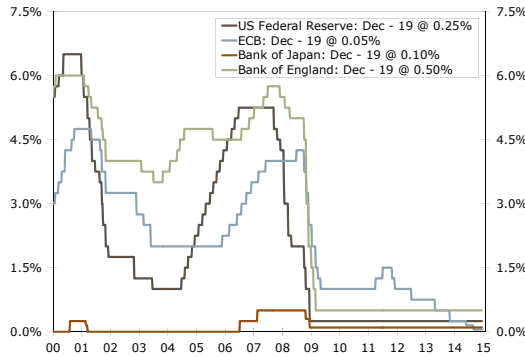
We forecasted two-year and five-year Treasury notes at 0.54 and 1.65 percent, respectively, and the results were 0.54 and 1.70. Stronger demand for longer-dated Treasuries as global bond yields compressed and regulatory requirements took hold, however, led to lower-than-expected yields at the long end of the curve.

**Janus: Looking Forward**

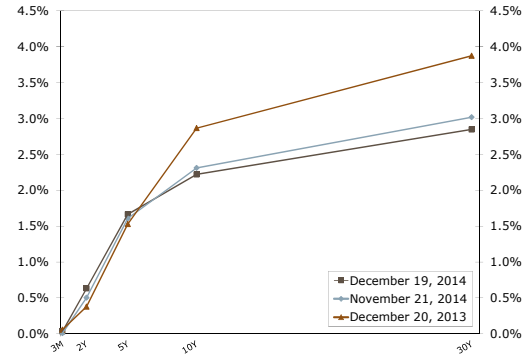
For the year ahead, we anticipate better economic growth. Consumer spending should improve based on steady job gains, stronger confidence and higher household wealth. Government spending should turn around and add to growth. One key factor for policy will be the steady decline in the unemployment rate to 5.4 percent, which could be considered full employment. We anticipate that oil prices will, on average, remain below 2014 levels, which should keep the CPI inflation gains in the mid-1.0-1.5 percent range, but will keep core inflation steady.

With the unemployment rate signaling full employment and inflation steady, we expect the Fed to raise the funds rate in mid-2015. This will move up Treasury yields in the 2-, 3- and 5-year maturities. However, we do not see a significant move upward in the 10-year Treasury note benchmark. Global concerns and a lack of rising inflation will put a ceiling on 10-year yields. The net result is that the yield curve should flatten during 2015. We anticipate that mortgage rates will remain remarkably steady with rates in the range of 4.1 to 4.5 percent. This pattern is consistent with the trend that the longer end of the Treasury yield curve remains steady.

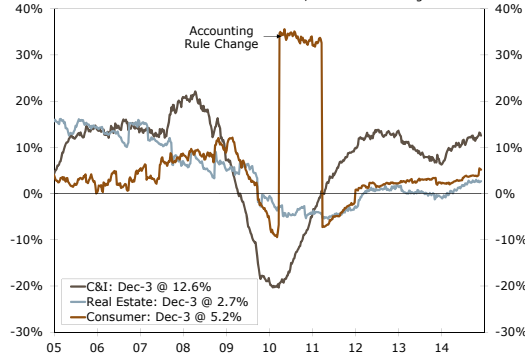
Central Bank Policy Rates



Yield Curve  
U.S. Treasuries, Active Issues



Bank Lending  
Assets at U.S. Commercial Banks, YoY Percent Change



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

**Credit Market Insights**

**Slight Hiccup in Household Equity**

Last week, the Fed released its quarterly Z.1 report on the Financial Accounts of the United States, more commonly known as the Flow of Funds survey. This report gives us a snapshot into the financial condition of households and the aggregate nonfinancial private sector.

The Flow of Funds survey reported that household net worth declined in the third quarter. Net worth still increased year over year, albeit at a much slower rate of 6.7 percent than previously seen. The \$141 billion decline reflected a decrease in assets and a slight increase in liabilities.

Within assets, nonfinancial assets increased modestly, led by household real estate. The growth rate of this series has slowed, however. This is not surprising, given the deceleration in home price gains. Financial assets, on the other hand, were the cause for the decline. Within financial assets, corporate equities and mutual fund shares led the decline. This likely reflects households selling some of their equity positions, as the S&P 500 increased over the quarter. Consumer credit contributed to the largest gain in liabilities.

Although a slight hiccup, the upward trend in net worth remains intact. Stronger household balance sheets support our outlook for continued growth in consumption and further strengthening in the housing market.

**Credit Market Data**

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
	30-Yr Fixed	3.80%	3.93%	3.97%
15-Yr Fixed	3.09%	3.20%	3.17%	3.51%
5/1 ARM	2.95%	2.98%	3.01%	2.96%
1-Yr ARM	2.38%	2.40%	2.44%	2.57%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
	Commercial & Industrial	\$1,769.0	-21.67%	19.29%
Revolving Home Equity	\$459.1	1.37%	-1.54%	-3.36%
Residential Mortgages	\$1,567.0	-10.74%	2.49%	0.82%
Commercial Real Estate	\$1,588.7	14.31%	5.03%	6.56%
Consumer	\$1,198.8	9.07%	3.53%	5.18%

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

## Topic of the Week

### Russian Government Default Not Likely

As we discussed in previous sections of this publication, Russia took center stage this week. For a litany of reasons, Russia is likely to experience a recession next year. Since July 1, the price of Brent crude oil has fallen nearly 50 percent, with the value of the ruble versus the dollar following almost monotonically in line with Brent prices (top chart). This would seemingly have dire consequences for government revenues; however, all oil is traded in dollars. Thus, as Russia's currency has depreciated roughly the same amount as oil prices, government revenues in ruble terms are unlikely to fall drastically. In dollar terms, however, revenues will likely take a significant hit.

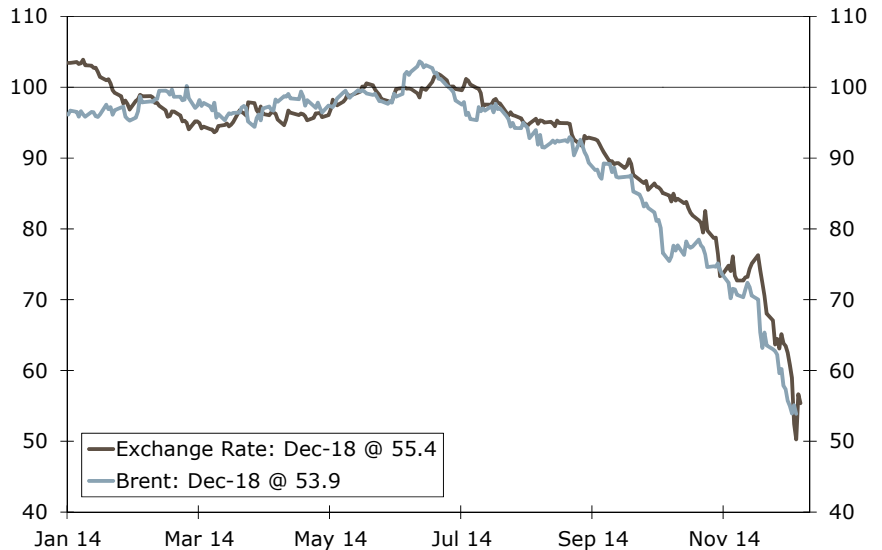
This has important implications for government debt. Specifically, the government should have no trouble paying its ruble-denominated debt—even if ruble revenues suddenly nosedive, the government can incur large deficits and print more rubles to pay its obligations. What about the government's dollar-denominated debt? Despite the ruble's significant loss in value against the dollar in recent months, a default on dollar debt is not likely either. Russia's central government has a significant amount of foreign exchange reserves, and while it has been forced to sell a sizable portion of them to put a floor on the ruble, \$400 billion of FX reserves still represents an ample war chest (bottom chart). In sum, while Russia is likely to experience economic turmoil in the year ahead, a default on its government debt is unlikely.

As mentioned previously in this publication, the more precarious debt situation lies in the other sectors of Russian economies. Specifically, our concern lies with banks and nonfinancial corporations that have a significant amount of foreign currency-denominated (in particular, dollar-denominated) debt.

For more on the situation, please see our special report "*The Ruble's Collapse and Russian External Debt*," available on our website.

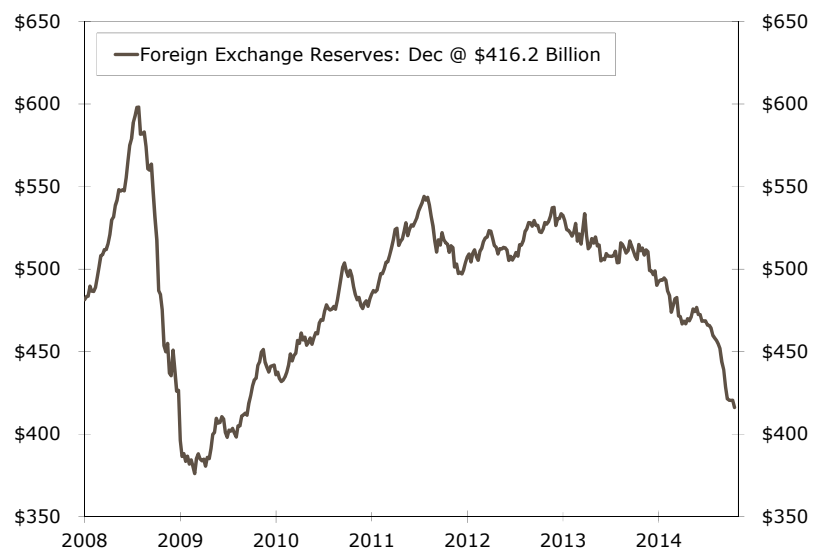
### Brent Oil Price vs. Russian Exchange Rate

USD per Barrel, USD per RUB; Index, July 1, 2014 = 100



### Russian Foreign Exchange Reserves

Billions of USD



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

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## Market Data ♦ Mid-Day Friday

## U.S. Interest Rates

	Friday 12/19/2014	1 Week Ago	1 Year Ago
3-Month T-Bill	0.03	0.02	0.07
3-Month LIBOR	0.25	0.24	0.24
1-Year Treasury	0.27	0.23	0.14
2-Year Treasury	0.63	0.54	0.36
5-Year Treasury	1.66	1.51	1.64
10-Year Treasury	2.22	2.08	2.93
30-Year Treasury	2.85	2.74	3.91
Bond Buyer Index	3.65	3.65	4.73

## Foreign Exchange Rates

	Friday 12/19/2014	1 Week Ago	1 Year Ago
Euro (\$/€)	1.228	1.246	1.366
British Pound (\$/£)	1.562	1.572	1.637
British Pound (£/€)	0.786	0.793	0.834
Japanese Yen (¥/\$)	119.360	118.750	104.250
Canadian Dollar (C\$/\\$)	1.160	1.158	1.066
Swiss Franc (CHF/\$)	0.981	0.964	0.898
Australian Dollar (US\$/A\$)	0.817	0.825	0.887
Mexican Peso (MXN/\$)	14.528	14.762	12.966
Chinese Yuan (CNY/\$)	6.221	6.188	6.071
Indian Rupee (INR/\$)	63.300	62.295	62.116
Brazilian Real (BRL/\$)	2.648	2.654	2.357
U.S. Dollar Index	89.389	88.363	80.630

Source: Bloomberg LP and Wells Fargo Securities, LLC

## Foreign Interest Rates

	Friday 12/19/2014	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.06	0.06	0.27
3-Month Sterling LIBOR	0.56	0.56	0.53
3-Month Canada Banker's Acceptance	1.29	1.28	1.28
3-Month Yen LIBOR	0.11	0.11	0.15
2-Year German	-0.08	-0.05	0.22
2-Year U.K.	0.49	0.47	0.54
2-Year Canadian	1.02	0.96	1.14
2-Year Japanese	-0.04	0.01	0.10
10-Year German	0.60	0.62	1.87
10-Year U.K.	1.90	1.80	2.96
10-Year Canadian	1.87	1.76	2.70
10-Year Japanese	0.36	0.40	0.67

## Commodity Prices

	Friday 12/19/2014	1 Week Ago	1 Year Ago
WTI Crude (\$/Barrel)	54.94	57.81	98.77
Gold (\$/Ounce)	1196.38	1222.50	1188.68
Hot-Rolled Steel (\$/S.Ton)	596.00	614.00	676.00
Copper (¢/Pound)	288.95	294.65	334.05
Soybeans (\$/Bushel)	10.30	10.40	13.34
Natural Gas (\$/MMBTU)	3.60	3.80	4.46
Nickel (\$/Metric Ton)	15,580	16,210	14,084
CRB Spot Inds.	492.34	501.05	530.49

## Next Week's Economic Calendar

	Monday 22	Tuesday 23	Wednesday 24	Thursday 25	Friday 26
U.S. Data	<b>Existing Home Sales</b> October 5.26M November 5.17M (W)	<b>Durable Goods Orders</b> October 0.4% November 3.2% (W)		<b>Christmas Day</b> U.S. Markets Closed	
		<b>GDP 3rd Revision (QoQ)</b> Q3 (2nd Revision) 3.9% Q3 (3rd Revision) 4.5% (W)			
	Global Data		<b>Mexico</b> <b>Economic Activity (YoY)</b> Previous (September) 2.93%		<b>Japan</b> <b>CPI (YoY)</b> Previous (October) 2.9%
		<b>Canada</b> <b>GDP (MOM)</b> Previous (September) 0.4%			

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

Source: Bloomberg LP and Wells Fargo Securities, LLC



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