

# Economics Group

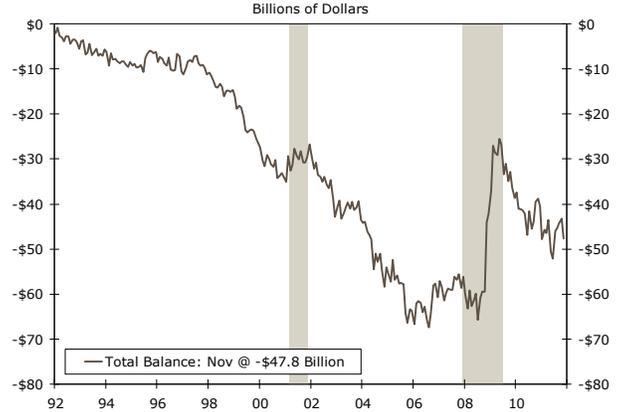
## Weekly Economic & Financial Commentary

### U.S. Review

#### Week Two Brings a Little Less Enthusiasm

- Some of the optimism about housing, consumer spending and the broader economy eased back a bit this week, amid a smattering of softer economic reports.
- Retail sales rose just 0.1 percent in December and core retail sales fell by the same amount. Holiday sales came in right in line with our expectations, rising 5.1 percent.
- Weekly first-time jobless claims spiked up to 399,000 and job openings listed in the JOLTs survey fell slightly.
- Data on international trade and inventories also point to a more modest gain in 2011 Q4 real GDP growth.

Trade Balance in Goods and Services

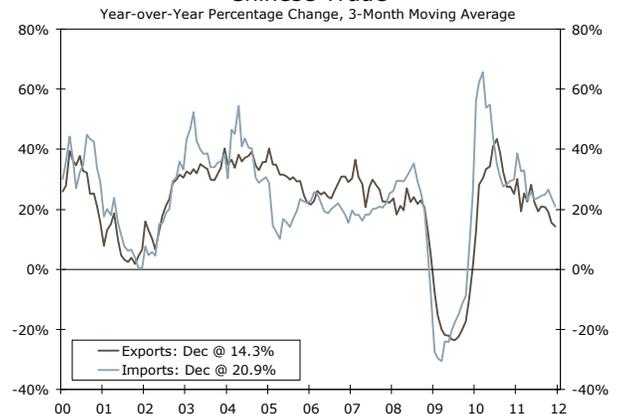


### Global Review

#### Global Trade and Industrial Production Slow Further

- Several countries reported trade and industrial production this week. Chinese efforts to contain the property bubble and rein in inflation have led to softening import demand, while weakening demand from Europe has curtailed exports. Germany's exports rose but import growth slowed markedly as the German economy teeters on the brink of a recession.
- With both external and domestic demand weakening, many countries reported slowing industrial production.
- Both the Bank of England and the European Central Bank held rates steady to help support economic growth.

Chinese Trade



Wells Fargo U.S. Economic Forecast

	Actual		Forecast				Actual		Forecast					
	2011				2012				2009	2010	2011		2012	2013
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product <sup>1</sup>	0.4	1.3	1.8	3.4	1.3	1.8	2.2	2.4	-3.6	3.0	1.8	2.0	1.9	
Personal Consumption	2.1	0.7	1.7	3.4	1.2	1.5	1.7	2.1	-2.0	2.0	2.2	1.7	1.4	
Inflation Indicators <sup>2</sup>														
"Core" PCE Deflator	1.1	1.3	1.6	1.7	1.7	1.5	1.4	1.6	1.5	1.4	1.4	1.5	1.6	
Consumer Price Index	2.2	3.3	3.8	3.3	2.4	1.9	1.5	1.8	-0.3	1.6	3.2	1.9	2.0	
Industrial Production <sup>1</sup>	4.8	0.7	6.1	2.7	2.7	3.7	3.1	2.4	-11.1	5.3	4.1	3.2	2.4	
Corporate Profits Before Taxes <sup>2</sup>	8.8	8.5	7.5	6.4	6.2	6.0	6.4	6.6	9.1	32.2	7.8	6.3	7.0	
Trade Weighted Dollar Index <sup>3</sup>	70.6	69.4	72.8	73.3	74.0	74.5	75.0	76.0	77.7	75.6	70.9	74.9	78.5	
Unemployment Rate	9.0	9.0	9.1	8.7	8.4	8.5	8.6	8.5	9.3	9.6	9.0	8.5	8.3	
Housing Starts <sup>4</sup>	0.58	0.57	0.62	0.66	0.66	0.70	0.69	0.70	0.55	0.58	0.61	0.69	0.80	
Quarter-End Interest Rates <sup>5</sup>														
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	4.84	4.51	4.11	3.96	4.00	4.10	4.10	4.20	5.04	4.69	4.46	4.10	4.30	
10 Year Note	3.47	3.18	1.92	1.89	1.90	2.00	2.10	2.20	3.26	3.22	2.78	2.05	2.35	

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Together we'll go far



Forecast as of: January 13, 2012  
<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

**U.S. Review**

**Optimism Already Appears to be Fading**

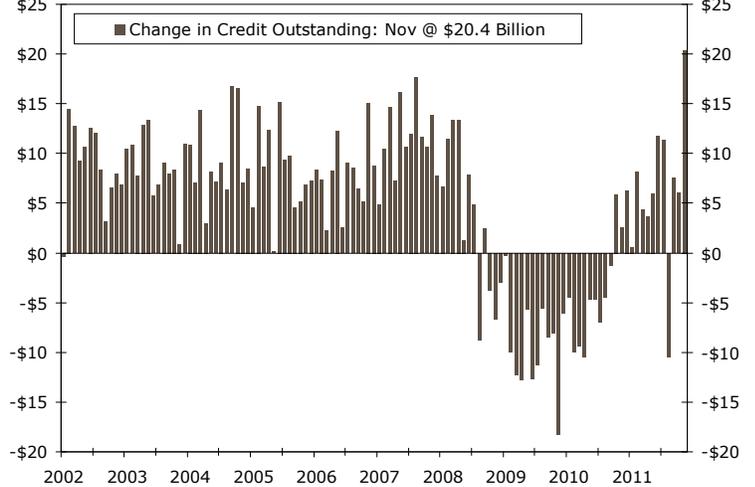
The New Year always seems to usher in an air of optimism and this year has been no exception. Better reports for the housing sector, an improving job market and generally positive news on holiday retail sales had raised hopes that the recovery was shifting into higher gear. Week two has brought in a more sober view. We have repeatedly noted our concerns about the narrow span of improvement in economic activity, the role that seasonal factors are playing in exaggerating that improvement and the lack of improvement in underlying fundamentals in our analysis and outlook for 2012. This week's data generally support that view.

Early in the week, we received news that consumer credit surged by \$20.4 billion in November, which was nearly three times more than the consensus estimate and the largest gain in nearly 10 years. The growth reflects increases in credit card use, car loans and student loans. Some analysts looked at this report as evidence consumers are once again confident enough to take on additional debt. This is partly true. The reduced pace of layoffs and drop in the unemployment rate are likely bolstering the confidence of folks who have jobs and they may be inclined to take on a little more debt. We fear the real driver, however, has been a lack of real income growth and higher prices for necessities, most notably food and gasoline, which have caused consumers to reduce saving and take on more debt.

The lack of real income growth and decline in the saving rate are the big reason why we expect consumer spending to slow in the first half of 2012. The latest retail sales data suggest this moderation may already be underway. Retail sales rose just 0.1 percent in December, following a 0.4 percent rise in November. Holiday sales got off to an unusually strong start, amid heavy discounting and longer store hours. Sales slowed in December, however, even though gasoline prices plummeted, freeing up a few more discretionary dollars. Sales, excluding gasoline, building materials and motor vehicle dealers fell 0.2 percent in December, marking the largest drop since July 2010. With the drop, core retail sales ended the fourth quarter slightly below their fourth quarter average, which means that it will be a real uphill battle for consumer spending to post even modest gains in the first quarter.

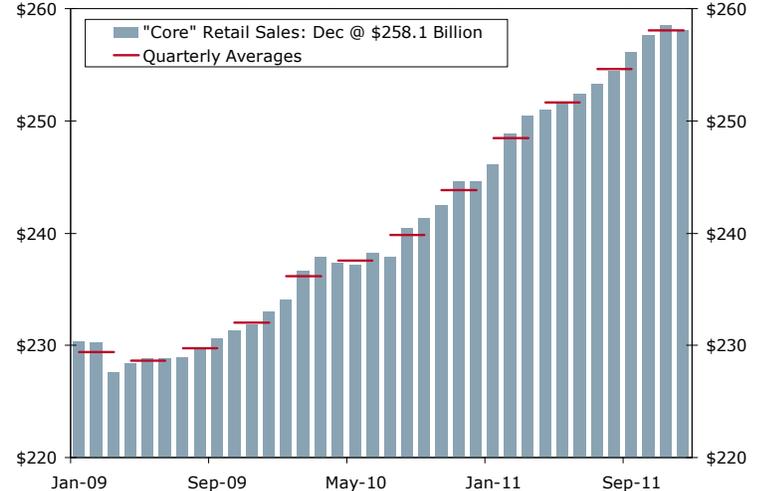
The employment data also look a little less robust this week. The JOLTs data show a slight pick-up in hiring and continued slide in job openings. The JOLTs data do not show anywhere near the improvement the payroll or household employment data do, which lends credence to our view that recent gains have been exaggerated by the seasonal adjustment process. Along those lines, the return to more normal seasonal factors appears to be behind the jump in weekly unemployment claims back up to 399,000 during the first week of January. Data on international trade and inventories also suggest growth was more modest during the fourth quarter and tend to refute claims that the pace of economic recovery is accelerating. We have slightly reduced our estimate for fourth quarter real GDP growth to 3.4 percent.

**Consumer Credit**  
Change in Billions of Dollars



**"Core" Retail Sales**

Billions of USD, Ex-Autos, Gas & Building Mat., Seasonally Adj.



**Job Openings Rate**

Seasonally Adjusted



**Industrial Production • Wednesday**

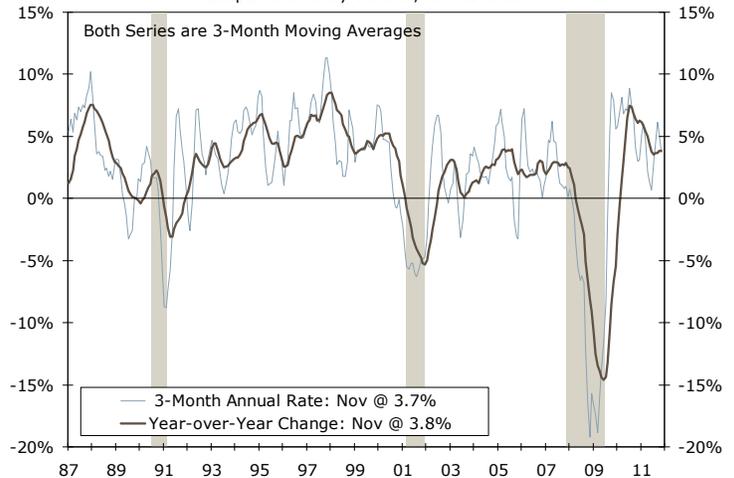
Industrial production declined 0.2 percent in the month of November, despite consensus expectations of a modest gain. The primary weak spot was auto production which dropped 3.4 percent in November. More broadly, manufacturing production fell 0.4 percent overall but dropped just 0.2 percent, ex-motor vehicles.

We may see some payback in the autos component for December when the industrial production report hits the wire on Wednesday. The ISM index posted a better than expected increase to 53.9 in December. Considering the resilience in factory sentiment measures, it would not be surprising to see industrial production post an increase for the final month of the year.

Speaking of sentiment, the NY Fed's Empire Index is due out on Tuesday and will offer a look at factory sentiment in the greater New York area.

**Previous: -0.2%**                      **Wells Fargo: 0.5%**  
**Consensus: 0.5% (Month-over-Month)**

**Total Industrial Production Growth**  
 Output Growth by Volume, not Revenue



**Consumer Price Index • Thursday**

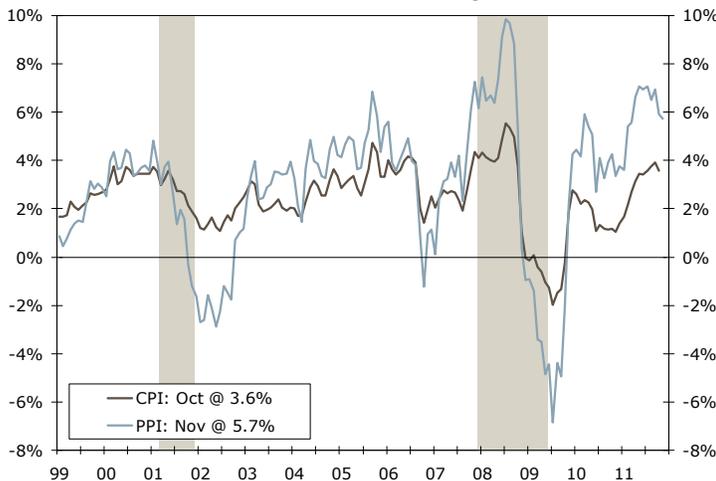
Wholesale prices have been growing more than twice as fast as consumer prices over the last two years. In the period between November 2009 and November 2011, the Producer Price Index averaged 5.0 percent on a year-over-year basis. During the same time period, the average annual rate of consumer inflation as measured by the Consumer Price Index was just 2.4 percent.

Despite rising input costs, businesses have lacked the pricing power to pass on these price increases in an environment of weak economic growth and high unemployment. The outcome has been slower price growth for consumers and tighter profit margins for businesses.

That said, there has been some relief in price pressure recently. We will find out how these price indexes finished the year when PPI comes out on Wednesday and CPI comes out Thursday.

**Previous: 3.4%**                      **Wells Fargo: 2.9%**  
**Consensus: 3.1% (Year-over-Year)**

**Consumer Price Index vs. Producer Price Index**  
 Year-over-Year Percent Change



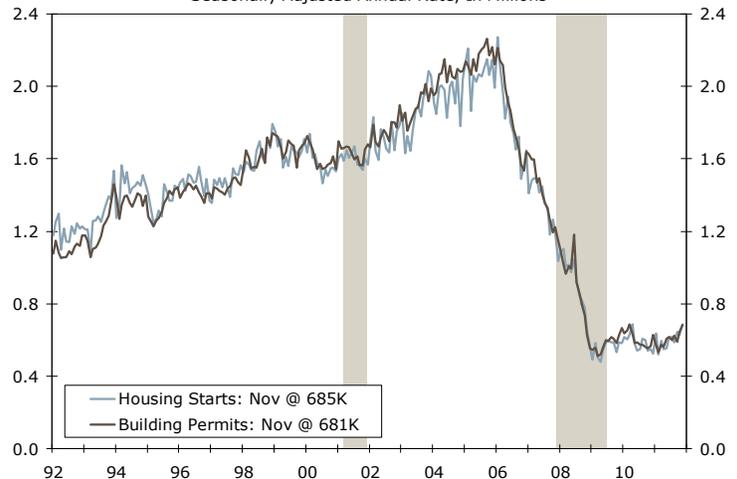
**Housing Data • Thursday & Friday**

Housing starts rose much more than expected during November, as unseasonably warm weather allowed builders to begin work on more projects than they usually do in November. Most of November's increase in starts and permits was in multifamily units, which are benefitting from strong demand for apartments.

The warmer weather continued into December, at least along the East coast and apartments remain in demand as an alternative to home ownership during uncertain times. These dynamics may underpin residential construction activity somewhat in the near term, but they are hardly a foundation for the sort of improvement upon which a real recovery could be based. A December report for housing starts and building permits is due out on Thursday of next week. We also get a look at existing home sales for December when that report is published on Friday.

**Previous: 685K**                      **Wells Fargo: 660K**  
**Consensus: 685K**

**Housing Starts and Building Permits**  
 Seasonally Adjusted Annual Rate, In Millions



## Global Review

### Global Trade Continues to Moderate

Several countries reported trade data this week, and the impact of the slowdown in China and Europe is evident. China's trade surplus widened to \$16.5 billion in December. While export growth slowed slightly to 13.4 percent year over year from 13.8 percent, import growth slowed markedly to 11.8 percent from 22.1 percent. China's efforts to rein in inflation and contain the property bubble are working, but the resulting slowdown in Chinese imports suggests China may not be the global economy's savior this time around as it was in the aftermath of the global financial crisis. Similarly, while export growth in Germany improved to 8.4 percent year over year in November from 6.9 percent in October, import growth slowed significantly from 11.0 percent to just 6.9 percent. The impact of the Eurozone debt crisis was noticeable as exports to European countries that do not use the euro were up 9.8 percent, but exports to Eurozone countries were up just 7.7 percent. However, companies ought to take note of the import side, which showed imports from non-euro European countries up 15.1 percent but from Eurozone countries up only 8.8 percent. More shocking was that imports from countries outside of Europe were up only 0.2 percent from the prior year, suggesting the German slowdown will weigh heavily on demand for foreign goods from outside the region. Over in the U.K., slowing European demand weighed on exports in November, which fell 1.5 percent on the month. With imports rising 1.1 percent, the trade deficit widened, which is not good news as the country embarks on austerity measures to shore up the budget deficit. All in all, it is clear that Europe's slowdown and China's attempt at a soft landing are restraining global trade, meaning most countries will need to rely on domestic demand to get them through the next round of global economic weakness.

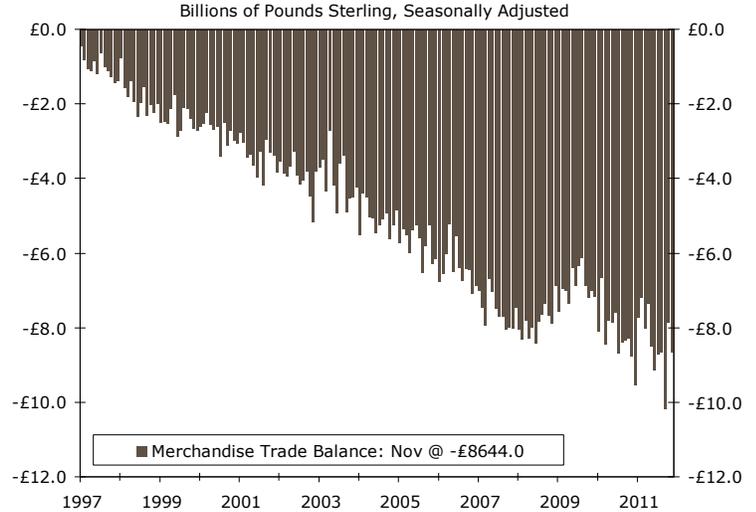
### Industrial Production Suffers Amid Weakening Demand

As slowing global trade and austerity measures hamper demand, industrial production has softened. In Germany, industrial production fell 0.6 percent in November and was down 3.6 percent from a year ago, the slowest annual rate of growth in almost two years. Production of all goods was down on the month, with a 3.3 percent plunge in durable goods leading the drop. This is congruent with the government's estimate of a 0.3 percent contraction in GDP in the fourth quarter. Production rose 1.1 percent in France, but again, the year-ago increase of 0.9 percent was the lowest in two years. The same was true in Spain, where production rose 0.6 percent on the month but was down 7.0 percent on a year-ago basis, the worst in over two years. In the U.K., production fell 0.6 percent on the month and was down 3.1 percent from a year earlier, also the worst in two years.

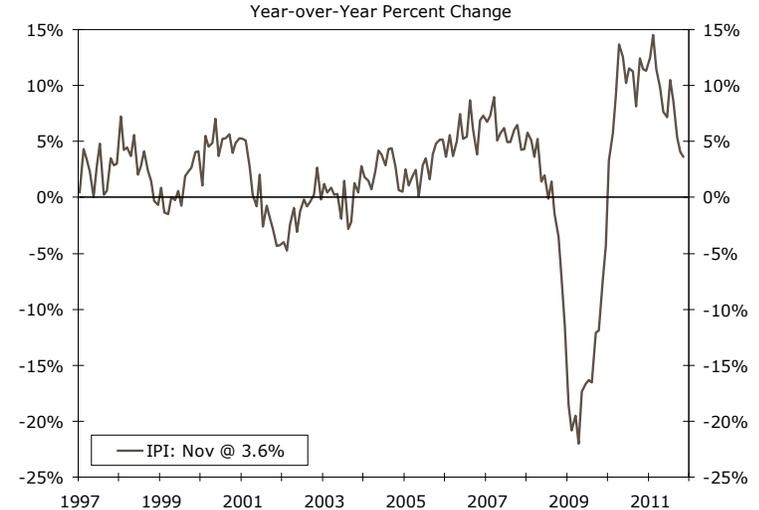
### Interest Rates on Hold for Now

Despite the slowdown in trade and production, the Bank of England kept interest rates steady this week, citing improvements in services and manufacturing indices in December. The European Central Bank also refrained from cutting rates, citing improving business confidence in December.

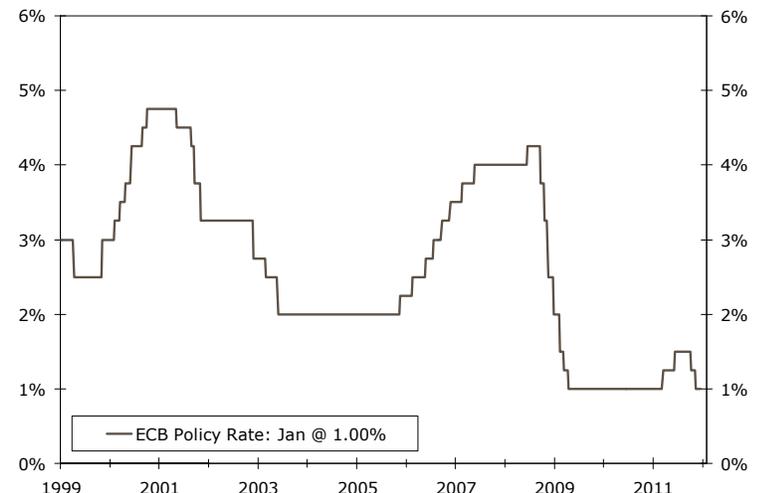
### U.K. Merchandise Trade Balance



### German Industrial Production Index



### Euro-zone Interest Rates



## China GDP • Monday

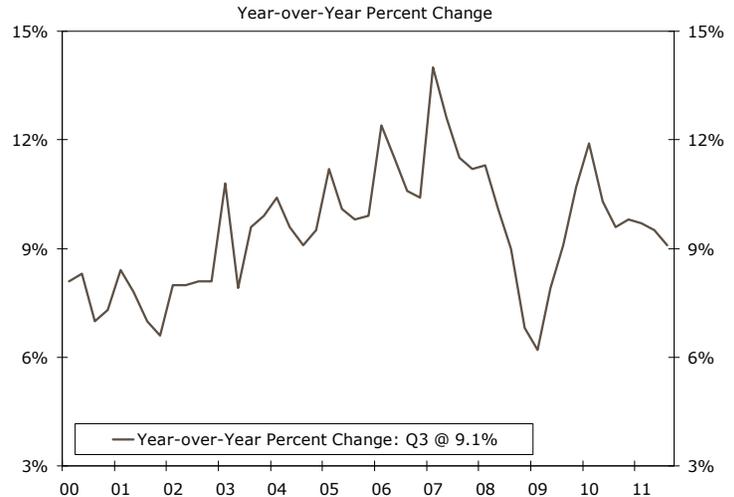
China's economic growth slowed to 9.1 percent year over year in the third quarter, less than the 9.3 percent expected and down from 9.5 percent in the second quarter. Economic growth has been steadily trending lower since the first quarter of 2010. To quell the rapid rebound in inflation following the global financial crisis, China has raised interest rates several times and curbed lending. In an effort to slow home price increases, the government has imposed limits on home purchases. These measures, along with slowing demand for China's exports, have contributed to slowing Chinese growth.

Now that inflation has subsided somewhat, the central bank has begun to ease credit a bit, reducing the required reserve ratio for banks. More policy easing is expected as European weakness weighs on exports. Weak external demand and a cooling property market suggest the downshift in growth is likely to continue.

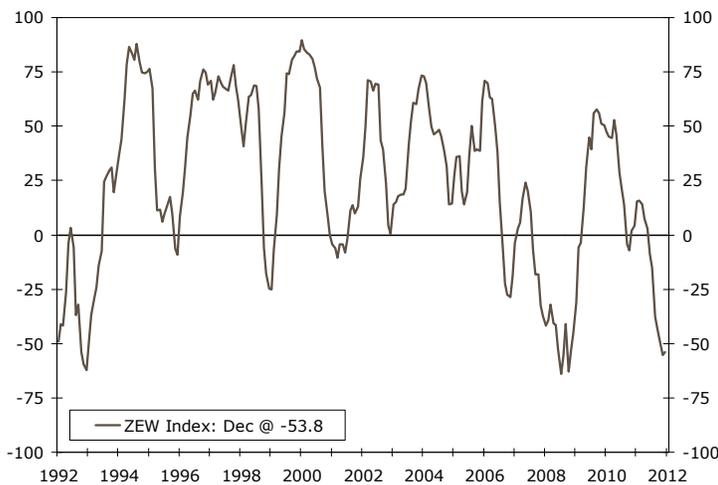
**Previous: 9.1%**

**Consensus: 8.7% (Year-over-Year)**

### Chinese Real GDP



### German ZEW Index



## German Investor Sentiment • Tuesday

German investor sentiment improved slightly to -53.8 in December, the first increase in 10 months, from a three-year low of -55.2 in November as hopes rose that European leaders would be able to stem the region's debt crisis. While the crisis has not been completely resolved, investors believe that leaders are finally beginning to make some progress on measures to get the situation under control. As such, the German stock market has been trending higher since mid-December. Still, investor sentiment remains near levels seen during the global financial crisis.

As for the economy, growth has cooled as equipment investment and export growth have slowed markedly on a year-ago basis. With the Eurozone likely to fall into recession and China's economy slowing, Germany will be increasingly reliant on domestic demand. As Germany is the Eurozone's largest economy, investor and consumer sentiment in Germany are being closely watched.

**Previous: -53.8**

**Consensus: -49.4**

## United Kingdom CPI • Tuesday

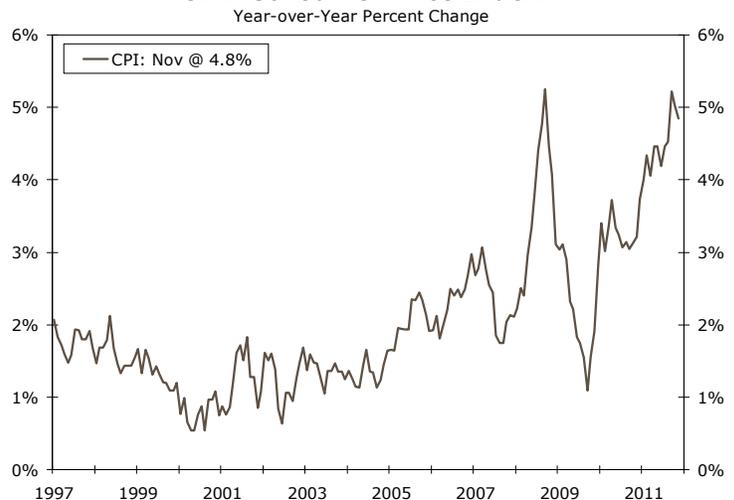
Consumer price inflation in the U.K. has begun to recede slightly, slowing to 4.8 percent year over year in November from a recent peak of 5.2 percent in September. For most of the year, inflation had been accelerating due to a weakening pound, high commodity prices and the increase in sales tax last January. More recently, however, price pressures have been ebbing thanks to the lagged effects of falling commodity prices and slowing food price increases in the wake of good harvests. Unemployment is at the highest in over a decade and is also sapping demand for clothing, furniture and other household goods.

Inflation is expected to continue to moderate as the country tightens the reins on spending in order to shore up the budget and as the Eurozone debt crisis weighs on confidence. This will allow the central bank to hold interest rates at record lows while also giving it the flexibility to inject more stimuli if needed.

**Previous: 4.8%**

**Consensus: 4.2% (Year-over-Year)**

### U.K. Consumer Price Index



**Interest Rate Watch**

**None Dare Call it QEIII**

During the last two weeks, commentary from a number of Federal Open Market Committee (FOMC) members and a Federal Reserve White Paper on housing suggests that the odds of a QEIII move in the form of large-scale purchases of mortgage backed securities have risen.

**Unemployment High, Inflation Low**

President Williams of the San Francisco Fed asserted, that unemployment is going to be sustained above a reasonable estimate of the natural rate of unemployment and this “does make an argument that we should have more stimulus.” Consider this, along with our observation that the Fed’s benchmark for inflation, the core PCE deflator, is likely to remain below its perceived two percent target then we gather that the economic background for further easing in the guise of asset purchases can be made by Chairman Bernanke—perhaps at his semi-annual testimony before the Senate Banking Committee.

**Housing: The Real Clincher**

Housing policy and the Federal Reserve became the big news with the release of the Fed’s White Paper putting focus on restoring the health of the housing market and a framework to address the issues and some calculus on tradeoffs. From the Fed’s view a number of issues surround the role of the GSEs, Fannie and Freddie. In this case, the focus on housing and the slow progress of recovery in the housing market identified by the Fed suggests that the Fed is seriously considering purchases of mortgage-backed securities as a means to provide liquidity to the mortgage markets. From our viewpoint, the pace of economic growth, ex-housing, has steadily improved in recent quarters and we believe the recovery is sustainable. However, we read the comments of President Williams and the Fed’s White Paper to mean the pace of growth is not good enough and with inflation low, further easing, possibly through another large-scale asset purchase program—none dare call it QEIII—is on the table for discussion at the January and March FOMC meetings.

**Credit Market Insights**

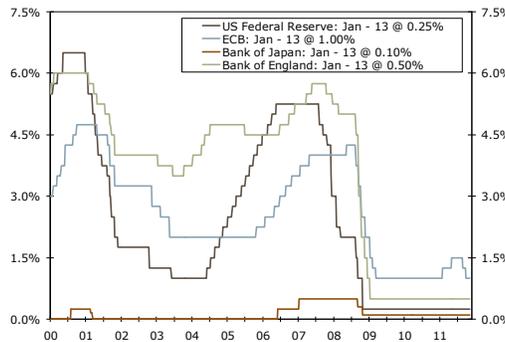
**Consumer Credit Surges**

Despite moderate economic growth and years of deleveraging, consumers put their fears and constraints aside and pushed consumer credit up to \$20.4 billion in November, the highest level since September 2009. The jump in consumer credit to a 9.9 percent seasonally adjusted annual rate was the largest monthly increase in a decade.

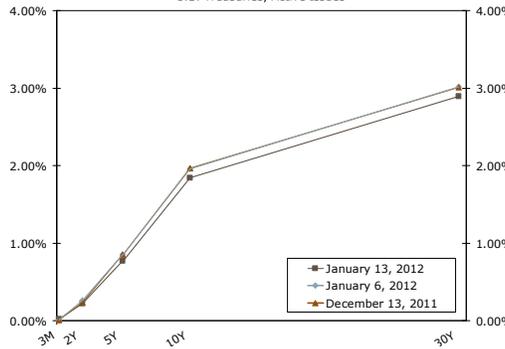
Nonrevolving credit surged to a 10.7 percent seasonally adjusted annual rate, the largest monthly gain since February 2005. Much of the increase was due to a gain in student loan credit. With many banks now offering fixed-rate student loans, students may be taking advantage of record low interest rates. Moreover, with an elevated unemployment rate, many discouraged workers are returning to school.

Revolving credit rose to an 8.5 percent annual rate, the highest since February 2008, as consumers used credit for holiday shopping. The jump in revolving credit supports the increase in core retail sales, which excludes building materials, gas and auto stores. Core retail sales were up at a 6.5 percent three month-annualized rate in November, the highest monthly gain in six months. The pullback in retail sales in December suggests consumers will likely return to their cautious ways of reducing household debt. That said, we continue to expect moderate consumer spending growth in the coming year.

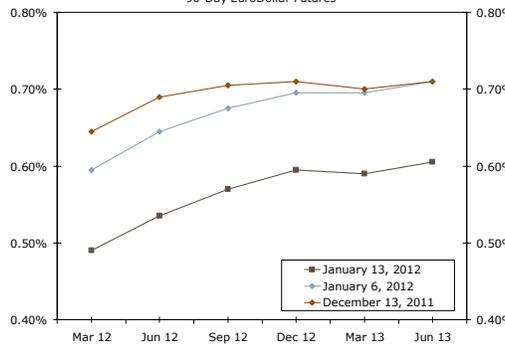
Central Bank Policy Rates



Yield Curve  
U.S. Treasuries, Active Issues



Forward Rates  
90-Day EuroDollar Futures



**Mortgage Data**

	Current	Week Ago	4 Weeks Ago	Year Ago
<b>Mortgage Rates</b>				
30-Yr Fixed	3.89%	3.91%	3.94%	4.27%
15-Yr Fixed	3.16%	3.23%	3.21%	3.72%
5/1 ARM	2.82%	2.86%	2.86%	3.47%
1-Yr ARM	2.76%	2.80%	2.81%	3.40%
<b>MBA Applications</b>				
Composite	663.1	634.5	677.0	482.7
Purchase	177.1	163.9	190.9	192.4
Refinance	3,560.6	3,448.3	3,573.7	2,219.2

Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

## Topic of the Week

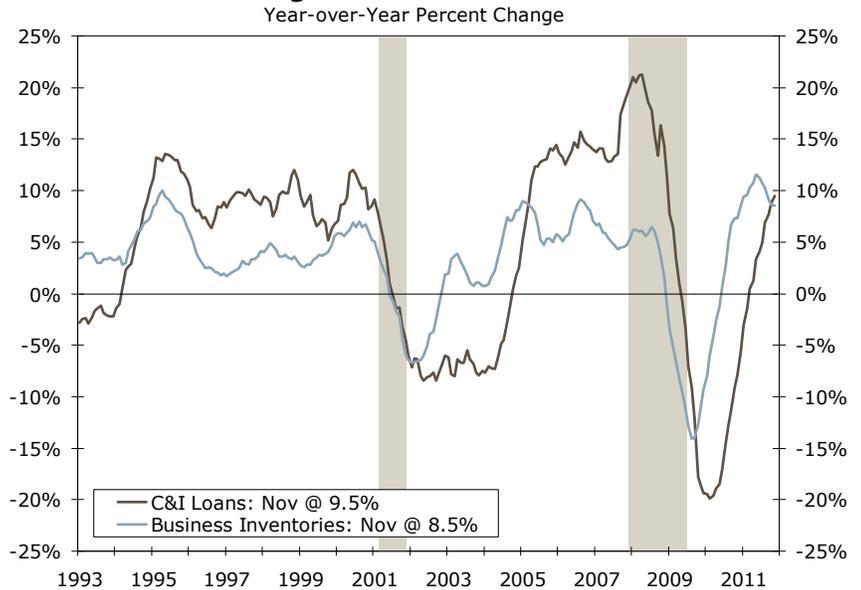
### Bank Credit: A Surprisingly Typical Cycle

Inventory finance is a staple of short-term bank lending and the link to inventory building is clearly evident in the top graph. As firms build inventories during periods such as 1995, 2002-2004 and now 2010-2011, these firms seek bank financing and, as such, this lending tends to follow a demand-driven model.

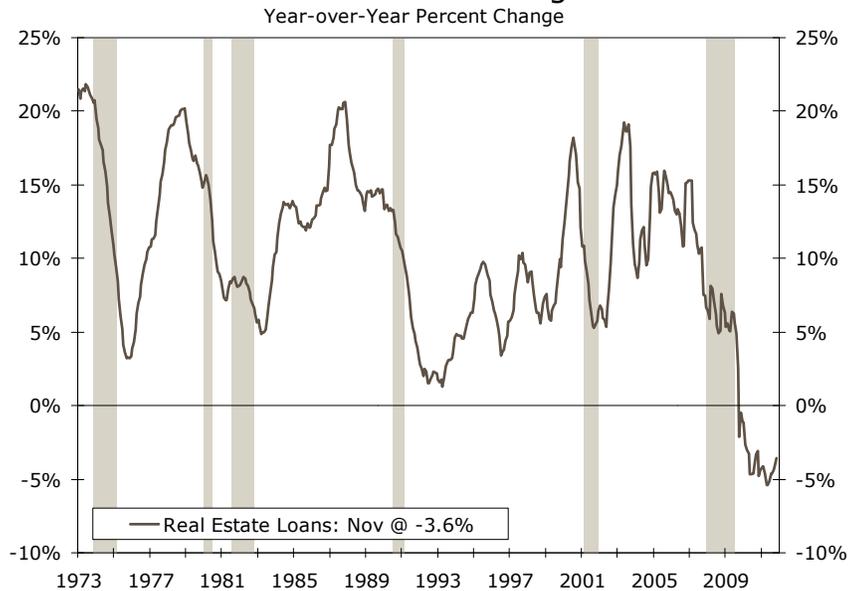
Inventories, in turn, tend to follow the business cycle. As firms are more confident of final sales, they will demand more inventories to maintain products on the shelves. This pattern creates a cycle where increases in expected sales induce firms to accumulate inventories to maintain a target inventory-to-sales ratio which, in turn, requires some firms to seek financing for that inventory from banks. This appears to be the pattern for this economic expansion as well. What is unusual in this cycle is the depth of the correction in real estate lending—a product of perceived home values. Retrenchment in real estate lending (bottom graph) has been much greater this cycle although the experience of 1990-1993 appears to have been of similar length—so far.

It is also interesting to note that the share of real estate lending done by small banks has fallen to 43 percent from a high of 47 percent during the housing boom, closer to the series historical average of 39 percent. Similar to 1990-1993, bank credit quality itself is under question and therefore banks have had to improve their balance sheets, as they have in the past. A thinner market for securitization has forced smaller banks to hold new real estate loans on their balance sheets, while questions about the value of the underlying real estate collateral persist. Moreover, the depth of the real estate correction suggests that the drop in lending is consistent with a rise in loan write-offs. Is this a new reality for real estate lending that requires lenders to be more cautious, and lend less, for some time, but not forever? Perhaps once real estate values recover, lending will return to a more rapid pace of growth.

### C&I Lending and Business Inventories



### Real Estate Lending



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## Market Data ♦ Mid-Day Friday

## U.S. Interest Rates

	Friday 1/13/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.02	0.01	0.14
3-Month LIBOR	0.57	0.58	0.30
1-Year Treasury	0.14	0.09	0.28
2-Year Treasury	0.22	0.26	0.58
5-Year Treasury	0.79	0.85	1.90
10-Year Treasury	1.86	1.96	3.30
30-Year Treasury	2.90	3.02	4.50
Bond Buyer Index	3.62	3.83	5.39

## Foreign Exchange Rates

	Friday 1/13/2012	1 Week Ago	1 Year Ago
Euro (\$/€)	1.270	1.272	1.336
British Pound (\$/£)	1.531	1.543	1.584
British Pound (£/€)	0.829	0.824	0.844
Japanese Yen (¥/\$)	76.960	76.970	82.810
Canadian Dollar (C\$/)\$)	1.024	1.028	0.989
Swiss Franc (CHF/\$)	0.953	0.955	0.964
Australian Dollar (US\$/A\$)	1.029	1.023	0.998
Mexican Peso (MXN/\$)	13.602	13.739	12.124
Chinese Yuan (CNY/\$)	6.307	6.310	6.599
Indian Rupee (INR/\$)	51.529	52.723	45.241
Brazilian Real (BRL/\$)	1.794	1.857	1.673
U.S. Dollar Index	81.377	81.254	79.191

## Foreign Interest Rates

	Friday 1/13/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.17	1.23	0.93
3-Month Sterling LIBOR	1.09	1.09	0.77
3-Month Canadian LIBOR	1.36	1.36	1.24
3-Month Yen LIBOR	0.20	0.20	0.19
2-Year German	0.16	0.17	1.09
2-Year U.K.	0.37	0.40	1.32
2-Year Canadian	0.94	0.93	1.77
2-Year Japanese	0.13	0.13	0.19
10-Year German	1.76	1.85	3.04
10-Year U.K.	1.97	2.02	3.61
10-Year Canadian	1.91	1.94	3.25
10-Year Japanese	0.95	0.98	1.20

## Commodity Prices

	Friday 1/13/2012	1 Week Ago	1 Year Ago
WTI Crude (\$/Barrel)	98.35	101.56	91.40
Gold (\$/Ounce)	1638.62	1617.95	1373.78
Hot-Rolled Steel (\$/S.Ton)	733.00	730.00	724.00
Copper (¢/Pound)	361.30	343.50	437.70
Soybeans (\$/Bushel)	11.65	11.89	13.86
Natural Gas (\$/MMBTU)	2.68	3.06	4.41
Nickel (\$/Metric Ton)	19,630	18,751	25,527
CRB Spot Inds.	526.88	520.38	592.67

## Next Week's Economic Calendar

	Monday 16	Tuesday 17	Wednesday 18	Thursday 19	Friday 20	
U.S. Data			<b>PPI (MoM)</b> November 0.3% December 0.1% (W)	<b>CPI (MoM)</b> November -0.0% December 0.1% (W)	<b>Existing Home Sales</b> November 4.42M December 4.65M (W)	
			<b>Net TIC Flows</b> October -\$48.8B	<b>Housing Starts</b> November 685K December 660K (W)		
			<b>IP (MoM)</b> November -0.2% December 0.5% (W)	<b>Building Permits</b> November 680K December 675K (C)		
	Global Data	<b>China</b> <b>Real GDP</b> Previous (3Q) 9.1%	<b>Germany</b> <b>ZEW-Econ Sentiment</b> Previous (Dec) -53.8			<b>Canada</b> <b>CPI (YoY)</b> Previous (Nov) 2.9%
		<b>China</b> <b>IP (YoY)</b> Previous (Nov) 12.4%	<b>U.K.</b> <b>CPI (YoY)</b> Previous (Nov) 4.8%			<b>U.K.</b> <b>Retail Sales (MoM)</b> Previous (Nov) -0.7%

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

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