

# Economics Group

## Weekly Economic & Financial Commentary

### U.S. Review

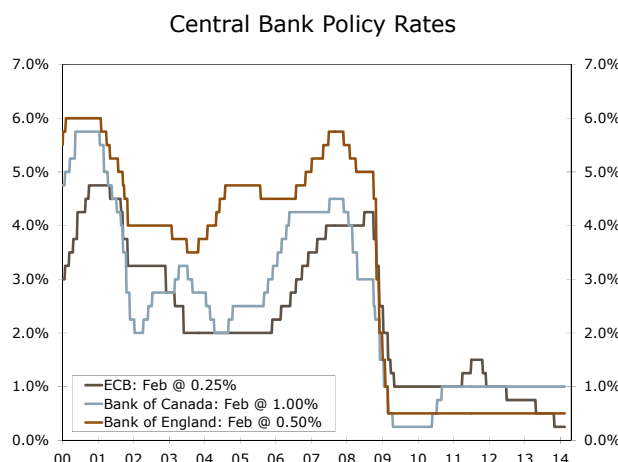
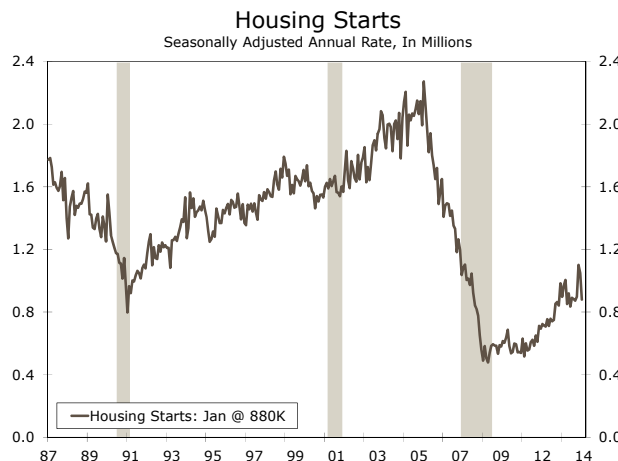
#### Weather Effects Continue to Influence Economic Data

- Housing starts plunged 16 percent in January to an 880,000-unit pace. Building permit activity also declined for the month but not as sharply.
- Inflation indicators continued to reflect subdued price pressures on businesses and consumers. The new producer price final demand index rose a modest 0.2 percent in January while the Consumer Prices Index posted a slight 0.1 percent rise for the month.
- The leading economic index rose 0.3 percent in January, indicating continued modest economic activity in the months ahead.

### Global Review

#### Developed Economies & Below Target Inflation

- Early in the week, we learned that Japanese GDP growth slowed in the final quarter of 2013. Unlike many of this week's headlines about the Japanese economy, we do not think the soft print is an indication that Abenomics is failing.
- The second half of the week featured consumer inflation data, not only in the United States, but also in Canada and the United Kingdom. In all three economies, the year-over-year CPI inflation rate is below the targets of the various central banks. We discuss what below-target inflation means for monetary policy in this week's global review.



Wells Fargo U.S. Economic Forecast													
	Actual				Forecast				Actual			Forecast	
	2013				2014				2011	2012	2013	2014	2015
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product <sup>1</sup>	1.1	2.5	4.1	3.2	1.5	1.8	2.6	3.1	1.8	2.8	1.9	2.5	3.0
Personal Consumption	2.3	1.8	2.0	3.3	2.9	2.2	2.2	2.3	2.5	2.2	2.0	2.5	2.5
Inflation Indicators <sup>2</sup>													
PCE Deflator	1.4	1.1	1.1	0.9	1.1	1.6	1.6	2.0	2.4	1.8	1.1	1.6	2.2
Consumer Price Index	1.7	1.4	1.6	1.2	1.4	1.9	1.7	2.0	3.1	2.1	1.5	1.8	2.1
Industrial Production <sup>1</sup>	4.1	1.2	2.4	6.8	4.9	4.3	4.4	4.5	3.4	3.6	2.6	4.5	4.7
Corporate Profits Before Taxes <sup>2</sup>	2.1	4.5	5.7	5.0	4.1	5.4	5.5	5.6	7.9	7.0	4.3	5.2	5.9
Trade Weighted Dollar Index <sup>3</sup>	76.2	77.5	75.2	76.4	77.8	78.5	79.5	80.0	70.9	73.5	75.9	78.9	80.6
Unemployment Rate <sup>3</sup>	7.7	7.5	7.2	7.0	6.5	6.5	6.4	6.4	8.9	8.1	7.4	6.5	6.2
Housing Starts <sup>4</sup>	0.96	0.87	0.88	1.00	0.99	1.04	1.10	1.16	0.61	0.78	0.92	1.07	1.22
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	0.44
Conventional Mortgage Rate	3.57	4.07	4.49	4.46	4.60	4.76	4.83	4.98	4.46	3.66	3.98	4.79	5.23
10 Year Note	1.87	2.52	2.64	3.04	3.05	3.18	3.34	3.47	2.78	1.80	2.35	3.26	3.66

Forecast as of: February 12, 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, Bloomberg LP and Wells Fargo Securities, LLC

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Together we'll go far



U.S. Review

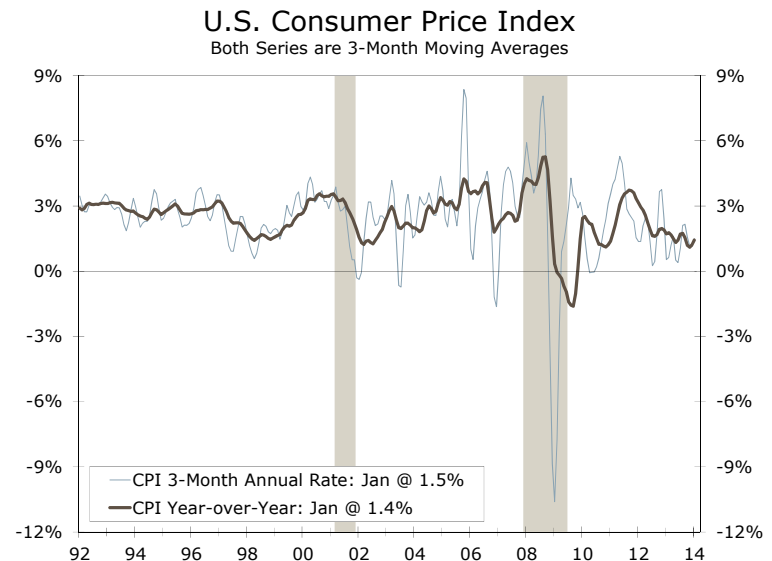
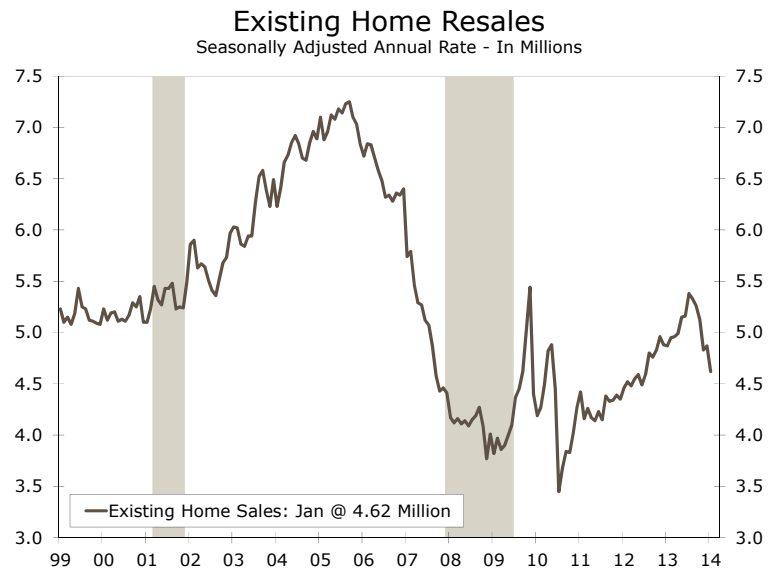
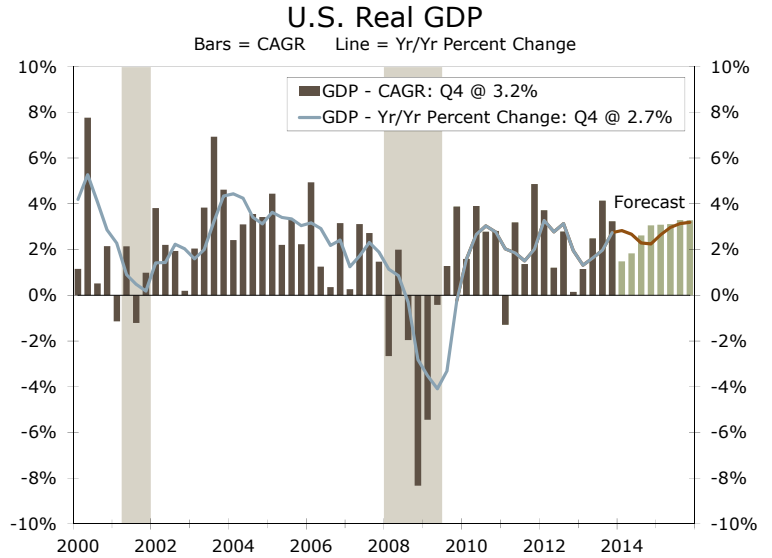
Weather Effects Continue to Influence Economic Data

Economic data this week continued to tell the story of how much the severe winter weather affected the economy to start the year. Housing market data indicated that home construction activity and existing home sales pulled back in January. While inflation remained in check, there was some evidence that the higher demand for energy put some upward pressure on prices for the month. Even with the much weaker-than-expected economic data to start the year, we continue to maintain that the bulk of the softness in the economic data is tied to temporary weather effects and does not signal a downshift in economic activity. Our expectation is that GDP will edge higher by 1.5 percent (annualized) in the first quarter.

Housing market data this week showed that housing starts declined 16 percent in January to an 880,000-unit pace while December's starts number was revised higher to a 1,048,000-unit pace. Building permit activity also fell in January, indicating that some of the softness in housing starts may spill over into February. The much weaker-than-expected starts number certainly raises some concern over a potential slowdown in housing activity. However, the forward-looking building permit activity remains 2.4 percent higher on a year-over-year basis. In addition, the number of homes under construction also remains far above last year's levels, supporting the argument that the weather effects are temporary. Existing home sales also declined in January, pulling back 5.1 percent for the month. Single-family home sales fell 5.8 percent while multi-family sales remained flat. It is likely that the delayed start to the year for new construction activity and existing home sales will lead to much higher housing starts and existing home sales once the spring thaw commences.

Inflation indicators continued to signal subdued price pressures on consumers and businesses, although some of the weather effects could be observed in energy prices. The revamped Producer Price Index rolled out this week showed that prices for goods, services and construction for final demand rose a modest 0.2 percent for the month. The slightly higher reading was attributed to prices for pharmaceuticals, residential electricity and natural gas prices. CPI increases also remained tame, rising just 0.1 percent in January. Again one of the key drivers of the higher consumer prices was related to higher fuels and utility prices which rose 2.0 percent.

The FOMC minutes released this week for the Jan. 28-29 meeting reflected the committee's view that much of the weakness in the December nonfarm payroll report was due to "unusually bad weather," thus allowing it to continue tapering the pace of asset purchases. We continue to believe the FOMC will maintain its \$10 billion per month reduction in its asset purchase program and conclude the "tapering" by year-end. At this point it appears that as long as the economic growth momentum resumes following the temporary weather effects, we should see the first Fed rate hike sometime toward the middle of next year.



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

**Consumer Confidence • Tuesday**

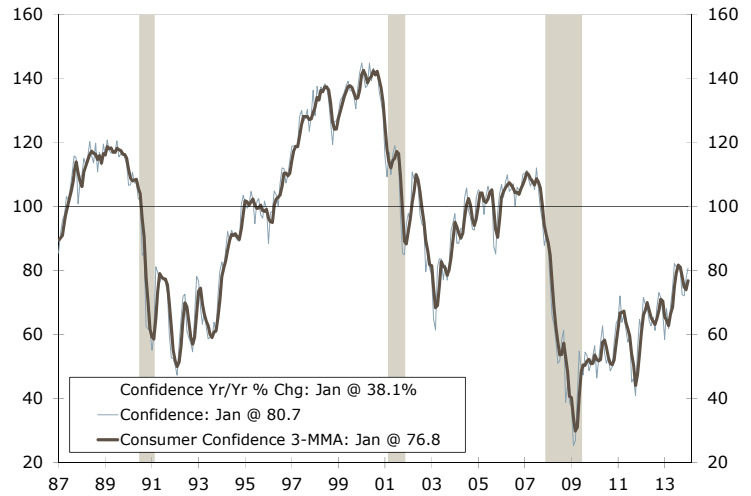
Consumer confidence rose 3.2 points to 80.7 in January after rebounding solidly in December. Both the present situation and the expectations components edged higher on the month. The present situation index ticked up to its highest reading since April 2008, and the future expectations component rose 2.8 points to 81.8. Although the index remains well below its pre-recession peak, the improvement is consistent with modest growth in the overall economy. Consumers also had an improved view on labor market conditions and income. The labor differential, which is the number of respondents that reported jobs are “plentiful” minus the number reporting jobs are “hard to get”, was the highest reading since September 2008. Together, the better assessment on employment and the increased optimism about future earnings suggest that the momentum behind stronger consumer spending observed in the fourth quarter could be maintained this year.

**Previous: 80.7**

**Wells Fargo: 80.6**

**Consensus: 80.0**

Consumer Confidence Index  
Conference Board



**New Home Sales • Wednesday**

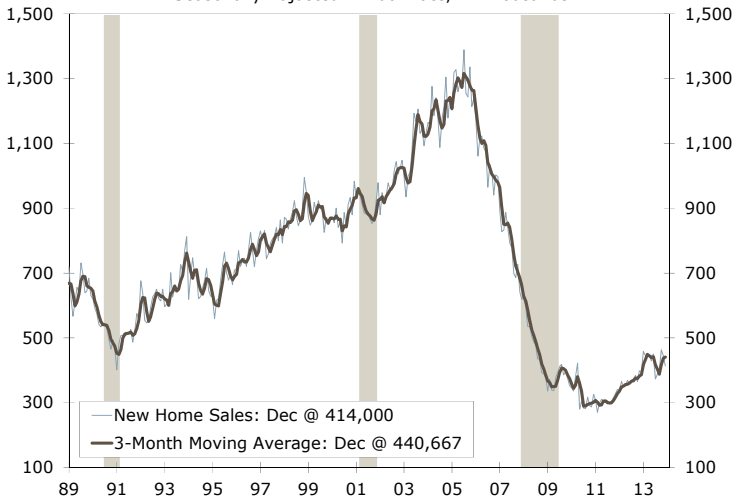
New home sales are expected to post a second consecutive monthly decline in February as unusually harsh winter weather conditions likely kept would-be buyers on the sidelines. A couple of tell-tale signs of further expected weakness are the sharp drop in the NAHB/Wells Fargo sentiment index in February and the successive declines in purchase mortgage applications. Mortgage applications for purchase have declined in four of the past five weeks and builder sentiment plunged to its lowest level since mid-2013. Although the weakness was broad-based, current sales saw the steepest decline, plummeting 11 points to 51. Builders noted the drop was due to unusually severe weather conditions, but also cited a shortage in skilled labor and lots. Although weather conditions are expected to be a temporary drag on construction activity, rising construction costs, including a dearth of skilled workers could slow the pace of the housing market recovery.

**Previous: 414,000**

**Wells Fargo: 402,000**

**Consensus: 400,000**

New Home Sales  
Seasonally Adjusted Annual Rate, In Thousands



**Durable Goods • Thursday**

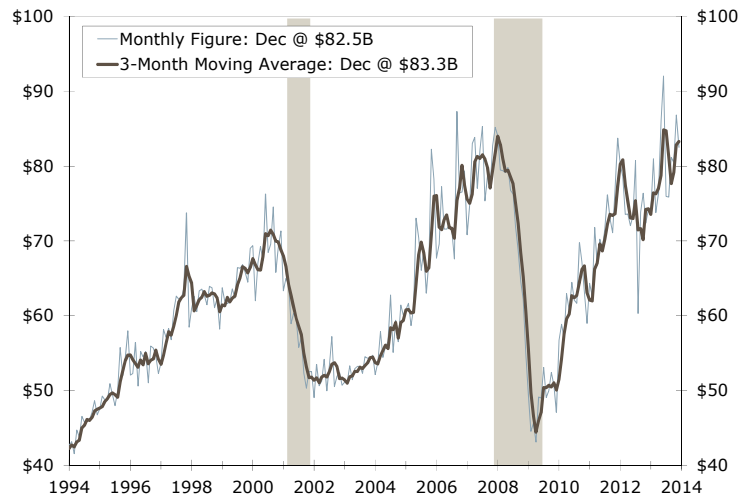
Unusually harsh winter weather conditions are expected to claim another sector in the U.S. economy as orders for durable goods will likely post its third decline in four months. Corroborating the projection of a monthly decline in durable goods orders is the new orders component of the ISM manufacturing index, which plunged 13.2 points to 51.2 in January. Boeing’s orders fell significantly in January, which could also pull the headline lower. However, the underlying trend in the data is a bit more promising. In December, durable goods orders excluding civilian aircraft rose at an annualized pace of 6.5 percent over the past three months, which is the second consecutive monthly gain for this measure. Although the new orders component in regional purchasing manager surveys was mixed with the Dallas and Kansas City Fed indices posting gains and the Philadelphia and Empire surveys weaker on the month, all new orders components remained in expansion territory.

**Previous: -4.3%**

**Wells Fargo: -3.0%**

**Consensus: -1.5%**

Nondefense Capital Goods New Orders  
In Billions of Dollars



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

## Global Review

### What is Behind Slower Japanese GDP Growth?

The first big international economic news this week was the Monday, Feb. 17, report that real GDP growth in Japan grew at a much slower-than-expected annualized rate of just 1.0 percent in the fourth quarter. The substantial miss kicked off a fresh round of headlines about the impending tax increase scheduled for April and new questions about the effect of Abenomics.

While we have serious questions about Abenomics to address Japan's fundamental structural problems, we do not think this one report should throw cold water on a program that likely will continue to be successful in the short term.

The biggest headwind for Japanese GDP growth in the fourth quarter was a 1.8 percentage point drag from net exports. Total domestic demand, which sums consumer spending, business capital investment, outlays by the government and inventory investment, grew at an annualized rate of 3.1 percent, reflecting a slight increase from 3.0 percent in the prior quarter.

### Benign Inflation Weakens Case for Tightening at BoE

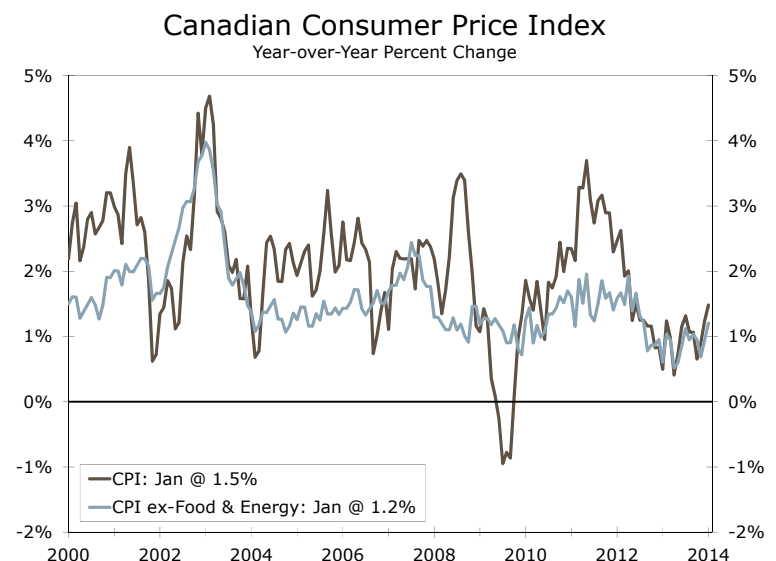
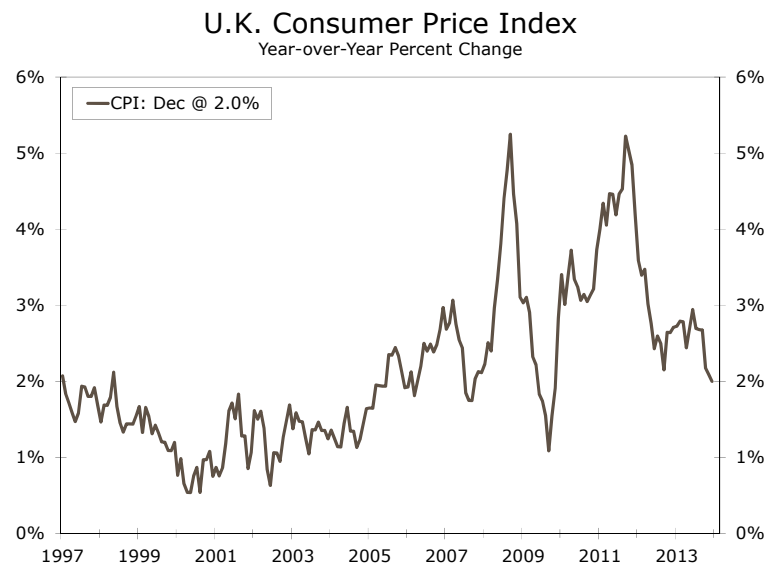
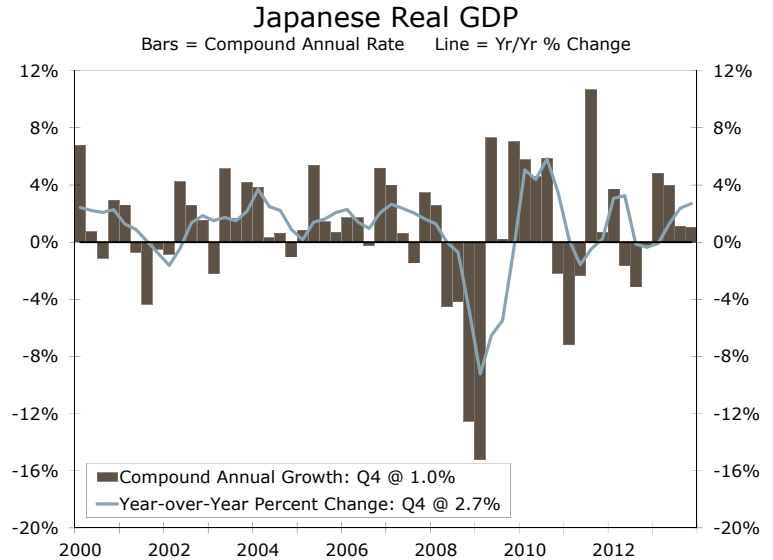
We also learned this week that CPI inflation in the United Kingdom slowed to a year-over-year rate of 1.9 percent, just below the Bank of England's (BoE) target of 2.0 percent. Last week's Inflation Report from the BoE noted that "Inflation is expected to remain at, or slightly below, the target over the forecast period." At its February policy meeting, the BoE noted there was some risk of inflation undershooting the target and therefore determined that there was "scope to absorb spare capacity further before raising Bank Rate."

We expect the BoE to remain on hold throughout 2014, which should allow the U.K. economy to continue to grow and absorb that spare capacity. By next year, higher inflation and an economy on even firmer footing will give the Monetary Policy Committee reason to begin raising the Bank Rate by mid-2015.

### The Polar Vortex Affected Canada Too

On Friday morning inflation data out of Canada showed more of a firming in inflation than had been expected. The year-over-year rate of 1.5 percent for the CPI in January exceeded the 1.2 percent inflation rate in the prior month and reflected the fastest rate of consumer price inflation since mid-2012. The development is somewhat unexpected, but inflation is still below the middle of the Bank of Canada's 2 percent-3 percent target range, which is exactly what Gov. Poloz recently said could be expected. We expect the BoC to remain on hold through 2015.

Somewhat more troubling for the Canadian economy was the larger-than-expected decline in December's retail sales. Across the border in the United States, retail sales fell in December and January and weather was broadly blamed as a factor in the weakness in consumer spending. If weather was indeed the explanation and not just an excuse, it stands to reason that Canadian retail sales might also have been susceptible as similar unseasonably cold weather affected more northern climes as well.



Source: IHS Global Insight and Wells Fargo Securities, LLC

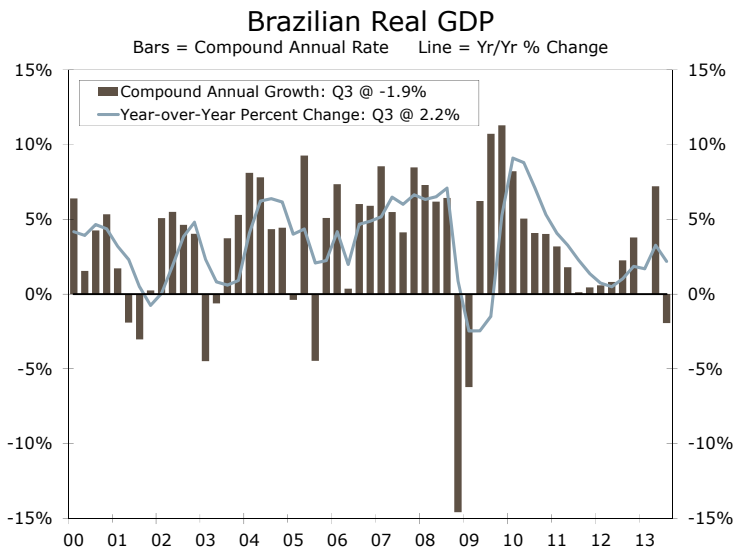
## Germany IFO • Monday

Germany is slated to release the IFO survey of business conditions result for February and the final GDP results for the last quarter of 2013. We do not expect any surprises on the GDP release as we already had a flash release of the annual growth rate in January and thus we expect the number for the last quarter to support the release made in January for the whole year. What will be more important for the German economy and perhaps for the rest of the Eurozone is for the IFO survey of business expectations to continue with its slow but steady improvement. A weaker-than-expected release is certainly possible as the February manufacturing PMI release was weaker than what the markets expected and this could be a negative for the Eurozone's short-term hopes.

After a negative reading in December, retail sales will be released on Friday and markets probably expect to see some better numbers from the German consumer sector.

**Previous: 110.6**

**Consensus: 110.5**



## Canada GDP • Friday

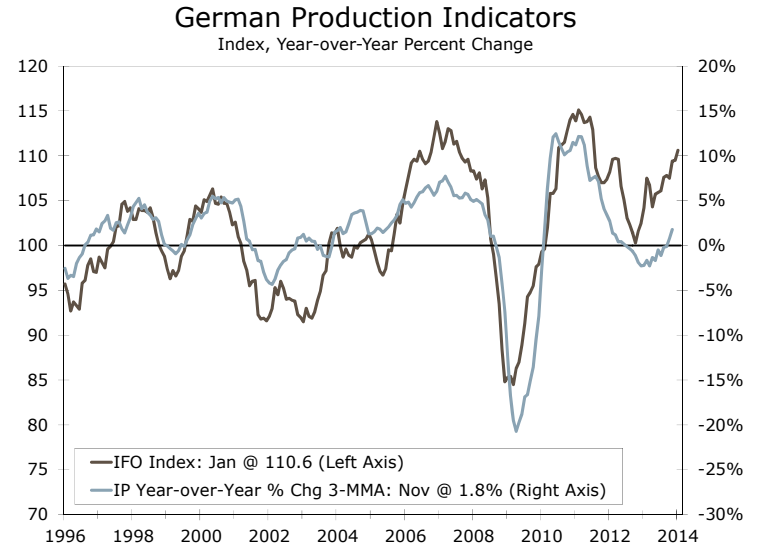
Canadian GDP for the last quarter of the year and for the full year is scheduled to be released on Friday. Consensus expectations call for a 2.7 percentage rate, although our expectation is for a weaker print. For the full year, we expect the economy to have also grown 1.7 percent, the same rate as last year. However, this time around, the biggest culprit for the still weak performance has been gross fixed investment, whereas in the previous year private consumption expenditures were one of the weaker sectors.

At the same time, real import growth increased 3.1 percent in 2012 and we expect growth in real imports to have been only 1.1 percent in 2013. Real exports, on the other hand, are expected to grow 1.5 percent, the same rate we saw in 2012. For 2014, we expect the Canadian economy to strengthen and post a growth rate of 2.3 percent.

**Previous: 2.7%**

**Wells Fargo: 1.7%**

**Consensus: 2.5%**



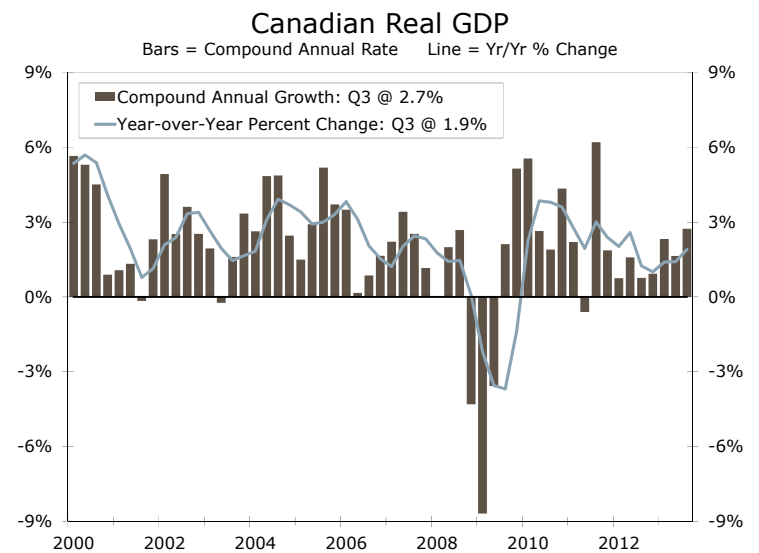
## Brazil GDP • Thursday

Brazil will release its quarterly and annual GDP result on Thursday, and markets will be watching, as the monthly index of economic activity and industrial production numbers for December 2013 were very weak. Some even expect Brazil to have technically entered into a recession, marked by two consecutive negative quarterly readings. The seasonally adjusted GDP for the third quarter was -0.5 percent. The consensus seems to be a bit more optimistic as it is predicting that Brazil could avoid this "technicality" with a print of 0.3 percent. The consensus also expects a 1.6 percent year-over-year result, which would put growth for the whole of 2013 at 2.2 percent. We expect year-over-year growth to come in a bit lower, at 1.0 percent for full-year growth of 2.0 percent. On Wednesday, the Brazilian central bank is expected to continue its tightening campaign by increasing the Selic rate 25 basis points to 10.75 percent from 10.50 percent.

**Previous: 2.2%**

**Wells Fargo: 1.0%**

**Consensus: 1.5%**



Source: IHS Global Insight and Wells Fargo Securities, LLC

**Interest Rate Watch**

**Policy in Context: The Fed**

In the past two weeks, Federal Reserve Board Chair Janet Yellen and the latest minutes of the FOMC meeting have hinted that the Fed may move on interest rates a bit sooner than many expected. Our view remains that the Fed likely will move during the second half of 2015. However, it is important to take any Fed move in context.

If the Fed were to raise the funds rate, with the current economic context, we would anticipate that real interest rates would rise and this would have a negative effect on the economy. Instead, we anticipate that any Fed move would more likely take place in the context of stronger economic growth, a better labor market and inflation at, or approaching, its 2 percent target. In that context, any rise in real rates would be muted and thereby have less of an impact on the economy.

More broadly, any movement in market interest rates takes place in the context of a global economy where many factors beyond the Fed might move rates. Here, we discuss two factors that have influenced rates over the past year.

First, despite the better second half economic data in the United States, longer-term Treasury rates declined. Context is central to understanding this. As the Fed hinted that it might begin to reduce Treasury purchases in the fall, capital flows rose into the United States from emerging markets and thereby acted to lower/offset the upward pressure on U.S. interest rates. After the fear of tapering fell away in September, U.S. rates remained lower as investors now were aware of the thinness in emerging markets and opted for the liquidity of the U.S. market.

Second, interest rates move within the context of changes in the economy and credit markets as prices of goods (inflation), interest rates and currencies interact to mutually determine their market prices. Interest rates do not stand alone, and, therefore, actions that alter the expected pace of economic growth, inflation or currency values will also alter the path for interest rates.

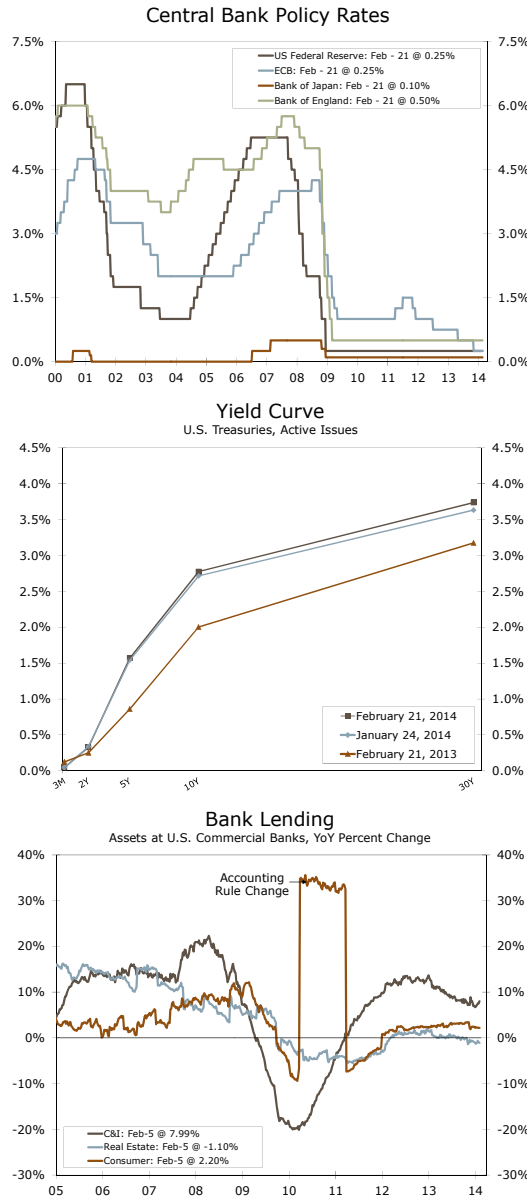
**Credit Market Insights**

**...And We're Back!**

The New York Federal Reserve released its *Quarterly Report on Household Debt and Credit* for the fourth quarter of 2013. It reported that household debt rose 2.1 percent, or \$241 billion, the largest quarter-over-quarter increase since the third quarter of 2007. Well into the recovery, consumer spending and borrowing has remained restrained. However, recent reports have indicated that consumers are feeling more confident about their financial situations and are now more willing to borrow.

The increase in borrowing came from broad-based growth across a variety of loan types. Mortgage debt, the largest portion of household debt, increased 1.9 percent in the fourth quarter. Foreclosures have been declining since Q2 2009 and are now at their lowest levels since the end of 2005. Furthermore, there were continued improvements in delinquency rates for mortgages.

Non-housing debt increased 3.3 percent as auto loan balances rose \$18 billion. Student loans added \$53 billion in Q4, leading to a \$114 billion increase for 2013. Late payments for student loans edged down; however, at 11.8 percent they still have the highest delinquency rate among loan types. An additional \$11 billion was added for credit card balances as limits rose 4.8 percent on the year. Overall, the turnaround in credit should be a positive boost to consumer spending and the overall economy in 2014.



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	4.33%	4.28%	4.39%
15-Yr Fixed	3.35%	3.33%	3.44%	2.77%
5/1 ARM	3.08%	3.05%	3.15%	2.64%
1-Yr ARM	2.57%	2.55%	2.54%	2.65%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
	Commercial & Industrial	\$1,632.5	49.29%	19.76%
Revolving Home Equity	\$469.5	-7.31%	-7.42%	-7.74%
Residential Mortgages	\$1,540.7	-37.28%	-0.78%	-4.52%
Commercial Real Estate	\$1,503.6	18.08%	10.41%	5.12%
Consumer	\$1,142.1	2.50%	-0.99%	2.20%

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

## Topic of the Week

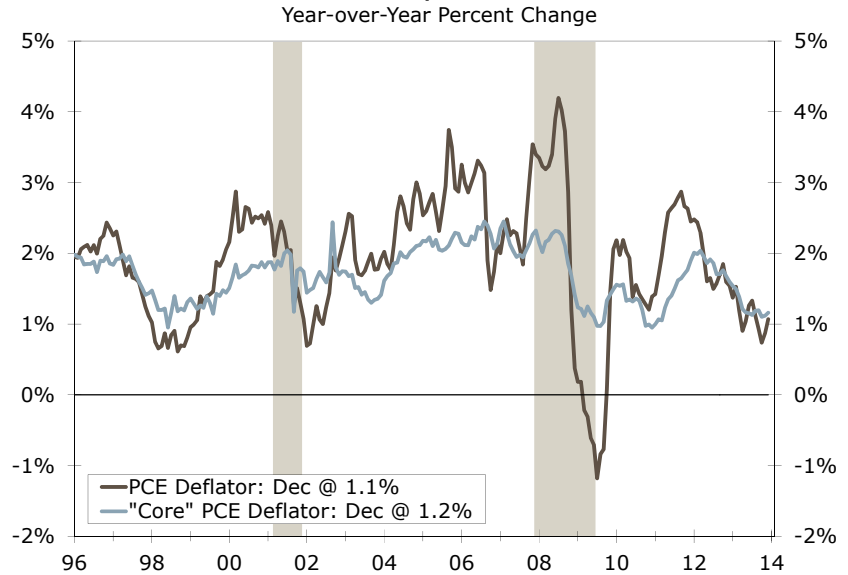
### Predicting the Probability of Inflation/Deflation

This week, the CPI and PPI indices were released for January, each leaving the FOMC plenty of room for accommodative monetary policy (see U.S. Review on page 2). As talk of deflation continues to be a constant for everyday discussion in the capital markets, a distinct look at these inflation indicators remains crucial for decision-makers. While the traditional way of forecasting inflation for the FOMC is to look at the single levels and/or growth rates of price measures such as the PCE deflator, which only shows 1.1 percent growth on the year (Figure 1), it seems that this may not be the most effective tactic. Using a statistical analysis, we estimate the six-months-ahead probability of three distinct scenarios for prices: inflationary pressure, deflationary pressure and price stability. We believe our method is different and more practical for decision-makers who must hedge their portfolios, but it is also useful for policymakers, investors and consumers who can attach a probability with each more-likely scenario of future price trends.

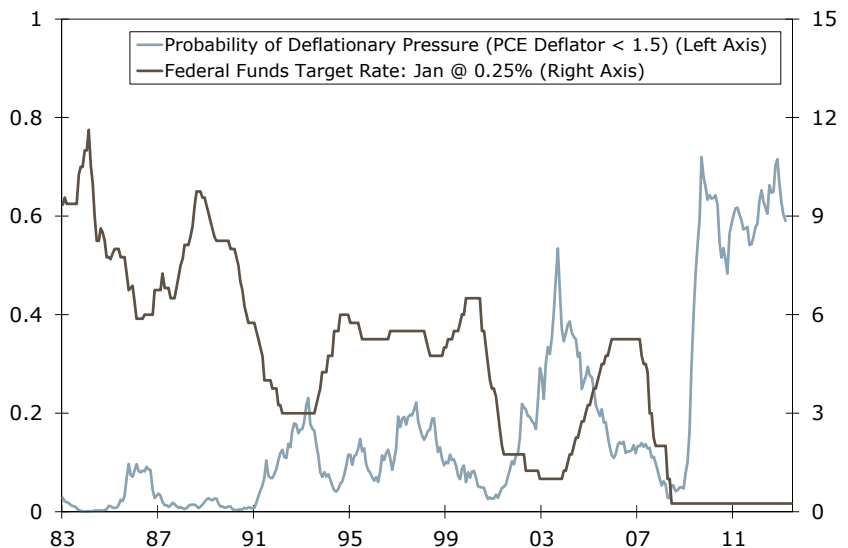
After running our analysis, one application of our results can be seen in the case of U.S. monetary policy. For example, while the Fed funds rate is still in the 0.00 percent—0.25 percent range, several rounds of quantitative easing (QE) have been introduced. Furthermore, it was widely expected that the FOMC would announce, at its September 2013 meeting, a move toward “tapering” its QE program. The FOMC decision was a surprise for many, but, given the statistical analysis results, it makes sense. That is, our model suggests that the risk of deflationary pressure has been high since January 2010, currently at a probability of 60 percent (Figure 2), and during a deflationary period the FOMC tends to follow an expansionary monetary policy. In sum, we suggest decision-makers consider using a statistical analysis, such as this one, to generate probabilities of different inflation scenarios.

For further discussion on this topic please see our recent report, “*Predicting the Probability of Inflation/Deflation: An Ordered Probit Approach*,” which is available on our website.

### Personal Consumption Price Deflator



### Probability of Deflationary Pressure vs. Federal Funds Target Rate



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

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## Market Data ♦ Mid-Day Friday

## U.S. Interest Rates

	Friday 2/21/2014	1 Week Ago	1 Year Ago
3-Month T-Bill	0.04	0.01	0.12
3-Month LIBOR	0.23	0.24	0.29
1-Year Treasury	0.16	0.12	0.19
2-Year Treasury	0.33	0.31	0.25
5-Year Treasury	1.57	1.52	0.84
10-Year Treasury	2.78	2.74	1.98
30-Year Treasury	3.74	3.70	3.17
Bond Buyer Index	4.44	4.46	3.74

## Foreign Exchange Rates

	Friday 2/21/2014	1 Week Ago	1 Year Ago
Euro (\$/€)	1.371	1.369	1.319
British Pound (\$/£)	1.667	1.675	1.525
British Pound (£/€)	0.823	0.818	0.865
Japanese Yen (¥/\$)	102.550	101.800	93.110
Canadian Dollar (C\$/\\$)	1.114	1.098	1.019
Swiss Franc (CHF/\\$)	0.889	0.893	0.931
Australian Dollar (US\$/A\\$)	0.896	0.903	1.025
Mexican Peso (MXN/\\$)	13.306	13.242	12.746
Chinese Yuan (CNY/\\$)	6.091	6.066	6.240
Indian Rupee (INR/\\$)	62.130	61.930	54.480
Brazilian Real (BRL/\\$)	2.373	2.389	1.973
U.S. Dollar Index	80.378	80.136	81.461

Source: Bloomberg LP and Wells Fargo Securities, LLC

## Foreign Interest Rates

	Friday 2/21/2014	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.26	0.26	0.14
3-Month Sterling LIBOR	0.52	0.52	0.51
3-Month Canada Banker's Acceptance	1.27	1.27	1.29
3-Month Yen LIBOR	0.14	0.14	0.16
2-Year German	0.12	0.11	0.17
2-Year U.K.	0.52	0.52	0.26
2-Year Canadian	1.02	1.01	1.11
2-Year Japanese	0.08	0.07	0.04
10-Year German	1.68	1.68	1.57
10-Year U.K.	2.82	2.79	2.10
10-Year Canadian	2.57	2.47	1.98
10-Year Japanese	0.60	0.60	0.74

## Commodity Prices

	Friday 2/21/2014	1 Week Ago	1 Year Ago
WTI Crude (\\$/Barrel)	102.53	100.35	92.84
Gold (\\$/Ounce)	1322.93	1318.69	1576.40
Hot-Rolled Steel (\\$/S.Ton)	655.00	658.00	611.00
Copper (\\$/Pound)	328.10	325.00	355.30
Soybeans (\\$/Bushel)	13.61	13.52	14.97
Natural Gas (\\$/MMBTU)	6.28	5.22	3.25
Nickel (\\$/Metric Ton)	14,326	14,089	17,104
CRB Spot Inds.	529.44	524.94	541.05

## Next Week's Economic Calendar

	Monday 24	Tuesday 25	Wednesday 26	Thursday 27	Friday 28
U.S. Data		<b>Consumer Confidence</b> January 80.7 February 80.6 (W)	<b>New Home Sales</b> December 414K January 402K (W)	<b>Durable Goods</b> December -4.2% January -3.0% (W)	<b>GDP (Annualized QoQ)</b> 4Q1: 3.2% 4Q2: 2.4% (W)
	<b>Eurozone</b> <b>CPI (MoM)</b> Previous (Dec) 0.3%		<b>United Kingdom</b> <b>GDP (QoQ)</b> Previous (Q3) 0.8%	<b>Japan</b> <b>Jobless Rate</b> Previous (Dec) 3.7%	<b>Eurozone</b> <b>Unemployment Rate</b> Previous (Dec) 12.0%
<b>Global Data</b>	<b>Mexico</b> <b>Unemployment Rate (SA)</b> Previous (Dec) 4.76%		<b>Australia</b> <b>Private Capital Expenditures</b> Previous (Q3) 3.6%	<b>Brazil</b> <b>GDP (QoQ)</b> Previous (Q3) -0.5%	<b>China</b> <b>Manufacturing PMI</b> Previous (Jan) 50.5

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

Source: Bloomberg LP and Wells Fargo Securities, LLC



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