February 05, 2016

Economics Group

Weekly Economic & Financial Commentary

U.S. Review

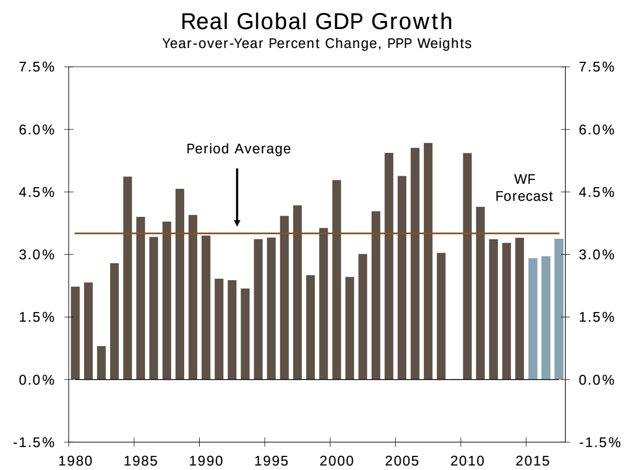
Still Moving Forward but Losing Steam

- Nonfarm employment rose less than expected in January, with the addition of 151,000 payroll jobs. The unemployment rate fell to 4.9 percent, marking the lowest level since February 2008.
- Data on the manufacturing sector continue to deteriorate, with factory orders and the ISM manufacturing survey both continuing to trend lower.
- The ISM non-manufacturing index also posted a much larger drop in January but motor vehicle sales perked up slightly.

Global Review

As Jitters Continue, Some Positive Signs Appear

- Global economic data have continued to show a challenging environment for economic growth.
- Better PMI readings taken together seem to suggest that the global manufacturing deterioration has, at least for now, eased somewhat. This is a good starting point for global economic growth but it is probably not enough for markets to start calming down.
- Although it seems that markets have concluded that the drop in oil prices is "bad" for the global economy the fact of the matter is that, perhaps, it is one of the only positive developments for demand across the world.



Wells Fargo U.S. Economic Forecast

	Actual			Forecast					Actual		Forecast		
	2015				2016				2013	2014	2015	2016	2017
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	0.6	3.9	2.0	0.2	1.9	2.5	2.6	2.5	1.5	2.4	2.4	1.9	2.4
Personal Consumption	1.8	3.6	3.0	1.7	2.7	2.7	2.7	2.6	1.7	2.7	3.1	2.6	2.5
Inflation Indicators [2]													
PCE Deflator	0.2	0.3	0.3	0.4	0.9	0.9	1.1	1.7	1.4	1.4	0.3	1.1	2.0
Consumer Price Index	-0.1	0.0	0.1	0.4	1.1	1.0	1.2	1.8	1.5	1.6	0.1	1.3	2.3
Industrial Production [1]	-0.3	-2.3	2.8	-3.4	-0.3	2.1	1.1	2.2	1.9	3.7	1.3	0.1	2.1
Corporate Profits Before Taxes [2]	4.6	0.6	-5.1	3.0	2.2	2.6	2.5	2.4	2.0	1.7	0.6	2.4	2.3
Trade Weighted Dollar Index [3]	92.1	89.9	92.3	94.5	93.3	94.8	96.5	97.8	75.9	78.5	91.1	95.6	99.3
Unemployment Rate	5.6	5.4	5.2	5.0	4.9	4.8	4.7	4.6	7.4	6.2	5.3	4.7	4.5
Housing Starts [4]	0.98	1.16	1.16	1.13	1.19	1.20	1.20	1.22	0.92	1.00	1.11	1.20	1.25
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.25	0.25	0.25	0.50	0.50	0.75	1.00	1.25	0.25	0.25	0.27	0.88	1.88
Conventional Mortgage Rate	3.77	3.98	3.89	3.96	4.05	4.13	4.15	4.19	3.98	4.17	3.85	4.13	4.34
10 Year Note	1.94	2.35	2.06	2.27	2.31	2.39	2.44	2.50	2.35	2.54	2.14	2.41	2.68

Forecast as of: January 22, 2016
[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, IHS Global Insight and Wells Fargo Securities, LLC

Inside

U.S. Review

Losing Momentum but Still Advancing

The U.S. economy clearly lost momentum during the latter part of 2015 and the employment data are now reflecting that slower pace. Employers added just 151,000 jobs in January, which was about 40,000 jobs shy of consensus expectations. Data for December were also revised lower, with nonfarm payrolls now showing a gain of 262,000 jobs instead of the initially reported 292,000-job gain. Job growth over the past three months still works out to a solid pace of 231,000 jobs per month.

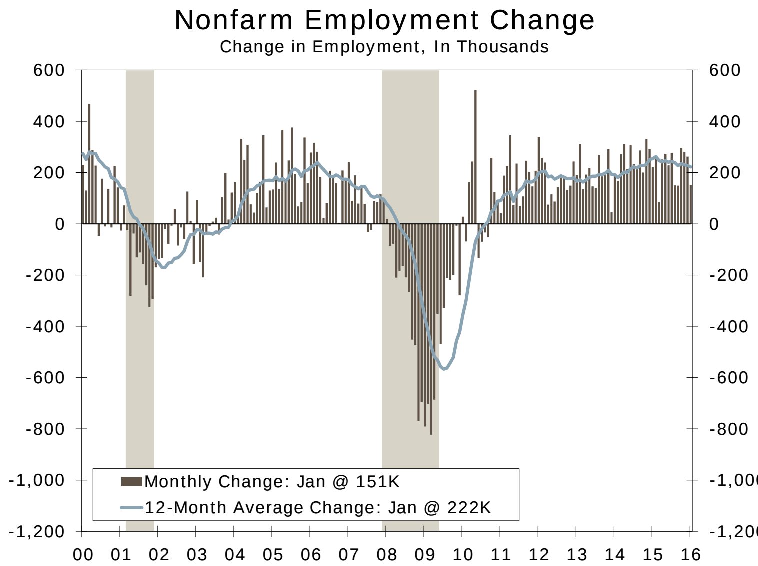
We would not extrapolate the stronger pace of the past three months out into 2016. Most of the recent employment indicators indicate that the pace of hiring is slowing. In addition to January's smaller net gain in jobs, data for prior months were revised notably lower. The Bureau of Labor Statistics revised nonfarm employment back to April 2014 and the net revision showed 105,000 fewer jobs than previously reported.

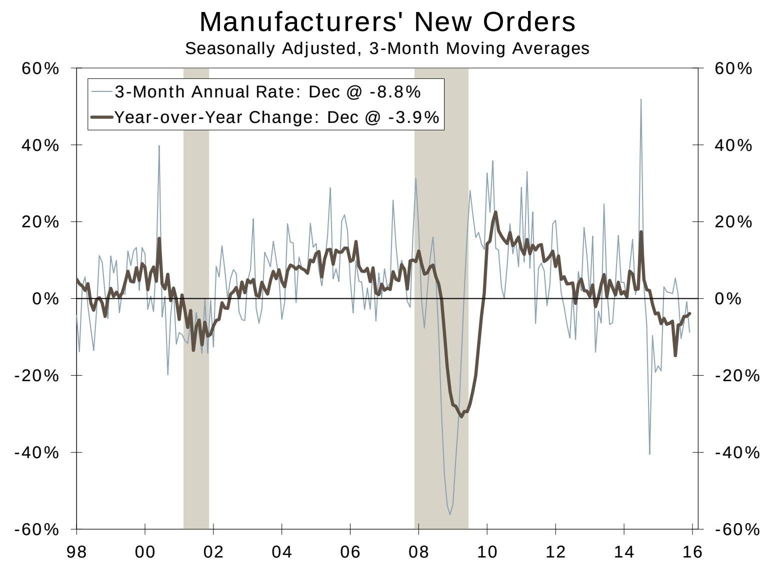
The composition of January's increase in nonfarm jobs was also somewhat dubious. Payrolls were bolstered by a 57,700-job seasonally adjusted gain in retail trade, which primarily results from retailers' having hired fewer temporary workers for the holiday season and, as a result, cutting fewer jobs than usual in January. The effects were partially offset by swings in employment in transportation and warehousing, where the effects of online retailing show up. There was also an outsized gain in jobs at restaurants, which added 46,700 jobs during the month. Once again, the gain results from less seasonal hiring than usual ahead of Christmas and subsequently fewer layoffs in January. Combined retail trade and food services accounted for more than two-thirds of the 151,000 jobs added in January.

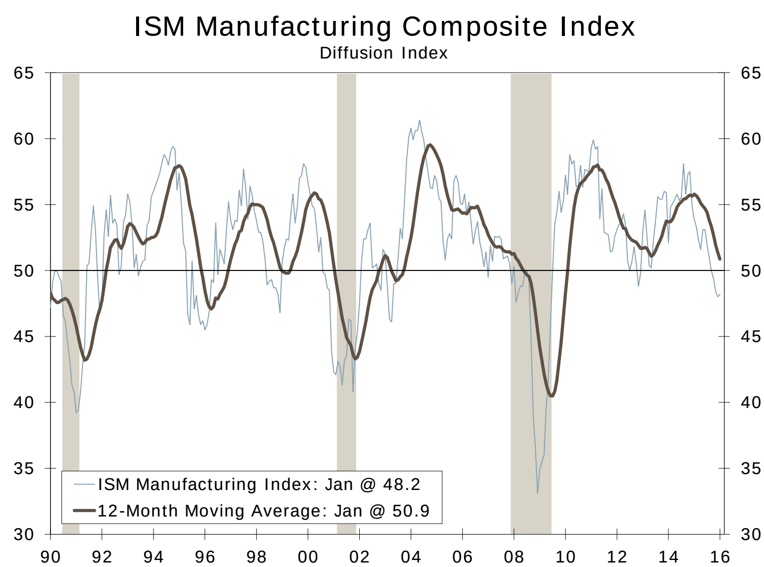
There were some notable bright spots. Manufacturing payrolls added a hearty 29,000 jobs during the month, with big gains in fabricated metal, motor vehicles and food processing. The increase seems inconsistent with recent data from the factory sector, which have shown factory orders declining sharply and fewer manufacturers adding workers. Construction payrolls also rose solidly during the month, with 18,000 jobs. Employment also rose solidly in health care and social assistance, with much of the gain occurring at hospitals.

The big gains in manufacturing and construction are one reason why average hourly earnings rose 0.5 percent in January. Hourly earnings were also likely boosted by hikes in the minimum wage in various cities and states, which would have been quite meaningful given the large hiring gains at retailers and restaurants–which employ lots of minimum wage workers.

The unemployment rate fell 0.1 percentage point to 4.9 percent in January, which marks its lowest level since February 2008. The drop reflects an unusual 615,000-person increase in household employment and 502,000-person rise in the labor force. The labor department makes a population adjustment each January, which tends to exaggerate the month-to-month changes in both series. After accounting for adjustment, the gain in household employment comes out to 409,000 jobs.







Source: U.S. Departments of Commerce and Labor, ISM and Wells Fargo Securities, LLC

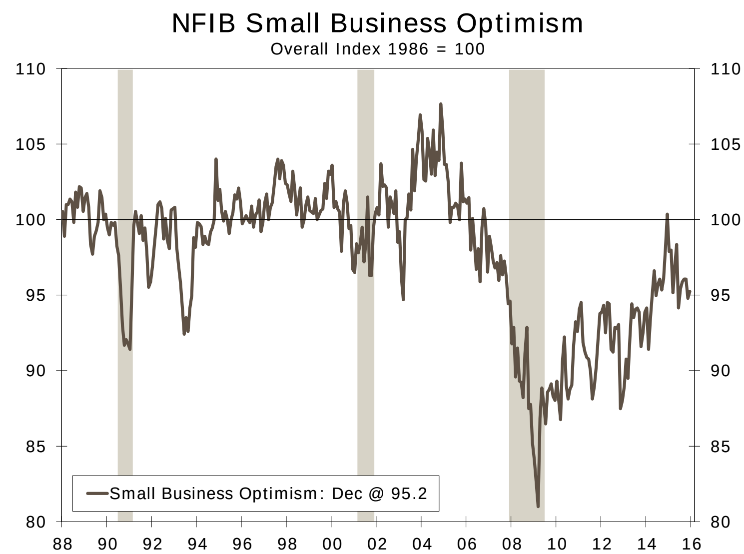
NFIB Small Business Optimism • Tuesday

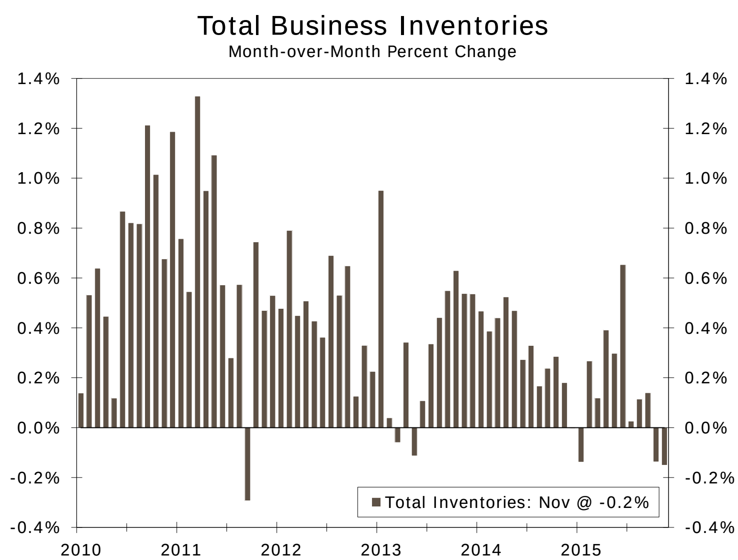
Small business optimism rebounded slightly in December, partly offsetting the previous month's decline. Two of the forward-looking components, hiring plans and sales expectations, were notably positive in December, with hiring plans rising 4 percentage points to 15 percent and the share expecting higher sales jumping 9 percentage points to 8 percent.

Despite the improvement in December, small business optimism has clearly deteriorated over the past year. While concerns about the fallout from lower energy prices and an international slowdown are likely weighing on confidence, a tightening labor market may also be contributing to small business' waning confidence. More businesses are raising compensation and labor quality is becoming an increasingly important challenge. With January's continued labor market improvement and financial market volatility, small business optimism likely fell further in January.

Previous: 95.2

Consensus: 94.5





Business Inventories • Friday

Inventories declined in the first two months of Q4, marking the first back-to-back declines in business inventories since 2009. This led to the inventories component of GDP to subtract 0.5 percentage points from the headline in the initial estimate of Q4 growth. Friday's release of business inventories, therefore, has implications for the revisions to the Q4 GDP figure. We expect a slight bounce-back, with inventories rising 0.1 percent in December. That said, inventory-to-sales ratios remained elevated in November, as sales were also softer during the month. These elevated ratios, which have increased for all industries, suggest that inventory investment will remain muted throughout the coming year. We expect inventories to subtract 0.2 percentage points from growth in 2016 as a whole.

Previous: -0.2% **Wells Fargo: 0.1%**

Consensus: 0.1% (Month-over-Month)

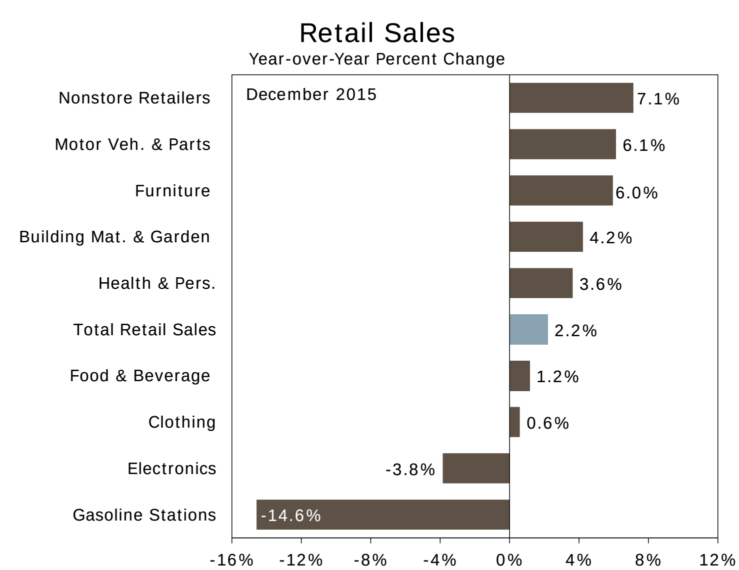
Retail Sales • Friday

Retail sales slipped 0.1 percent in December to end a disappointing year for the sector. Retail sales rose 2.2 percent on a year-earlier basis in December compared to an increase of 3.5 percent during 2014. Recall that retail sales are reported in nominal terms and the softer inflation figures likely weighed on sales.

As has been the case for much of the past year, sales at gasoline stations were the largest drag on retail sales while nonstore retailers and autos showed the most improvement over the past year. Although sales at gasoline stores generally fall in January on a non-seasonally adjusted basis (an average 4.2 percent decline since 1993), the 12 percent plummet in gasoline prices should lead the seasonally adjusted numbers to also again detract from the headline. We expect that retail sales were flat in January.

Previous: -0.1% **Wells Fargo: 0.0%**

Consensus: 0.1% (Month-over-Month)



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

Global Review

As Jitters Continue, Some Positive Signs Appear

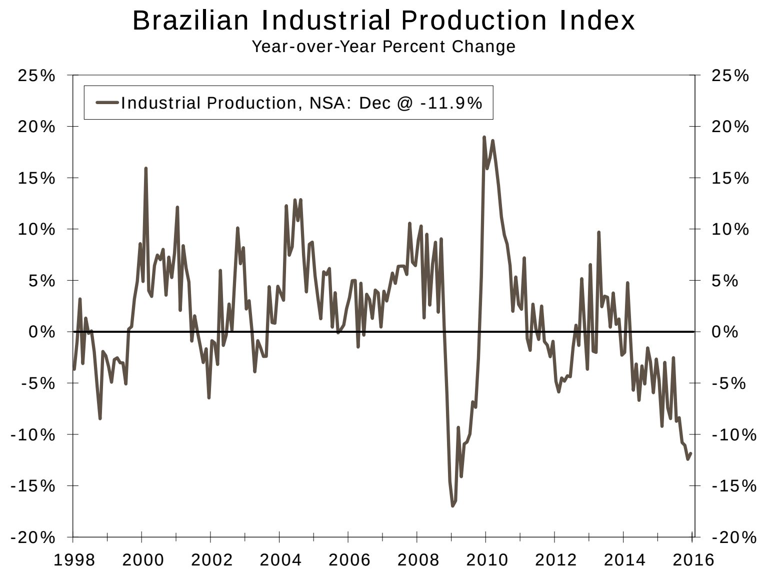
Global economic data have continued to show a challenging environment for economic growth. Last week, the Bank of Japan surprised the markets with negative rates and there is now talk even in the United States that if financial conditions tighten too much Fed officials would not discount using such a tool within the U.S. economy. We do not anticipate such an eventuality, however.

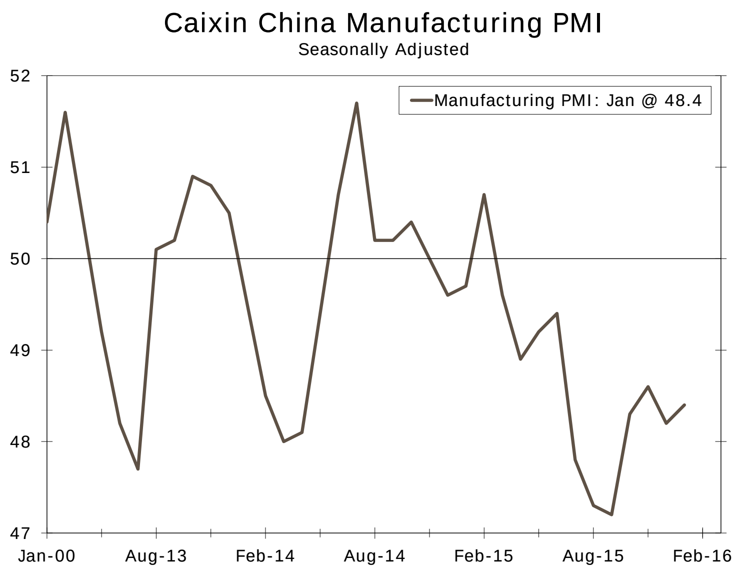
This week we saw further deterioration in industrial conditions in Brazil where industrial production plunged 11.9 percent, getting closer to the trough recorded during the 2008-2009 financial crisis when it plunged 15 percent on a year-over-year basis. Perhaps the biggest difference between that drop and this one is that the expectation is for industrial conditions to remain difficult and for the potential recovery to remain uncertain compared to what happened after the Great Recession. On the positive side, the Brazilian manufacturing PMI, while remaining below the 50 demarcation line, improved a bit in January, to 47.4.

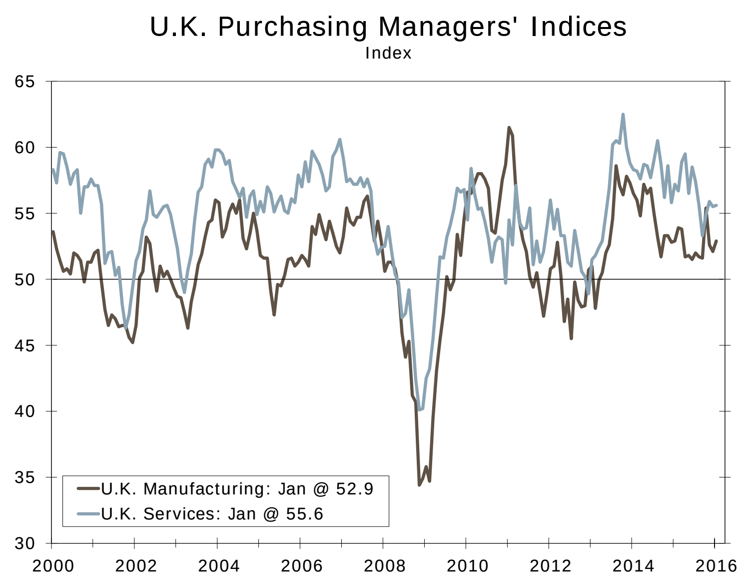
We saw a similar slight improvement in the Chinese Caixin PMI manufacturing index for January, to 48.4 from 48.2, which may not be a great number but is marginally better than the previous month. The lowest reading for this index was in September of last year, at 47.2. Furthermore, we saw an improvement in the Chinese service PMI index, which had gotten close to the 50 demarcation line, at 50.2 in December. January's reading was a relatively healthy 52.4, which means that the Chinese service sector, which has been the most dynamic sector of the economy, is still contributing to economic growth.

Meanwhile, the U.K. manufacturing index also saw an improvement, to 52.9 in January from 52.1 in December. All of these PMIs taken together seem to suggest that the global manufacturing deterioration has, at least for now, eased somewhat. This is a good starting point for global economic growth but it is probably not enough for markets to start calming down. Furthermore, there is renewed speculation that the U.S. economy may be heading into a recession, which could complicate global expectations for the future even though we believe that the probability of such an event is still low. What is true across the global economy is that expectations of higher interest rates seem to have diminished over the past several weeks, as global economic growth remains limited, at best. And this is true even in the United States even as the Federal Reserve is still talking about interest rate increases during this year.

Although it seems that markets have concluded that the drop in oil prices is "bad" for the global economy the fact of the matter is that, perhaps, it is one of the only positive developments for demand across the world, as the global economy struggles with complementing expansive monetary policies with tighter fiscal policies. The fact that the drop in oil prices is helping consumers across the world should not be taken lightly and should make markets wonder what would have been the state of the global consumer had oil prices remained north of $100 per barrel.







Source: IHS Global Insight and Wells Fargo Securities, LLC

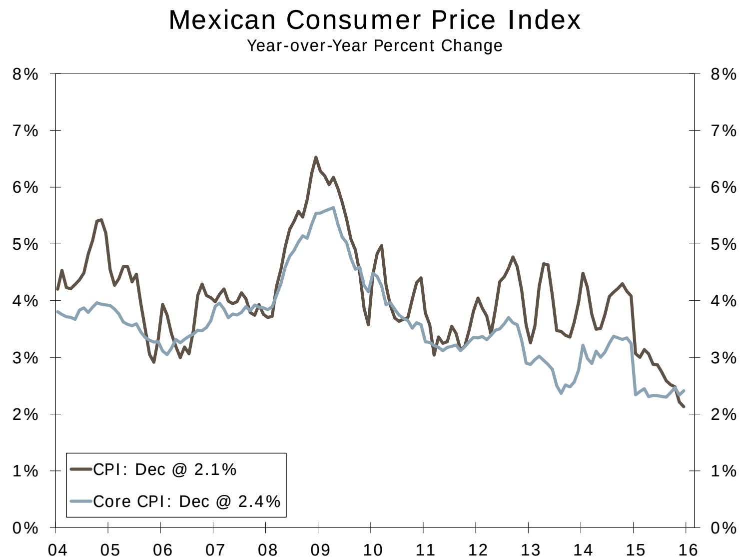
Mexico CPI • Tuesday

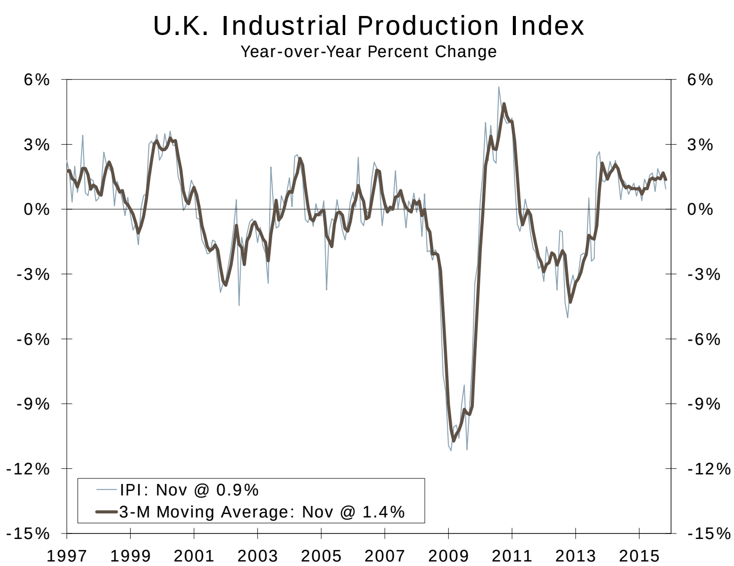
CPI inflation has slowed markedly in Mexico over the past year or so, largely a reflection of the weakness in domestic demand, particularly among goods-producing sectors. Notably, this comes at a time when the peso has weakened nearly 20 percent against the U.S. dollar over the past year, suggesting inflation pass-through from exchange rate weakness has been rather limited. Mexico's central bank raised its policy rate 25 bps in December in part as a means of stemming the currency's slide, but the peso has since continued to depreciate vis-à-vis the greenback. The central bank has acknowledged that pass-through inflation risk cannot be ruled out if the currency continues to weaken.

Industrial production data for December are also slated for release next week. Last week's preliminary release of Q4 GDP showed a flat output reading from the industrial sector over the quarter, partly reflecting slowing U.S. auto demand and reduced mining activity.

Previous: 2.1%

Consensus: 2.5% (Year-over-Year)





U.K. Industrial Production • Wednesday

In aggregate, U.K. industrial output has been fairly resilient in recent months even as the global economic backdrop has become somewhat less favorable. That said, the headline figure masks more nuanced developments among different sectors. In particular, manufacturing output contracted on a year-over-year basis in each of the first five months of H2 2015.

Meanwhile, mining and quarrying output has been steadily growing at or near double-digit rates over the past year after a steady secular decline that lasted nearly 15 years. While this is certainly a welcome respite given the challenging commodity price environment, this sector may become less of an impetus for growth going forward given the renewed slide in commodity prices that began when the calendar turned to 2016.

Previous: -0.7%

Consensus: -0.1% (Month-over-Month)

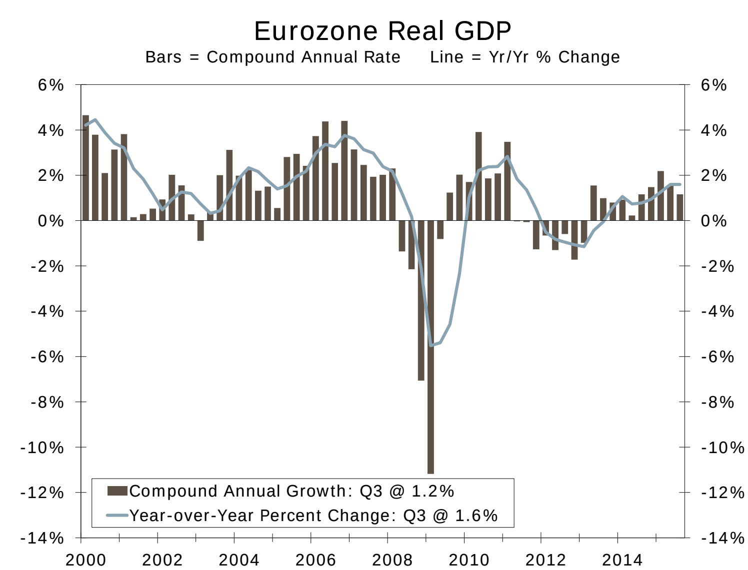
Eurozone GDP • Friday

Real GDP in the Eurozone continued to grow modestly in Q3 2015, posting a 1.6 percent year-over-year growth rate. Growth was again led by personal consumption, which grew 1.7 percent from a year earlier, although other components of domestic demand posted similar rates of growth in Q3. In short, the modest acceleration in Eurozone economic activity appears to still be in place.

The European Central Bank (ECB) eased monetary policy further in December, reducing its deposit rate deeper into negative territory and extending the length of its QE program, but fell short of aggressive market expectations. However, as we have said before, these additional policy measures are likely to help only on the margin. As a result, we believe it is unlikely that the Eurozone economy will suddenly "break out" in the near future.

Previous: 0.3% **Wells Fargo: 0.4%**

Consensus: 0.3% (QoQ, Not Annualized)



Source: IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

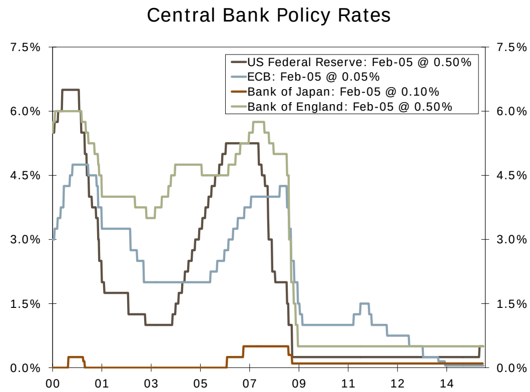
No Rate Hikes Soon in Europe

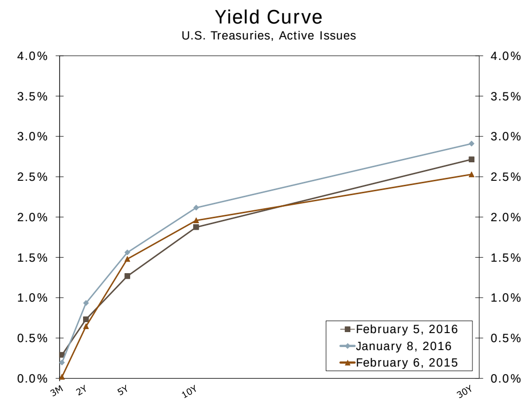
The Bank of England (BoE) held its monthly policy meeting this week. As widely expected, the Monetary Policy Committee (MPC) decided to maintain its main policy rate at 0.50 percent and keep the size of its asset purchase program unchanged at £375 billion. What was unexpected was that all nine MPC members voted to keep the policy rate unchanged at 0.50 percent. MPC member Ian McCafferty, who is a noted "hawk" and who had voted for a rate increase at the past six MPC meetings, voted to keep rates on hold this week.

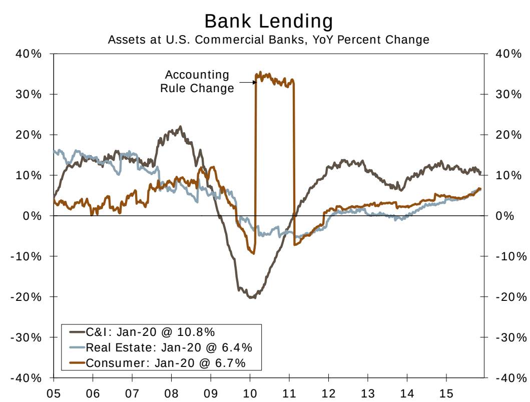
Furthermore the BoE revised down its forecasts for GDP growth and CPI inflation in 2016 and 2017. The MPC is mandated by the British government to achieve a CPI inflation rate of 2 percent in the "medium term." With the overall rate of CPI inflation currently hovering around 0 percent, the downward revisions to the forecasts imply that the MPC will refrain from raising rates for the foreseeable future.

Likewise, the European Central Bank (ECB) will not be raising rates anytime soon. Indeed, many analysts look for the ECB to ease further at the next policy meeting on March 10. The statement that was released after the last meeting in January stated that it will be "necessary to review and possibly reconsider our monetary policy stance at our next meeting in early March." Analysts took this statement as a hint that more accommodative policies are on the way.

What could the ECB do? First, it has already taken its deposit rate down to 0.30 percent. That is, it charges banks 30 bps for the excess reserves they hold at the central bank. The idea is that charging commercial banks for their excess reserves should induce them to use some of those reserves to create loans for businesses and consumers. So the ECB could reduce its deposit rate further. In addition, the ECB is currently buying €60 billion worth of government bonds per month. It could increase its monthly purchases and/or extend the expected duration of the program beyond March 2017, when it is currently expected to end. Stay tuned.







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

Credit Market Insights

Mortgage Credit Plays Hard to Get

Recent data from the Mortgage Bankers Association indicates that lending standards for mortgages have tightened. The Mortgage Credit Availability Index (MCAI), which uses credit score, loan type, and loan-to-value ratio, reported two consecutive monthly declines. A decline in the MCAI generally indicates that lending standards are tightening. The index fell a combined 4.1 percent in November and December to a reading of 124.3. While lending appears to have tightened, the MCAI's overall level remains consistent with ample credit availability, as the current reading indicates lending has eased 24.3 percent over the past three years.

The MCAI can be broken down into four subcomponents—conventional, government, conforming, and jumbo mortgages. The greatest tightening was seen in the conventional and jumbo indices, which declined 4.8 percent and 4.2 percent in December, respectively.

The global slowdown and recent financial market turmoil will likely cause consumers to reassess their expectations of interest rates. Our outlook is for mortgage rates to tick up in line with the modest pace of increases in the Fed's short-term interest rate. Continued low mortgage rates, while not a game changer, should be a supporting factor for improvement in the housing market.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.72%	3.79%	3.92%	3.59%
15-Yr Fixed	3.01%	3.07%	3.19%	2.92%
5/1 ARM	2.85%	2.90%	3.01%	2.82%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$1,988.4	43.28%	7.98%	10.81%
Revolving Home Equity	$435.7	0.83%	-5.29%	-4.43%
Residential Mortgages	$1,654.3	58.43%	3.06%	4.51%
Commerical Real Estate	$1,796.3	-1.68%	7.90%	11.34%
Consumer	$1,280.2	6.65%	10.35%	6.67%

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

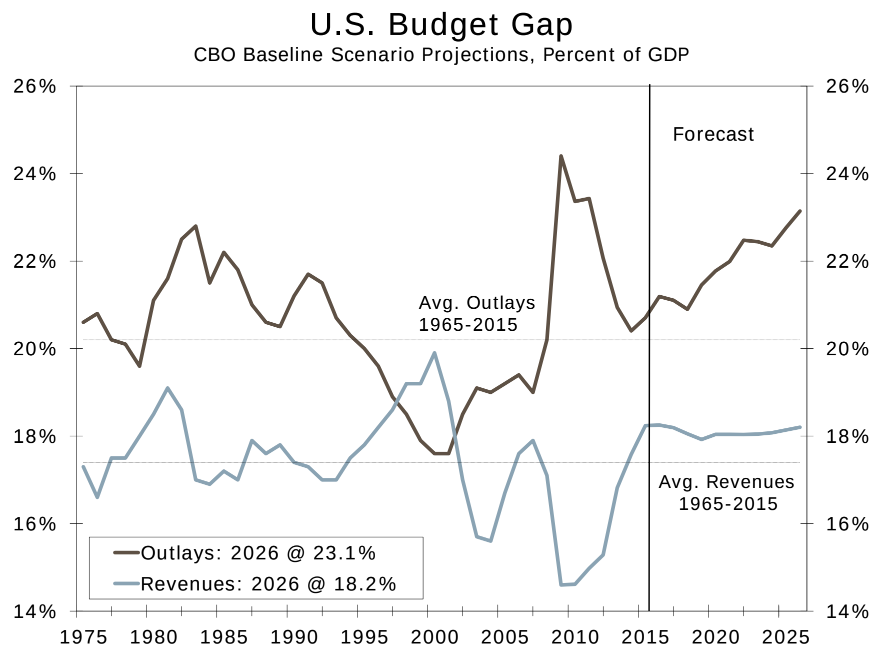
Topic of the Week

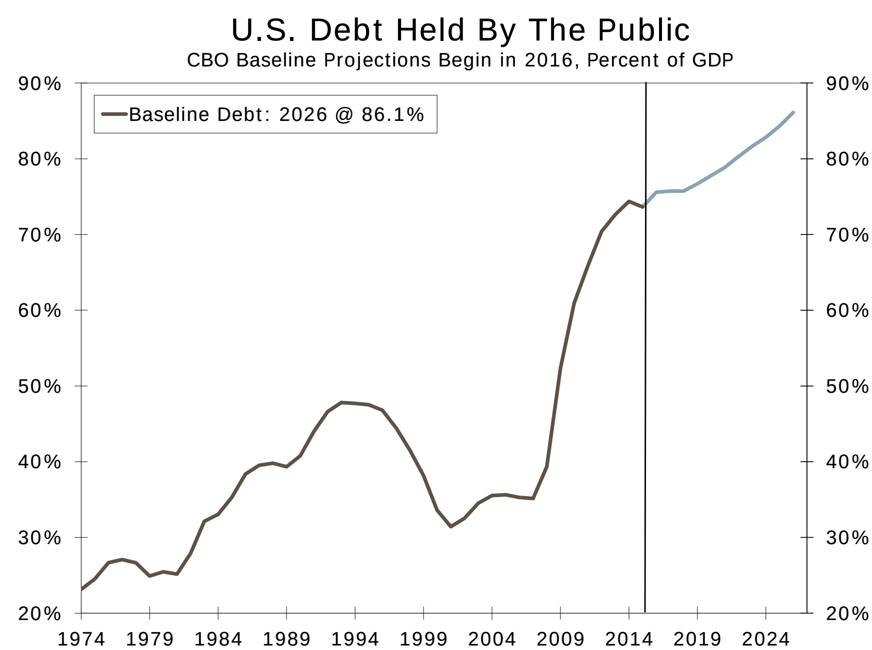
A Bleak Fiscal Outlook

Last week, the Congressional Budget Office (CBO) released its annual Budget and Economic Outlook. The report showed that the federal budget deficit is scheduled to rise in the 2016 fiscal year for the first time since 2009. The deficit is projected to grow from $544 billion, or 2.9 percent of GDP, in FY 2016 to $1.4 trillion, or 4.9 percent of GDP, by 2026 under current law. While revenues are expected to rise to 18.3 percent of GDP in FY 2016 and more or less remain stable as a share of GDP, outlays are expected to rise from 21.2 percent of GDP to 23.1 percent of GDP by 2026 (top graph). The three main drivers of the outlay growth over the next 10 years are Social Security, health care programs and net interest payments. In addition, the budget deficits projected in this year's budget outlook show a rather dramatic rise in annual deficits over the next decade relative to last year's report primarily due to legislation enacted at the end of last year that included the retroactive extension of several tax provisions that reduce corporate and individual income taxes.

Rapid growth in budget deficits over the course of the next decade will in turn add to the stock of debt. CBO estimates that total debt held by the public will reach nearly $14 trillion or 75.6 percent of GDP, by the end of fiscal year 2016 and will grow to $23.8 trillion, or 86.1 percent of GDP, by 2026 (bottom graph). With such a large and growing stock of debt and interest rates expected to rise over the next several years, the interest burden will continue to grow, which could crowd out other forms of government spending.

Importantly, the economic assumptions underlying the CBO's analysis do not incorporate the inclusion of an assumption about an economic downturn since the CBO does not attempt to forecast cyclical changes in growth. Thus, should a downturn occur at some point over the next 10 years, the result would be an even more dramatic rise in annual budget deficits and the debt-to-GDP ratio.





Source: Congressional Budget Office and Wells Fargo Securities, LLC

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 2/5/2016	1 Week Ago	1 Year Ago
3-Month T-Bill	0.28	0.31	0.01
3-Month LIBOR	0.62	0.62	0.26
1-Year Treasury	0.66	0.69	0.14
2-Year Treasury	0.73	0.77	0.52
5-Year Treasury	1.26	1.33	1.30
10-Year Treasury	1.87	1.92	1.82
30-Year Treasury	2.71	2.74	2.43
Bond Buyer Index	3.30	3.38	3.36

Foreign Exchange Rates

	Friday 2/5/2016	1 Week Ago	1 Year Ago
Euro ($/€)	1.116	1.083	1.148
British Pound ($/£)	1.451	1.424	1.533
British Pound (£/€)	0.769	0.761	0.749
Japanese Yen (¥/$)	116.990	121.140	117.530
Canadian Dollar (C$/$)	1.380	1.398	1.243
Swiss Franc (CHF/$)	0.993	1.023	0.921
Australian Dollar (US$/A$)	0.713	0.708	0.780
Mexican Peso (MXN/$)	18.369	18.107	14.788
Chinese Yuan (CNY/$)	6.574	6.576	6.253
Indian Rupee (INR/$)	67.654	67.793	61.739
Brazilian Real (BRL/$)	3.896	3.999	2.745
U.S. Dollar Index	96.961	99.606	93.569

Source: Bloomberg LP and Wells Fargo Securities, LLC

Foreign Interest Rates

	Friday 2/5/2016	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.18	-0.17	0.03
3-Month Sterling LIBOR	0.59	0.59	0.56
3-Month Canada Banker's Acceptance	0.85	0.86	0.99
3-Month Yen LIBOR	0.04	0.08	0.10
2-Year German	-0.48	-0.49	-0.19
2-Year U.K.	0.38	0.34	0.40
2-Year Canadian	0.40	0.42	0.44
2-Year Japanese	-0.19	-0.07	0.05
10-Year German	0.31	0.33	0.37
10-Year U.K.	1.57	1.56	1.55
10-Year Canadian	1.18	1.23	1.37
10-Year Japanese	0.03	0.10	0.36

Commodity Prices

	Friday 2/5/2016	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	31.24	33.62	50.48
Gold ($/Ounce)	1148.33	1118.17	1264.81
Hot-Rolled Steel ($/S.Ton)	399.00	404.00	542.00
Copper (¢/Pound)	209.70	206.70	259.50
Soybeans ($/Bushel)	8.72	8.66	9.63
Natural Gas ($/MMBTU)	2.03	2.30	2.60
Nickel ($/Metric Ton)	8,507	8,553	15,070
CRB Spot Inds.	421.97	413.84	483.22

Next Week's Economic Calendar

	Monday 8	Tuesday 9	Wednesday 10	Thursday 11	Friday 12
U.S. Data		**NFIB Small Business Optimism** December 95.2 January 94.5 (C) **JOLTS** November 5431 December 5350 (C)	**Federal Budget Statement** December January $10.1B (C)		**Import Price Index** December -1.2% January -1.1% (W) **Retail Sales (MoM)** December -0.1% January 0.0% (W)
Global Data		**Mexico** **CPI (YoY)** Previous (December) 2.1%	**United Kingdom** **Industrial Production (MoM)** Previous (November) -0.7%		**Eurozone** **GDP (QoQ)** Previous (Q3) 0.3%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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