February 12, 2016

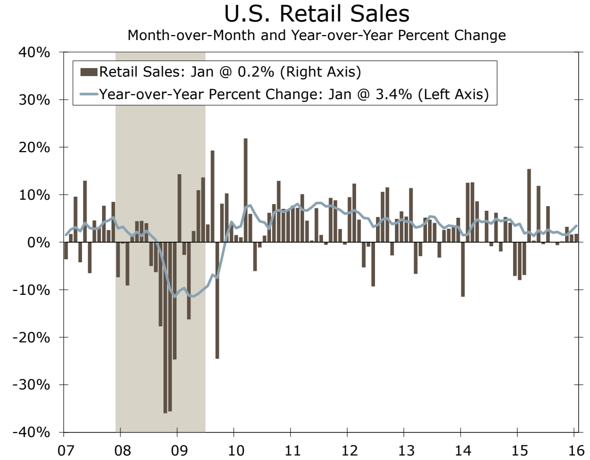
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Consumer Spending Still a Key Support for Growth

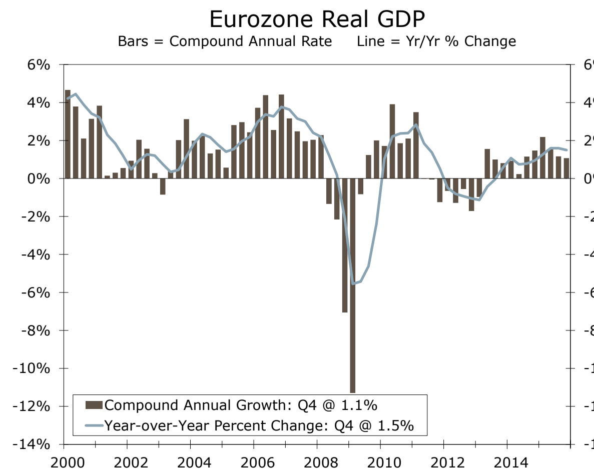
- Retail sales posted a 0.2 percent rise in January, while core sales rose an impressive 0.6 percent for the month. While some price effects remain, the strong pace of sales suggests that consumer spending remains robust enough to support modest economic growth.
- Import prices continued to slide to start the year, falling 1.1 percent in January, but the pace of declines has begun to diminish.
- Business inventories rose 0.1 percent in December while November's inventories were revised slightly higher to a decline of 0.1 percent.



Global Review

Foreign GDP Data Mixed This Week

- Real GDP in the Eurozone rose 0.3 percent (not annualized) on a sequential basis in Q4. With risks to the GDP outlook in the euro area skewed to the downside and with inflation well below 2 percent at present, the ECB likely will provide further policy accommodation in coming months.
- Real GDP in India grew 7.3 percent on a year-ago basis in Q4-2015, and it appears likely that the Indian economy will continue to grow faster than the Chinese economy in coming years. The problem is that India does not mean as much to the global economy as China in terms of contribution to overall growth.



Wells Fargo U.S. Economic Forecast

	Actual 2015 1Q	2Q	3Q	4Q	Forecast 2016 1Q	2Q	3Q	4Q	Actual 2013	2014	2015	Forecast 2016	2017
Real Gross Domestic Product [1]	0.6	3.9	2.0	0.7	1.0	2.4	2.4	2.3	1.5	2.4	2.4	1.8	2.3
Personal Consumption	1.8	3.6	3.0	2.2	2.8	2.7	2.7	2.6	1.7	2.7	3.1	2.7	2.5
Inflation Indicators [2]													
PCE Deflator	0.2	0.3	0.3	0.4	0.9	0.8	1.1	1.6	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	1.7	1.5	1.6	0.1	1.3	2.2
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	2.3	2.6	2.5	2.4	2.4	2.0	1.7	0.4	2.5	2.3
Trade Weighted Dollar Index [3]	92.1	89.9	92.3	94.5	92.0	93.5	95.0	96.3	75.9	78.5	91.1	94.2	97.8
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	3.96	4.01	4.06	4.16	3.98	4.17	3.85	4.05	4.40
10 Year Note	1.94	2.35	2.06	2.27	2.01	2.06	2.12	2.23	2.35	2.54	2.14	2.10	2.52

Forecast as of: February 10, 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

Consumer Spending Still a Key Support for Growth

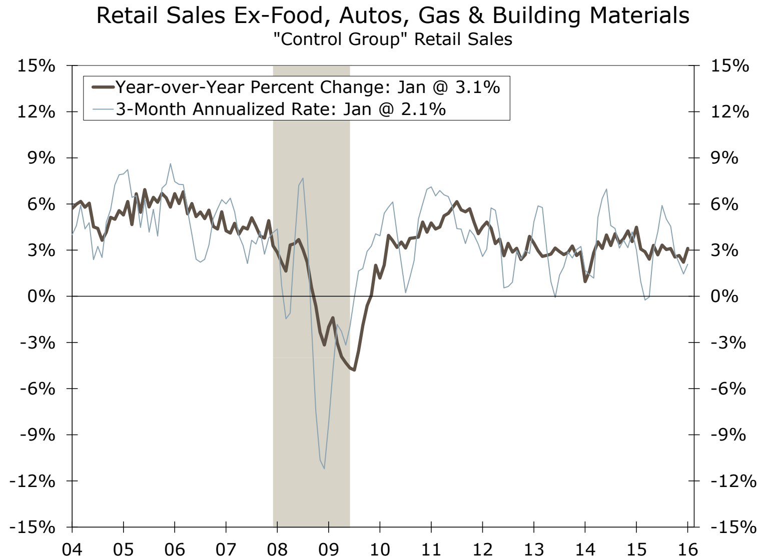
Following last Friday's nonfarm payroll report for January, the economic data this week continued to support a modest pace of economic activity as opposed to recession. Retail sales data pointed toward another quarter of solid consumer spending. Preliminary numbers for import prices continued to reflect lower oil prices, posting another monthly decline, but the effects from oil appear to be diminishing. Business inventories were not as weak as expected in November and December but we still expect a slight drag to first quarter growth. January's reading of small business confidence showed signs that the equity market sell-off so far this year appears to be affecting business owners' confidence. In our monthly economic outlook released this week, we downwardly revised our call for first quarter GDP growth to just 1.0 percent. With the volatile swings in equity markets lately, recession fears have reemerged. Given the economic data this week, we do not see evidence of a negative growth environment developing in the U.S.

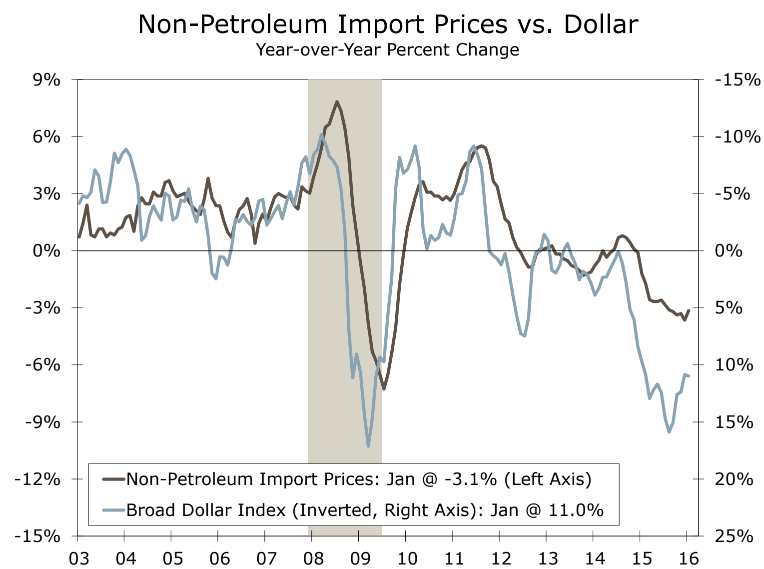
Retail sales in January rose 0.2 percent for the month while December's sales figures were revised higher to a 0.2 percent increase. The control group, which feeds into the calculation of GDP, was up an impressive 0.6 percent, suggesting robust consumer spending in Q1. Auto sales, which have helped to support total retail sales activity over the past year, remained strong, rising 0.6 percent in January. One of the key supports to our first quarter GDP call is that real consumer spending will continue to hold up and this week's retail report supports our view. In a separate release this week, the preliminary University of Michigan consumer sentiment survey pointed toward erosion in consumer confidence likely related to the persistent sell-off in equity markets, suggesting some downside risks to February consumer spending.

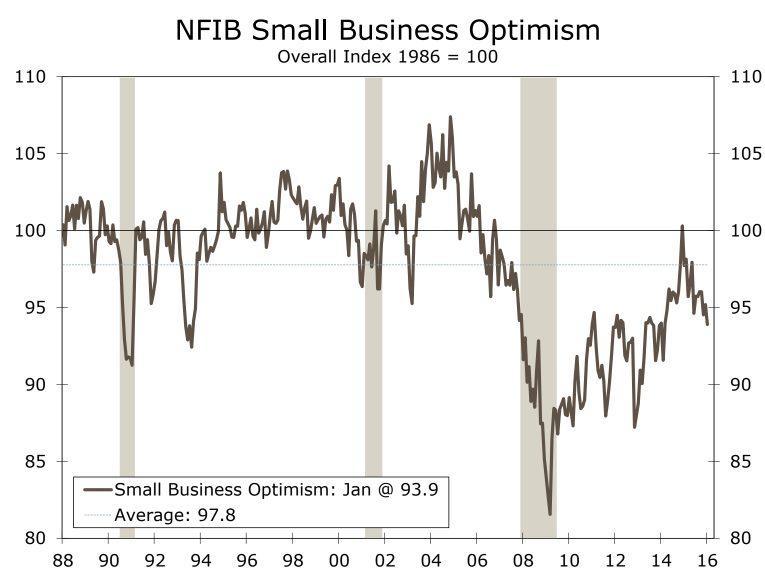
In the first look at inflation for the year, import prices in January declined further with the slide in oil prices for the month. One piece of possible good news is that the U.S. dollar has begun to weaken slightly, which may help allay some fears about a strong U.S. dollar resulting in imported disinflation. While oil prices continue to slide, the magnitude of the declines has begun to diminish.

Business inventories rose 0.1 percent in December while November's reading was revised higher. Even with a somewhat higher pace of inventory building in December, we expect a drag from inventories again in the first quarter.

January's National Federation of Independent Business small business optimism index declined 1.3 points to 93.9, the lowest reading since February 2014. With ongoing equity market volatility it is likely that small business owners are becoming increasingly worried about current economic conditions. The plans to hire component of the index fell for the month, and fewer firms indicated that they expect a better economy and higher sales.







Source: U.S. Dept. of Commerce, U.S. Dept. of Labor, National Federation of Independent Business and Wells Fargo Securities, LLC

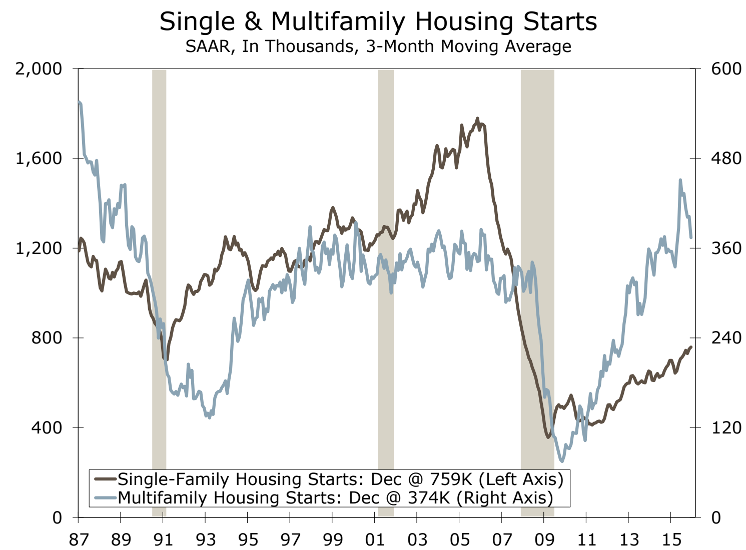
Housing Starts • Wednesday

Housing starts unexpectedly fell 2.5 percent in December to a 1.15 million-unit pace, as single-family starts declined 3.3 percent and multifamily dipped 1.0 percent. Meanwhile, permits declined 6.1 percent over the month. Housing starts and permits can be notoriously volatile on a monthly basis, and the drops follow double-digit increases for both starts and permits in the prior month. Through the monthly volatility, starts rose 6.4 percent from a year ago and permits increased a more robust 11.8 percent.

Our expectation is that new construction in single- and multifamily will continue to be a bright spot for the U.S. economy. Homebuilder sentiment remains near cycle highs, which should underpin single-family gains, while pent-up demand from young adults living at home should support multifamily activity in the coming quarters. Looking ahead, we expect total housing starts will increase about 8 percent in 2016.

Previous: 1,149K **Wells Fargo: 1,151K**

Consensus: 1,175K



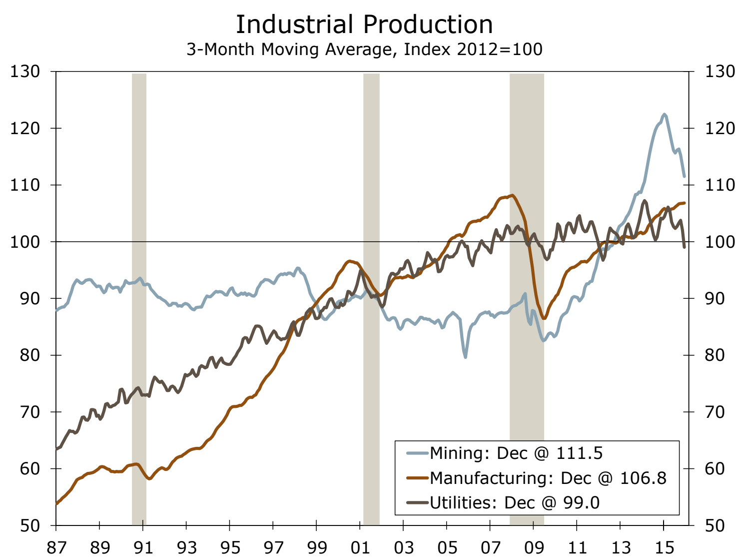
Industrial Production • Wednesday

Industrial production growth fell into negative territory on a year-over-year basis in November 2015 for the first time since 2009, and the decline steepened in December. While the weakness can be partly attributed to the ongoing drag from mining and the drop in utilities output amid a warmer-than-expected end to 2015, manufacturing production growth has clearly slowed over the past year or so.

Manufacturing output rose just 0.7 percent on a year-over-year basis in December, down from nearly 5 percent growth a year earlier. Given our expectation that the headwinds on the factory sector—weak global growth, strong dollar and low commodity prices—are likely to remain in place for quite some time, manufacturing production is unlikely to stage a significant comeback anytime soon. Accordingly, any rebound in overall industrial production growth is likely to be fairly modest.

Previous: -0.4% **Wells Fargo: 0.4%**

Consensus: 0.3% (Month-over-Month)



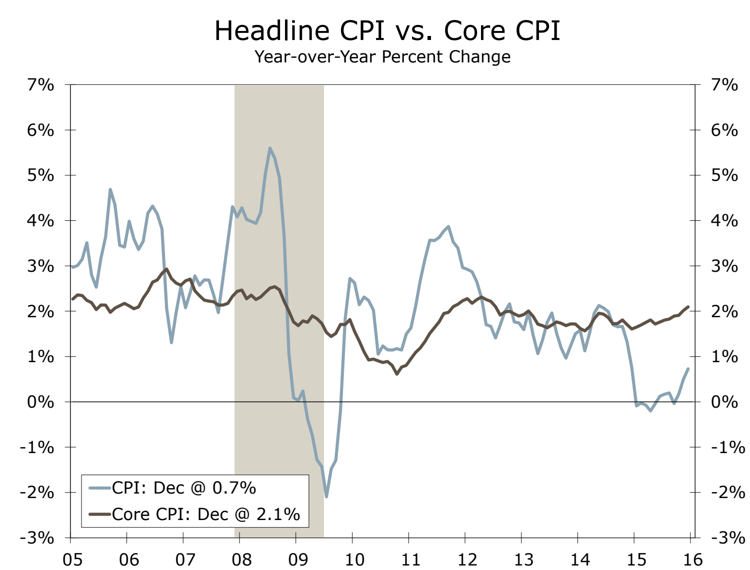
CPI • Friday

The headline CPI fell 0.1 percent in December, dragged down by lower energy and food prices. However, the year-over-year growth rate picked up to 0.7 percent even as gasoline prices reached new cycle lows. While gas prices were down about 20 percent from a year earlier, this represented a more moderate decline than the year-over-year drops observed earlier in the year.

Looking past the direct effects of energy prices, core CPI inflation has continued to edge higher over the past few months. The year-over-year change in the core CPI rose to 2.1 percent in December, the quickest pace since mid-2012. Although the Fed's preferred measure of core inflation, the PCE deflator, has been stuck around 1.3 percent over the past year, the uptrend in core CPI suggests underlying inflation is not as unequivocally weak.

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

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



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

Global Review

Foreign GDP Data Mixed This Week

Although economic data took a back seat this week to volatility in financial markets and comments by central bank officials, the foreign economic data that were released this week were mixed. On the weak end of the spectrum, real GDP in the Eurozone rose 0.3 percent (not annualized) in the fourth quarter (see graph on front page). On a year-over-year basis, GDP was up 1.5 percent. In short, the current expansion in the Eurozone has been ongoing for nearly three years, but it is not particularly strong at present.

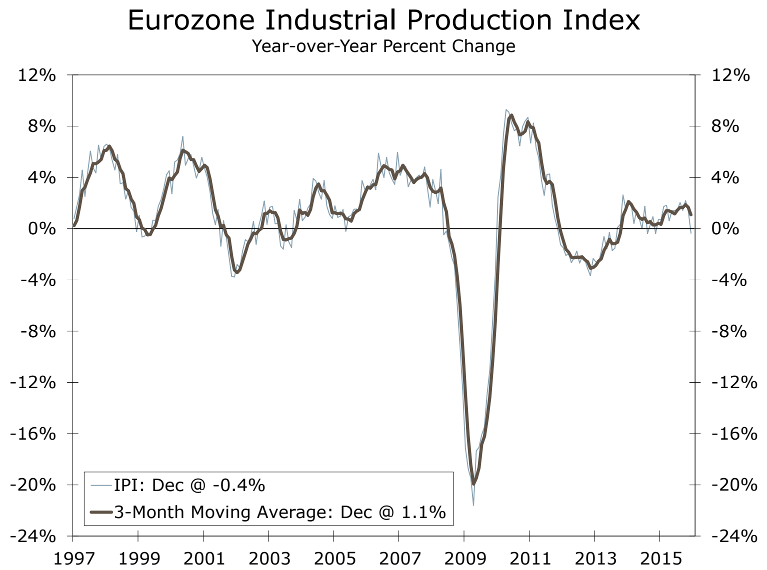
A breakdown of real GDP into its underlying demand components will not be released until early March, but monthly data give us some more insights into the underlying state of the economy. Industrial production (IP) in the Eurozone fell 0.1 percent (not annualized) in Q4 relative to Q3. Yes, unseasonably warm weather depressed utilities production and contributed to the sharp monthly declines in IP in November (-0.5 percent) and December (-1.0 percent). However, the underlying pace of manufacturing production was also anemic, which likely reflects, at least in part, weakness in real exports as well as in investment spending. GDP growth in the Eurozone has been paced recently by modest growth in consumer spending, and the sharp increase in car registrations that occurred in Q4 suggests that consumer purchases of durable goods were solid.

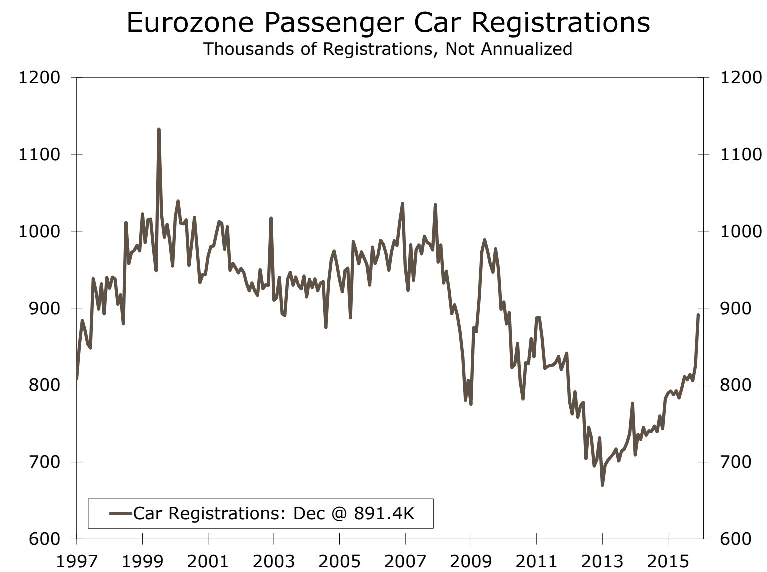
As noted above, the pace of economic growth in the Eurozone is not particularly strong, and CPI inflation is well below the ECB's objective of "below but close to 2 percent." (The overall rate of CPI inflation was only 0.4 percent in January.) Furthermore, recent volatility in financial markets means that risks to the real GDP and inflation outlooks are probably skewed to the downside.

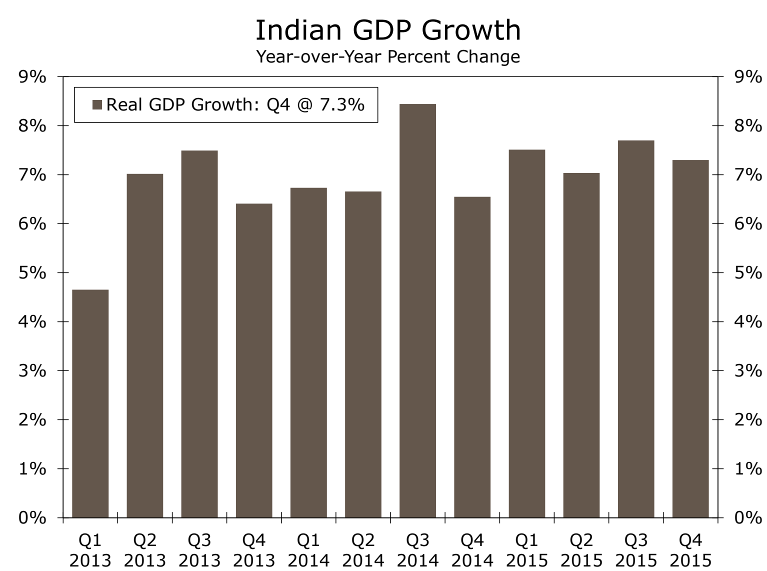
The ECB has taken its deposit rate into negative territory. That is, it charges commercial banks 30 bps to hold excess reserves at the central bank. It is also purchasing €60 billion worth of sovereign bonds per month. But, as ECB President Draghi hinted after the last policy meeting in January, monetary policy likely will become even more accommodative in coming months.

At the stronger end of the spectrum, real GDP in India rose 7.3 percent on a year-ago basis in Q4 2015. Although the outturn represented a modest slowdown from the 7.7 percent rate that was registered in the third quarter, it was stronger than most analysts had expected. Indian statistical authorities estimate that real GDP will grow 7.6 percent in the fiscal year that ends in March. It appears that the Indian economy will grow faster than the Chinese economy for the foreseeable future.

The problem is that India does not mean as much to the global economy as China in terms of contribution to growth. In terms of GDP (measured at market exchange rates), the Chinese economy is five times as large as the Indian economy. China takes in 9 percent of the world's exports whereas India accounts for only 2 percent of global exports. The Indian economy can grow as fast as it wants in coming quarters, but investors simply won't care until economic growth in China shows some signs of stabilizing. Until then, financial markets probably will remain volatile.







Source: IHS Global Insight and Wells Fargo Securities, LLC

Japanese GDP • Monday

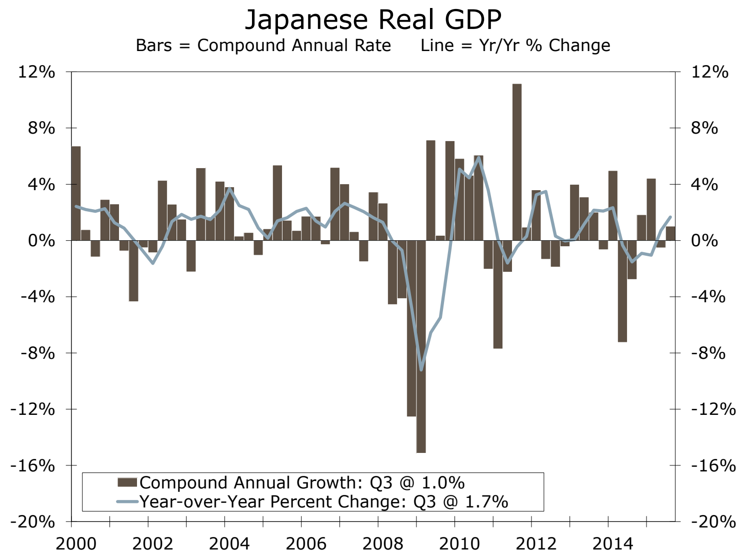
Abenomics, the combination of stimulative monetary and fiscal policy and limited structural reforms in Japan, has lost momentum.

After gaining some initial traction in the first few quarters of 2013, real GDP growth in Japan has been negative in four out of the past eight quarters. The first major international economic news next week will likely be that the Japanese economy tumbled again in the fourth quarter of 2015. Retail sales fell in two out of three months in the final period of the year, which suggests soft consumer spending figures. Trade may offset that somewhat as the soft domestic demand environment resulted in steep declines in imports.

We expect the saw-tooth pattern for growth to continue with full-year growth figures of 0.6 percent for 2016.

Previous: 1.0% **Wells Fargo: -0.8%**

Consensus: -0.8% (CAGR)



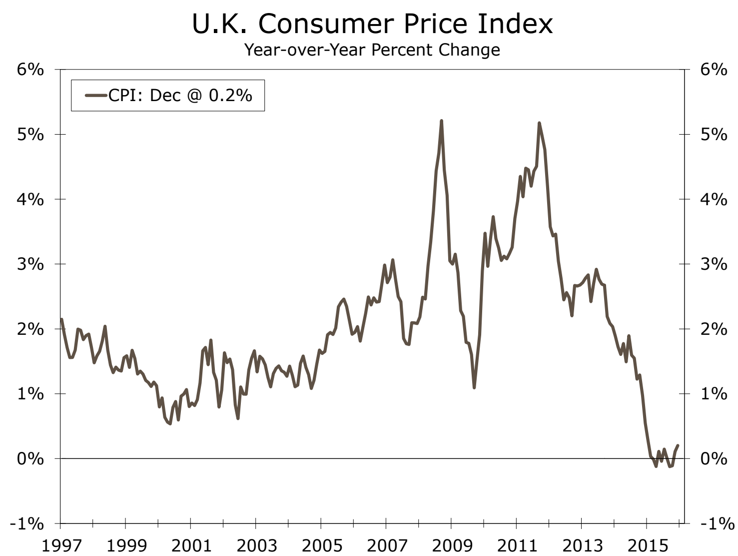
United Kingdom CPI • Tuesday

At its policy meeting last week, the Bank of England's Monetary Policy Committee (MPC) opted to leave its target lending rate unchanged. While that outcome was more or less expected, the fact that one voting member changed his vote came as a dovish surprise. Ian McCafferty had been a hold-out in recent meetings, preferring to commence with rate hikes; he dropped that opposition. The MPC also downgraded its 2017 CPI inflation forecast to just 1.9 percent from 2.1 percent previously.

The unrelenting fall in oil prices in particular and the broader drop in commodity prices more broadly has put downward pressure on prices in many economies, and the United Kingdom is no exception. On Tuesday of next week, the latest CPI figures print for the United Kingdom.

Previous: 0.2% **Wells Fargo: 0.3%**

Consensus: 0.3% (Year-over-Year)



Canadian CPI • Friday

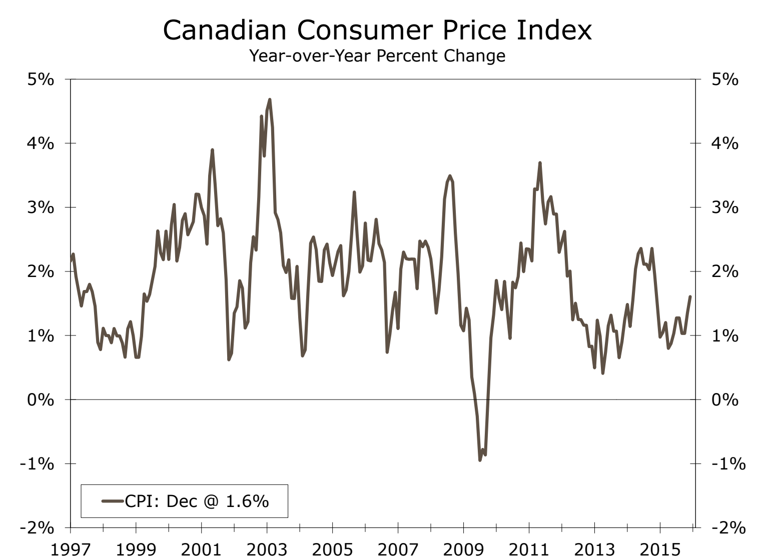
Headline inflation is close to zero in many of the advanced economies of the world, but Canada, with a headline consumer inflation rate of 1.6 percent, is something of an exception.

The Canadian dollar is down more than 15 percent versus its U.S. counterpart since May of last year. The good news for Canadian businesses is that a weaker loonie makes Canadian goods more affordable, all else equal. The downside is that the cost of many goods sourced from overseas are more expensive to Canadian households and businesses.

The Bank of Canada opted not to cut rates at its last meeting despite a growing minority of analysts expecting that it would. The rise in inflation might be a factor in staying the hand of BoC policymakers. January CPI for Canada prints on Friday.

Previous: 1.6% **Wells Fargo: 1.9%**

Consensus: 1.7% (Year-over-Year)



Source: IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

Risks Mount

In her semi-annual testimony to Congress this week, Fed Chair Janet Yellen made an effort to stress that the Fed's next move—or lack thereof—is not yet set. On the positive side for the economy, continued improvement in the labor market and low energy prices have supported real household spending, while housing has continued to recover.

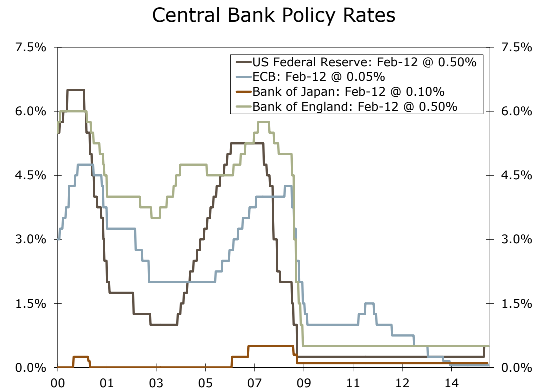
Yet less than two months after the Fed's long-awaited move off of zero, Yellen's emphasis on the outlook has shifted away from normalization and back toward caution. Since December, the downside risks to the outlook have intensified, which was plainly reflected in Yellen's testimony.

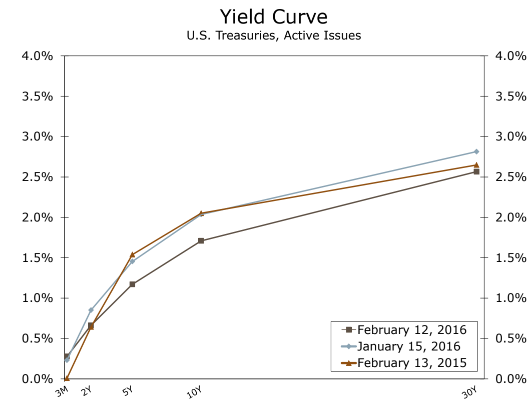
The Fed has made an effort to not appear beholden to financial markets after having passed on a September rate increase in the wake of market turmoil last August. Once again, however, equity markets have headed lower and credit spreads are rising. The tightening in financial conditions has the Fed on notice, but Yellen indicated that the recent downturn in markets would need to be persistent before altering views on economic activity and the labor market.

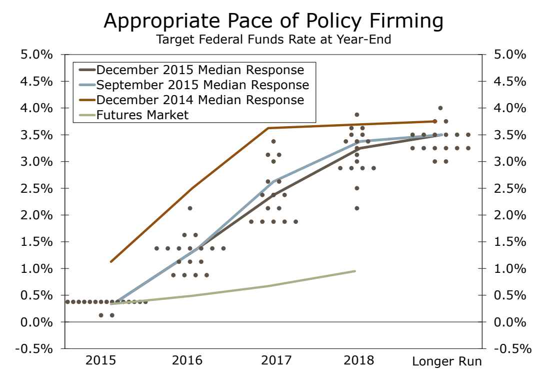
A clearer risk to the U.S. outlook remains the state of the global economy. China's ongoing adjustment has injected added uncertainty into financial markets, while weighing on global growth prospects. As other major central banks have remained firmly in easing mode to soften the slowdown, the relative policy stances continue to weigh on financial conditions via upward pressure on the dollar.

Ever More Gradual

In addition to the downside risks to the outlook, Yellen indicated more progress can be made on its dual mandates, as "some slack in labor market remains" and "inflation is expected to remain low in the near term." The path of policy tightening at liftoff was already expected to be gradual relative to previous tightening cycles, but Yellen's focus on the downside risks to the outlook suggest that further tightening will be even more gradual than outlined in December. In that regard, the Fed once again looks to be moving toward the market.







Source: Bloomberg LP, Federal Reserve Board and Wells Fargo Securities, LLC

Credit Market Insights

Lending to Households Brightens

In the most recent Senior Loan Officer Opinion Survey released by the Federal Reserve, lending standards to consumers are expected to loosen over the first quarter, especially for residential mortgage loans, while banks are seeing a decline in loan demand from businesses.

According to the survey, consumer lending to households remained relatively unchanged for credit cards and auto loans; however, banks indicated that they expected to ease standards on some of the different types of mortgage loans over the course of 2016. More than likely, this would take place in programs that focus more on prime and near-prime borrowers rather than those who qualify for subprime loans. This still could prove helpful to the housing market as we start to see more moderate increases in mortgage rates.

On the other hand, businesses appear to still be hesitant to take on additional risk, as banks have seen a decline in demand for business loans. Demand for commercial and industrial loans was weaker for medium and large firms as well as small ones as firms pull back on investment in plants and equipment. This comes as the U.S. economy only saw a 0.7 percent growth rate for Q4 GDP in addition to January's ISM manufacturing index being in contraction territory. It could be a while before we see a meaningful increase in investments from business if current conditions carry on longer than expected.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.65%	3.72%	3.81%	3.69%
15-Yr Fixed	2.95%	3.01%	3.10%	2.99%
5/1 ARM	2.83%	2.85%	2.91%	2.97%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$2,000.4	37.74%	16.50%	11.43%
Revolving Home Equity	$435.1	-6.25%	-5.12%	-4.55%
Residential Mortgages	$1,654.3	1.52%	3.54%	4.39%
Commerical Real Estate	$1,804.0	29.55%	12.07%	11.56%
Consumer	$1,279.4	-2.95%	5.00%	6.50%

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

Topic of the Week

Manufacturing & Mining: Spillover Risks?

The mining and manufacturing sectors have weakened in recent months, raising concerns that the U.S. economy is at risk of recession from softness in these sectors. Could the manufacturing and mining sectors pull the service sector down with them?

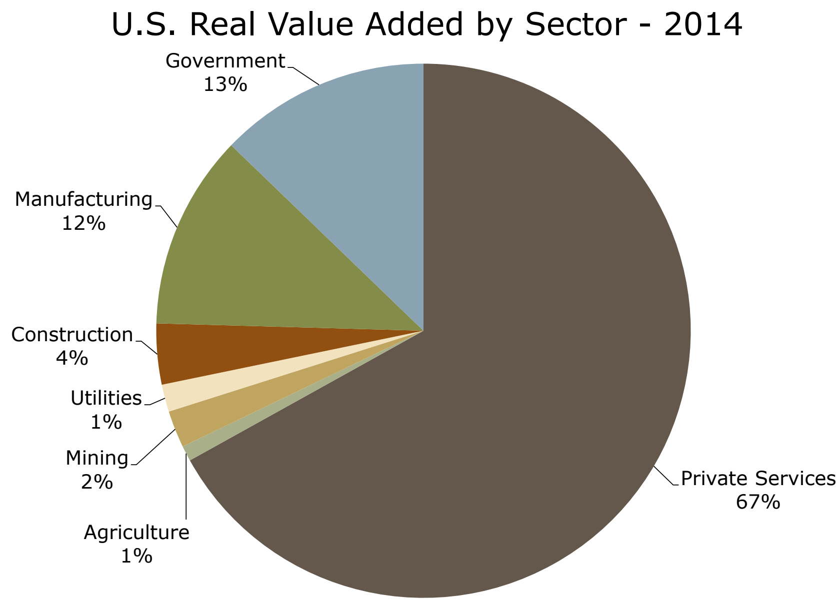
The relative sizes of these sectors are important to bear in mind when assessing potential spillover effects. Manufacturing and mining account for 12 percent and 2 percent, respectively, of real value-added (i.e., wages, salaries and profits) in the U.S. economy, while private services account for roughly two-thirds (top chart). The service sector, more than five times as large as the manufacturing sector in real value added terms, represents an outsized share of the U.S. economy.

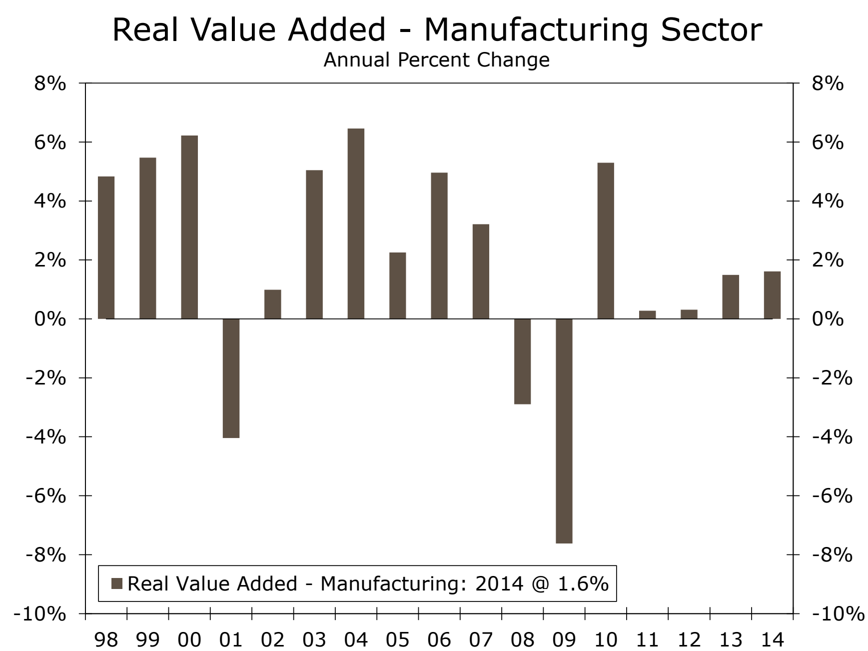
To measure the effects a downturn in one of these sectors would have on other sectors, we use a statistical technique that allows us to impart a "shock" to growth in one sector. We then analyze the effect that shock subsequently has on growth in other sectors of the economy.

Our statistical analysis finds that the effect of the mining sector on the service sector is rather small. Given the small size of the former, this result is intuitively appealing. Manufacturing has a more pronounced effect on the service sector, but our analysis finds that it would still require a 3 percent contraction in real value added in the manufacturing sector to turn growth in the service sector negative.

How likely is a contraction of this magnitude in the manufacturing sector? A decline in the manufacturing sector roughly of this order occurred in the 2001 recession (bottom chart). So, while a contraction of this magnitude is not without precedent, the downturn in manufacturing would need to be rather sizable to bring the entire economy to its knees.

For further reading, see *Can Manufacturing Take Down the Service Sector?* available on our website and upon request.





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 2/12/2016	1 Week Ago	1 Year Ago
3-Month T-Bill	0.27	0.29	0.01
3-Month LIBOR	0.62	0.62	0.26
1-Year Treasury	0.58	0.66	0.16
2-Year Treasury	0.66	0.72	0.62
5-Year Treasury	1.17	1.24	1.49
10-Year Treasury	1.71	1.84	1.98
30-Year Treasury	2.56	2.67	2.58
Bond Buyer Index	3.27	3.30	3.49

Foreign Exchange Rates

	Friday 2/12/2016	1 Week Ago	1 Year Ago
Euro ($/€)	1.125	1.116	1.140
British Pound ($/£)	1.447	1.450	1.538
British Pound (£/€)	0.778	0.769	0.741
Japanese Yen (¥/$)	112.820	116.870	119.110
Canadian Dollar (C$/$)	1.391	1.392	1.251
Swiss Franc (CHF/$)	0.977	0.991	0.931
Australian Dollar (US$/A$)	0.708	0.707	0.774
Mexican Peso (MXN/$)	19.103	18.440	14.917
Chinese Yuan (CNY/$)	6.574	6.576	6.253
Indian Rupee (INR/$)	68.235	67.654	62.306
Brazilian Real (BRL/$)	3.979	3.904	2.824
U.S. Dollar Index	96.028	97.031	94.094

Source: Bloomberg LP and Wells Fargo Securities, LLC

Foreign Interest Rates

	Friday 2/12/2016	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.20	-0.19	0.02
3-Month Sterling LIBOR	0.59	0.59	0.56
3-Month Canada Banker's Acceptance	0.85	0.85	0.96
3-Month Yen LIBOR	0.01	0.03	0.10
2-Year German	-0.52	-0.50	-0.22
2-Year U.K.	0.37	0.37	0.39
2-Year Canadian	0.41	0.37	0.42
2-Year Japanese	-0.16	-0.19	0.05
10-Year German	0.25	0.30	0.32
10-Year U.K.	1.39	1.56	1.66
10-Year Canadian	1.10	1.13	1.40
10-Year Japanese	0.09	0.03	0.40

Commodity Prices

	Friday 2/12/2016	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	28.66	30.89	51.21
Gold ($/Ounce)	1238.93	1173.82	1222.15
Hot-Rolled Steel ($/S.Ton)	397.00	399.00	535.00
Copper (¢/Pound)	203.45	210.30	260.20
Soybeans ($/Bushel)	8.72	8.72	9.74
Natural Gas ($/MMBTU)	1.97	2.06	2.71
Nickel ($/Metric Ton)	7,562	8,507	14,691
CRB Spot Inds.	421.52	421.97	468.68

Next Week's Economic Calendar

	Monday 15	Tuesday 16	Wednesday 17	Thursday 18	Friday 19
U.S. Data		**TIC** November $31.4B	**Housing Starts** December 1149K January 1151K (W) **PPI Final Demand (MoM)** December -0.2% January -0.1% (W)	**LEI** December -0.2% January -0.2% (W)	**CPI (MoM)** December -0.1% January -0.1% (W)
Global Data		**United Kingdom** **CPI (YoY)** Previous (January) 0.2% **Germany** **ZEW Survey Expectations** Previous (January) 10.2		**Russia** **Unemployment Rate** Previous (December) 5.8%	**Canada** **CPI (YoY)** Previous (December) 1.6%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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