

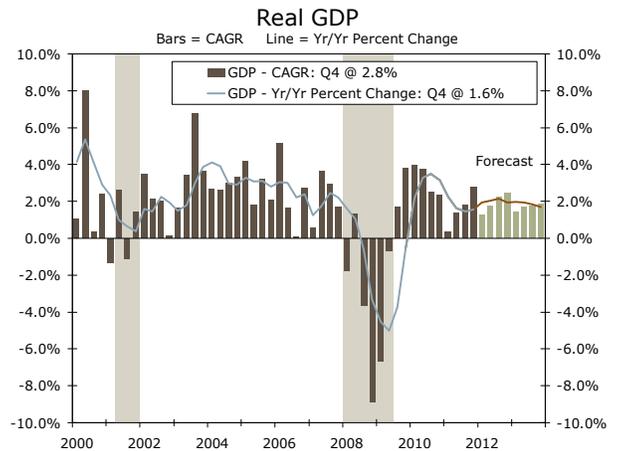
# Economics Group

## Weekly Economic & Financial Commentary

### U.S. Review

#### Less Strength Than Meets The Eye

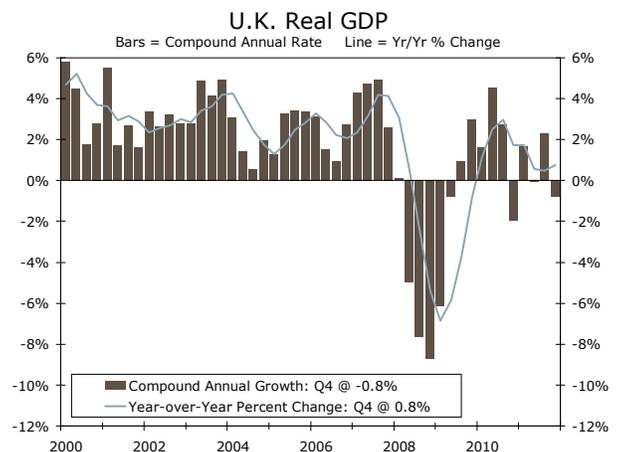
- Real GDP grew at a 2.8 percent annualized rate during the fourth quarter, but the underlying data show the economy has less momentum going into 2012.
- Durable goods orders and shipments rebounded solidly in December, casting some doubt on the earlier weak readings and bringing the data more closely in line with anecdotal reports and regional manufacturing surveys.
- Expectations for a housing rebound may have gotten a little ahead of themselves. New home sales fell slightly in December, and sales remain stuck near their average for the past 8 months.



### Global Review

#### Has the U.K. Economy Slipped into Another Recession?

- Real GDP in the United Kingdom declined at an annualized rate of 0.8 percent in the fourth quarter, marking the third time in the past five quarters that the British economy has contracted.
- However, we think it is likely that growth will return to positive territory again in the first quarter. Although the U.K. economy should narrowly escape a “technical” recession, the economic outlook is not very rosy. With growth likely to remain very sluggish, the Bank of England may elect to increase the size of its asset purchase program (i.e., quantitative easing).



Wells Fargo U.S. Economic Forecast													
	Actual 2011				Forecast 2012				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2009	2010	2011	2012	2013
Real Gross Domestic Product <sup>1</sup>	0.4	1.3	1.8	2.8	1.5	1.7	2.1	2.1	-3.6	3.0	1.7	1.9	1.8
Personal Consumption	2.1	0.7	1.7	2.8	1.7	1.5	1.6	1.7	-2.0	2.0	2.2	1.7	1.3
Inflation Indicators <sup>2</sup>													
"Core" PCE Deflator	1.1	1.3	1.6	1.7	1.7	1.5	1.4	1.5	1.5	1.4	1.4	1.5	1.6
Consumer Price Index	2.2	3.3	3.8	3.3	2.3	1.8	1.5	1.7	-0.3	1.6	3.1	1.8	2.0
Industrial Production <sup>1</sup>	4.8	0.7	6.3	3.1	3.3	3.6	3.0	2.2	-11.1	5.3	4.1	3.4	2.3
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

Forecast as of: January 27, 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

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Together we'll go far



## U.S. Review

### A Little Less Strength than Meets the Eye

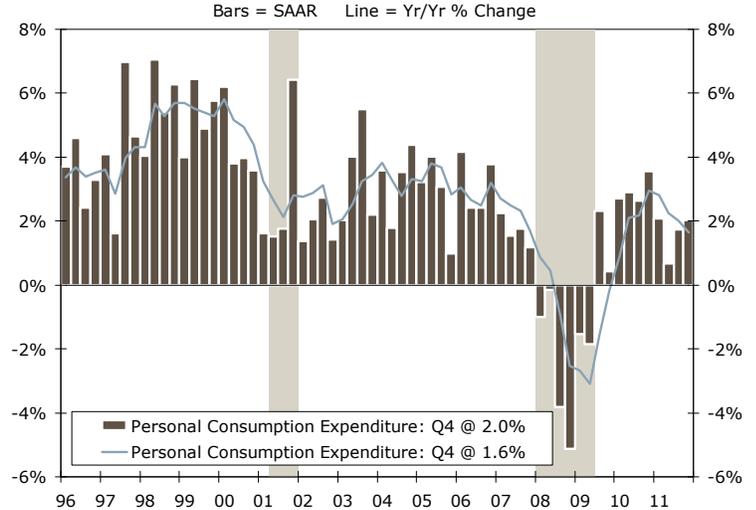
Real GDP grew at a 2.8 percent annualized rate during the fourth quarter. Growth was helped by a \$58 billion swing in inventory building, which accounted for 1.9 percentage points of the quarter's growth. The rise in inventories means that the production of goods and services increased faster than final demand, which is something that cannot continue for very long and raises questions about how strong growth will be during the first half of 2012. The economy's underlying momentum appears to remain intact, however, and economic activity should continue to improve at a modest pace over the next few quarters.

The composition of economic gains in the fourth quarter provides some important clues as to the economy's underlying momentum and staying power. Real personal consumption rose at a 2.0 percent annual rate, reflecting a 14.8 percent surge in durable goods purchases and a more modest 1.7 percent rise in nondurable goods. Services outlays rose at just a 0.2 percent pace, likely reflecting reduced demand for utilities amid unseasonably mild weather across much of the country. Motor vehicle sales reportedly held up relatively well in January but will not likely come close to duplicating the growth posted in the fourth quarter. Moreover, sales of smartphones and tablet PCs, which took off in October, appear to have tapered off in December. The 2 percent rise in personal consumption during the fourth quarter still outpaced income during the period. Therefore, consumers will likely take a breather during the first part of 2012.

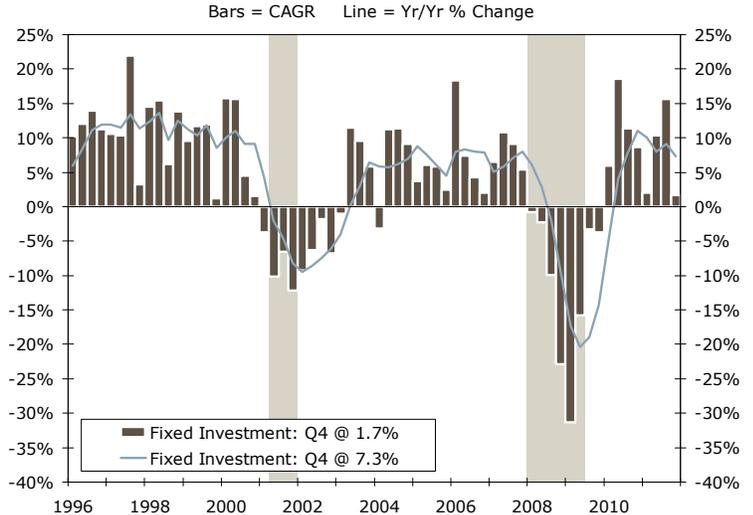
Nonresidential investment grew at just a 1.7 percent pace during the fourth quarter, with spending on equipment and software rising at a 5.2 percent pace and spending for nonresidential structures falling at 7.2 percent annual rate. The rise in equipment and software spending matches up well with anecdotal reports from businesses that suggested investment outlays were running stronger than the durable goods orders and shipments data suggested. Businesses had a huge incentive to get equipment delivered and up and running by year's end so that they could qualify for more generous depreciation. While orders bounced back in December, we suspect that deliveries may still slow a bit early this year. A significant portion of equipment ordered in December was probably for off-the-shelf products that were likely delivered in December.

We have consistently warned that the recent optimism about the economy and prospects for housing in particular appeared to be a little overdone. New home sales have been stuck at the current level for the past 18 months. Conditions have improved in recent weeks, but part of that improvement reflects the effects of unseasonably mild winter weather and overly active seasonal adjustment. Private real final demand grew at a 2.1 percent pace during the fourth quarter and continues to be weighed down by sluggish income growth and some lingering anxiety about the European financial crisis and the likely course of economic policy in the United States. We are currently projecting that real GDP will grow in the 1.5–2.0 percent range during the first half of 2012 and average just under a 2.0 percent pace for the year.

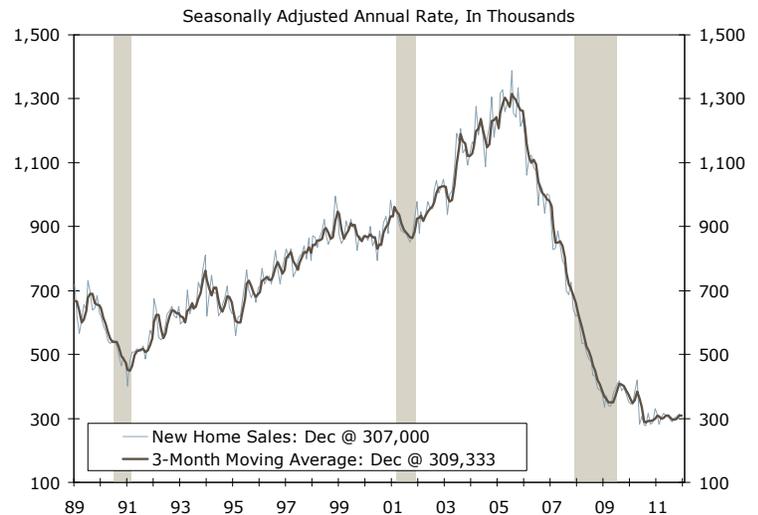
### Real Personal Consumption Expenditures



### Real NonRes Business Fixed Investment



### New Home Sales



## Consumer Confidence • Tuesday

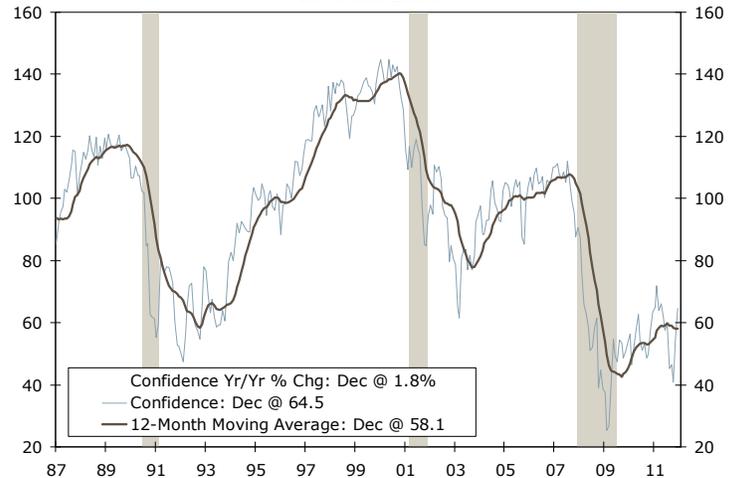
Despite Eurozone worries, consumer confidence rose for the second consecutive month in December, reaching its highest level since April. The jump in confidence over the past two months is consistent with solid holiday shopping sales and modest improvement in the labor market. Both consumers' assessment of current conditions and expectations continued to improve in December. The employment components also improved in December. Indeed, the proportion of households reporting that jobs were "hard to get" fell 1.2 points to 41.8. The drop coincides with a modest improvement in weekly first-time unemployment claims, which have fallen below the key 400,000 level for the past two weeks, and the number of consumers reporting that jobs were plentiful rose. While the improvement is promising, the level remains extraordinarily low, suggesting employment still has a few hurdles to jump.

**Previous: 64.5**

**Wells Fargo: 67.8**

**Consensus: 68.0**

Consumer Confidence Index  
Conference Board



## ISM Manufacturing • Wednesday

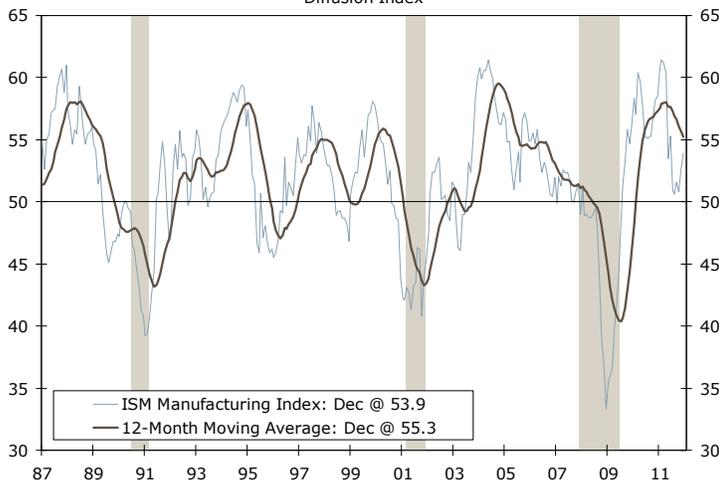
The manufacturing sector continued to improve in December and has been in expansionary territory since mid-2009. While December's reading of 53.9 is well below its cycle peak of 61.4 reached in early 2011, we expect the factory sector to continue its positive momentum. To be sure, the forward-looking new orders component has risen in each of the past three months, and now sits at 57.6, the highest level since April. Moreover, the employment component rose to 55.1 in December, which suggests further strength in manufacturing employment. With this increase, the new orders component is now comfortably above the overall index, which has in the past presaged an acceleration in the overall index. The production component also continued to show improvement. The increase in production is likely due to a pickup in motor vehicle production following cutbacks tied to parts shortages from the Japanese earthquake.

**Previous: 53.9**

**Wells Fargo: 54.5**

**Consensus: 54.5**

ISM Manufacturing Composite Index  
Diffusion Index



## Nonfarm Employment • Friday

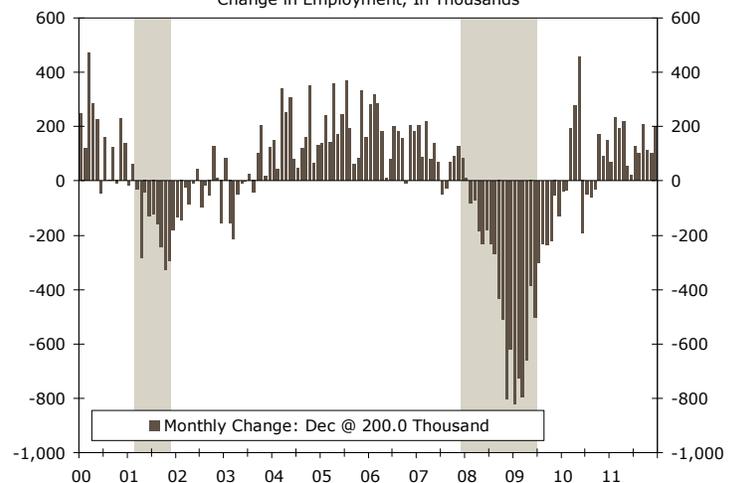
Nonfarm payrolls rose by 200,000 in December, which was better than the consensus estimate. The gains were broad-based with only two sectors showing declines (government and temporary jobs). Indeed, the private sector added 164,000 jobs in December. While the holiday shopping season likely skewed the headline to the upside (i.e., hiring of couriers adding 42,000 jobs), the trend will likely remain positive. Indeed, over the past three months, nonfarm employment increased by 137,000 jobs, which coincides with other forward-looking employment indicators. Regional manufacturing surveys, such as the Philadelphia Fed manufacturing index, the Empire State Manufacturing Survey and the Richmond manufacturing index, all showed improvement in the employment component for January. Moreover, the trend in initial jobless claims illustrated by the four-week moving average has remained below the threshold of 400,000 since early November.

**Previous: 200K**

**Wells Fargo: 125K**

**Consensus: 150K**

Nonfarm Employment Change  
Change in Employment, In Thousands



## Global Review

### U.K. GDP Growth Turned Negative Again in Q4

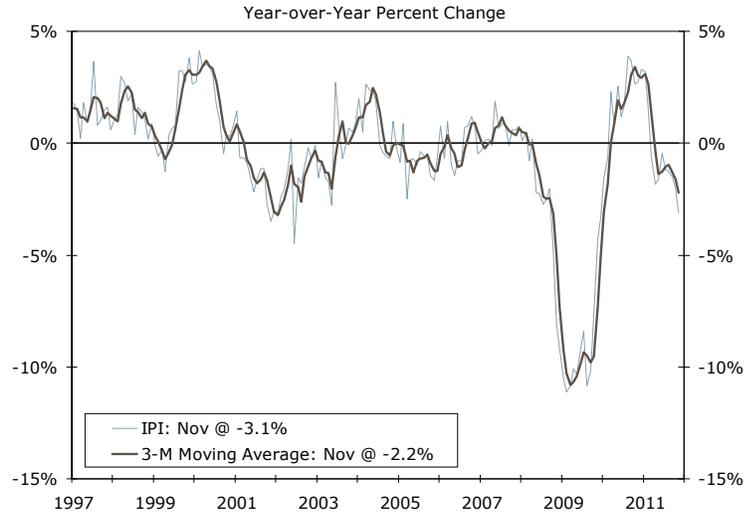
Data released this week showed that real GDP in the United Kingdom declined 0.2 percent (0.8 percent at an annualized rate) in the fourth quarter, marking the third time in the past five quarters that the British economy has contracted (see graph on the front page). The paltry 0.7 percent year-over-year growth rate shows just how weak the British economy is at present. A decomposition of real GDP into its underlying demand-side components will not be available until late February. However, the combination of the sectoral breakdown by industry in conjunction with some monthly data shows where the weakness within the British economy is concentrated at present and provides some insights into its near-term trajectory.

Output in the service sector was reported to have been flat during the fourth quarter, but the construction sector contracted 0.5 percent (not annualized) and manufacturing production dropped 0.9 percent (top chart). Monthly data on trade volumes indicate that exports rose modestly in the fourth quarter and real retail sales grew 0.9 percent during the last three months of the year. So, if both exports and consumer spending rose during the quarter, then why did manufacturing production decline? Business fixed-investment spending certainly could have softened, which would have caused suppliers of capital goods to have reduced production. We suspect, however, that producers generally cut back output over the past few months due to uncertainties regarding the economic outlook.

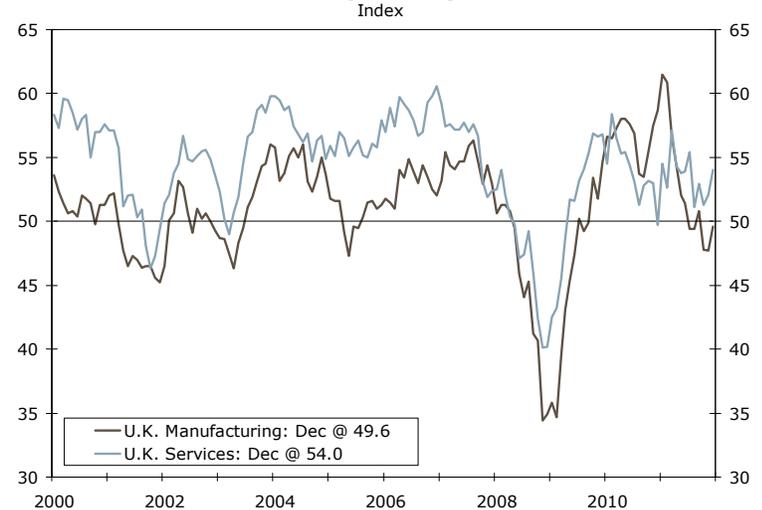
### Will GDP Decline Again in Q1?

If output was cut back while most areas of spending continued to grow, then inventories may have declined sharply in the fourth quarter. If so, some rebound in manufacturing production and GDP could occur in the current quarter as stocks are replenished. Indeed, both the manufacturing and service sector PMIs rose in December (middle chart), and survey data suggest that the manufacturing sector has strengthened a bit further in January. We forecast that real GDP in the United Kingdom will grow, albeit slowly, in the first quarter and, consequently, the British economy will narrowly escape a “technical” recession (i.e., two consecutive quarters of negative GDP growth). That said, the outlook for the British economy is hardly rosy. Our forecast calls for real GDP to rise only 1 percent in 2012 and less than 2 percent in 2013 as fiscal consolidation will continue to exert headwinds on GDP growth. In addition, the combination of elevated inflation—consumer prices rose more than 4 percent in 2011—and sluggish wage growth means that purchasing power has been squeezed. Consequently, growth in consumer spending will likely be anemic, and it is difficult to envision significant strength in exports with the Eurozone—to which the United Kingdom sends one-half of its exports—in a recession. The Bank of England governor, Mervyn King, recently acknowledged that growth in 2012 will probably be rather sluggish. With the bank’s policy rate about as low as it can go, we look for the bank to increase the size of its asset purchase program, perhaps as soon as next month, to help support the sluggish economy.

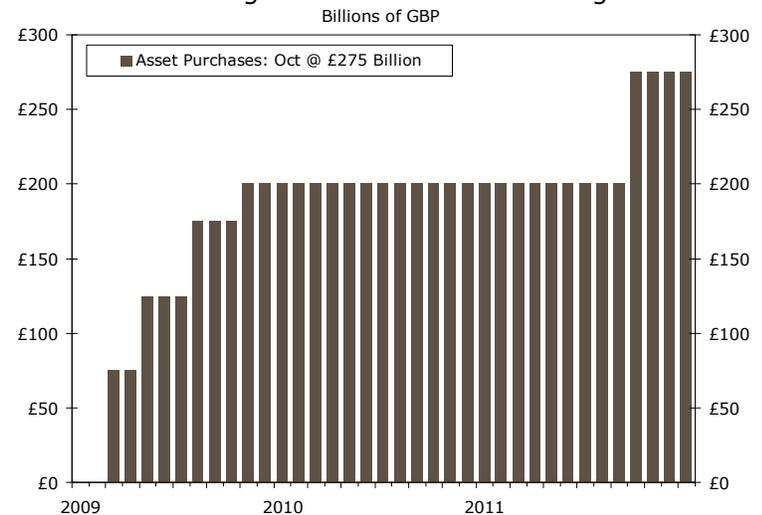
### U.K. Industrial Production Index



### U.K. Purchasing Managers' Indices



### Bank of England's Asset Purchase Program



## Japanese Industrial Production • Monday

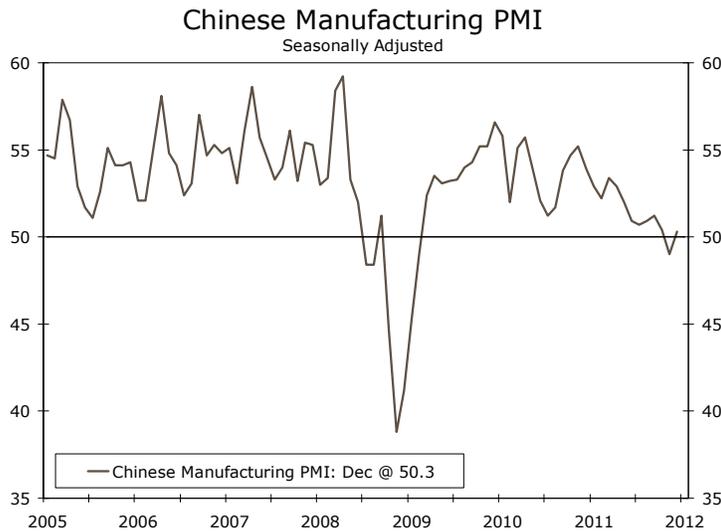
Industrial production plunged back in March 2011, as huge chunks of the island nation's manufacturing capacity went offline in the wake of the devastating earthquake and tsunami that struck that month.

The subsequent supply chain disruptions that originated in Japan had ripple effects not just in Japan but all over the world as foreign factories lacked the Japanese-made input components to complete a project further along in the production process. This was particularly true for autos, where the lack of inventory was manifested by empty dealer lots in the United States for some Japanese brands.

Output has been choppy in subsequent months, reflecting an uncertain outlook for global growth. We get data for December Japanese industrial production on Tuesday.

**Previous: -2.7%**

**Consensus: 2.9% (Month-over-Month)**



## Canadian Jobs • Friday

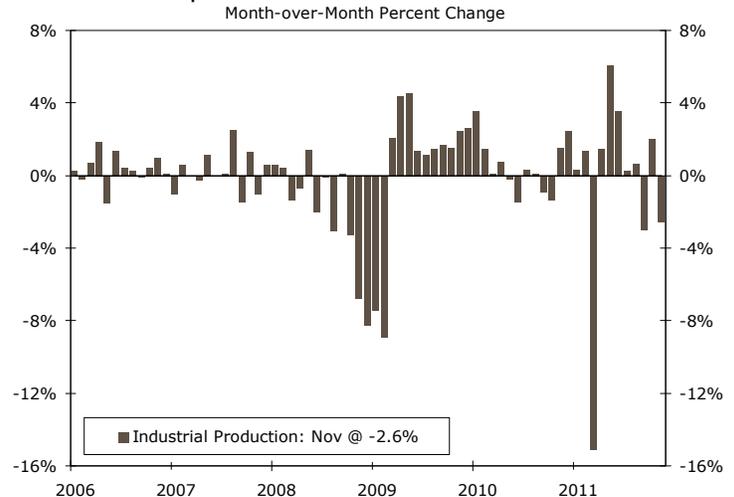
The job market in Canada has long-since recovered all the jobs lost in the recession. By that measure, the Canadian job market is in much better shape than the U.S. job market, which remains years away from a return to prerecession employment levels. That said, the U.S. economy has been putting up better-than-expected job gains in recent months, and both jobless claims and the unemployment rate are both trending lower. Over the same period, the job market in Canada seems to be experiencing growing pains. Payrolls there have fallen three of the past five months, and the unemployment rate has been rising since September.

As Canada's No. 1 export market, a stronger U.S. economy is generally supportive to Canadian jobs. We will see if recent improvement in U.S. prospects can turn around the Canadian jobs market when that report hits the wire Friday morning.

**Previous: 17.5K**

**Consensus: 24.5K**

## Japanese Industrial Production



## Chinese PMI • Tuesday

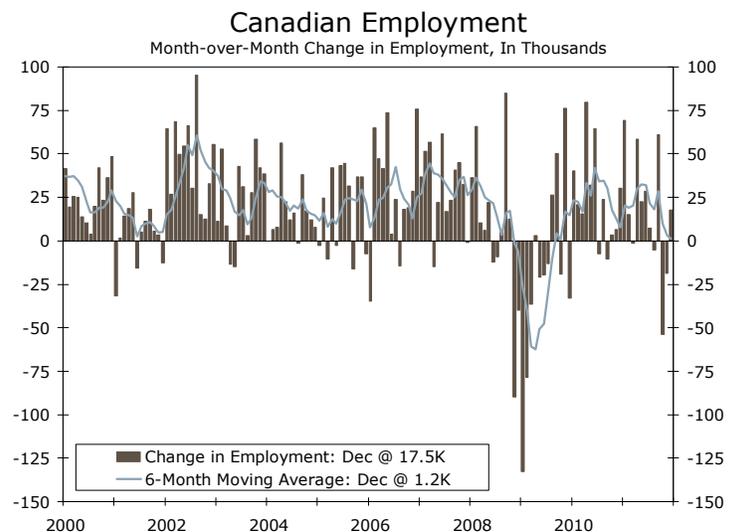
The International Monetary Fund (IMF) made waves earlier this week when it downgraded its forecast for global GDP growth to 3.3 percent in 2012 and 3.9 percent in 2013. That compares to September forecasts of 4 percent in 2012 and 4.5 percent in 2013.

Most of the IMF concern is in Europe, but the IMF is worried about slowing growth in China as well. The full-year forecasts for Chinese GDP were revised down for both 2012 and 2013. Chinese business sentiment has been deteriorating on trend for the past couple of years. Indeed, Chinese PMI slipped below 50 in November before climbing back above breakeven in December.

We will get a sense of how Chinese sentiment is shaping up in 2012 when Chinese PMI prints on Wednesday of next week.

**Previous: 50.3**

**Consensus: 49.6**



**Interest Rate Watch**

**FOMC and GDP: Low Rates Stay**

This weeks messages from both the FOMC (Federal Open Market Committee) and Friday’s GDP release were that interest rates will remain low—the positive—but that there will be no near-term exit for debtors—public and private—from their deleveraging and rationalizing of spending.

The FOMC indicated that current easy monetary policy will remain in place through 2014. Although, by examining the preferences of individual members, it was also clear that some preferred to raise rates earlier—some preferred much earlier. In addition, the FOMC stated its inflation expectation for the long run to be 2 percent for the overall, not core, PCE deflator.

Meanwhile, the real GDP data released Friday showed growth at 2.8 percent in the fourth quarter and 1.6 percent over the year-earlier period. The PCE deflator came in at 0.7 percent for the quarter but 2.6 percent year over year. Our expectation is that this year-over-year rate will moderate going forward.

**Net Result: Low Rates—but Credit and Earnings?**

While the upshot of these two bits of news would appear positive for the case for lower rates, the pace of growth does raise questions on the assumed pace of earnings that underlie asset valuations for private and public sector debt. As a result, we may see wider yield spreads compared to benchmark Treasuries despite continued low interest rates in general.

At 2 percent growth for the national economy, many state and local governments will continue to face revenue gains that will not provide an easy out of current fiscal problems. Revenues growing, but the pace of such growth will not be enough to avoid further spending cuts. Nor does the pace of growth suggest that the federal government can grow its way toward fiscal rectitude.

Finally, private debt, both corporate and household, will continue to be a burden for some, as gains in earnings and incomes will not be sufficient to dig out of the debt loads taken up in the past. Modest growth is a mixed blessing in the debt markets.

**Credit Market Insights**

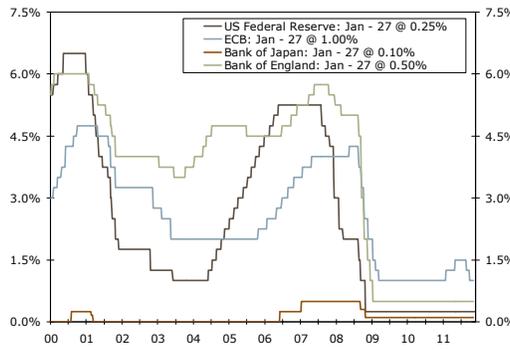
**Consumers Stay Picky, Credit Suffers**

While we have seen some strengthening of the U.S. credit market, economic activity is still preventing this market from helping to smooth out personal consumption expenditures. This was clear with the release of fourth quarter GDP, which showed a consumer sector that was very picky when buying goods and services during the last quarter of the year. The surprising fourth quarter results for Apple underscores our point, in that, consumers did not have any problem purchasing highly sought after goods, but at the same time were very weary to go on a buying spree during the holiday season.

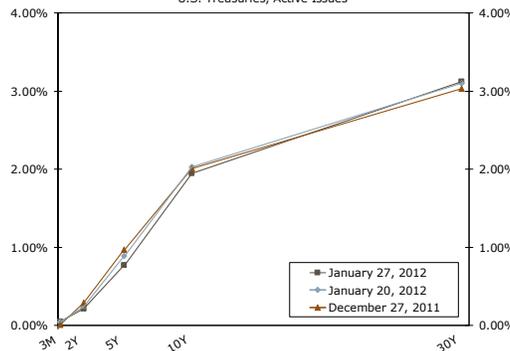
It is true that consumer credit was very strong in November 2011, growing by \$20.4 billion, the highest monthly increase since November 2001. However, with the results of personal consumption expenditures for the last quarter of the year, our expectation is for consumer credit to have weakened again in December to reflect the weak performance of consumption during the quarter.

Up until November 2011 consumer credit represented 21.4 percent of personal disposable income, down from the peak of 24 percent before the crisis and still high compared to a historical average of approximately 18 percent. Thus, we still expect the credit market to remain under pressure for years to come as consumers continue to deleverage.

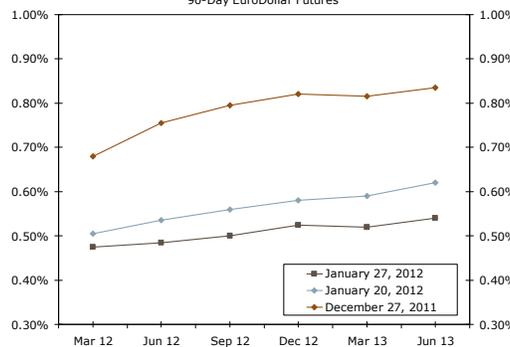
Central Bank Policy Rates



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	3.98%	3.88%	3.95%	4.27%
15-Yr Fixed	3.24%	3.17%	3.24%	3.72%
5/1 ARM	2.85%	2.82%	2.88%	3.47%
1-Yr ARM	2.74%	2.74%	2.78%	3.40%
<b>MBA Applications</b>				
Composite	775.6	816.1	661.4	441.8
Purchase	184.8	195.4	181.4	172.3
Refinance	4,265.3	4,500.6	3,535.0	2,025.2

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

## Topic of the Week

### The FOMC's Economic Projections: Downshift

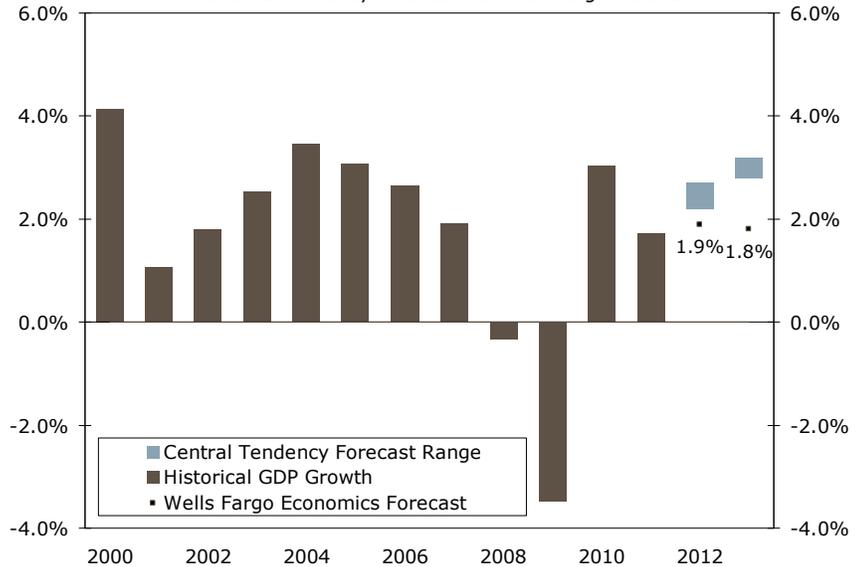
Earlier this week, the Federal Open Market Committee (FOMC) released its most recent economic projections. Compared to the committee's previous release in early November, the committee downshifted its expectations for growth in 2012 to 2.2–2.7 percent from 2.5–2.9 percent. These changes reflect the committee's outlook for only "modest" growth in the coming quarters. Indeed, despite some recent improvement, the U.S. economy still faces a number of challenges in the year ahead, including weaker consumer spending growth, slower global growth and a still-unresolved debt crisis in Europe. We forecast GDP growth of 1.9 percent in 2012.

In its outlook for the unemployment rate, one side of the FOMC's dual mandate, the committee expected the unemployment rate to decline more steeply in 2012 and 2013 compared to previous projections. This likely reflects some recent improvement in the labor market, such as the decline in jobless claims and the sharp drop in the unemployment rate over the past two months. That said, unemployment through 2014 is still expected to remain significantly higher than rates the committee deems appropriate in the longer run (5.2–6.0 percent). Furthermore, with labor-force participation at a 25-year low, "maximum employment" likely remains outside the forecast horizon.

For the other half of the committee's dual mandate—price stability—members continued to project inflation at or below 2 percent through 2014. Notably, the long-run projection for inflation was changed to 2 percent, whereas previously the committee submitted a range of values. With inflation projected to remain under the committee's now-explicit 2 percent target over the next year (the central tendency ranges from 1.4–1.8 percent in 2012) and unemployment projected to run above long-term targets, an additional round of asset purchases certainly remains on the table. For more on this week's FOMC meeting, see *FOMC: Why the Recent Past Seldom Predicts the Future*.

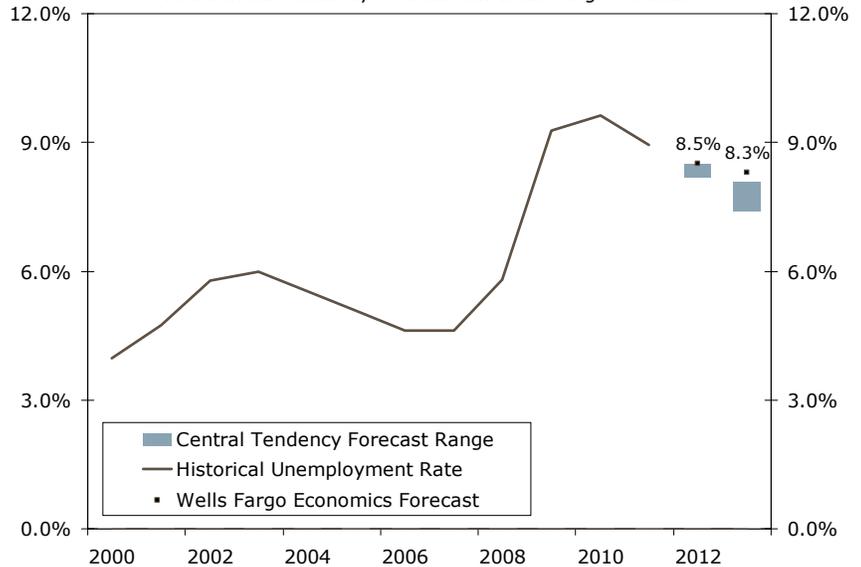
### Real GDP Growth Forecast

Fed Central Tendency Forecast vs. Wells Fargo Forecast



### Unemployment Forecast

Fed Central Tendency Forecast vs. Wells Fargo Forecast



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## Market Data ♦ Mid-Day Friday

## U.S. Interest Rates

	Friday 1/27/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.05	0.04	0.14
3-Month LIBOR	0.55	0.56	0.30
1-Year Treasury	0.13	0.14	0.23
2-Year Treasury	0.21	0.24	0.58
5-Year Treasury	0.77	0.89	1.98
10-Year Treasury	1.95	2.02	3.39
30-Year Treasury	3.12	3.10	4.57
Bond Buyer Index	3.68	3.60	5.25

## Foreign Exchange Rates

	Friday 1/27/2012	1 Week Ago	1 Year Ago
Euro (\$/€)	1.314	1.293	1.373
British Pound (\$/£)	1.570	1.558	1.593
British Pound (£/€)	0.837	0.830	0.862
Japanese Yen (¥/\$)	76.940	77.010	82.920
Canadian Dollar (C\$/\\$)	1.000	1.013	0.993
Swiss Franc (CHF/\$)	0.919	0.935	0.945
Australian Dollar (US\$/A\$)	1.067	1.048	0.992
Mexican Peso (MXN/\$)	12.934	13.181	12.037
Chinese Yuan (CNY/\$)	6.309	6.336	6.584
Indian Rupee (INR/\$)	49.316	50.335	45.565
Brazilian Real (BRL/\$)	1.740	1.755	1.676
U.S. Dollar Index	79.197	80.223	77.727

## Foreign Interest Rates

	Friday 1/27/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.07	1.13	1.00
3-Month Sterling LIBOR	1.08	1.09	0.78
3-Month Canadian LIBOR	1.38	1.38	1.22
3-Month Yen LIBOR	0.20	0.20	0.19
2-Year German	0.18	0.21	1.37
2-Year U.K.	0.37	0.41	1.28
2-Year Canadian	1.02	1.04	1.73
2-Year Japanese	0.13	0.13	0.20
10-Year German	1.86	1.93	3.21
10-Year U.K.	2.07	2.11	3.69
10-Year Canadian	2.04	2.06	3.28
10-Year Japanese	0.97	0.99	1.24

## Commodity Prices

	Friday 1/27/2012	1 Week Ago	1 Year Ago
WTI Crude (\$/Barrel)	99.93	98.46	85.64
Gold (\$/Ounce)	1722.45	1666.65	1313.93
Hot-Rolled Steel (\$/S.Ton)	730.00	733.00	790.00
Copper (¢/Pound)	391.75	374.50	433.85
Soybeans (\$/Bushel)	12.18	11.90	13.61
Natural Gas (\$/MMBTU)	2.62	2.34	4.32
Nickel (\$/Metric Ton)	21,535	20,148	26,469
CRB Spot Inds.	541.41	532.11	603.57

## Next Week's Economic Calendar

	Monday 30	Tuesday 31	Wednesday 1	Thursday 2	Friday 3
<b>U.S. Data</b>	<b>Personal Income</b> Nov ember 0.1% December 0.3% (W)	<b>Empl. Cost Index</b> 3Q 0.3% 4Q 0.5% (W)	<b>ISM Manufacturing</b> December 53.9 January 54.5 (W)	<b>Unit Labor Costs</b> 3Q -2.5% 4Q P 0.7% (W)	<b>Nonfarm Payrolls</b> December 200K January 125K (W)
	<b>Personal Spending</b> Nov ember 0.1% December 0.1% (W)	<b>Consumer Confidence</b> December 64.5 January 67.8 (W)	<b>Construction Spending</b> Nov ember 1.2% December 0.2% (W)	<b>Nonfarm Productivity</b> 3Q 2.3% 4Q P 0.8% (W)	<b>ISM Non-Mfg.</b> December 52.6 January 53.0 (W)
	<b>PCE Deflator (YoY)</b> Nov ember 2.5% December 2.4% (W)		<b>Total Vehicle Sales</b> December 13.48M January 13.63M (W)		<b>Factory Orders</b> Nov ember 1.8% December 1.2% (W)
<b>Global Data</b>	<b>Germany</b> <b>CPI (MoM)</b> Previous (Dec) 0.7%	<b>Brazil</b> <b>IP (YoY)</b> Previous (Nov) -2.5%	<b>Eurozone</b> <b>CPI (YoY)</b> Previous (Dec) 2.8%	<b>Canada</b> <b>Employment Change</b> Previous (Dec) 21.7K	
	<b>Japan</b> <b>IP (YoY)</b> Previous (Nov) -4.2%	<b>China</b> <b>PMI Manufacturing</b> Previous (Dec) 50.3	<b>U.K.</b> <b>Home Prices (MoM)</b> Previous (Dec) -0.2%	<b>Eurozone</b> <b>Retail Sales (MoM)</b> Previous (Nov) -0.8%	

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

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