

**WELLS
FARGO**

SECURITIES

Touch and Go Decisions in the Mid-Cycle Expansion

Philadelphia Council for Business Economics

John E. Silvia, Chief Economist

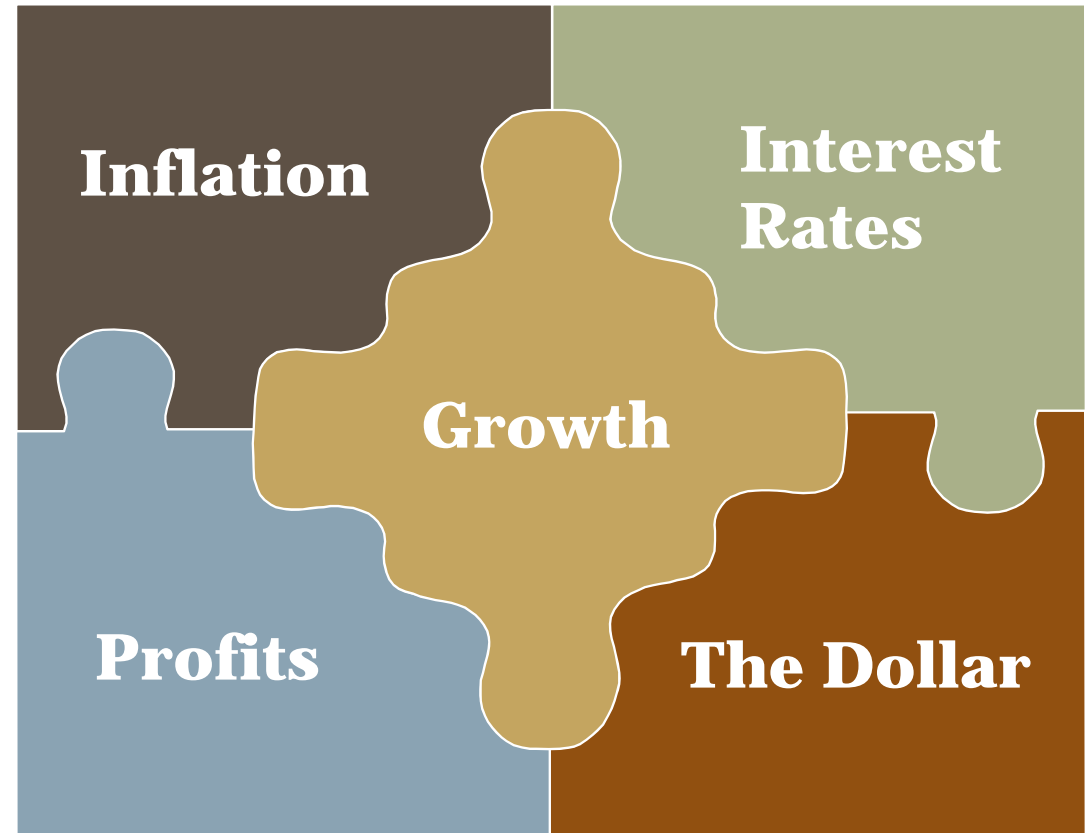
June 4, 2014

Together we'll go far



Where Are We Now?

Five benchmarks for good
decision making



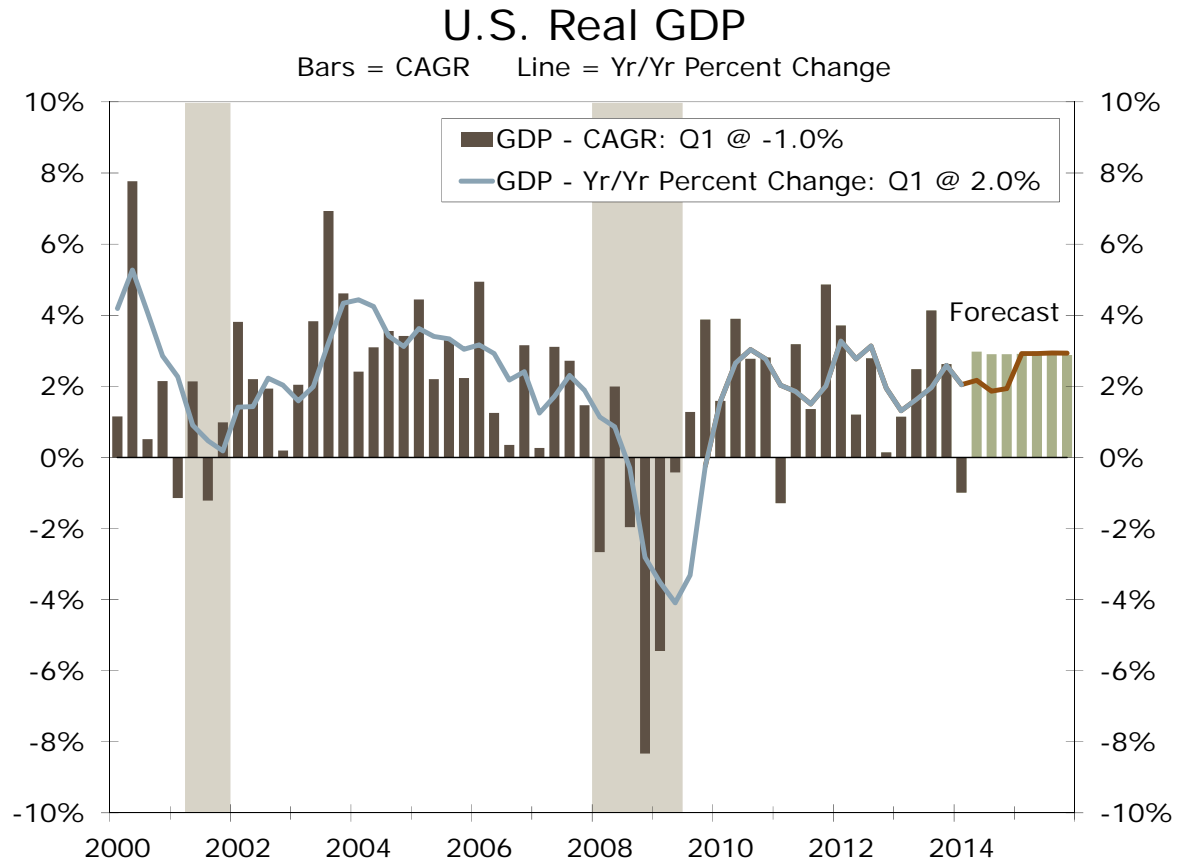
How do we differ from
consensus?

Expectations for the Future

- Sustained-trend plus growth
- Employment—cyclical and structural change
- Still cautious on consumer segments
- Housing improving—multifamily especially
- State and local governments—still restructuring
- Unsustainable long-run fiscal policy
- Europe exits recession
- China growth stable at 7 percent plus

What We Get Versus What We Expect

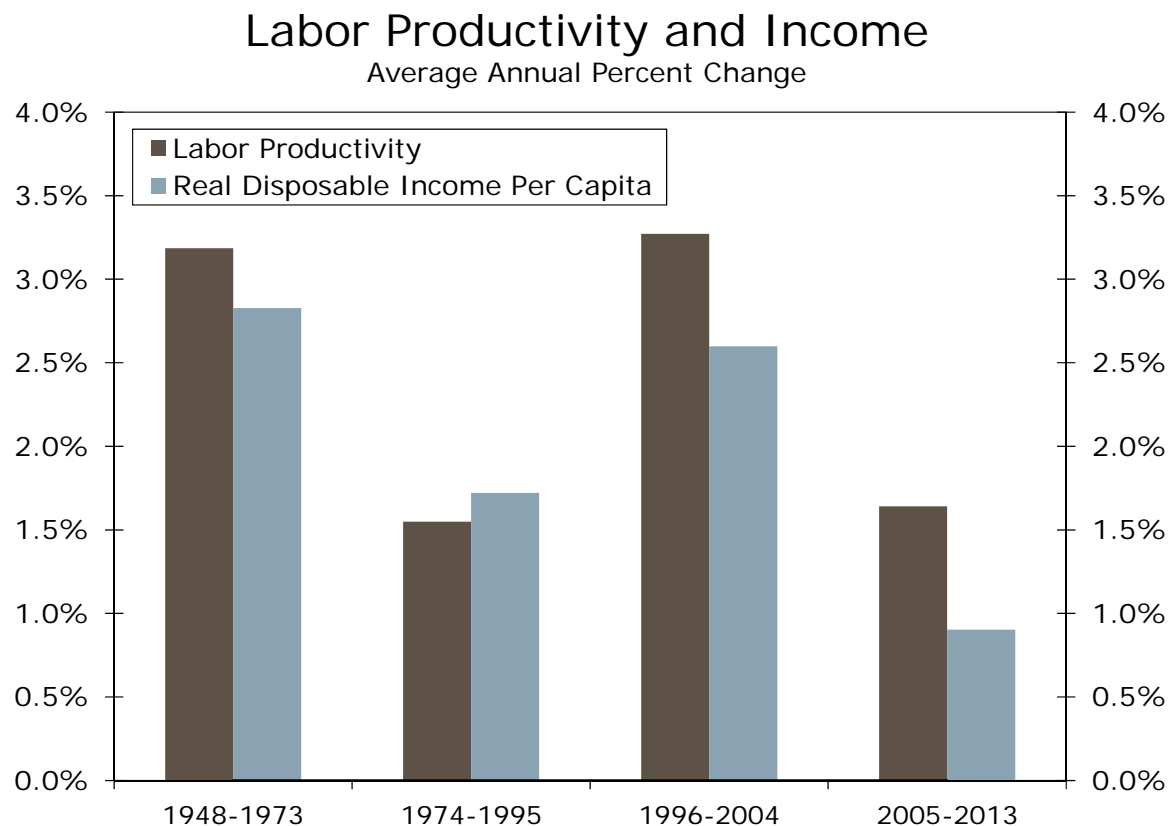
Sustained recovery in 2014 at 2.8 percent, but near historical experience—benchmark 2.75 percent is trend from 1982-2012



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

Decision I – Is acceleration between 2H 2014 and 1H 2015 one-off or trend?

If labor productivity growth remains weak, the paltry pace of real income growth that the country has experienced in recent years seems set to continue



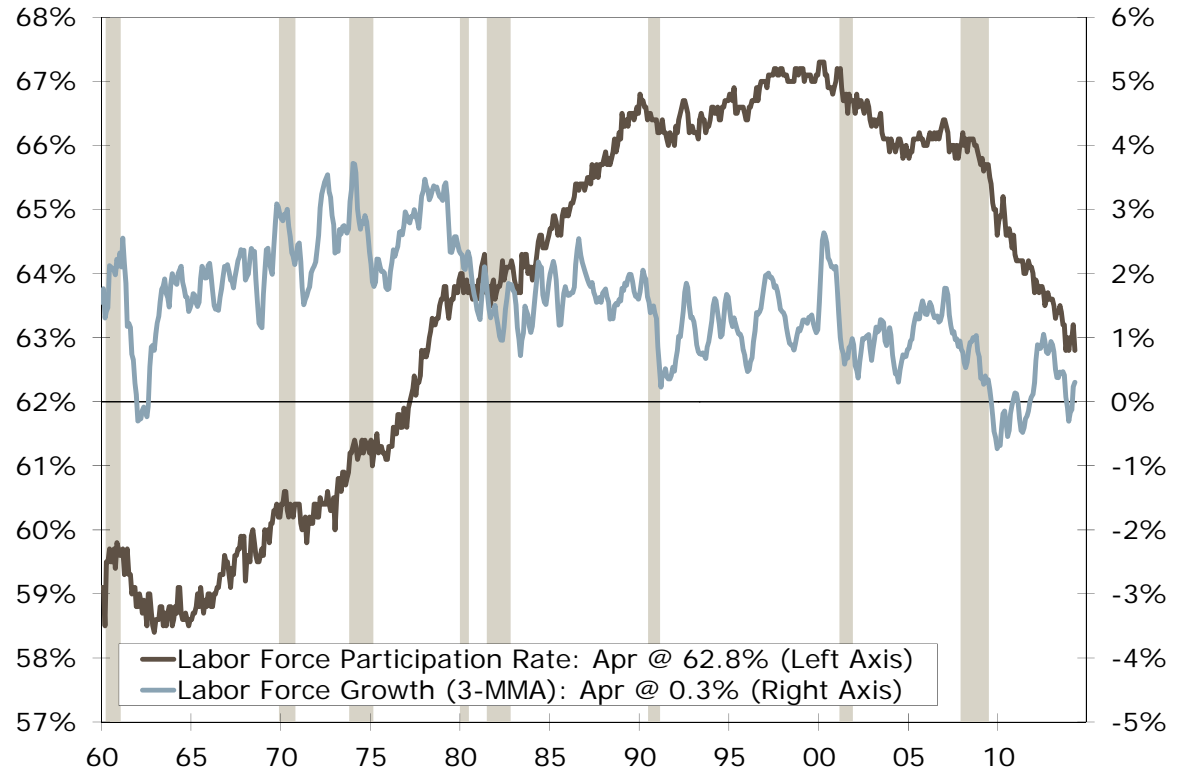
Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities, LLC

Labor Force Participation

Labor force growth has slowed as the participation rate has come down

Labor Force Growth vs. Participation Rate

16 Years and Over, SA, Year-over-Year Percent Change

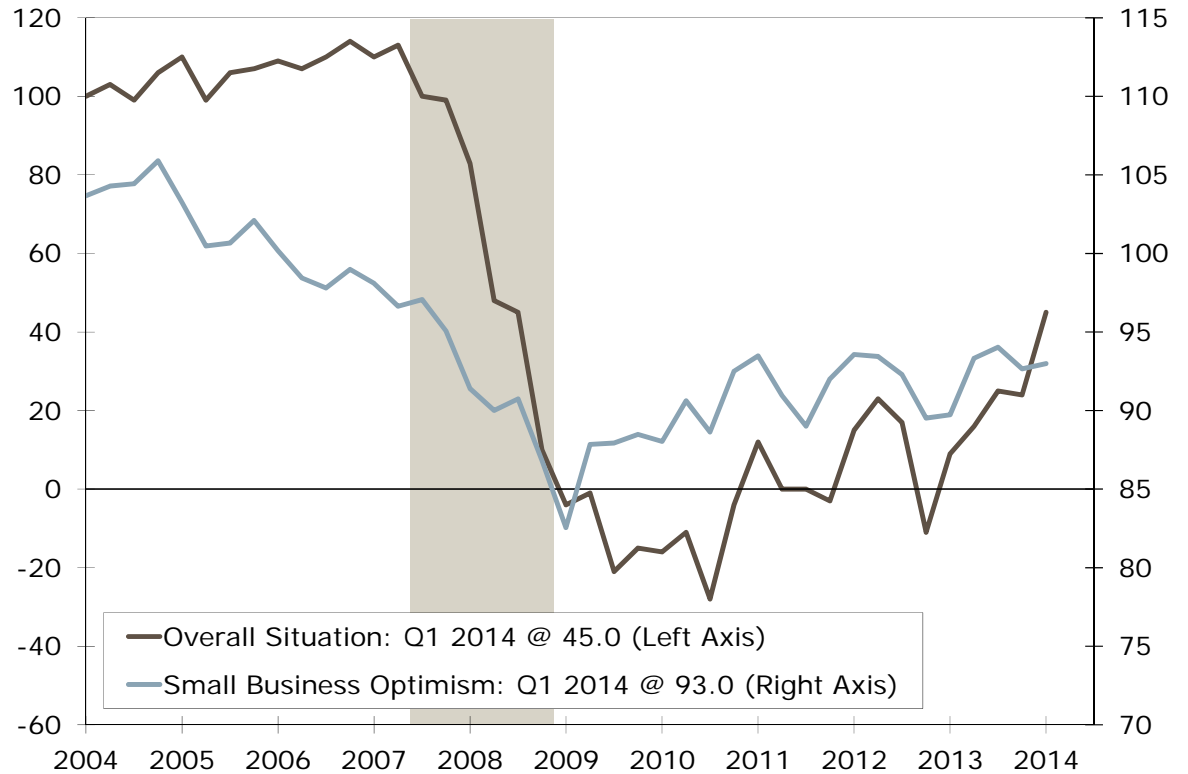


Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Small Businesses:
A full recovery in small business
optimism is still distant, taxes
and regulation the two big issues

Wells Fargo Small Business Survey & NFIB

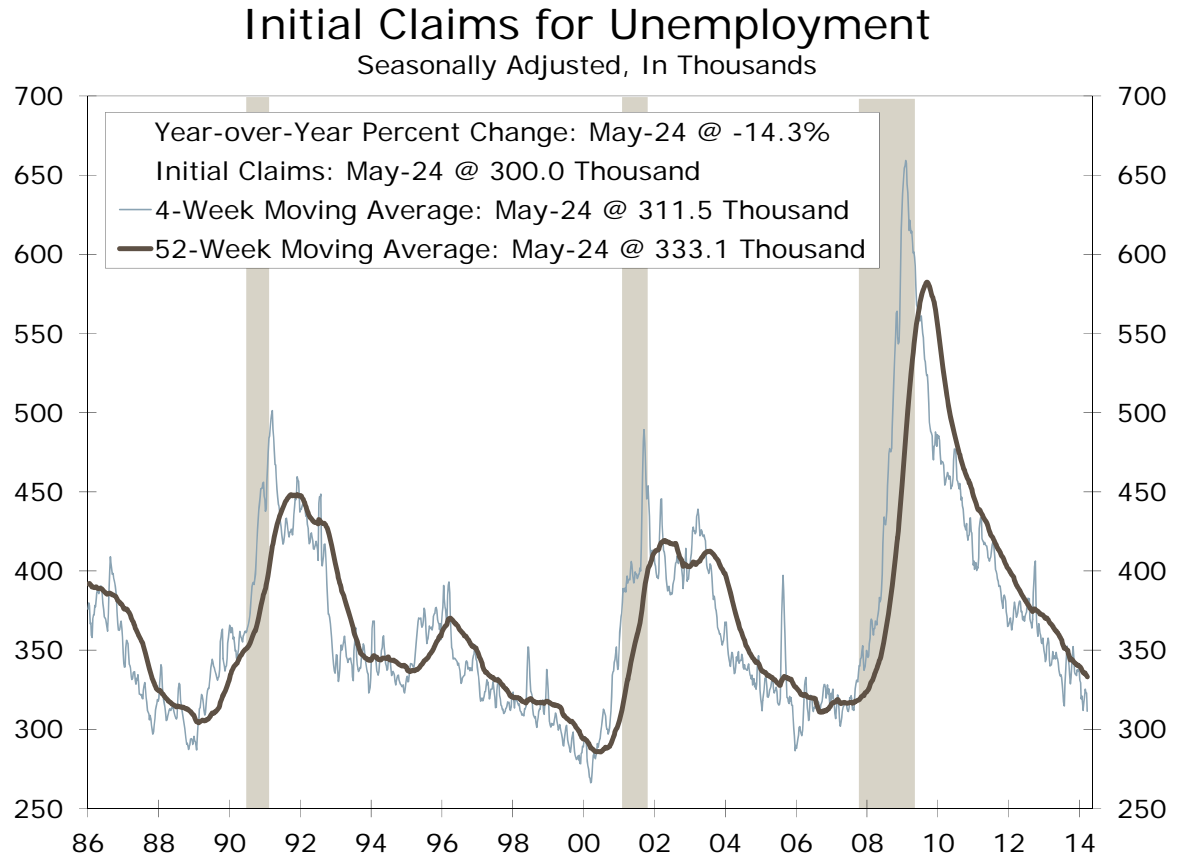
Overall Situation, NFIB Small Business Optimism 1986=100



Source: National Federation of Independent Businesses, Gallup, Wells Fargo Bank and Wells Fargo Securities, LLC

Initial Unemployment Claims: Cyclical

Signaling continued, moderate job gains ahead

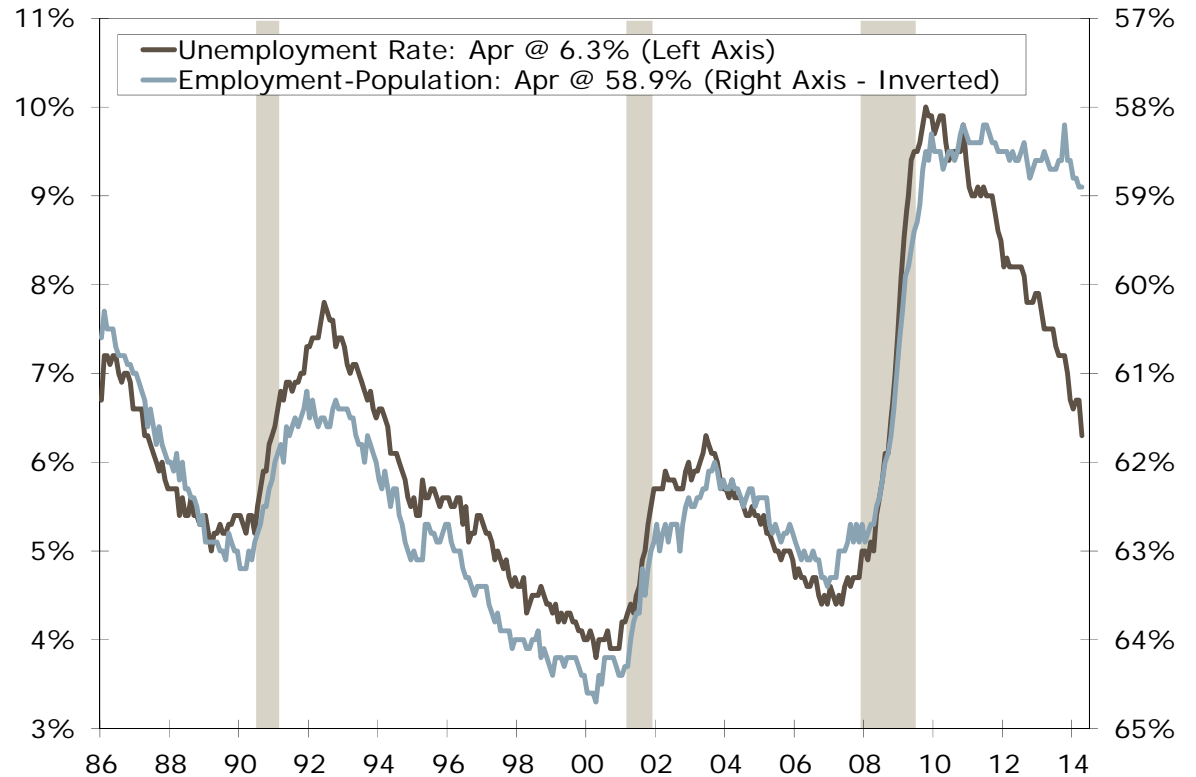


Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Employment: Structural

Structural Change:
A much lower base to support
growth and spending, especially
for entitlements

Unemployment vs. Employment-Population Ratio 16 Years and Over, Seasonally Adjusted



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

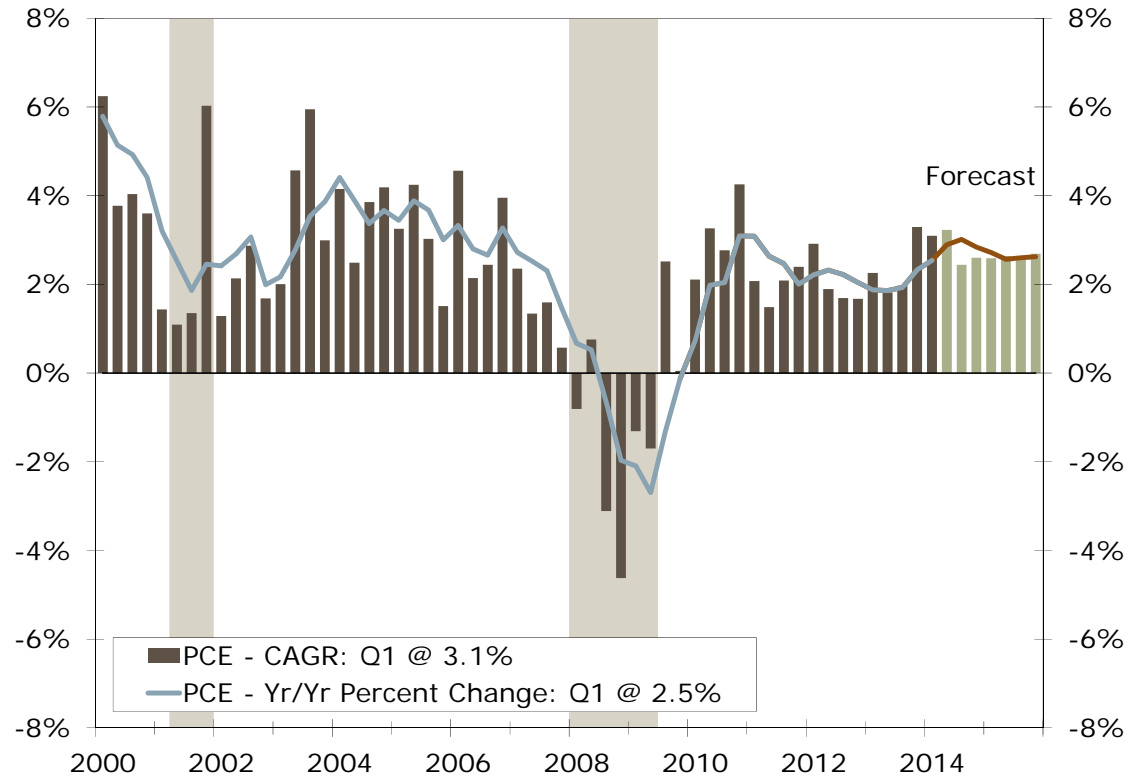
Decision II – Will middle income consumers recover?

Consumer Spending

Subpar recovery suggests slower consumer spending and lower state sales tax revenues compared to the past

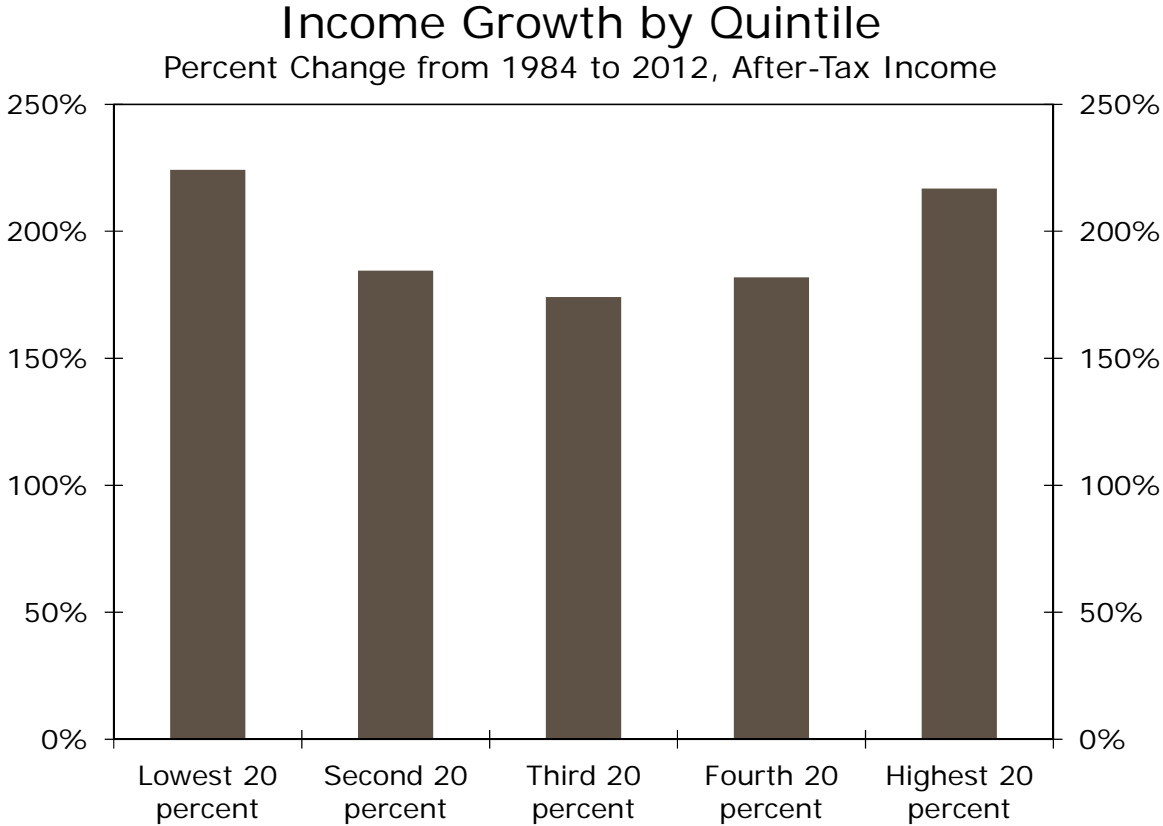
Real Personal Consumption Expenditures

Bars = CAGR Line = Yr/Yr Percent Change



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

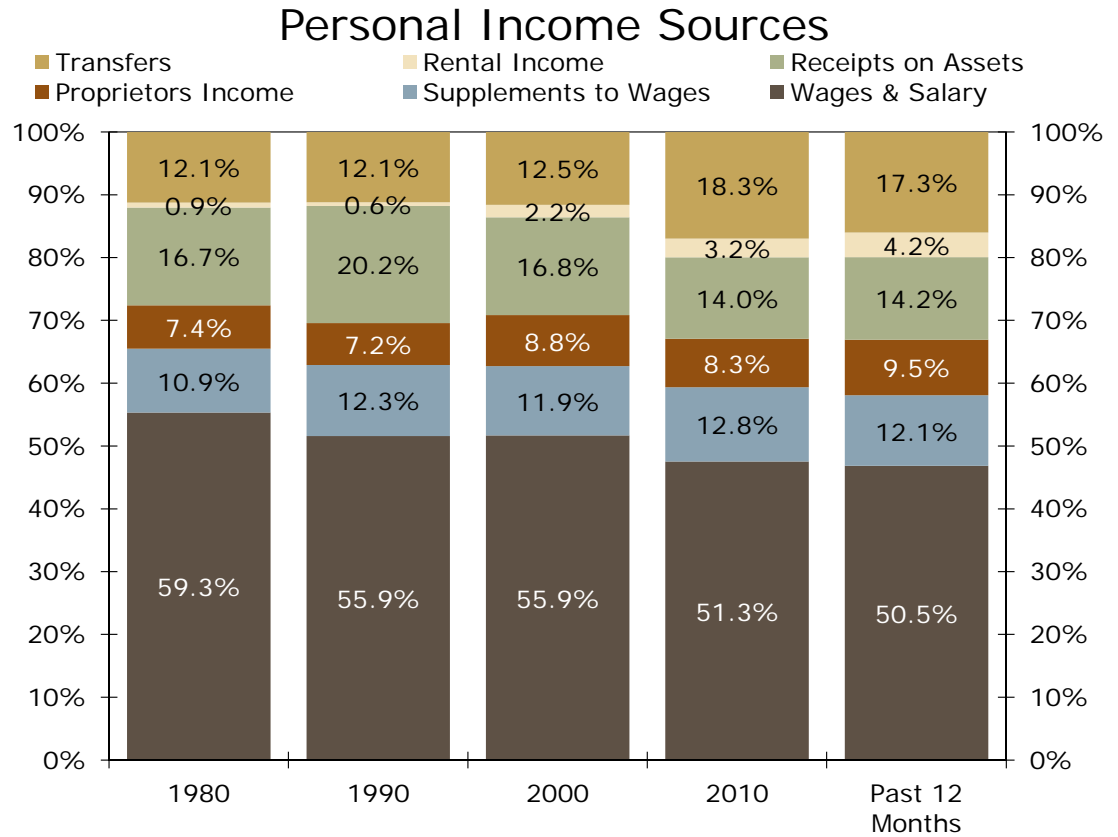
After-tax nominal income has increased the most for the lowest and highest income households since the mid-1980s



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

Personal Income

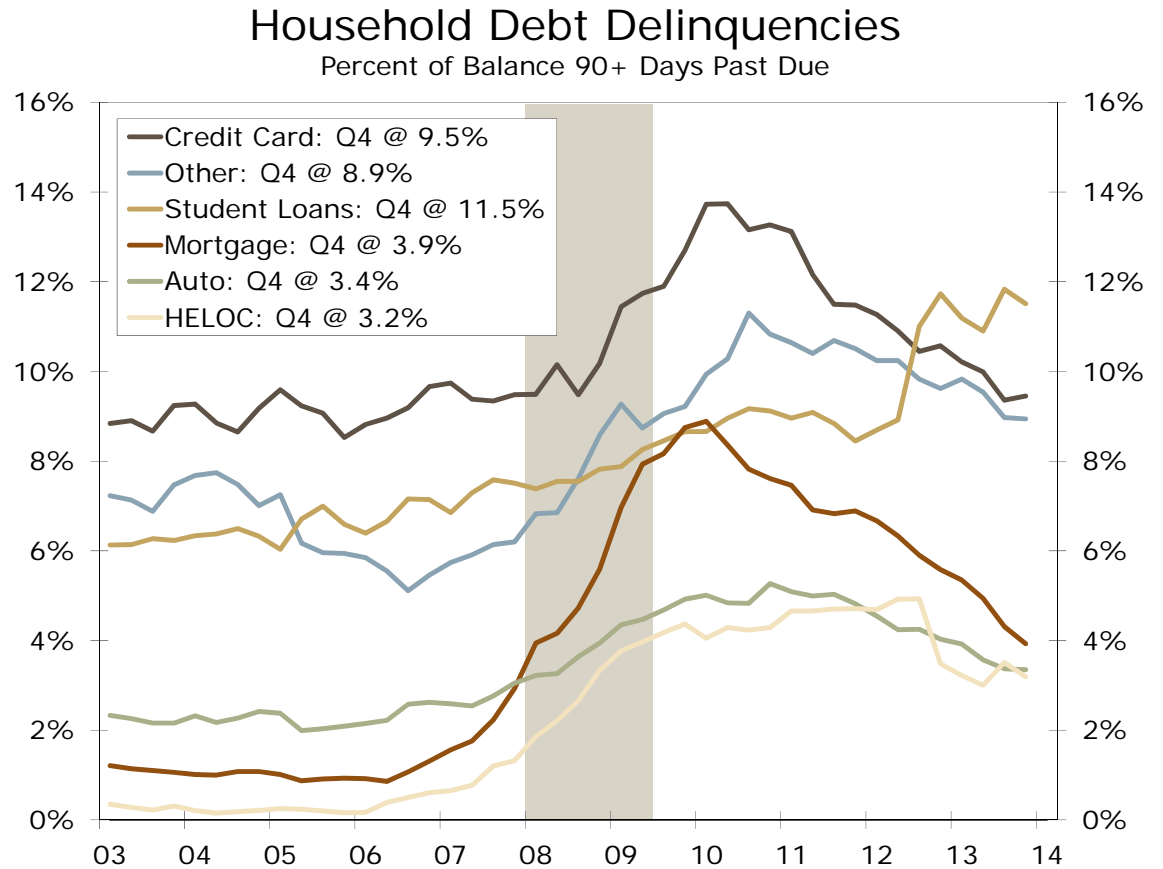
Wages and salaries make up about half of personal income as transfer payments make up a greater share of income over time



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

Household Debt Delinquencies

Tighter credit standards and a strengthening economy have helped to improve the credit position of households over the past 3 years



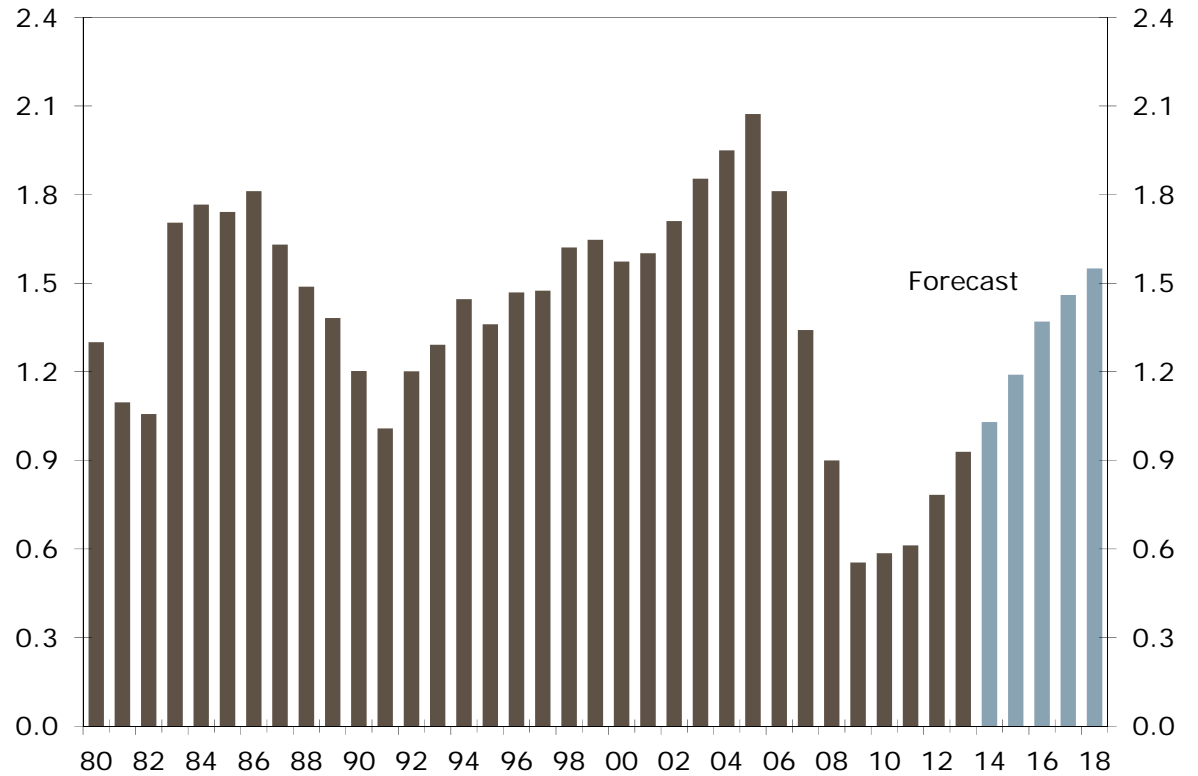
Source: Federal Reserve Bank of New York and Wells Fargo Securities, LLC

Decision III – Will housing model return to old form?

Continued improvement ahead

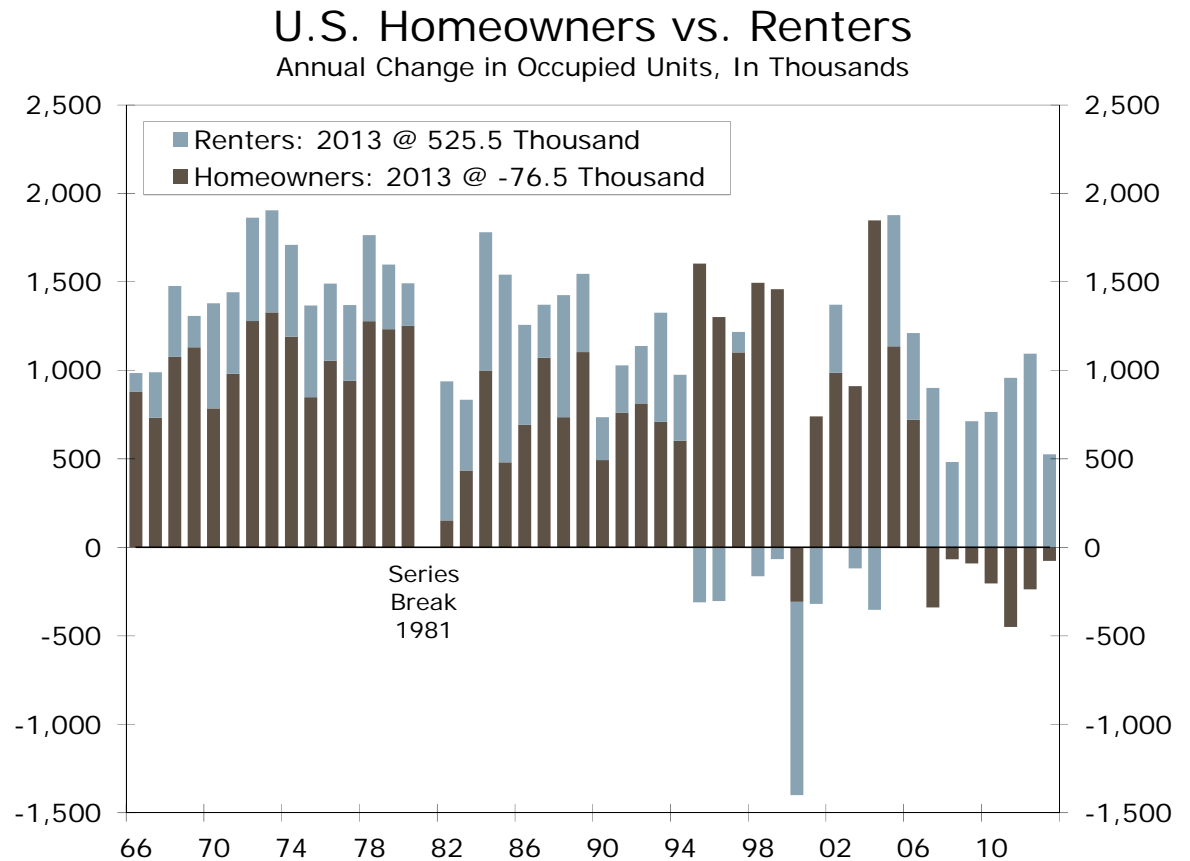
U.S. Housing Starts

Millions of Units



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

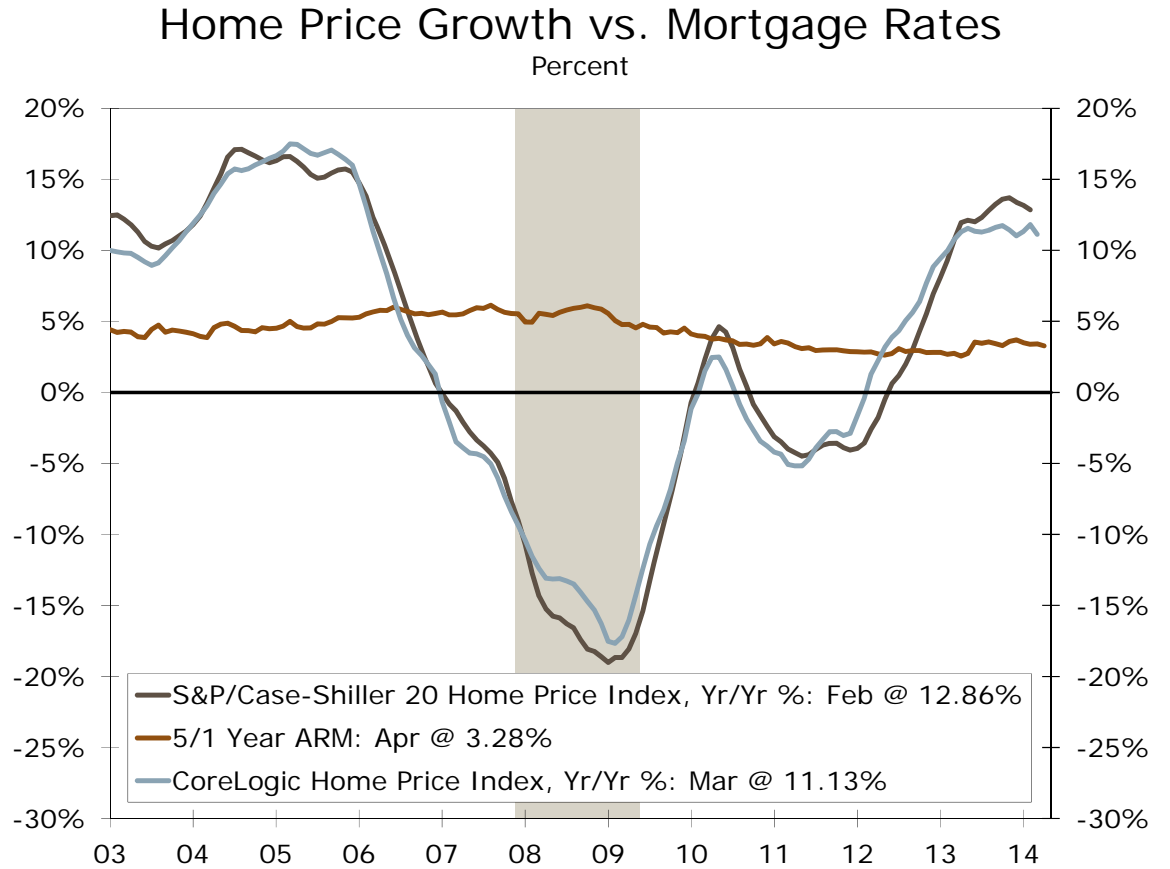
The number of renters has been accelerating steadily since 2007, while homeowners have been declining



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

Home Prices

Home prices are rising faster than mortgage interest rates

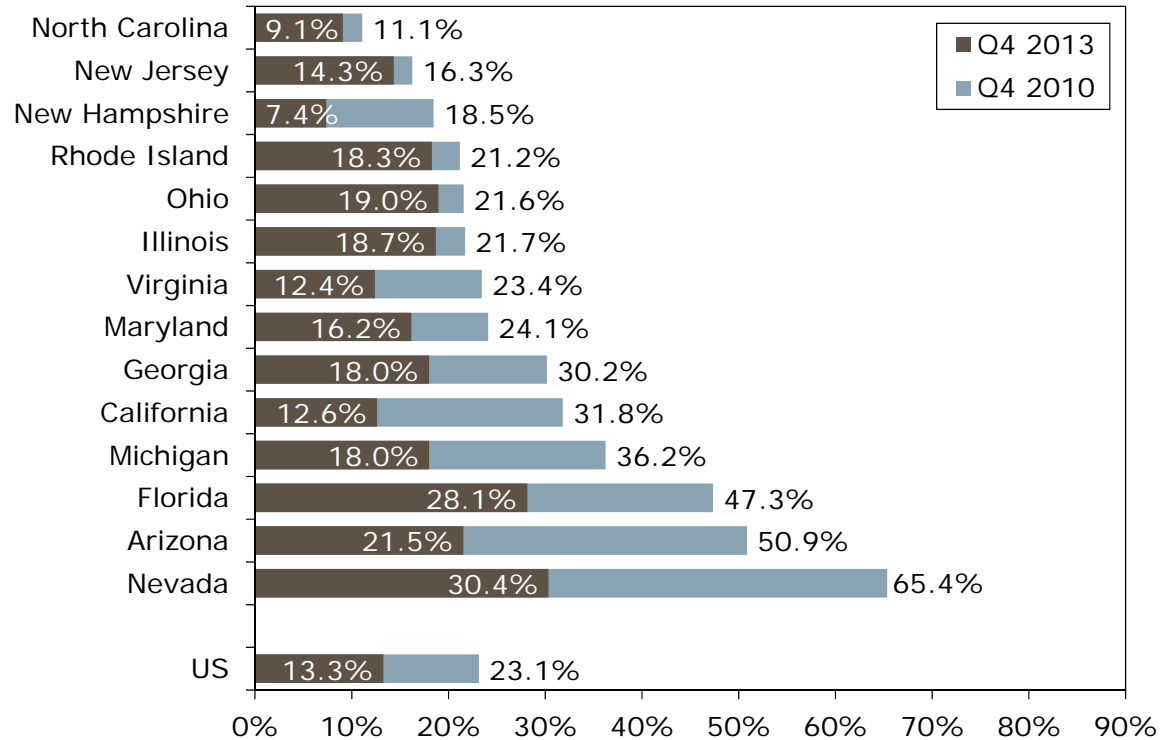


Source: S&P/Case-Shiller, CoreLogic, Bloomberg LP and Wells Fargo Securities, LLC

Negative equity in homes has contributed to foreclosures and reduced labor mobility, but much improvement has been seen since 3 years ago

Negative Equity by State

Percent of Mortgages Outstanding

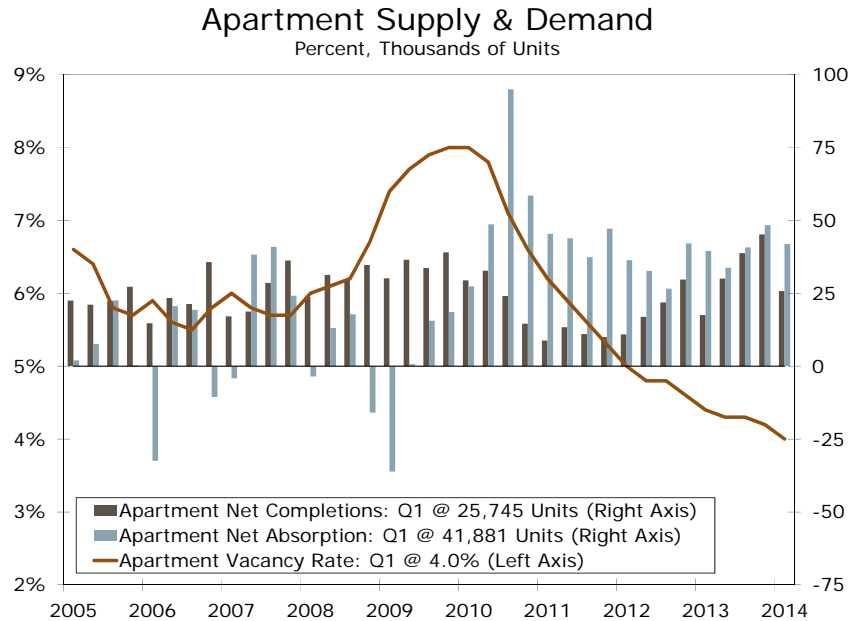


Source: CoreLogic and Wells Fargo Securities, LLC

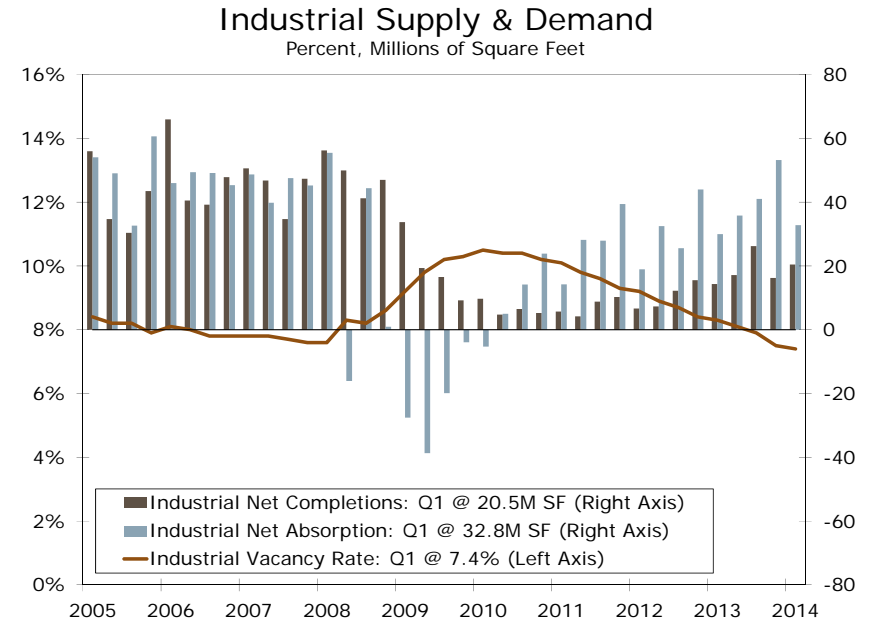
Decision IV – How long will CRE divergence persist?

Apartments have seen the greatest improvement in operating fundamentals but are also seeing intense new development. The industrial market has also improved quite significantly.

Apartment Supply & Demand



Industrial Supply & Demand



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

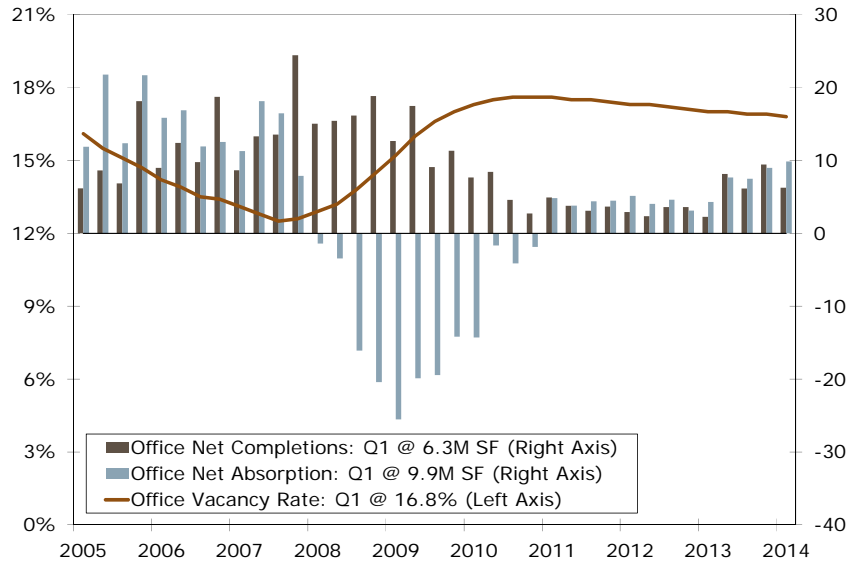
Commercial Real Estate

Office and retail commercial real estate have not seen the same type of improvement as apartments and industrial space, as vacancy rates remain somewhat elevated.

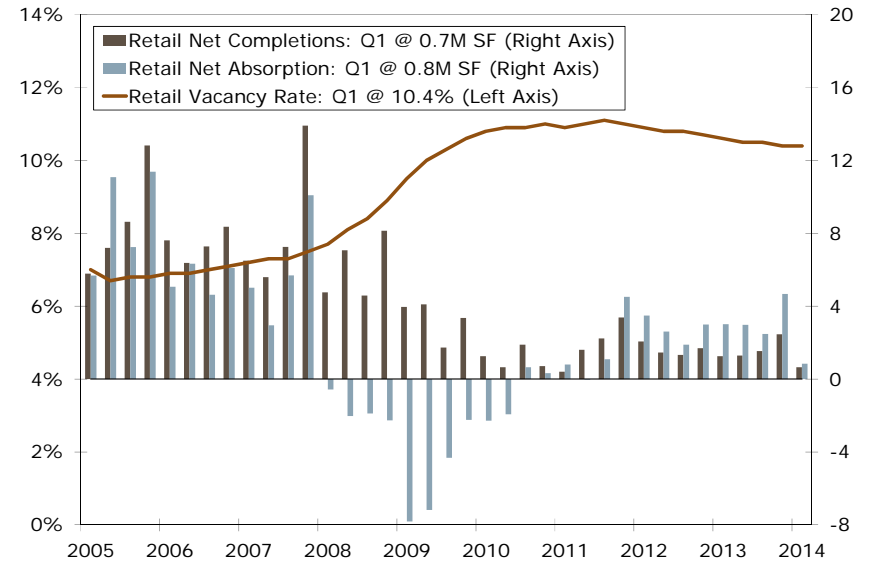
Apartment Supply & Demand

Industrial Supply & Demand

Office Supply & Demand
Percent, Millions of Square Feet



Retail Supply & Demand
Percent, Millions of Square Feet



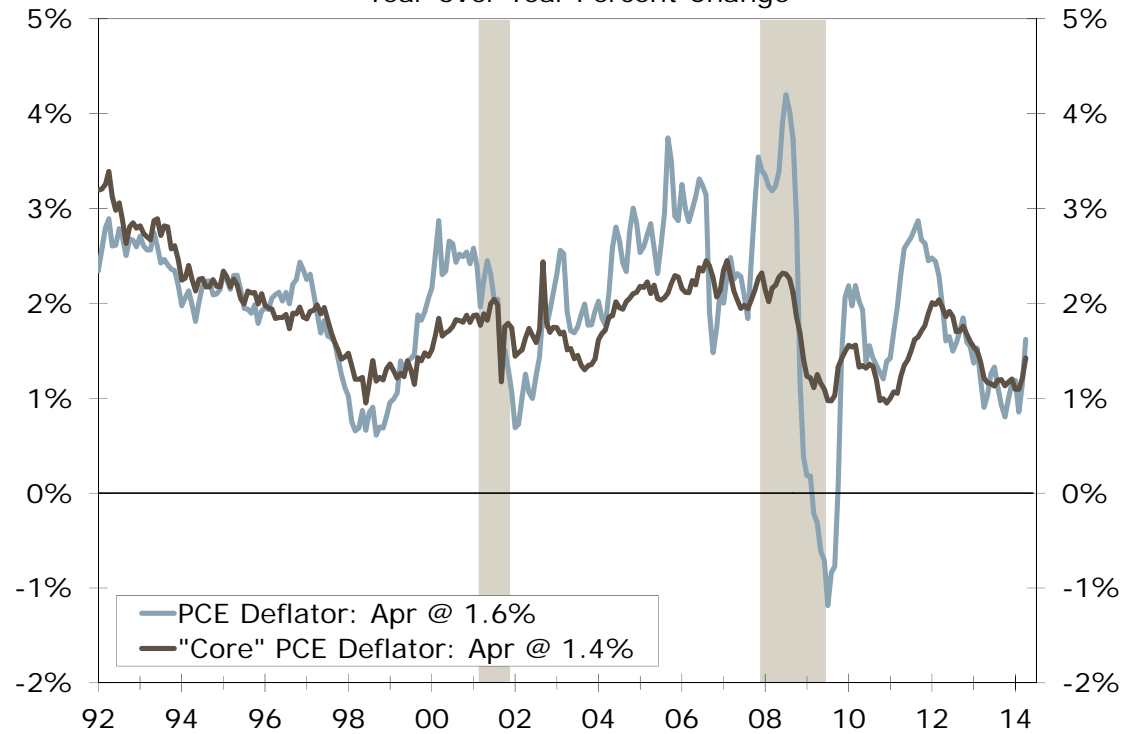
Source: Reis, Inc., PPR, U.S. Department of Commerce and Wells Fargo Securities, LLC

Decision V – How much will inflation rebound?

Inflation remains contained and does not currently pose a threat to easy monetary policy

PCE Deflator vs. Core PCE Deflator

Year-over-Year Percent Change

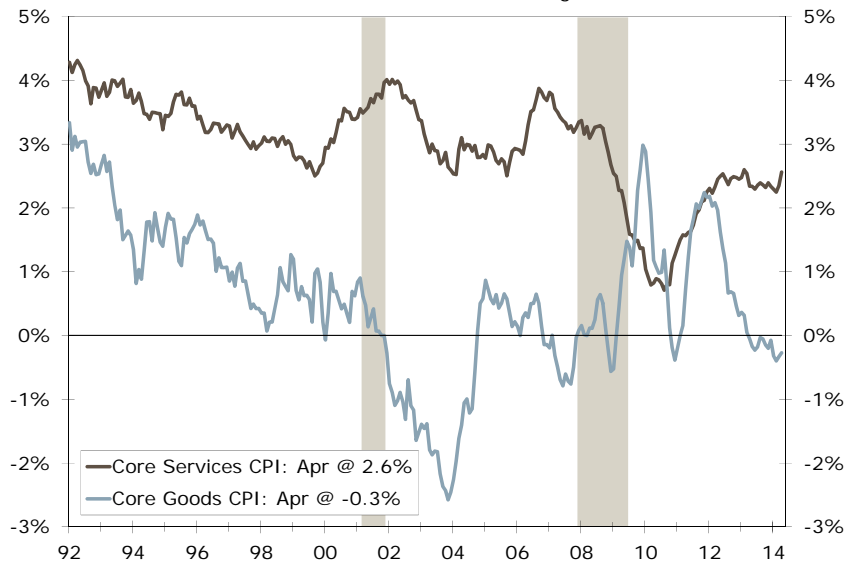


Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Services continue to underpin overall inflation, led by rising shelter costs as the housing market has recovered

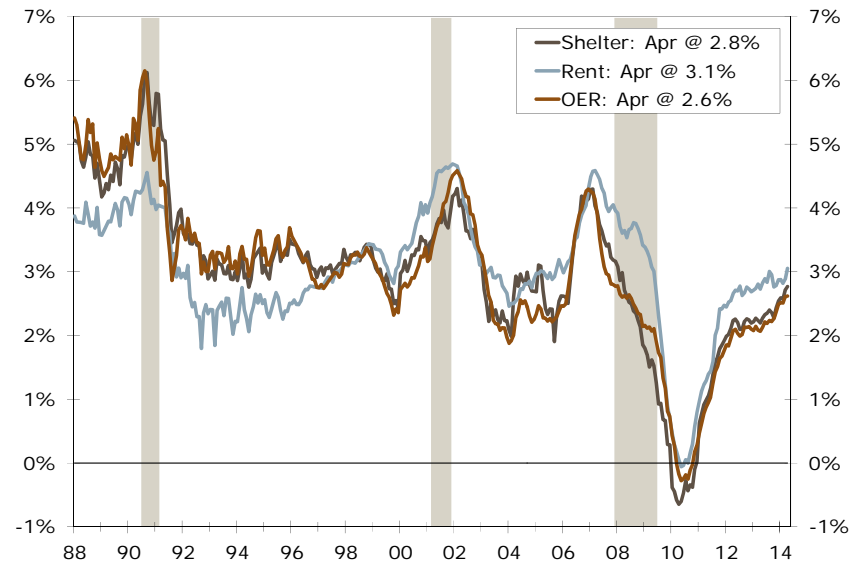
Services vs. Goods

U.S. "Core" CPI - Services vs. Goods
Year-over-Year Percent Change



Shelter Costs

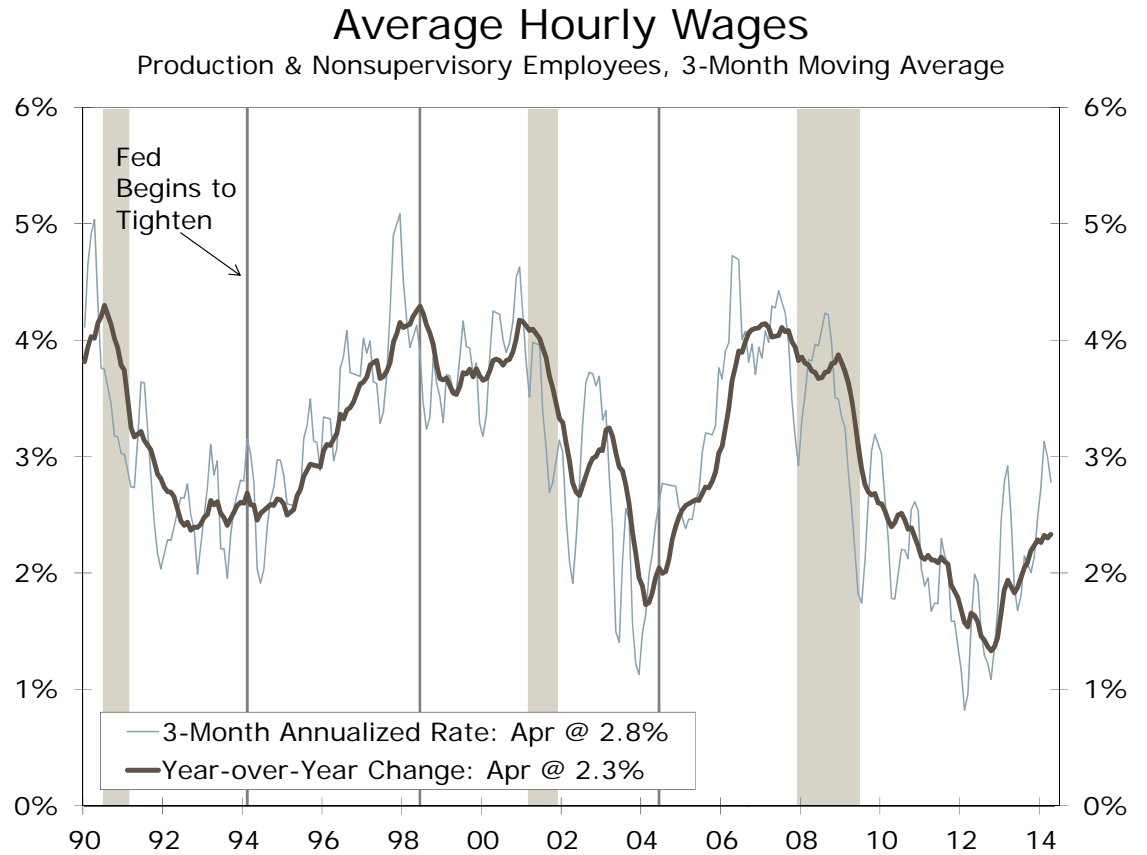
Shelter, OER & Rent Costs
Year-over-Year Percent Change



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

Wage Growth

Wage growth remains fairly tepid, but is showing signs of firming

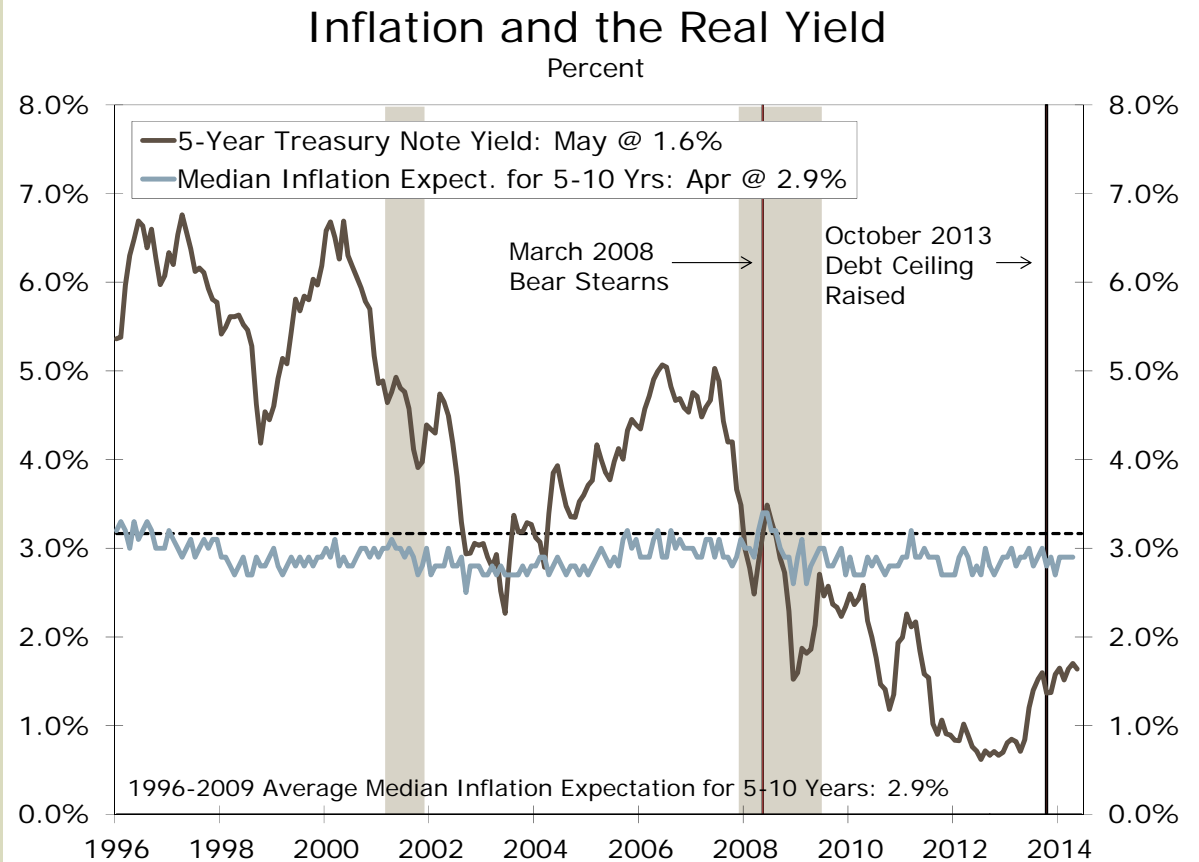


Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Decision VI – Will real rates return to historical form?

Inflation vs. Yields: Negative Real Yields – Three Non-market Buyers

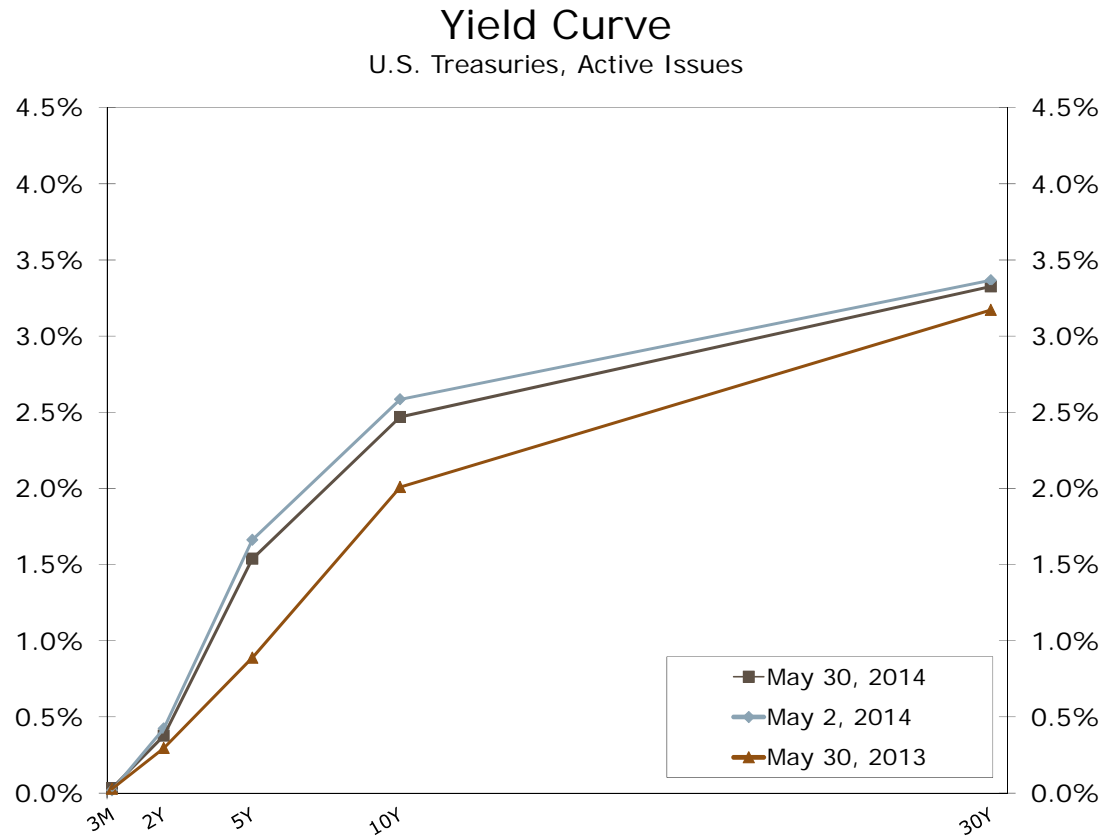
Inflation expectations exceed nominal returns, suppressed interest rates, not free market



Source: Federal Reserve Board, University of Michigan and Wells Fargo Securities, LLC

Yield Curve

The Fed will continue easy policy in 2014, but the yield curve is steepening as the Fed tapers asset purchases



Source: Bloomberg LP and Wells Fargo Securities, LLC

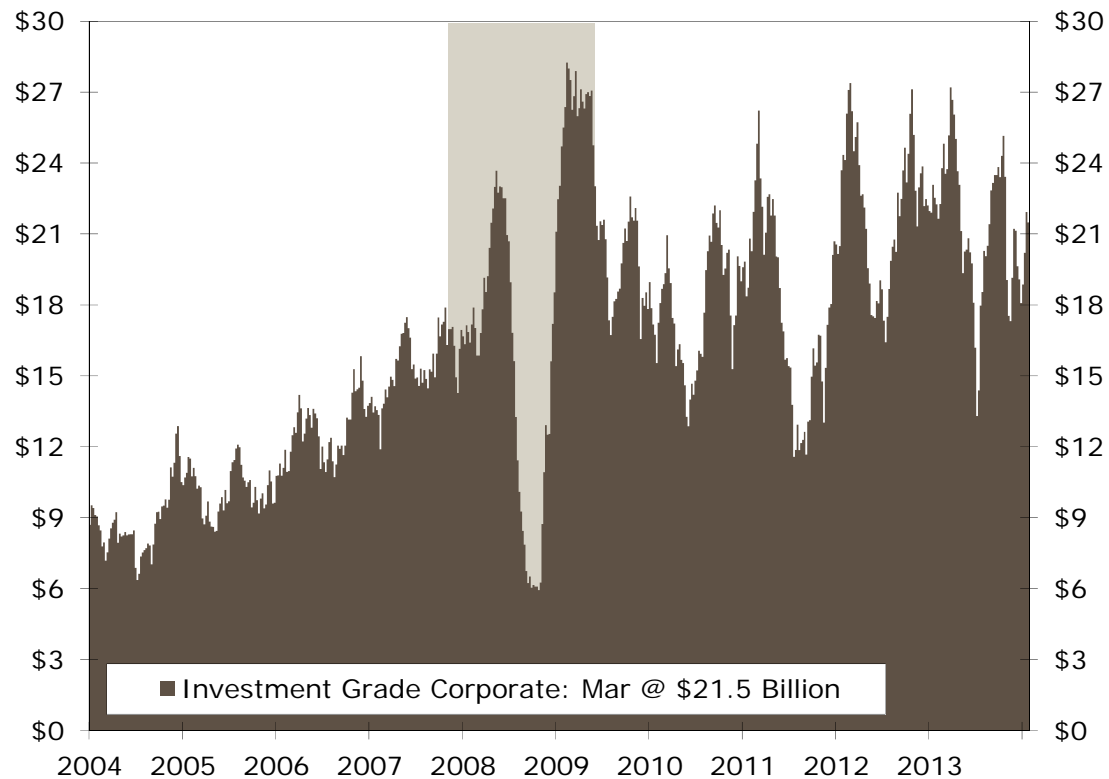
Decision VII – What are the limits to business finance?

Investment Grade Corporate Bonds

Businesses are taking advantage of low interest rates

Investment Grade Corporate Issuance

3-Month Moving Average, Billions of USD



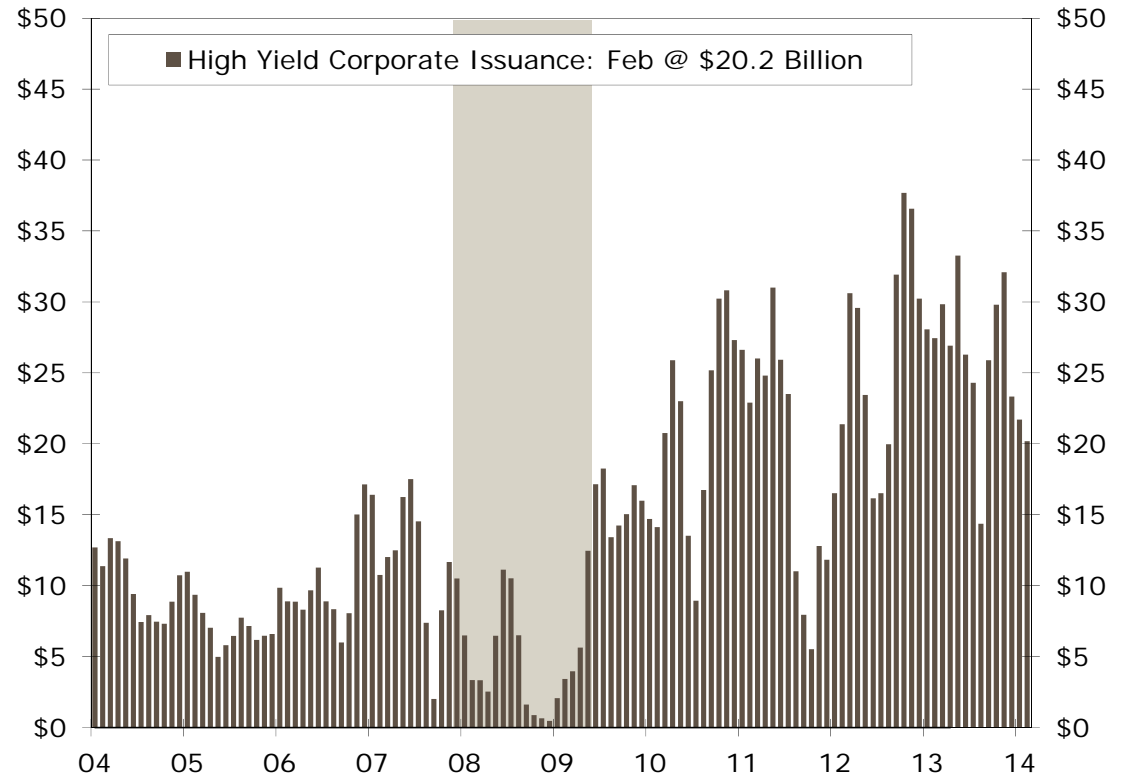
Source: IFR Markets and Wells Fargo Securities, LLC

High Yield Corporate Bonds

As investors search for yield among exceptionally low interest rates, bond issuance has gained momentum

High Yield Corporate Issuance

3-Month Moving Average, Billions of USD

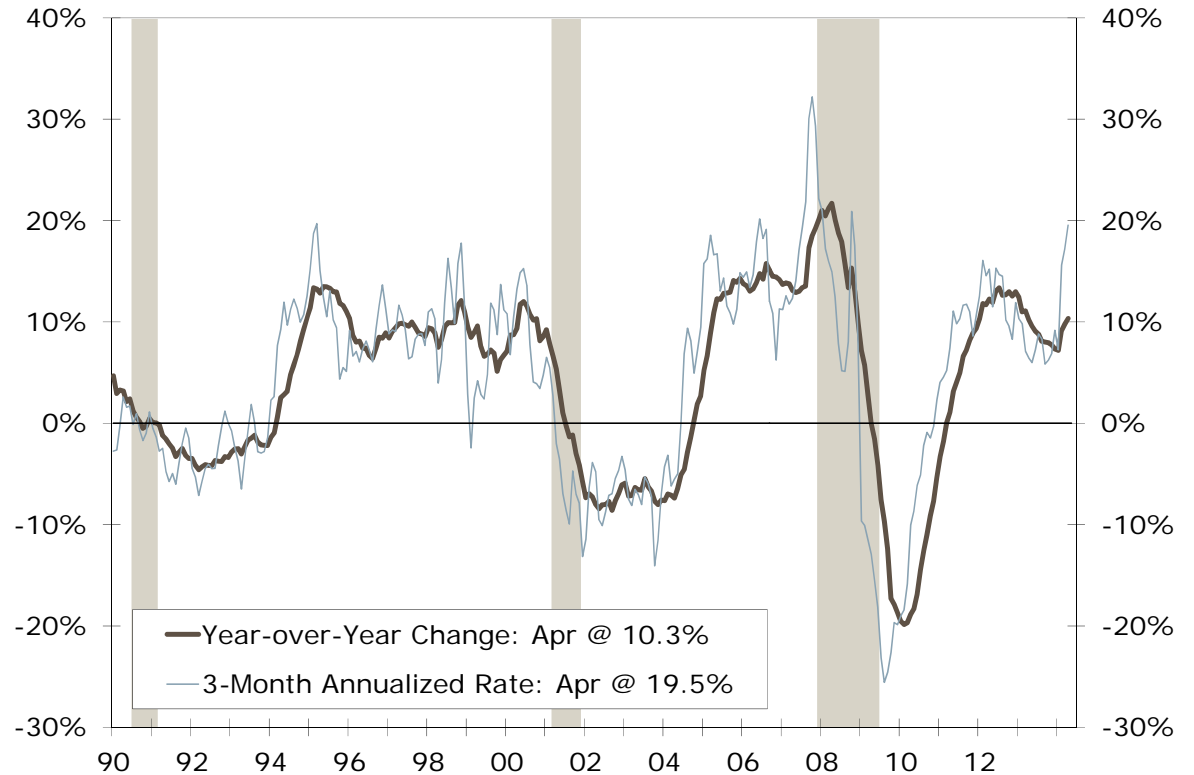


Source: IFR Markets and Wells Fargo Securities, LLC

Commercial and industrial lending has surged over the past quarter, helped by easier credit standards and increased demand

Commercial and Industrial Loans

At Commercial Banks in the United States

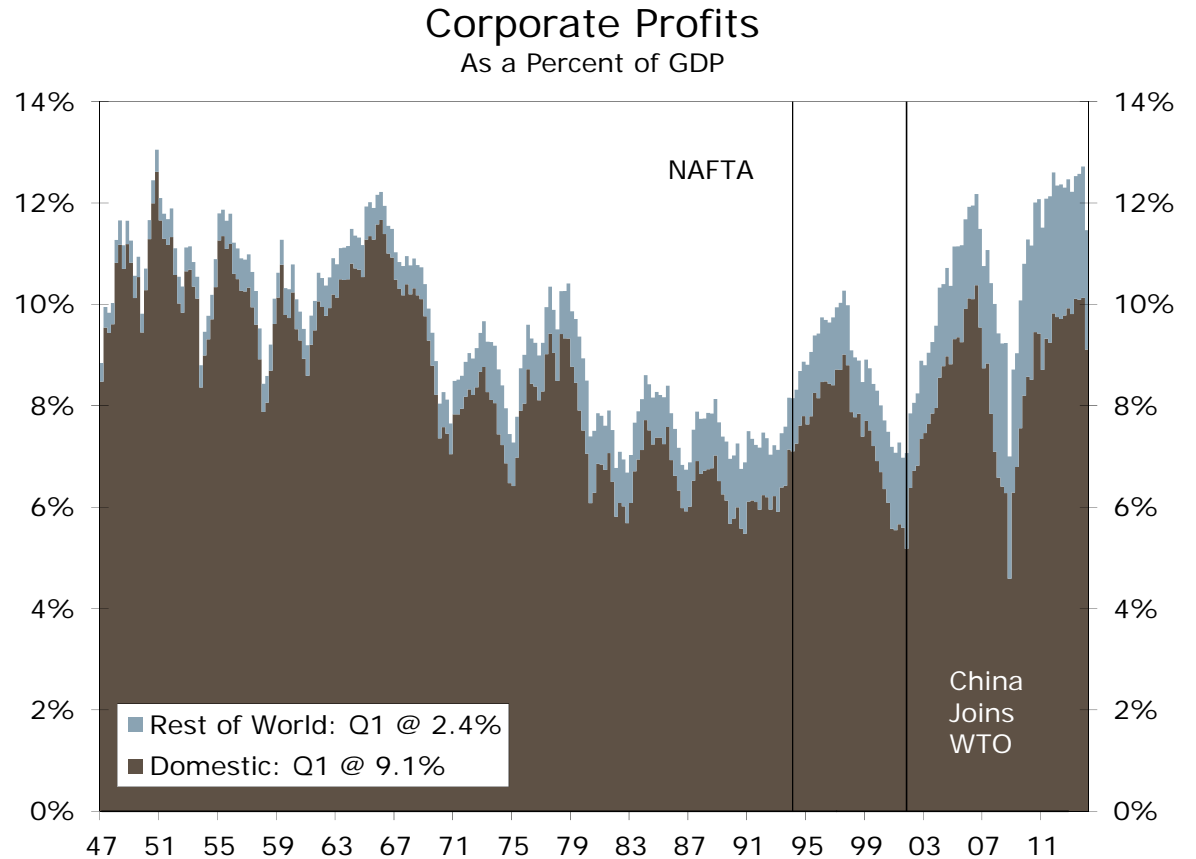


Source: Federal Reserve Board and Wells Fargo Securities, LLC

Decision VIII – What is the balance for globalization between secular and cyclical forces?

Corporate Profits: Increasing Role of Global Profits

Profits as a percentage of GDP are historically high and are being boosted by profits earned abroad



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

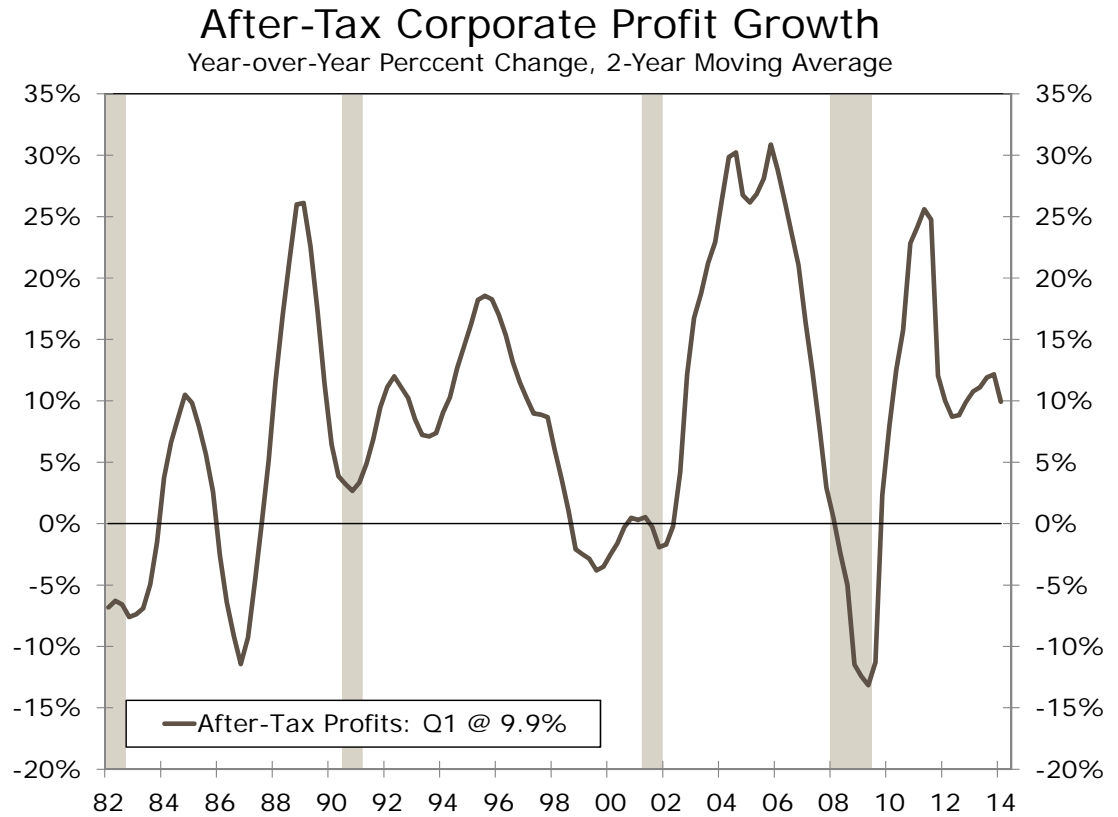
Many U.S. companies rely on the health of international economies

U.S. Companies listed in the S&P 500 with Greater Than 50 Percent of Sales Abroad (A Sample)

- Goodyear Tire
- BorgWarner
- Priceline.com
- Nike
- Coca-Cola
- Heinz
- Proctor & Gamble
- Avon
- Exxon Mobil
- AFLAC
- Intel
- Applied Materials
- Oracle
- Johnson & Johnson
- Merck
- Boeing
- Eaton Corp.
- Emerson Electric
- Fluor
- GE
- 3M
- Caterpillar
- Cisco
- Qualcomm
- Apple
- eBay
- IBM
- Symantec

Corporate Profit Growth

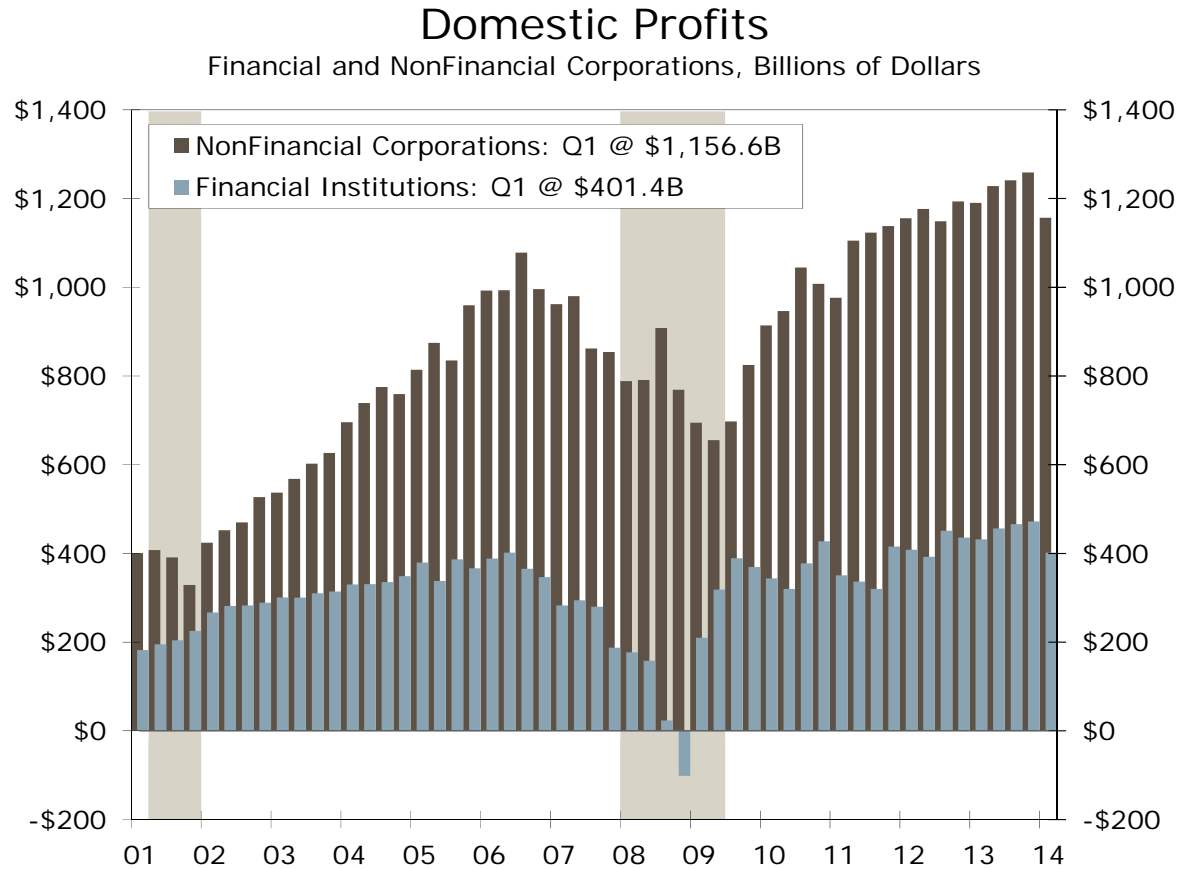
Corporate profit growth remains firm



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

Corporate Profits: Domestic Profits

Big gains in profits have been from nonfinancial corporations

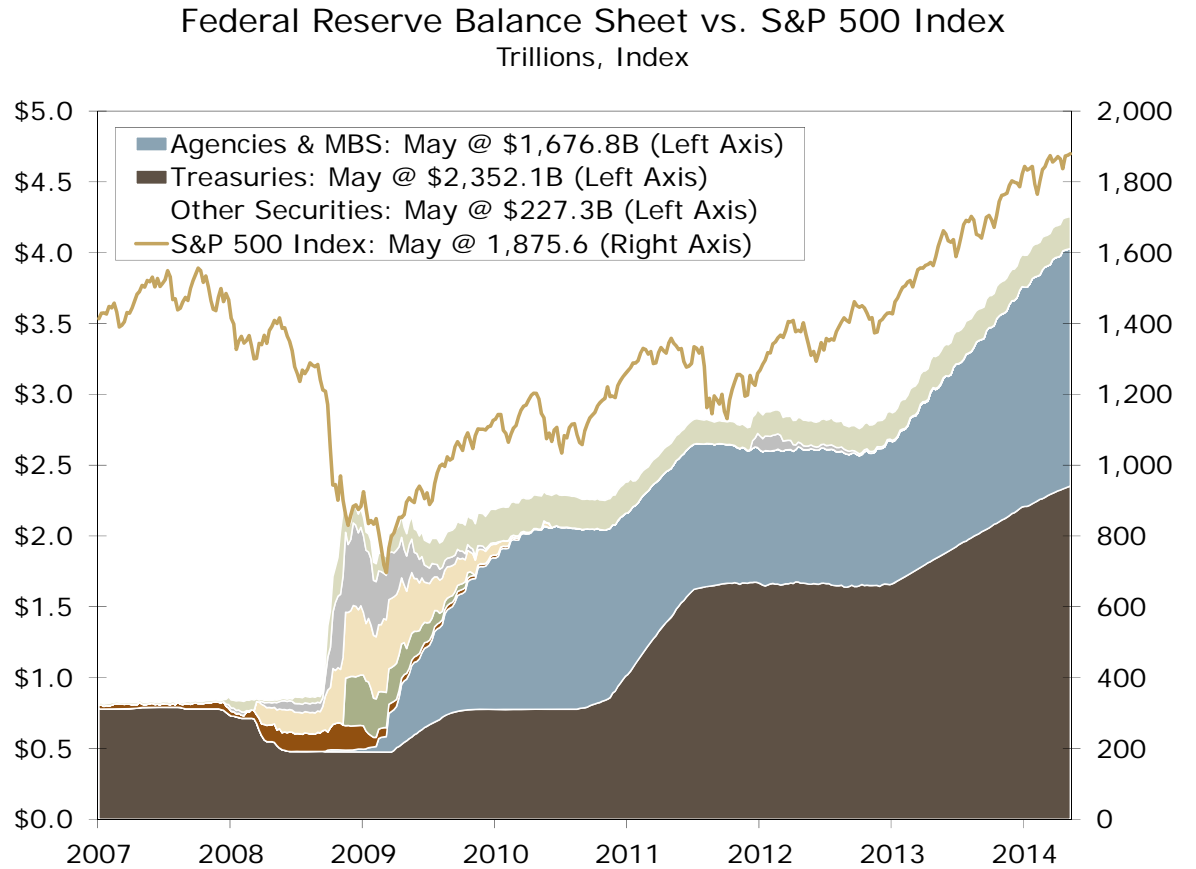


Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Decision IX – How will equity prices react to a stable Fed balance sheet?

Fed Balance Sheet

We have seen a strong correlation in the expansion of the Fed's balance sheet and the rise in the S&P 500



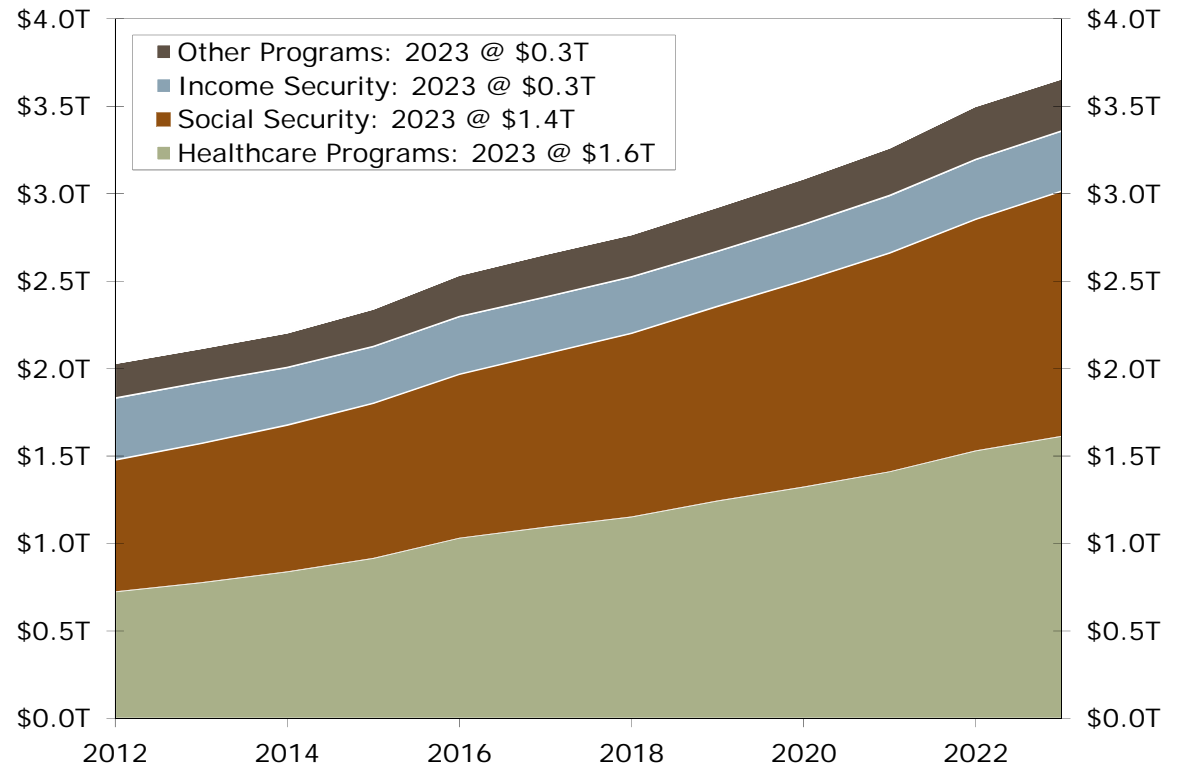
Source: Federal Reserve Board and Wells Fargo Securities, LLC

Federal Government Spending

The unfunded liabilities of the entitlement programs reflect a commitment to spend in the future

U.S. Federal Government Mandatory Outlays

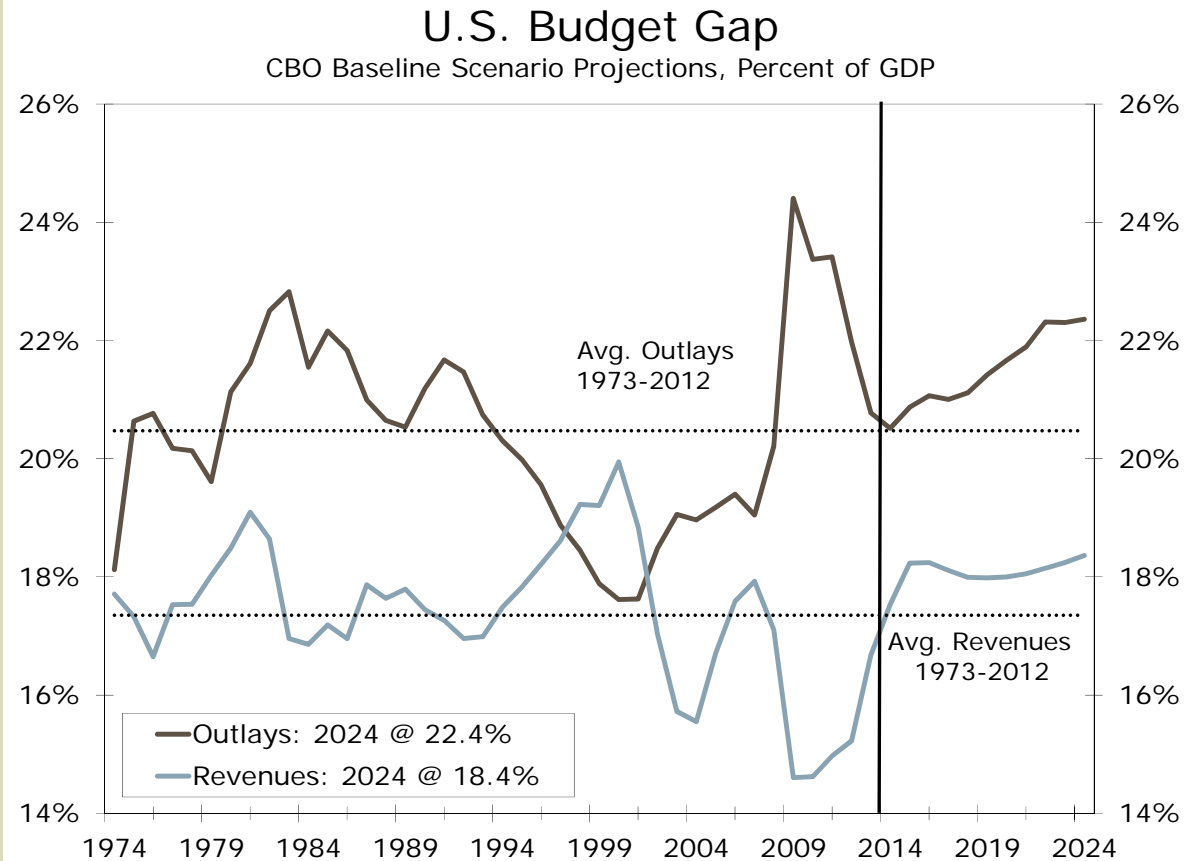
Trillions of U.S. Dollars, Projections Begin in 2013



Source: Congressional Budget Office and Wells Fargo Securities, LLC

Discussion X – When will investors discount the long run federal budget balance outlook?

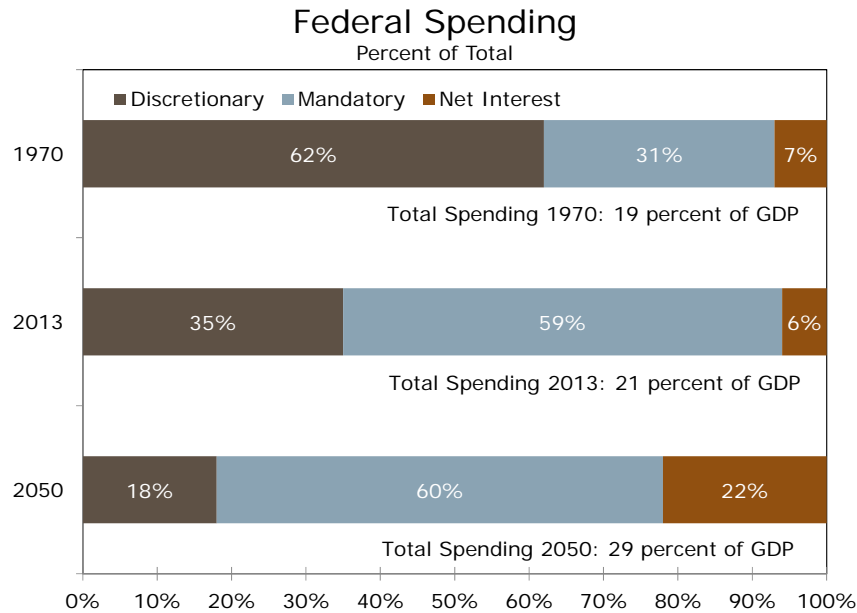
The federal government faces some significant fiscal challenges—the current path is not sustainable



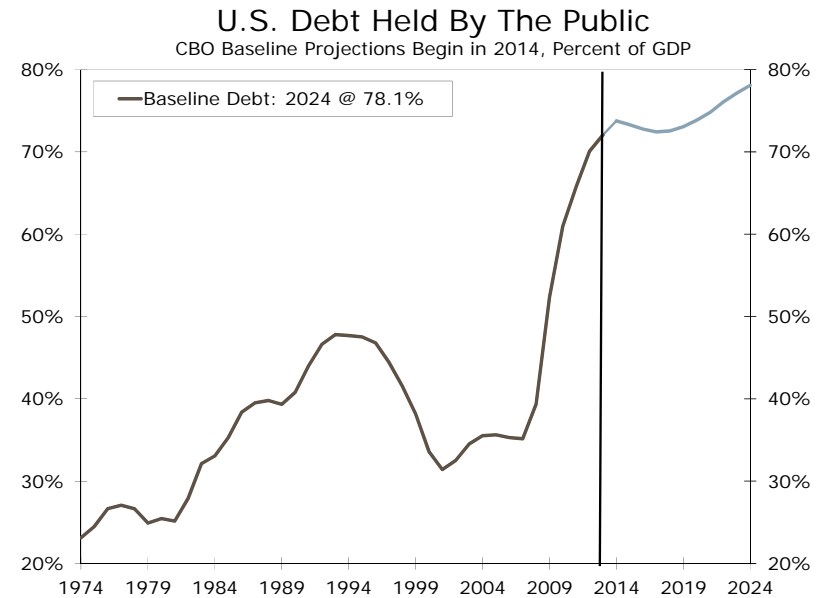
Source: Congressional Budget Office and Wells Fargo Securities, LLC

The composition of federal spending has shifted dramatically.
The CBO projects that the debt-to-GDP ratio will reach nearly 80 percent by 2024.

Composition of Federal Spending



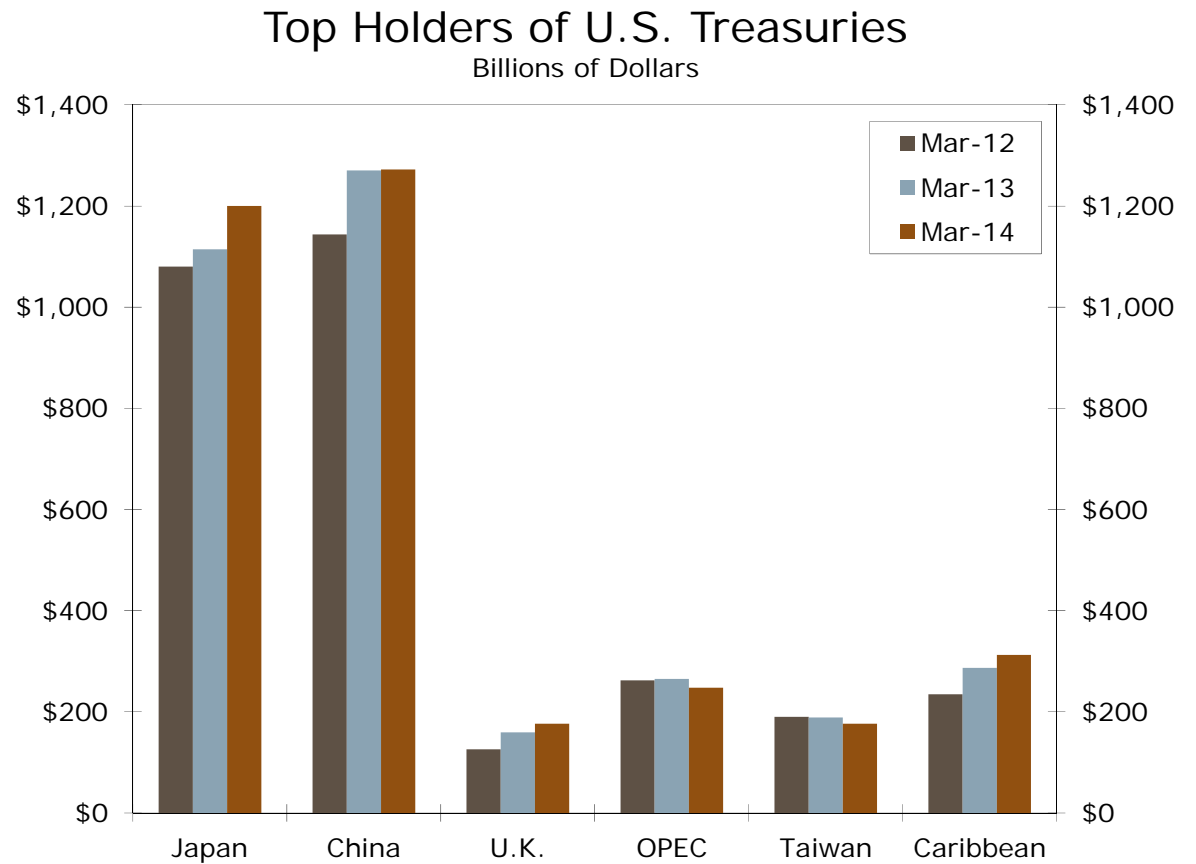
Federal Debt Continues to Rise



Source: Congressional Budget Office and Wells Fargo Securities, LLC

U.S. Government Debt: Who Holds Our Debt?

Japan and China hold an unprecedented amount of U.S. debt



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

What are the primary risks to the outlook?

Potential Challenges to the Outlook

- Tighter monetary policy brings questions for the dollar, inflation and interest rate outlook
- Fiscal policy: tax increases and/or spending cuts face unsustainable long-run outlook
- Housing: unable to sustain growth on its own if rates rise?
- European debt crisis weighs on global growth and global credit allocation over the long-run
- Weak employment growth means less-than-expected real income and spending growth for some consumer segments

U.S. Forecast

Wells Fargo U.S. Economic Outlook

	Actual				Forecast				Actual			Forecast	
	2013				2014				2011	2012	2013	2014	2015
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product ¹	1.1	2.5	4.1	2.6	-1.0	3.0	2.9	2.9	1.8	2.8	1.9	2.0	2.9
Personal Consumption	2.3	1.8	2.0	3.3	3.1	3.2	2.4	2.6	2.5	2.2	2.0	2.8	2.6
Inflation Indicators ²													
PCE Deflator	1.4	1.1	1.1	1.0	1.1	1.6	1.6	1.8	2.4	1.8	1.1	1.5	2.0
Consumer Price Index	1.7	1.4	1.5	1.2	1.4	1.9	1.9	2.2	3.1	2.1	1.5	1.9	2.2
Industrial Production ¹	4.2	1.9	2.5	4.9	4.5	3.1	4.1	4.3	3.3	3.8	2.9	3.8	4.6
Corporate Profits Before Taxes ²	2.1	4.5	5.7	6.2	-3.0	3.6	3.8	4.0	7.9	7.0	4.6	2.2	4.3
Trade Weighted Dollar Index ³	76.2	77.5	75.2	76.4	76.9	76.5	76.5	76.5	70.9	73.5	75.9	76.6	78.1
Unemployment Rate	7.7	7.5	7.2	7.0	6.7	6.3	6.2	6.1	8.9	8.1	7.4	6.3	5.9
Housing Starts ⁴	0.95	0.86	0.88	1.03	0.92	1.06	1.06	1.07	0.61	0.78	0.92	1.03	1.19
Quarter-End Interest Rates ⁵													
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	4.34	4.30	4.50	4.70	4.46	3.66	3.98	4.46	5.16
10 Year Note	1.87	2.52	2.64	3.04	2.73	2.65	2.90	3.10	2.78	1.80	2.35	2.85	3.56

Forecast as of: May 30, 2014

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, Freddie Mac and Wells Fargo Securities, LLC

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Recent Special Commentary

May-23	Mexican Economy: Still Weak in Q1 2014	Alemán
May-23	Baltimore's Growth: Slow and Steady, Not Divine	Vitner & Wolf
May-22	Labor Market Slack Diminishing? Fed to Follow?	Silvia & House
May-19	Chilean Economy Slows Down Further in Q1 2014	Alemán
May-19	Russian GDP Growth Remains Very Weak	Bryson
May-16	California Employment Conditions: April 2014	Vitner & Wolf
May-16	Texas Employment Gains Strongest in the Nation	Vitner & Wolf
May-16	Florida Employment Shines in April	Vitner & Wolf
May-12	Corporate Profits and the Business Cycle: A Preliminary Review of the Data Part 1	Silvia, Brown & Griffiths
May-08	Housing Data Wrap-Up: April 2014	Vitner & Khan
May-08	Continued Job Growth in Australia	Quinlan
May-06	San Francisco Bay Area Real Estate Outlook	Vitner, Wolf & Miller
May-06	Short- and Long-Term Unemployment: A Labor Market Divided	Silvia & House
May-02	Will the ECB Ease Policy Further at Next Week's Meeting?	Bryson
May-02	Inflation Chartbook: May 2014	Bullard & House
May-01	Recession Memories Fade as Credit Card Usage Nudges Up	Silvia & Zachary
April-30	Modest Pace of Expansion Continues in Taiwan	Bryson
April-29	Mexican Auto Sector Sourcing Turns Inward	Alemán & Griffiths
April-29	Strong U.K. Economic Recovery Remains Intact	Bryson
April-24	Export Surge Lifts First Quarter GDP in Korea	Quinlan
April-18	Strong Payroll Growth for the Tar Heel State	Vitner & Wolf
April-18	Employment Gains in California Modest for March	Vitner & Wolf
April-18	Texas Payroll Gains Moderate in March	Vitner & Wolf
April-18	Florida's Payroll Gain the Largest in the Nation	Vitner & Wolf
April-17	Different Times for the U.S. Consumer	Alemán & Griffiths
April-17	"Ex-" Marks the Spot: A Focused Outlook for the Transportation Sector	Quinlan & House
April-16	Has the Chinese Economy Pulled Off a "Soft Landing?"	Bryson
April-16	Brazilian Economy Strengthens in February	Alemán
April-14	Nevada Economic Outlook: April 2014	Vitner & Wolf
April-14	Singaporean Real GDP Growth Weakens a Bit in Q1	Bryson
April-11	No Respite for Mexican Industrial Production	Alemán
April-10	Stronger Aussie Jobs Report and Implications for RBA	Quinlan
April-09	Labor Force Participation: Where to Now?	Silvia & House
April-09	Housing Chartbook: March 2014	Vitner & Khan

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