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Economic Outlook: Cyclical Recovery, Structural Challenges

Philadelphia Council for Business Economics

John E. Silvia, Chief Economist

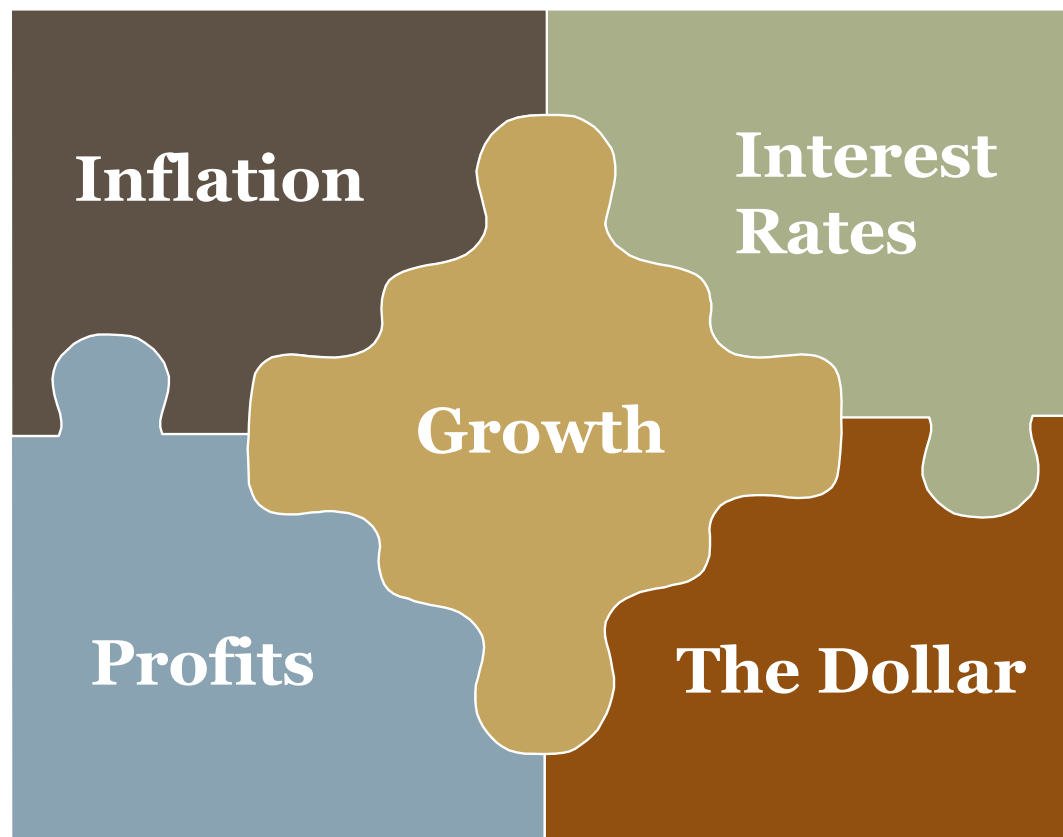
April 3, 2013

Together we'll go far



Where Are We Now?

Five benchmarks for good
decision making



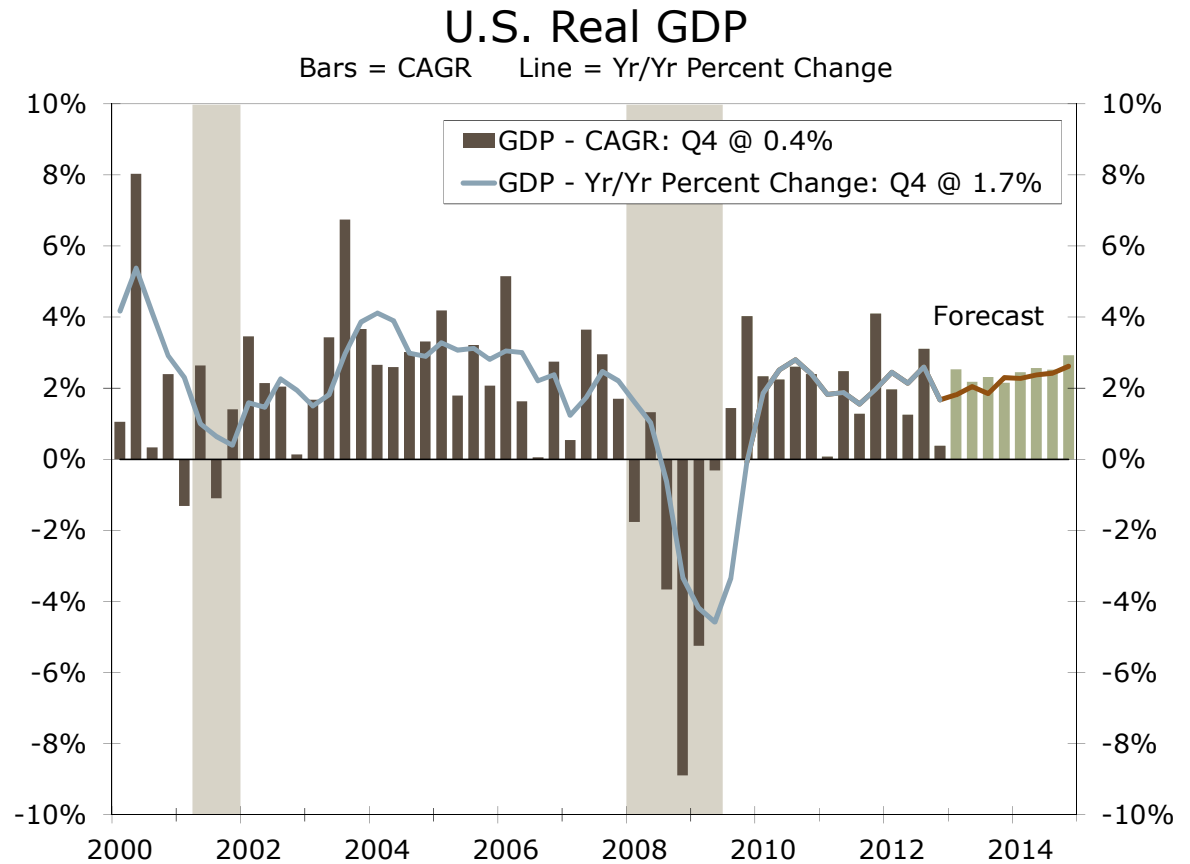
How do we differ from
consensus?

Expectations for the Future

- Sustained below-trend growth
- Still cautious on consumer segments
- Housing improving—multifamily especially
- State and local governments—still restructuring
- Employment—cyclical and structural change

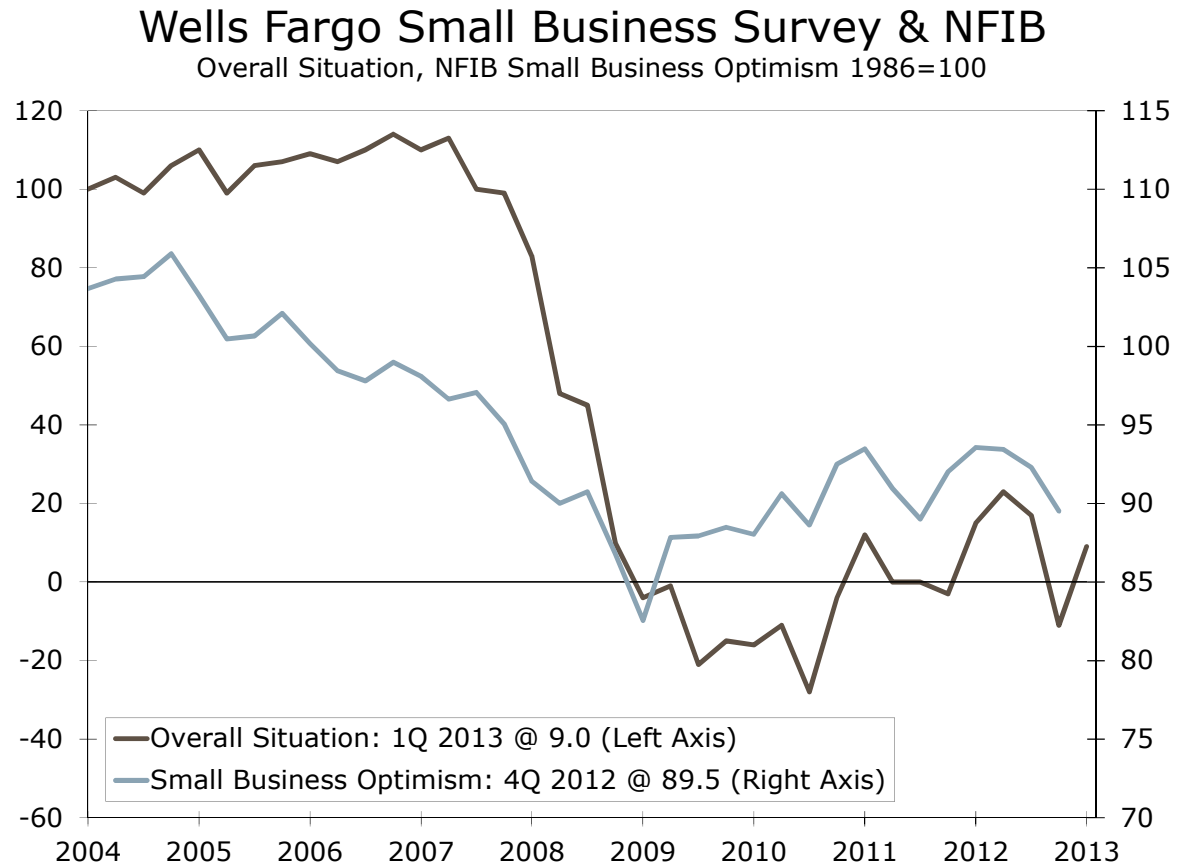
What We Get Versus What We Expect

Sustained recovery in 2013, but still below historical experience—benchmark 2.75 percent is trend from 1982-2012



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

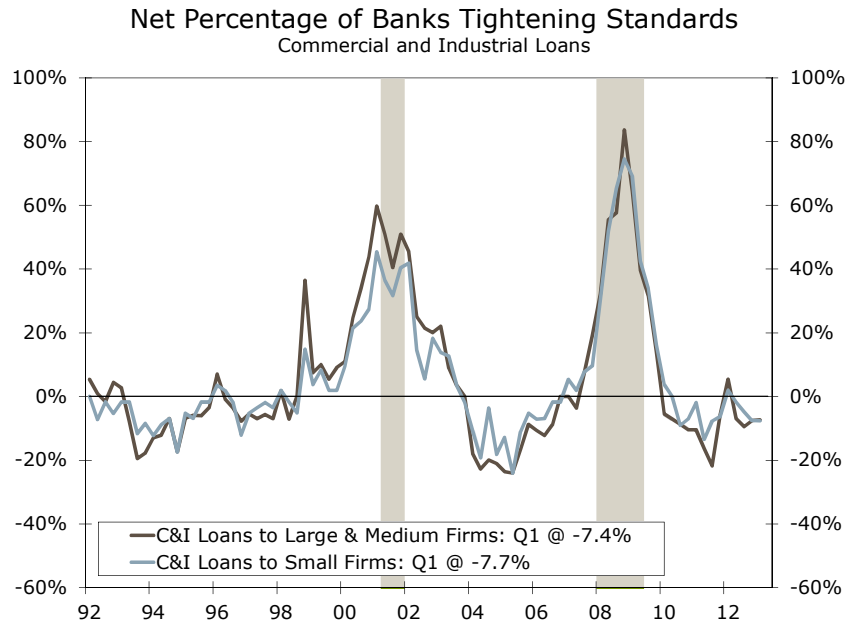
Small Businesses:
A full recovery in small business
optimism is still distant



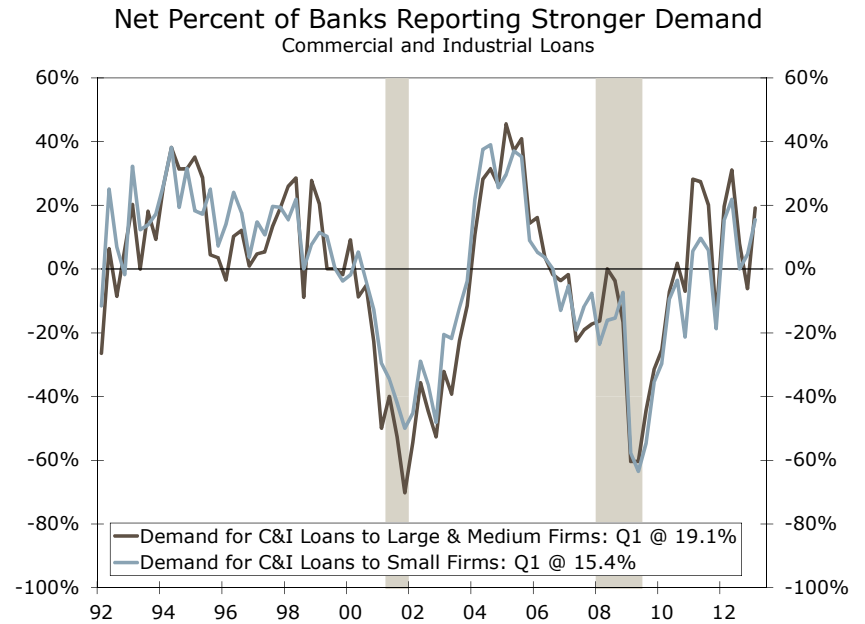
Source: National Federation of Independent Businesses, Gallup, Wells Fargo Bank and Wells Fargo Securities, LLC

Business credit is poised to grow as standards are relaxed

Standards

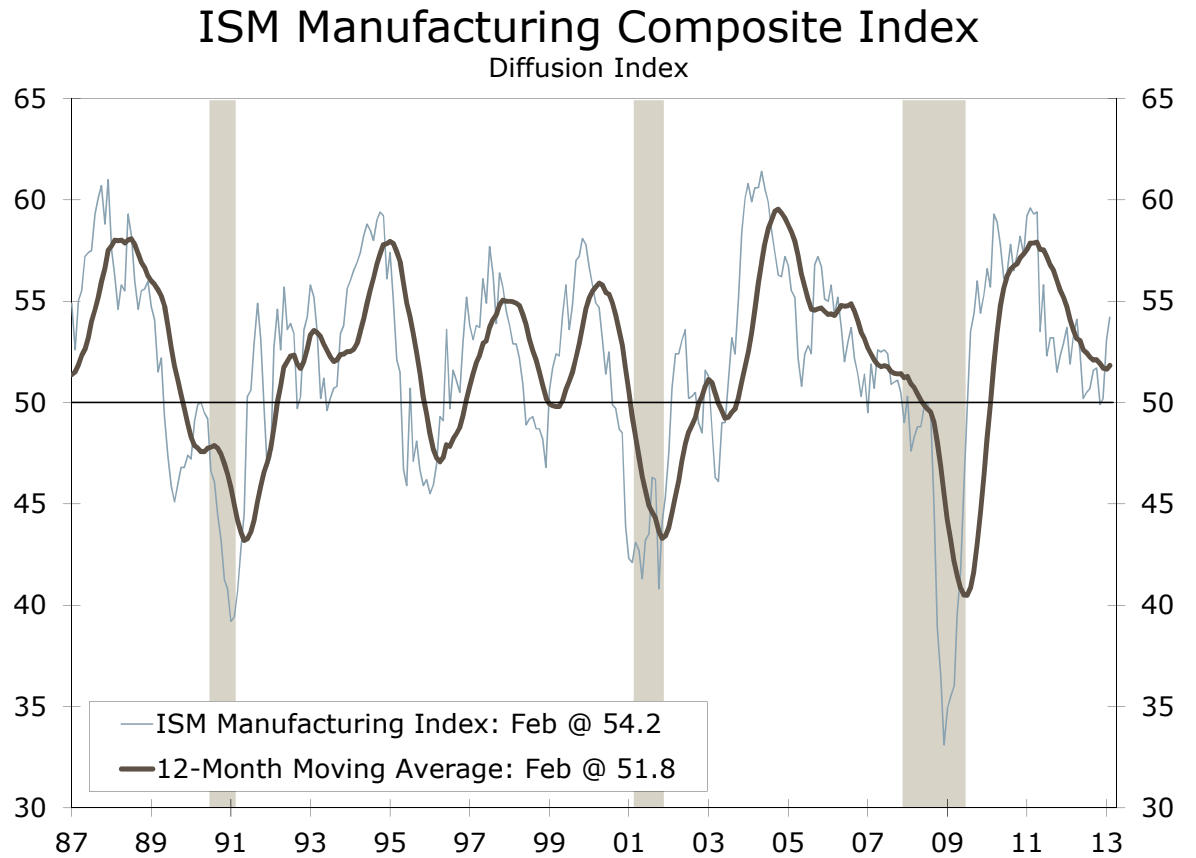


Demand



Source: Federal Reserve Board and Wells Fargo Securities, LLC

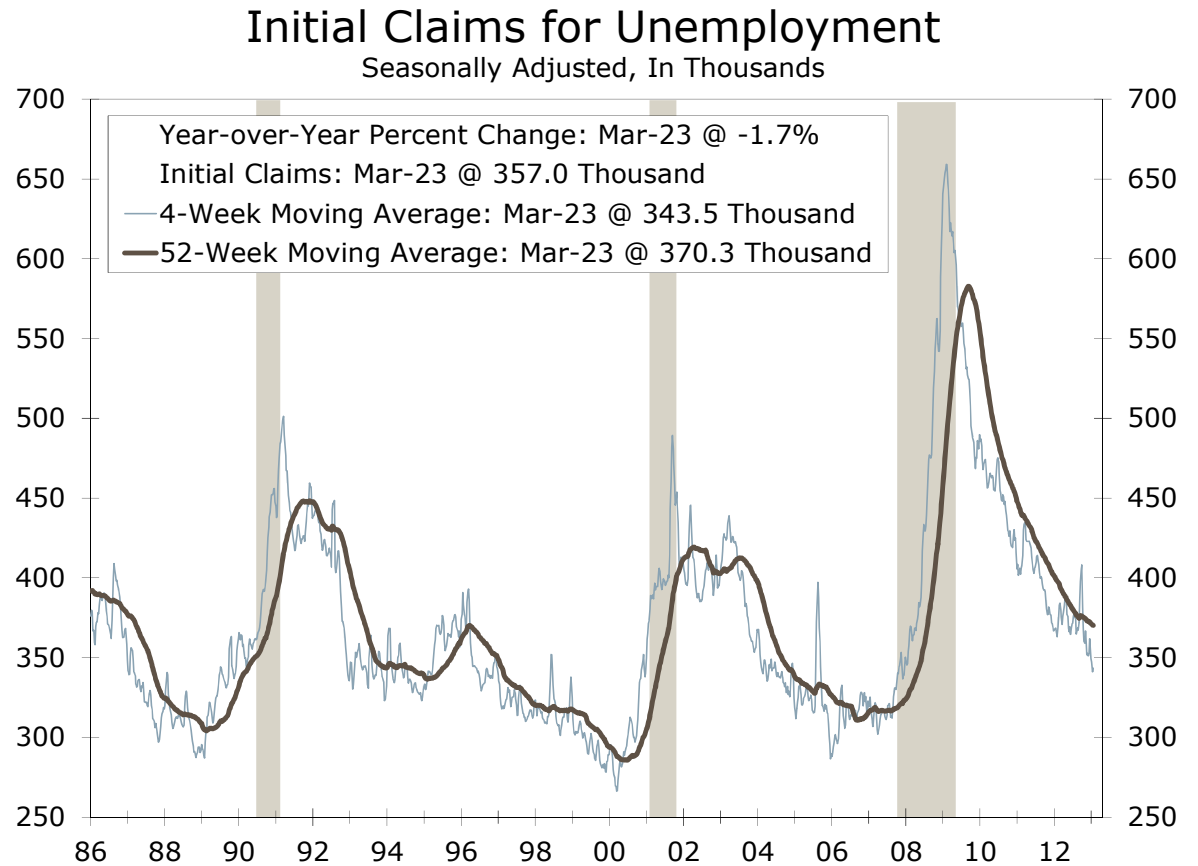
Large, Global Businesses:
Slowdown in manufacturing
recently after typical recovery



Source: Institute for Supply Management and Wells Fargo Securities, LLC

Initial Unemployment Claims: Cyclical

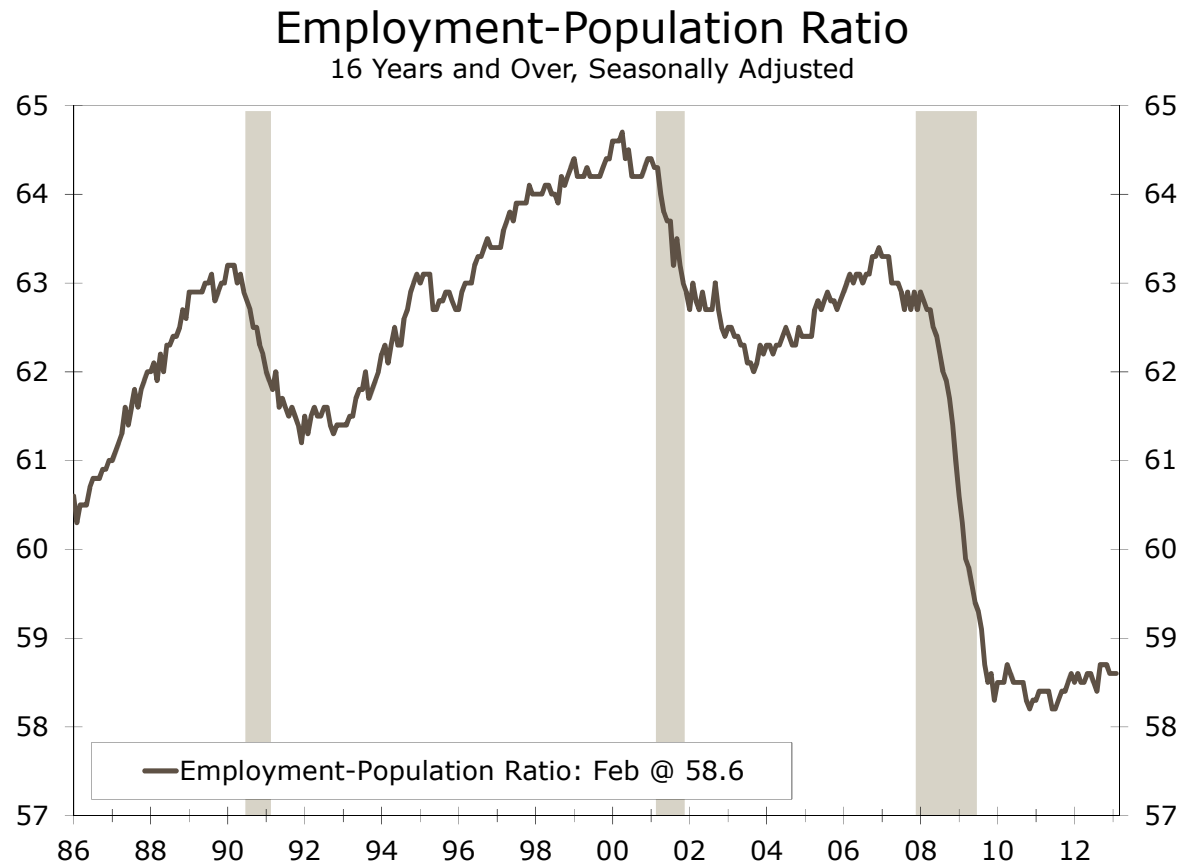
Signaling continued, moderate job gains ahead



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

Employment: Structural

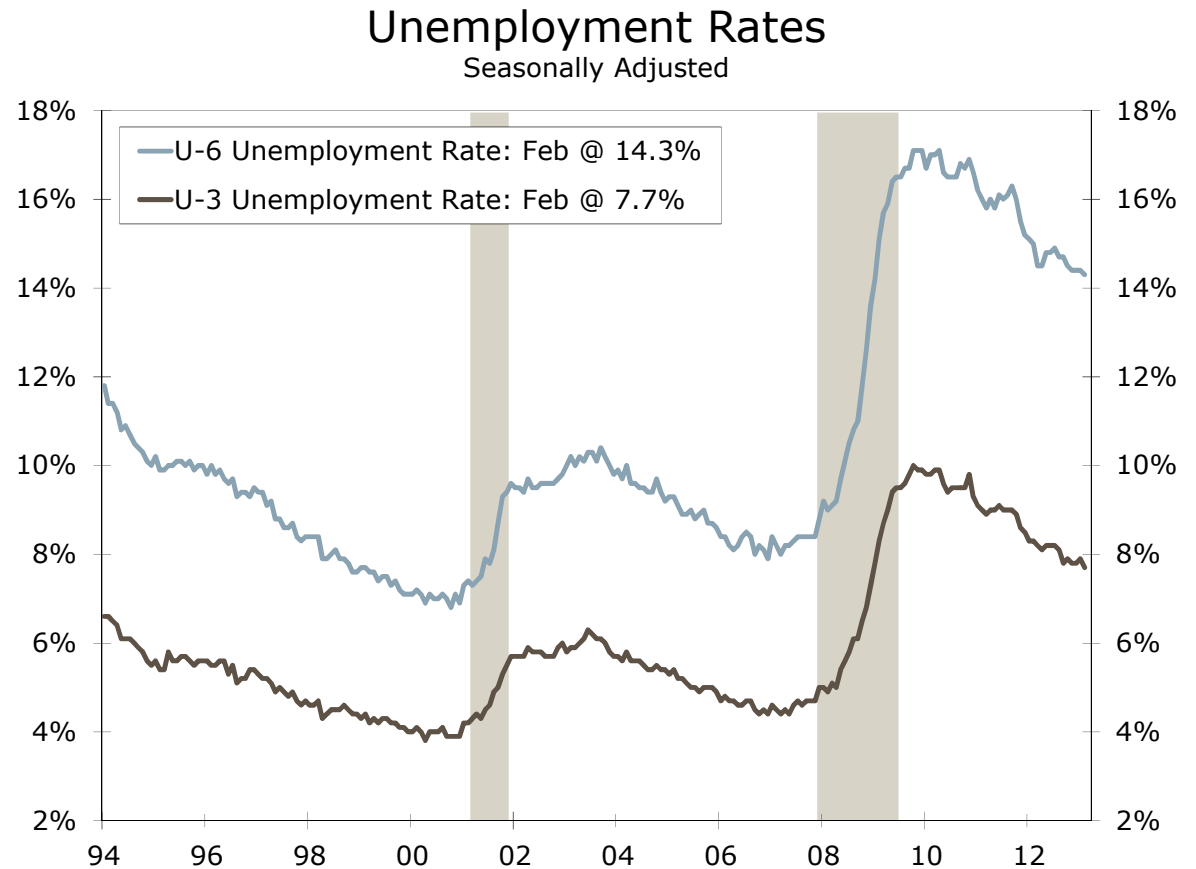
Structural Change:
A much lower base to support
growth and spending, especially
for entitlements



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

Employment: Structural

U-3 reverting to 6.37 percent long-run average, but U-6 is not mean-reverting. Employment growth is mean-reverting at 1.28 percent.



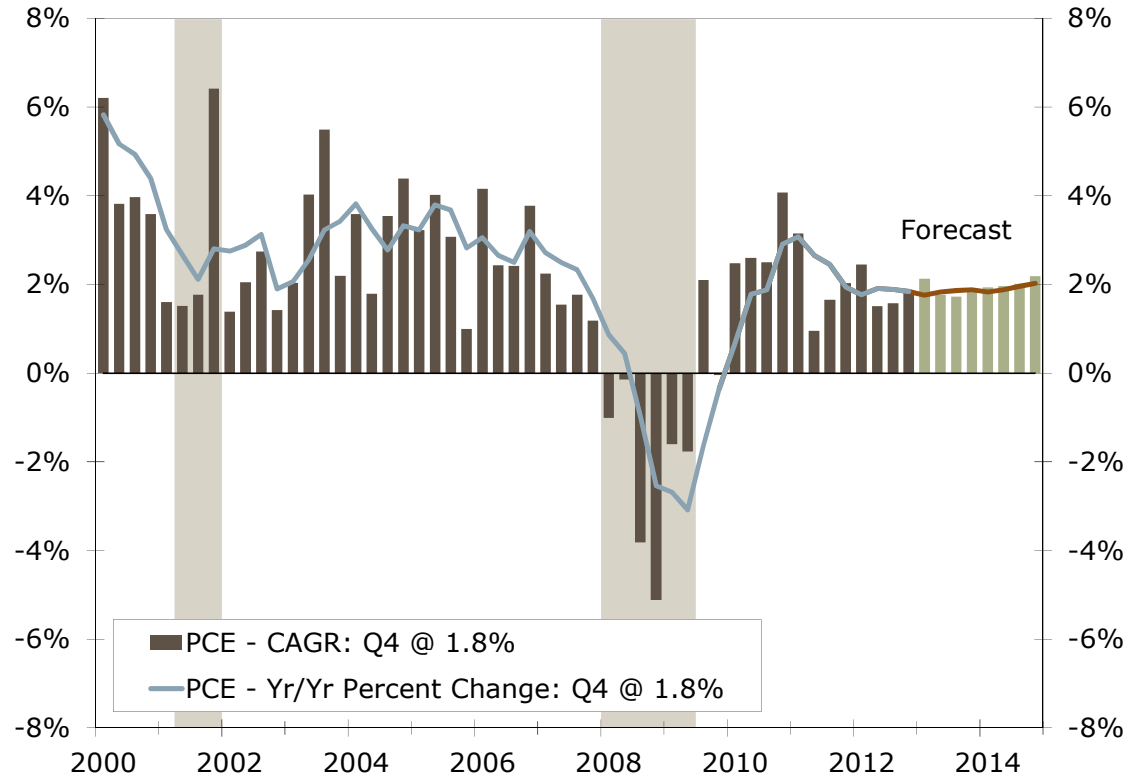
Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Consumer Spending

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

Real Personal Consumption Expenditures

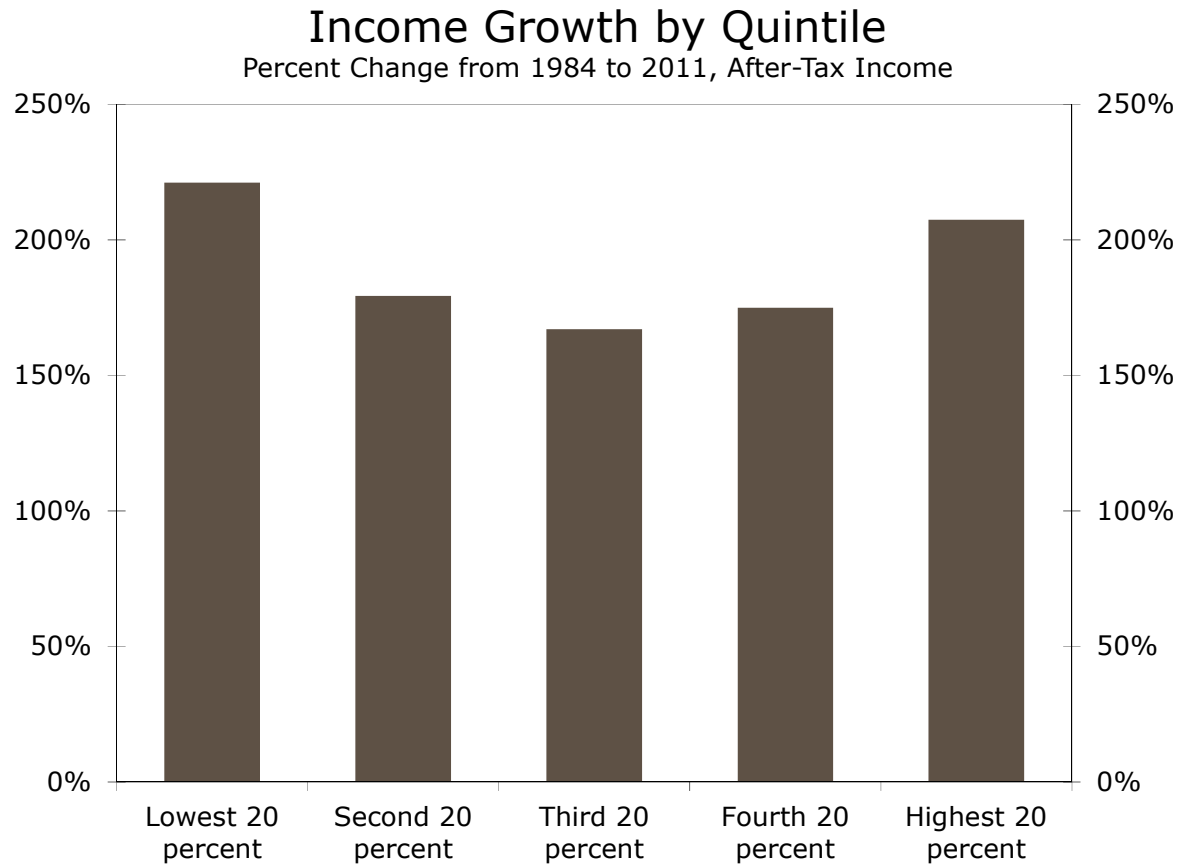
Bars = CAGR Line = Yr/Yr Percent Change



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

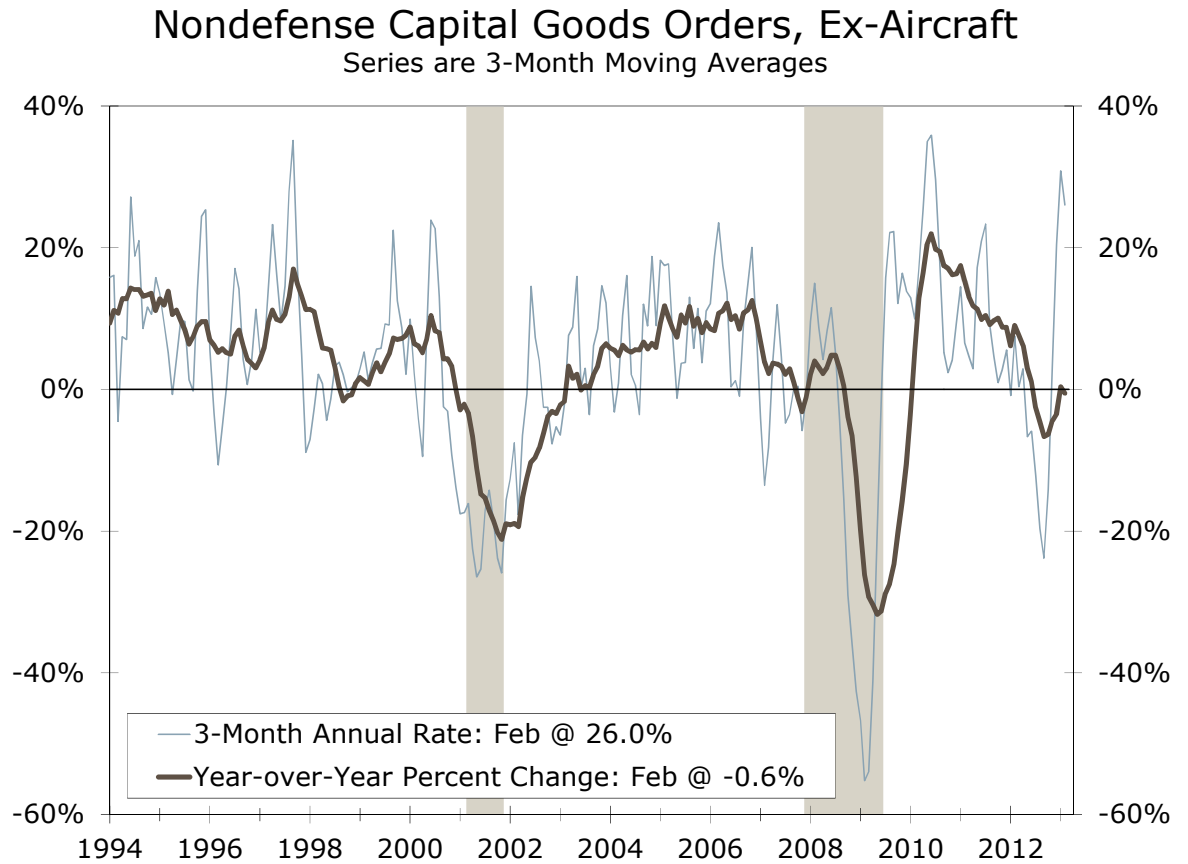
Income Growth

After-tax 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

Signs of life appeared early in this recovery in capital goods orders—now the slowdown—fiscal cliff?



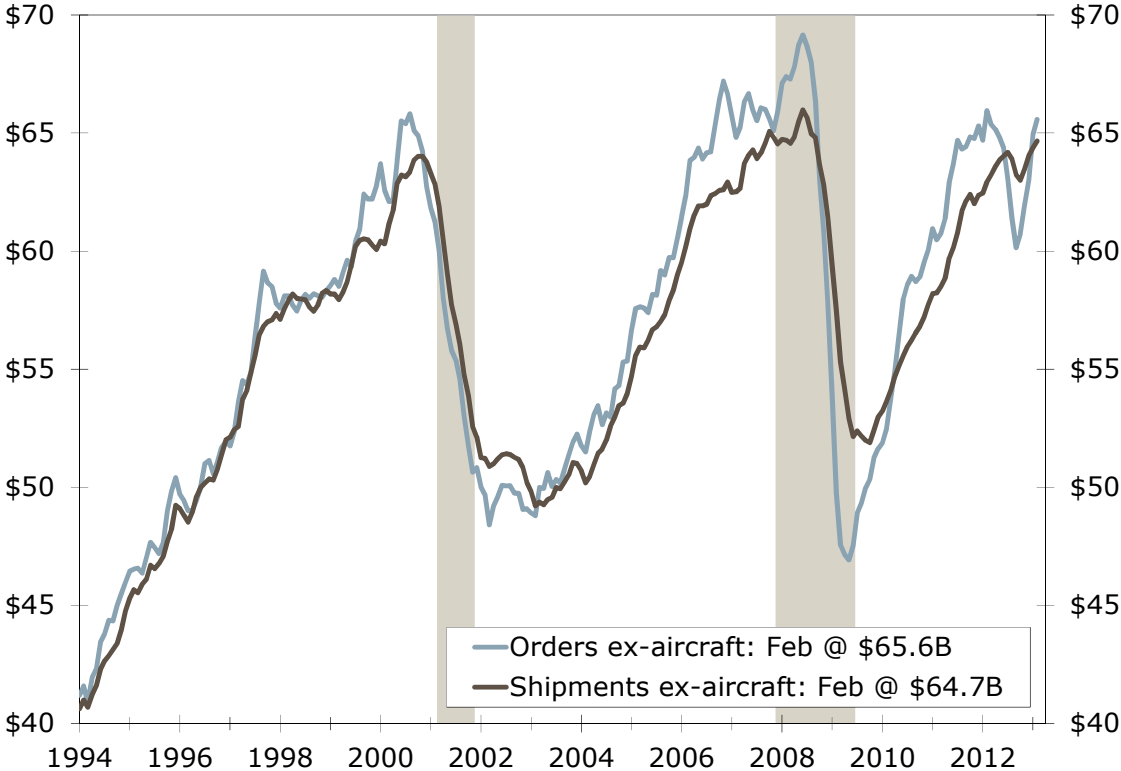
Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

New Orders and Shipments

The recent drop in new orders below shipments is concerning

Nondefense Capital Goods Orders vs. Shipments

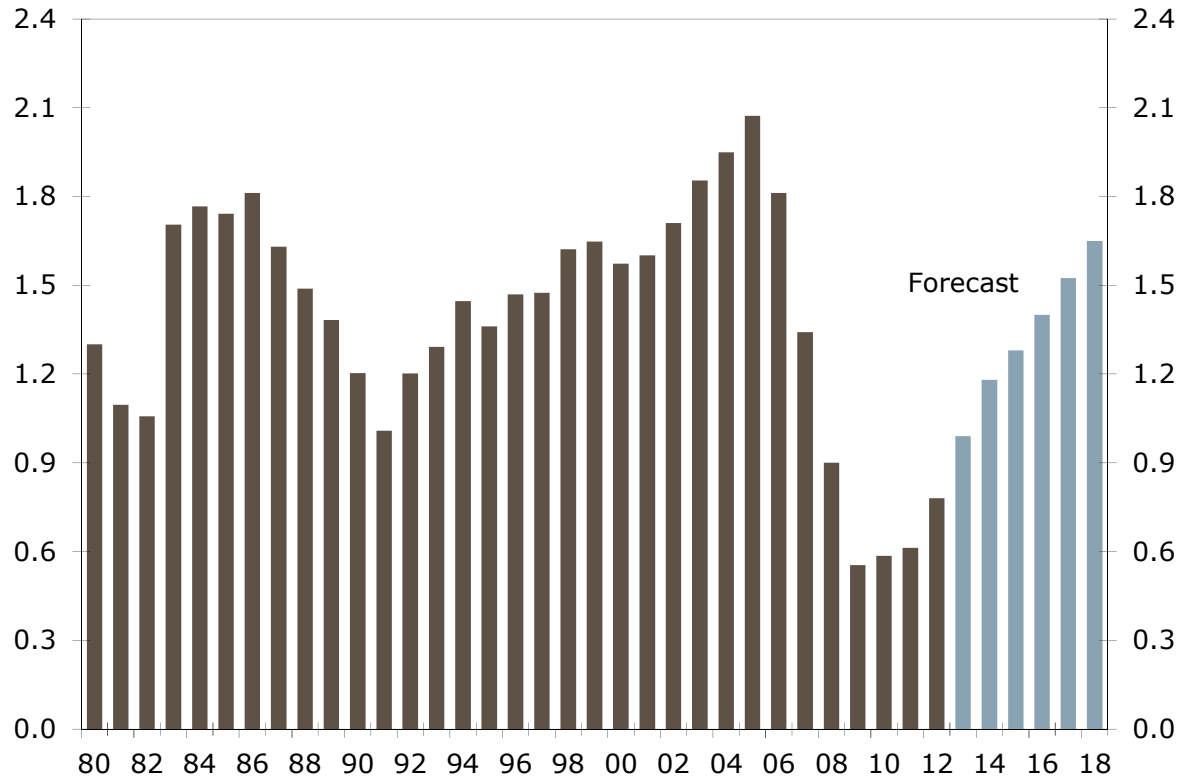
Ex-Aircraft, Series are 3-Month Moving Averages in Billions



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

Continued improvement ahead

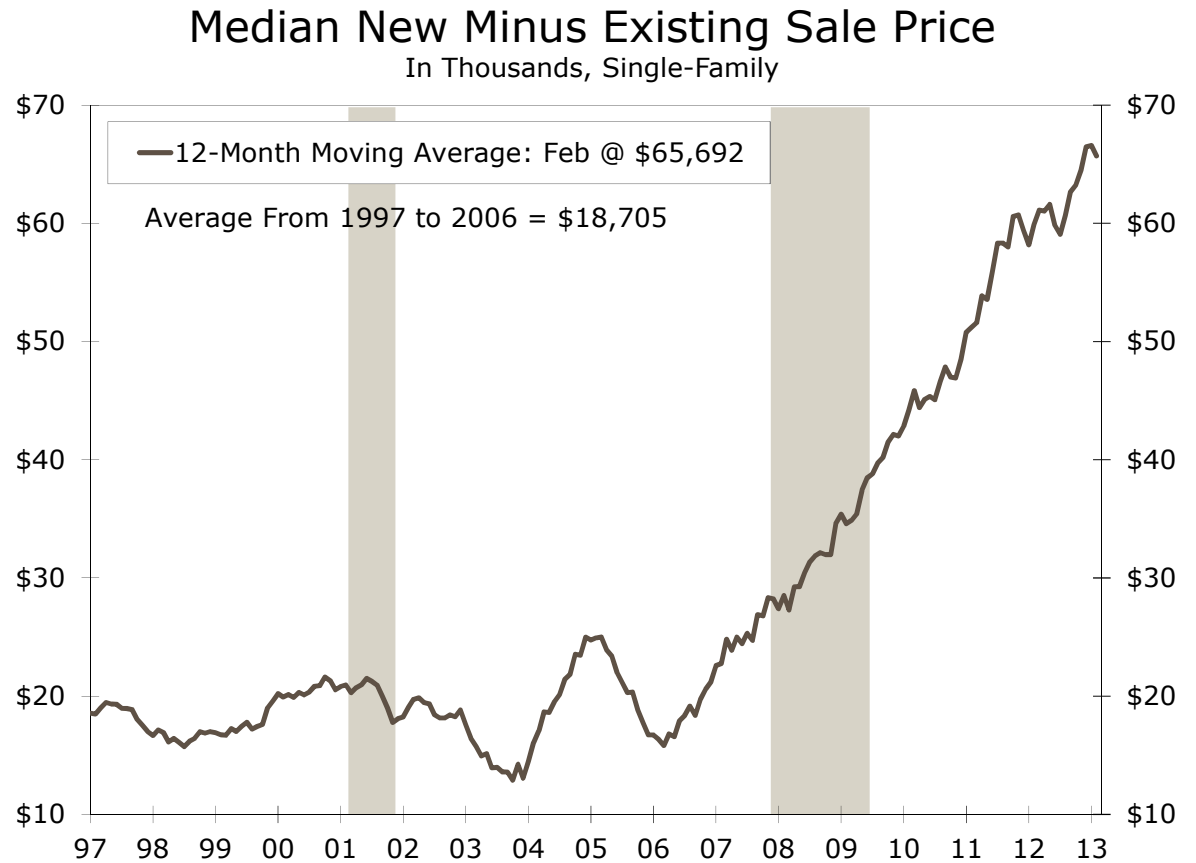
U.S. Housing Starts
Millions of Units



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

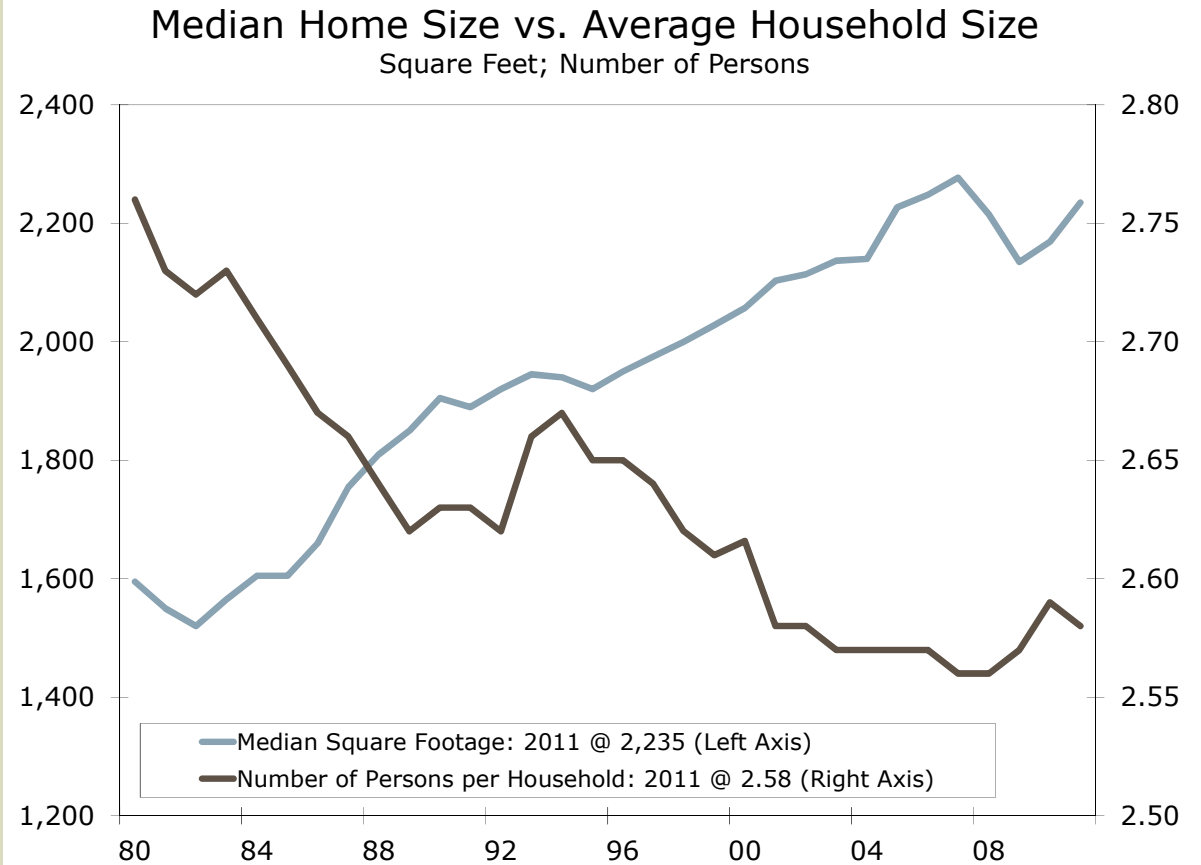
Home Prices: Barrier to Recovery

The high inventory of discounted existing homes has led to a large price premium for new homes



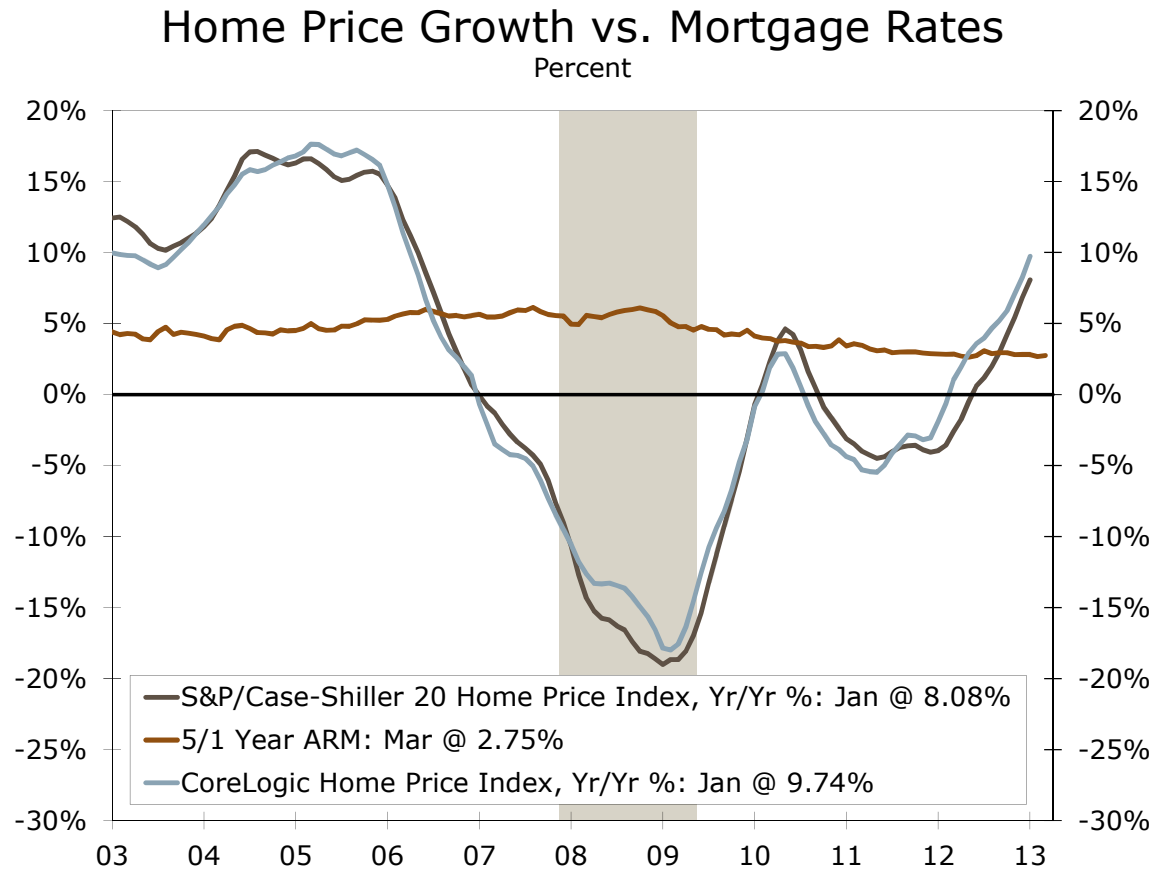
Source: U.S. Department of Commerce, National Association of Realtors and Wells Fargo Securities, LLC

Secular Shift?
Households are living in smaller homes with more people since the recession, but longer-term trends may win out



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

Home prices are rising faster than mortgage interest rates

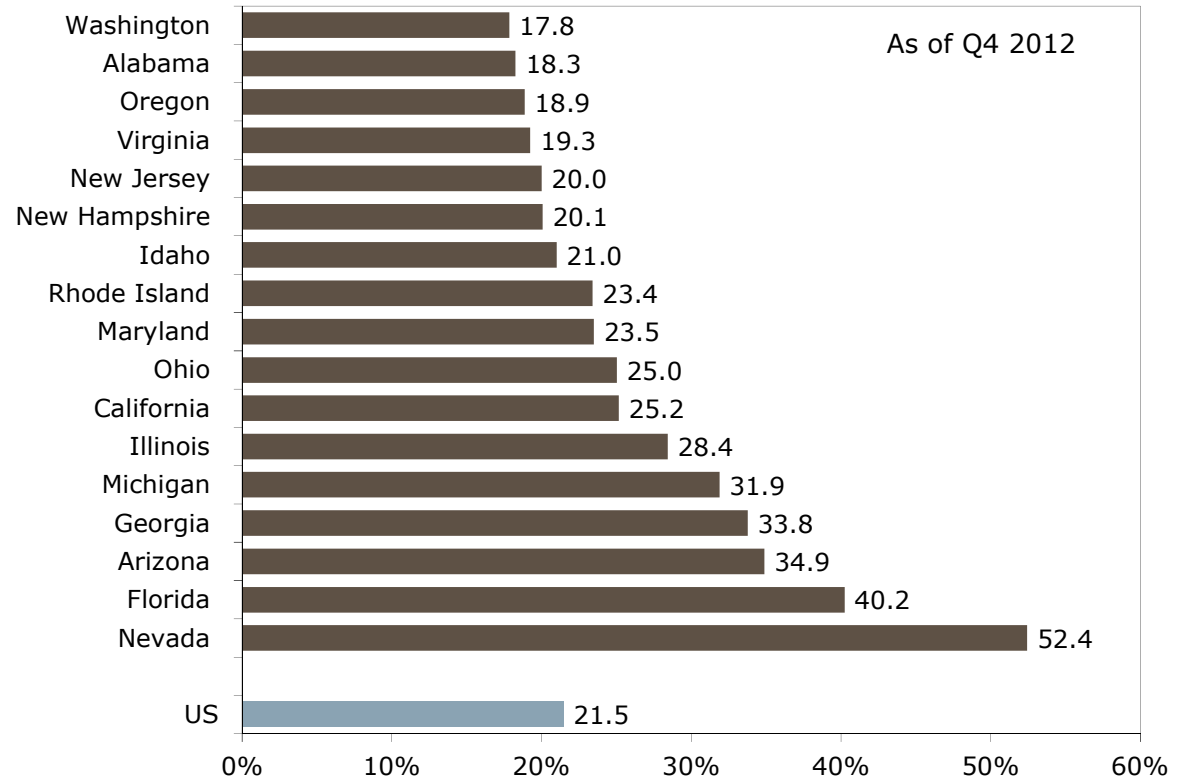


Source: S&P/Case-Shiller, CoreLogic, Bloomberg LP and Wells Fargo Securities, LLC

Negative equity in homes has contributed to foreclosures and reduced labor mobility

Negative Equity Mortgages - By State

Percent of Mortgages Outstanding

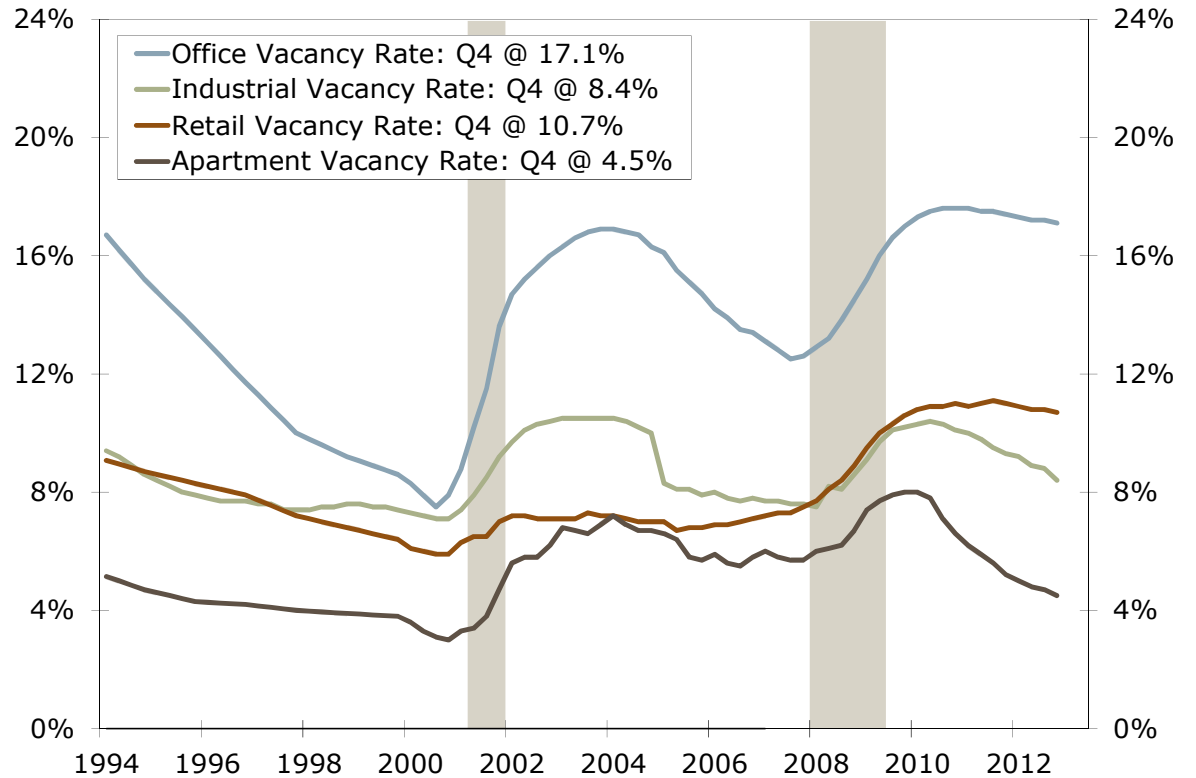


Source: CoreLogic and Wells Fargo Securities, LLC

The recovery has been uneven across property types

Commercial Real Estate Vacancy Rates

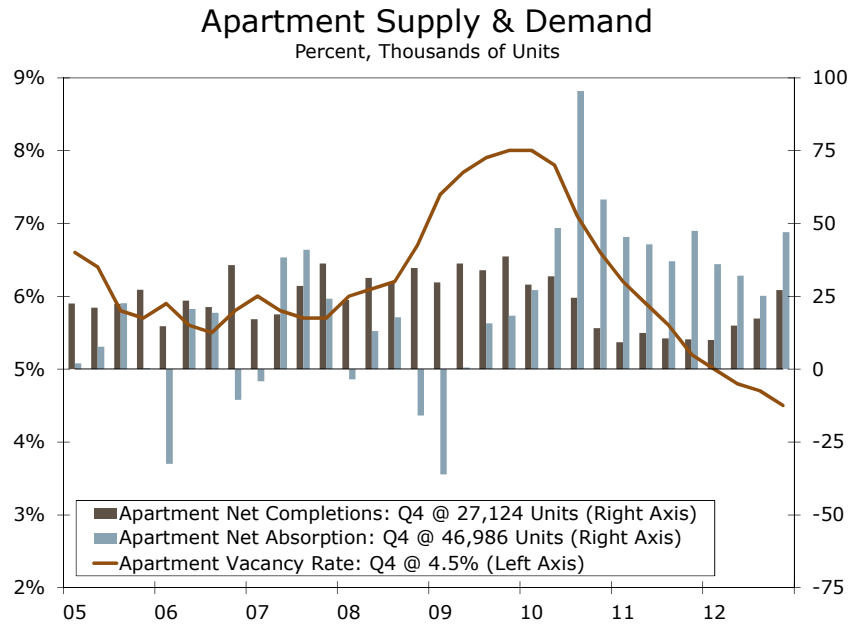
Percent



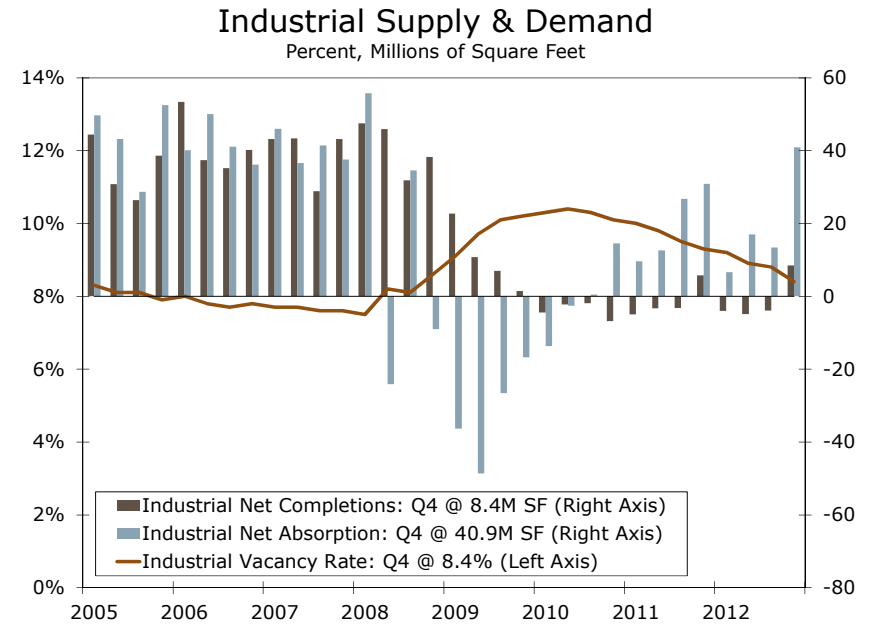
Source: Reis, Inc., PPR and Wells Fargo Securities, LLC

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



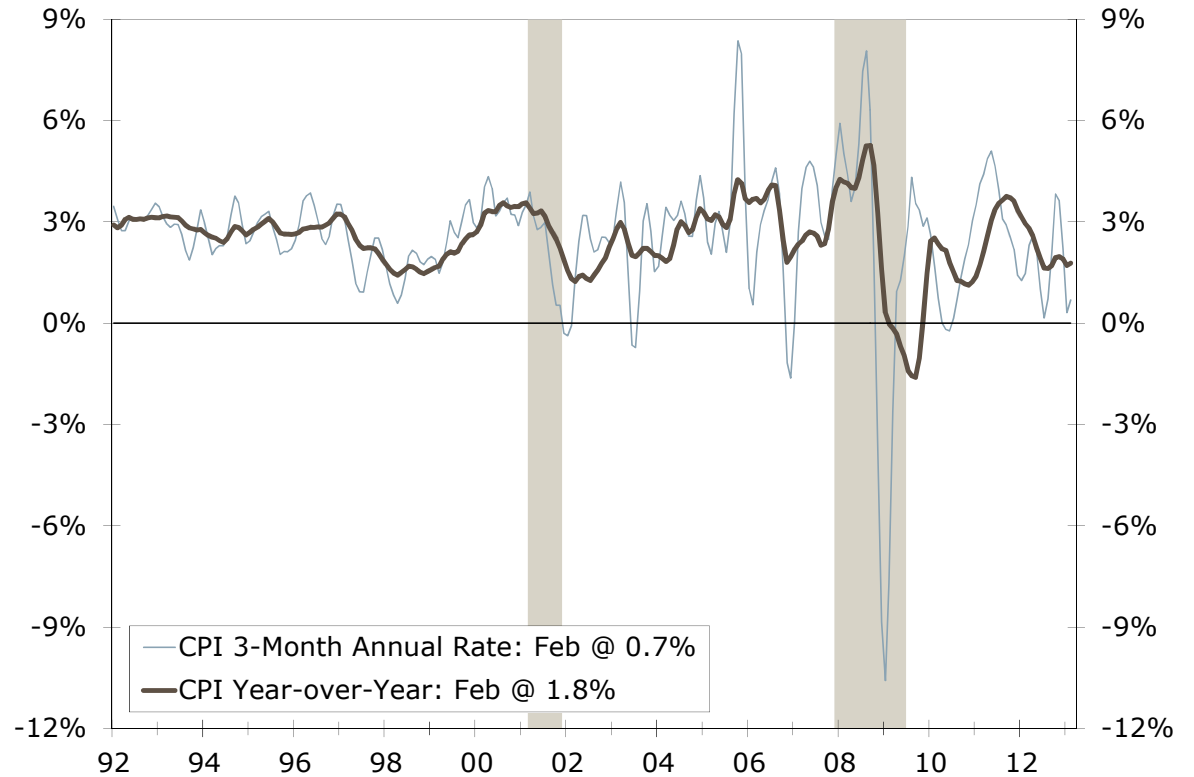
Source: Reis, Inc., U.S. Department of Commerce and Wells Fargo Securities, LLC



Consumer price growth should not pose a barrier to easier Federal Reserve policy in 2013

U.S. Consumer Price Index

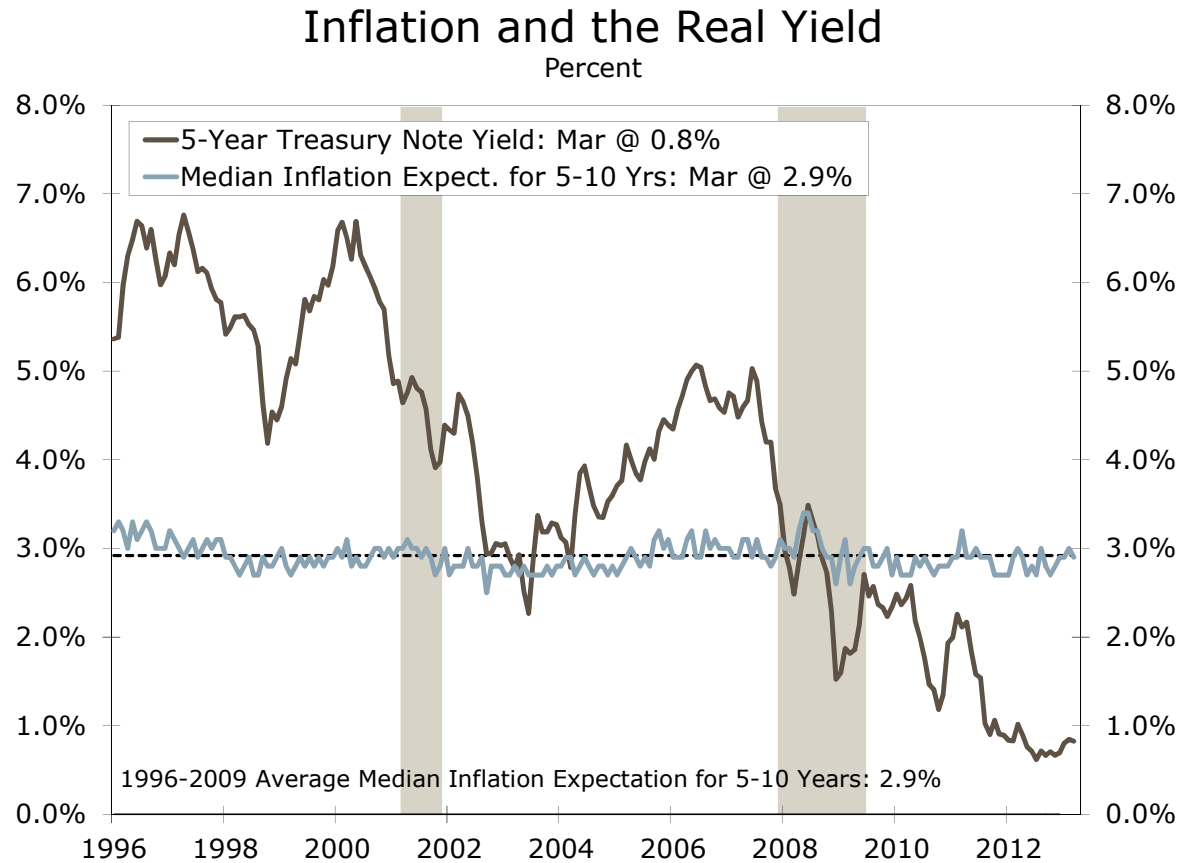
Both Series are 3-Month Moving Averages



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

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

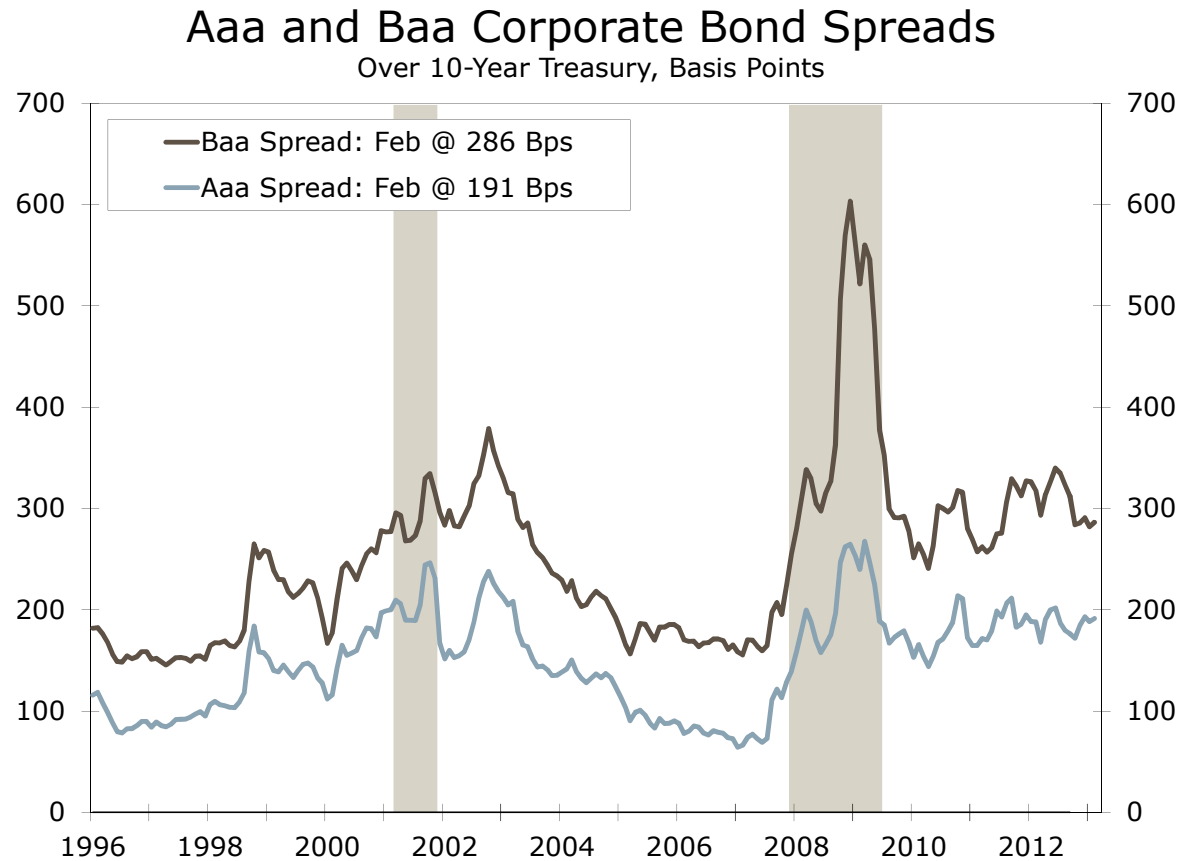
Inflation expectations exceed nominal returns



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

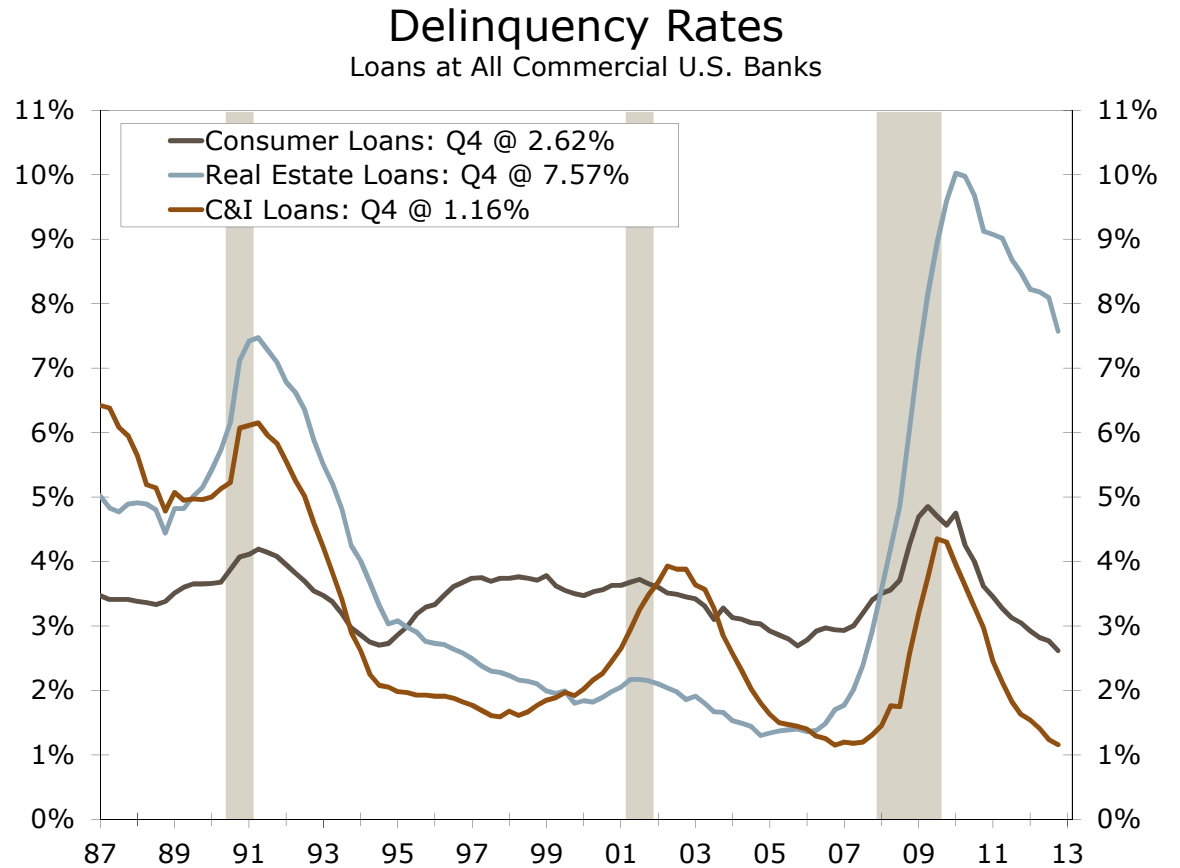
Corporate Spreads: Positive for Issuance

Spreads have returned to a more normal level; bond issuance is strong



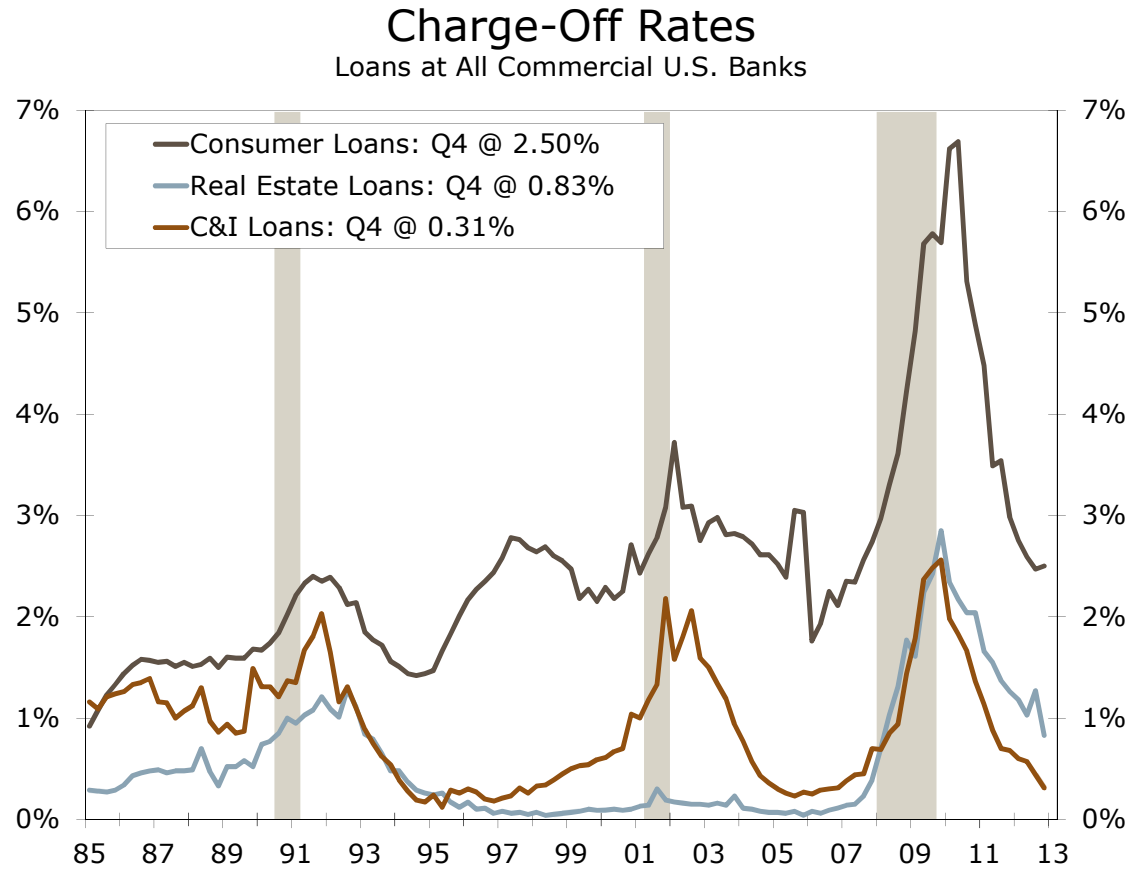
Source: Federal Reserve Board and Wells Fargo Securities, LLC

Delinquencies of real estate loans are significantly different from consumer and C&I loans



Source: Federal Reserve Board and Wells Fargo Securities, LLC

Patterns in charge-off rates have also changed

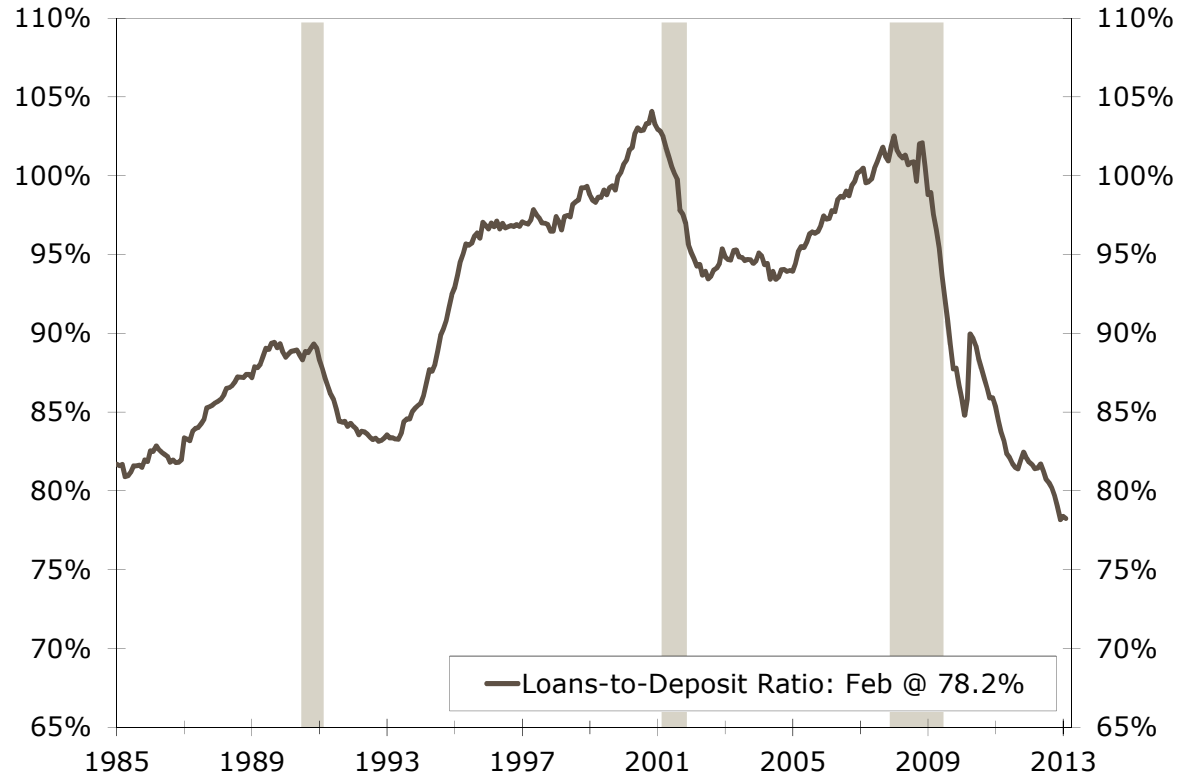


Source: Federal Reserve Board and Wells Fargo Securities, LLC

Bank Lending: Money Multiplier

Banks are no longer turning over deposits into loans at the previous pace

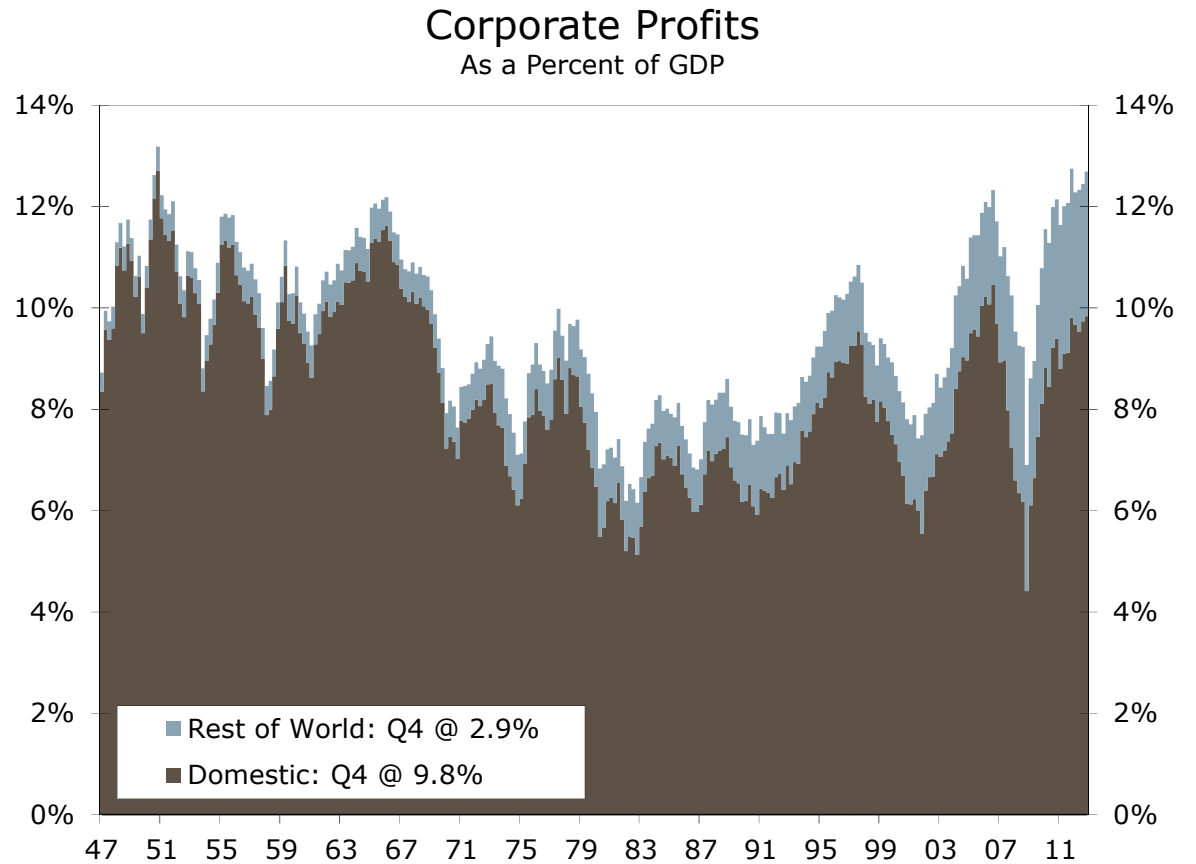
Loan-to-Deposit Ratio At Commercial Banks in the United States



Source: Federal Reserve Board and Wells Fargo Securities, LLC

Corporate Profits: Increasing Role of Global Profits

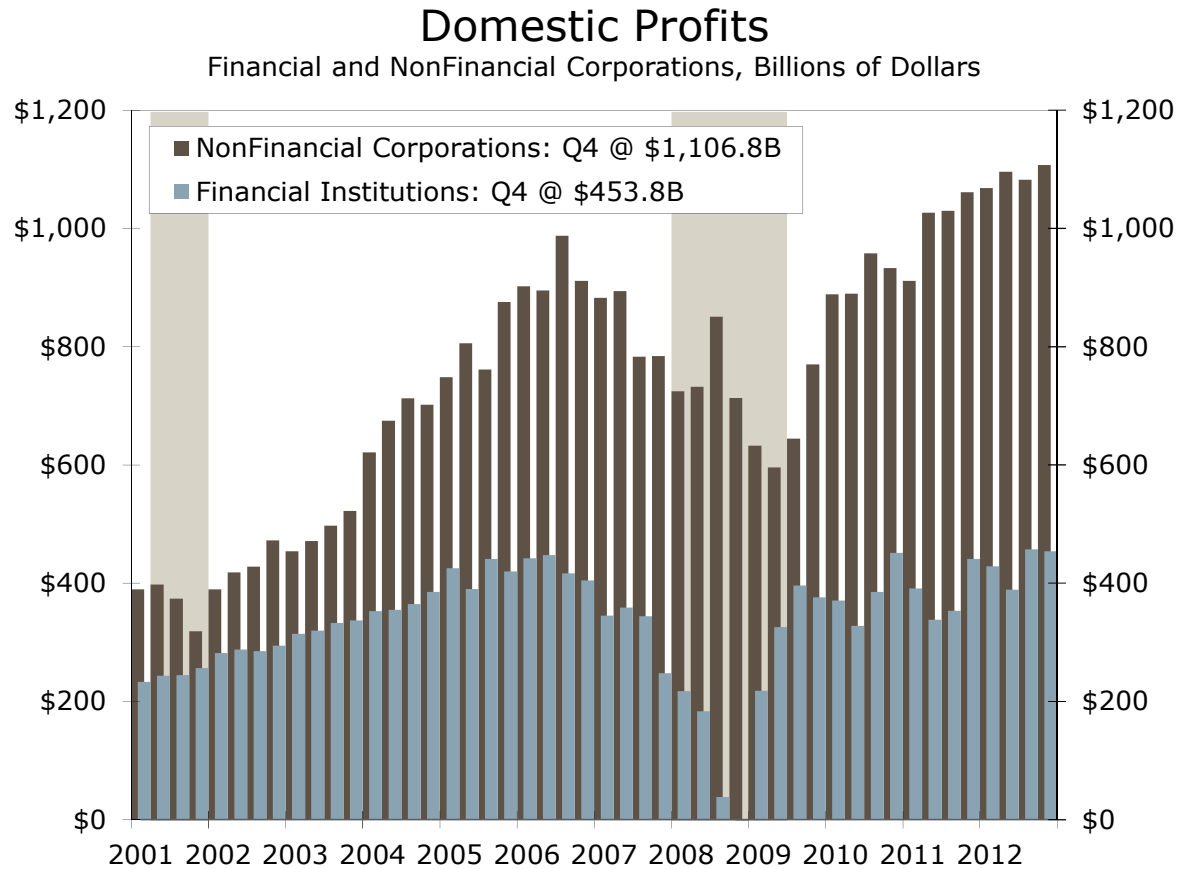
Profits as a percentage of GDP are historically high and are being boosted by profits earned abroad



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

Corporate Profits: Domestic Profits

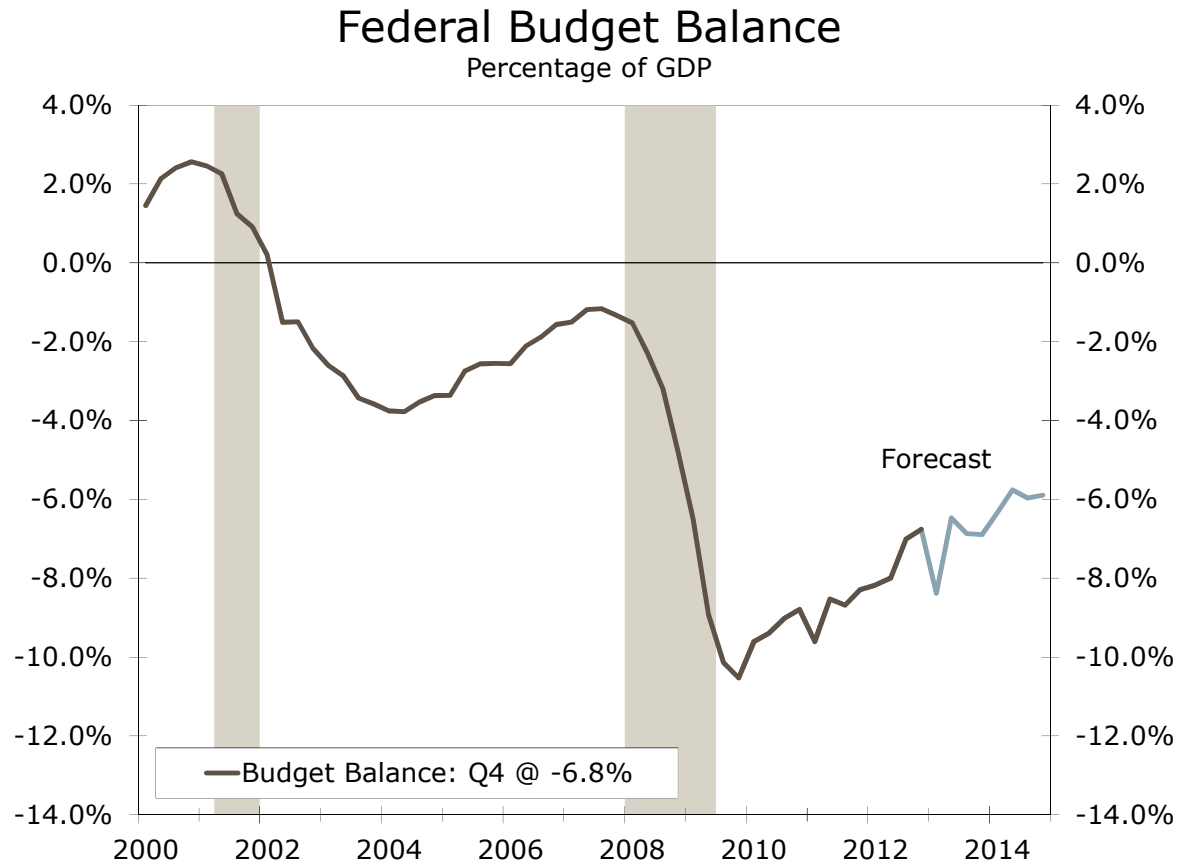
Financial institutions have struggled to see profits rise after the recession



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

Fiscal Policy: Difficult Choices/Chronic Imbalance

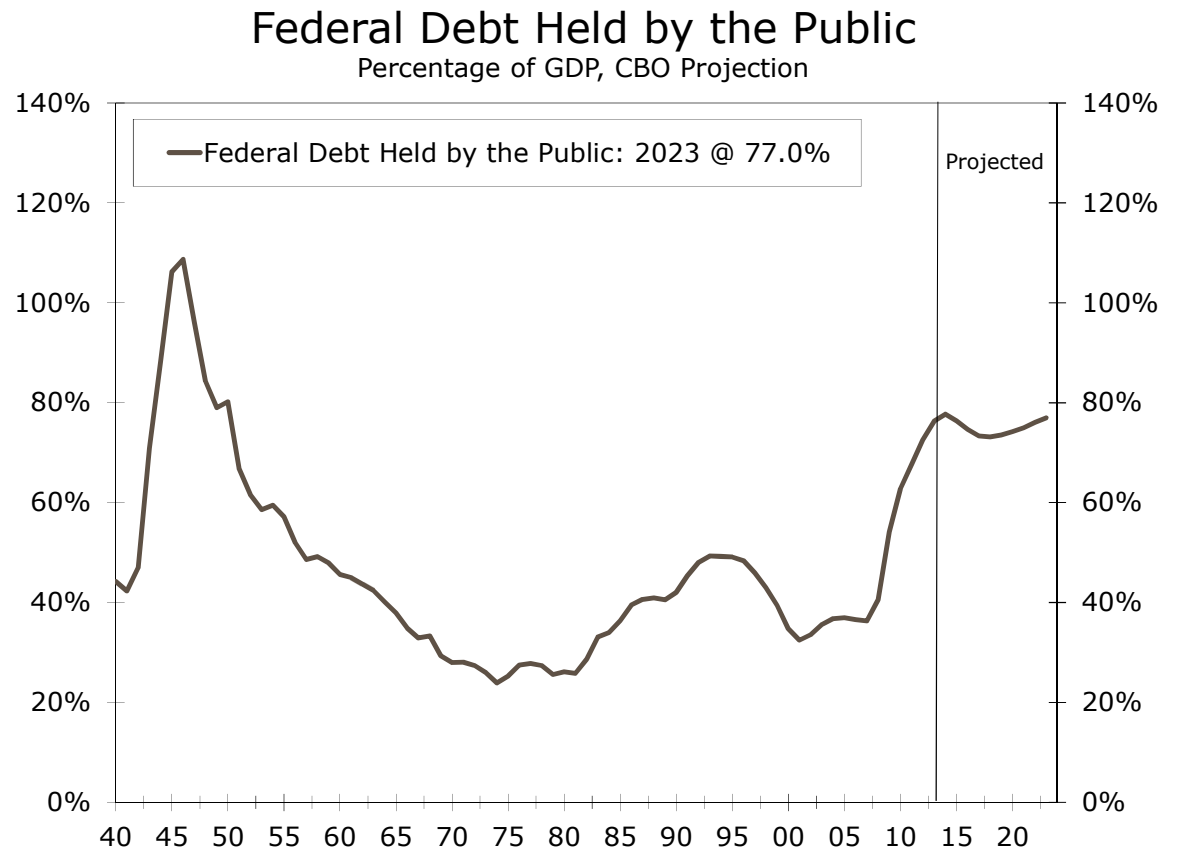
The nation has entered uncharted waters in fiscal policy—no balance at 2.75 percent GDP growth



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

Federal Debt Held by the Public: Unsustainable

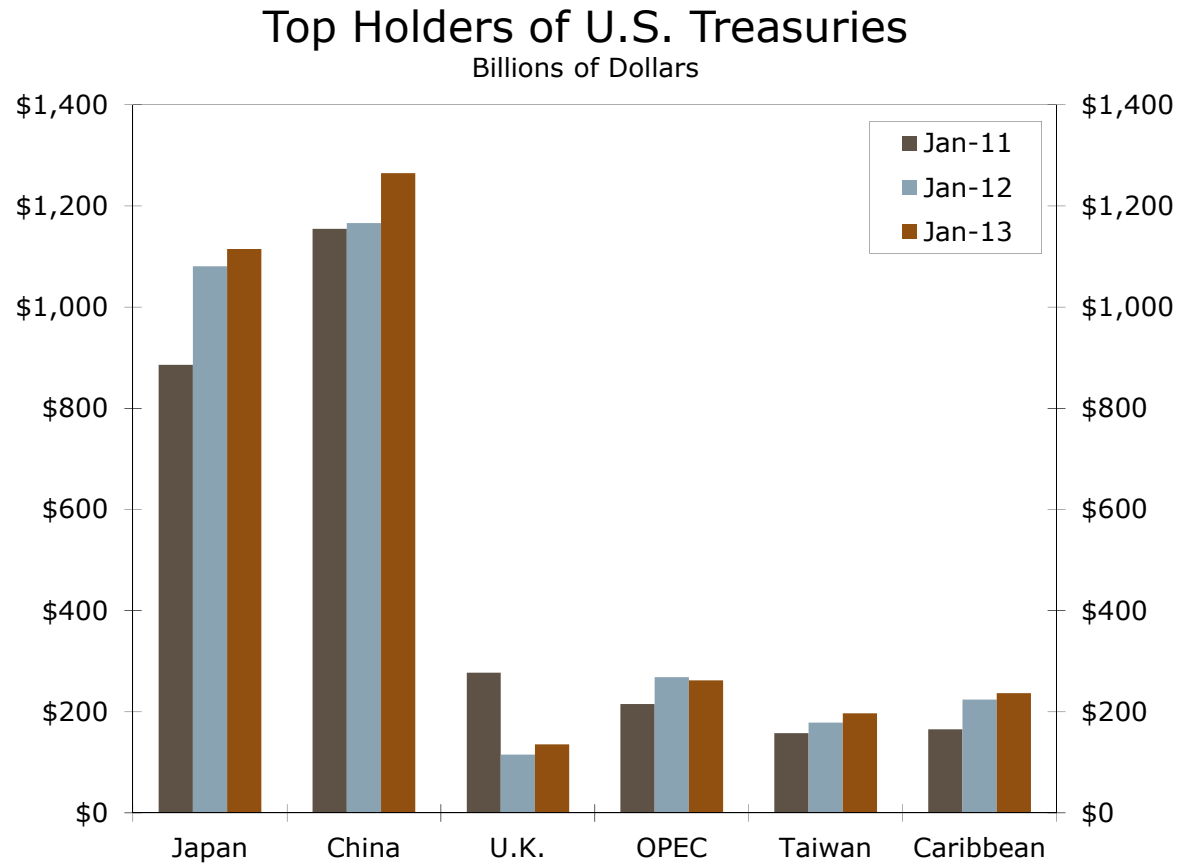
Federal debt held by the public will likely remain near 80 percent



Source: Congressional Budget Office and Wells Fargo Securities, LLC

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

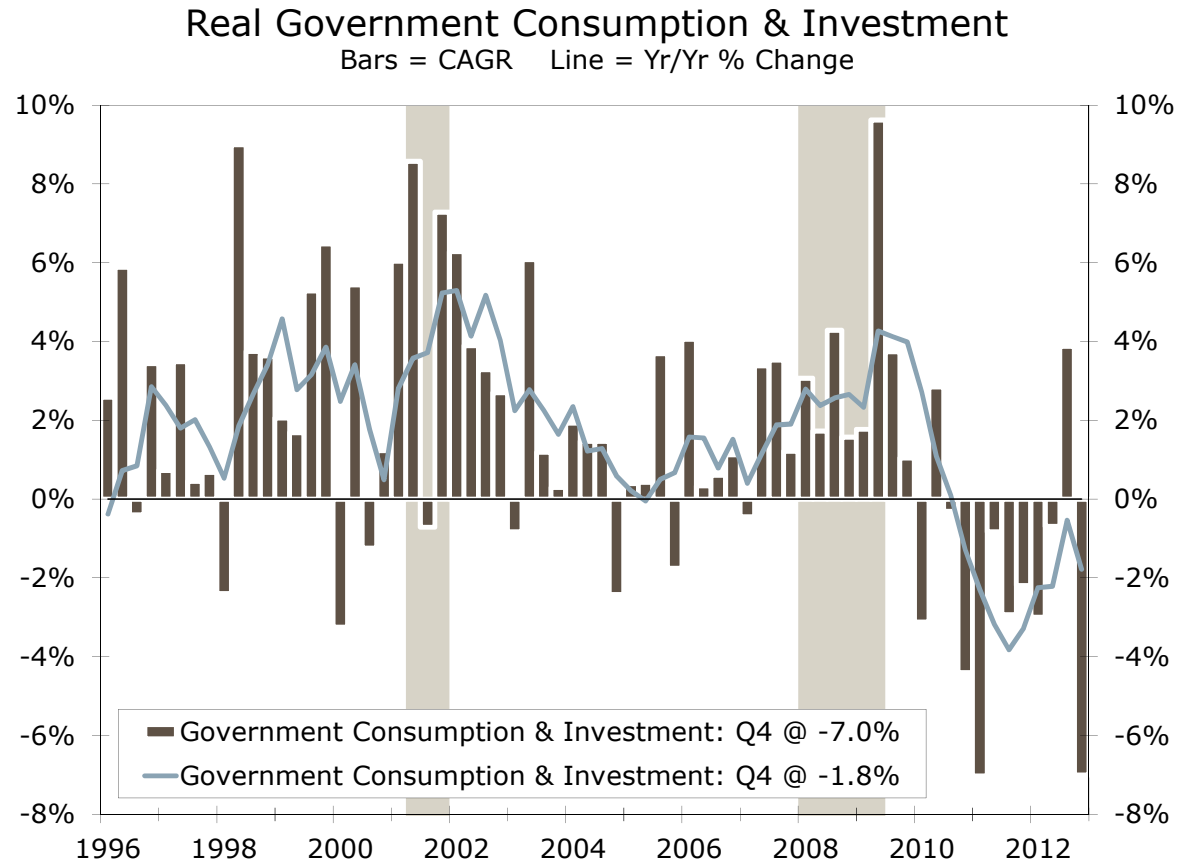
Japan and China hold an unprecedented amount of U.S. debt



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

Fiscal Policy: Restructuring Continues

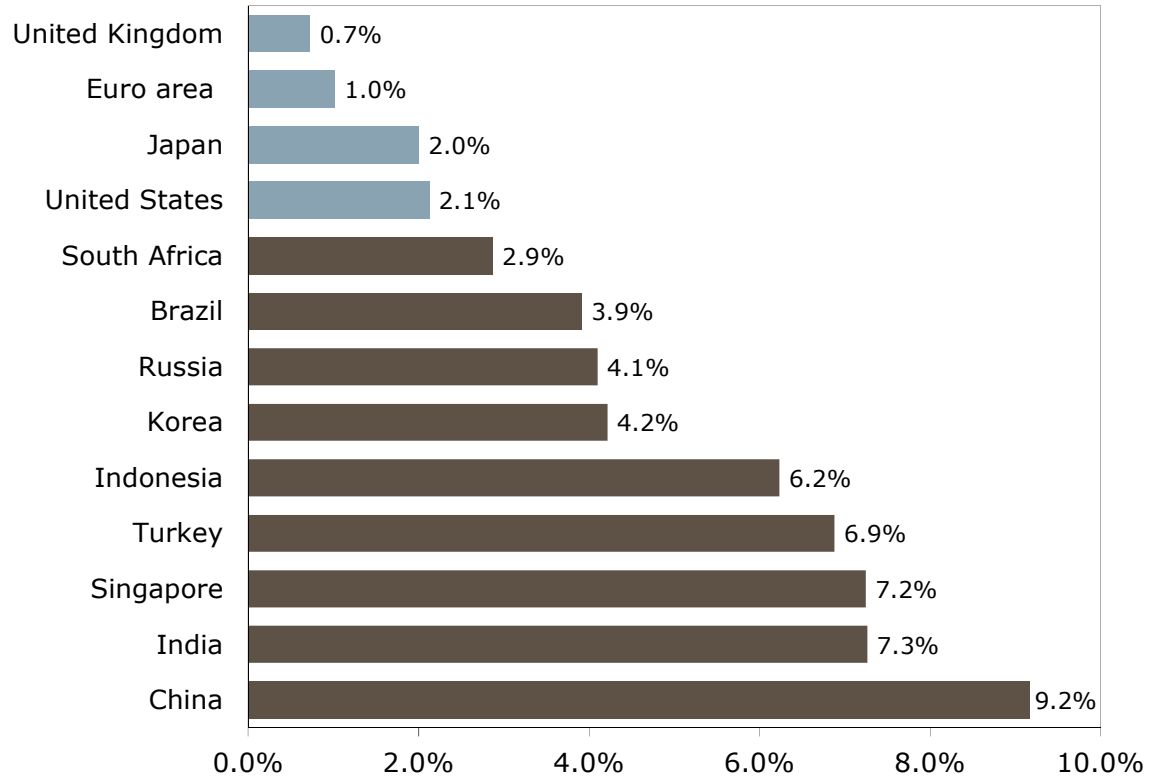
The government sector continues to be a drag on GDP as state and local governments restructure



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

The global recovery is being driven by emerging markets

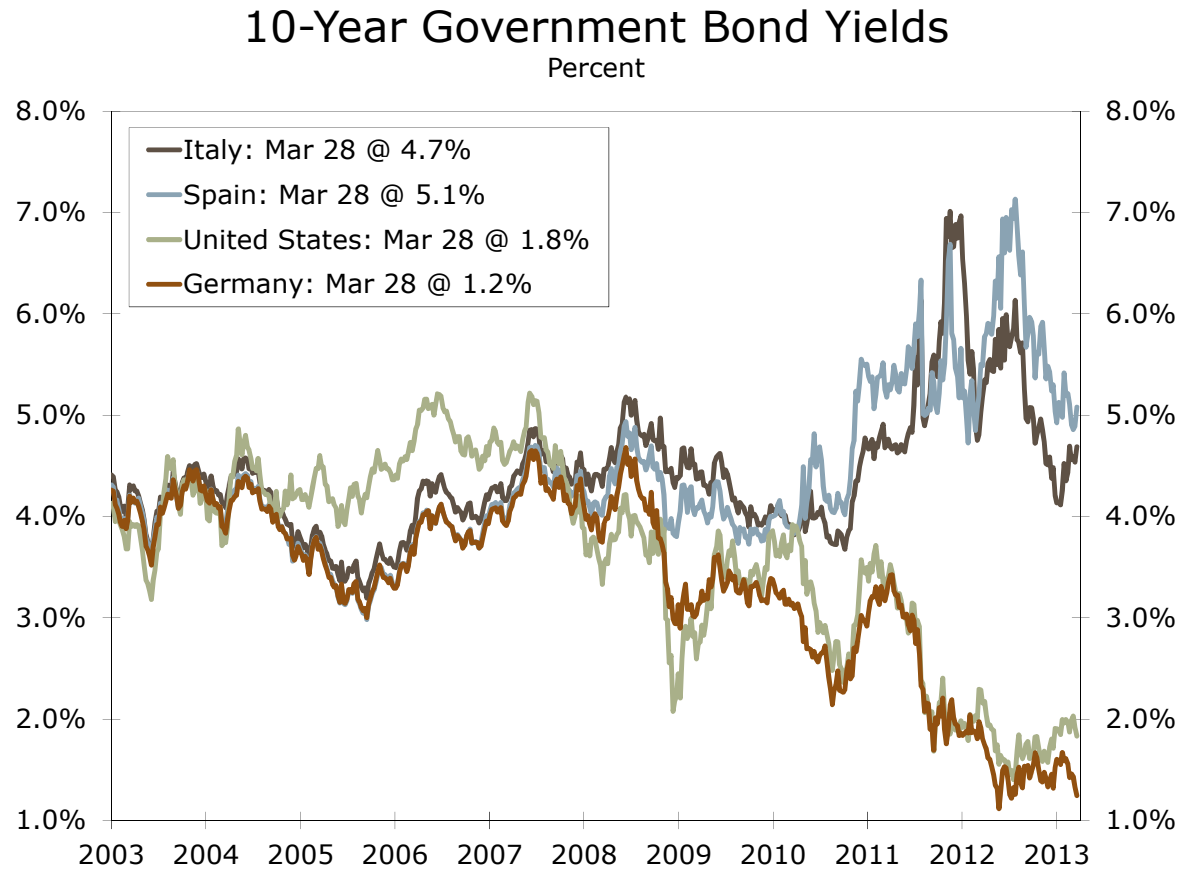
GDP Growth Post-Recession
Average Annual Percent Change for 2010-2012



Source: International Monetary Fund and Wells Fargo Securities, LLC

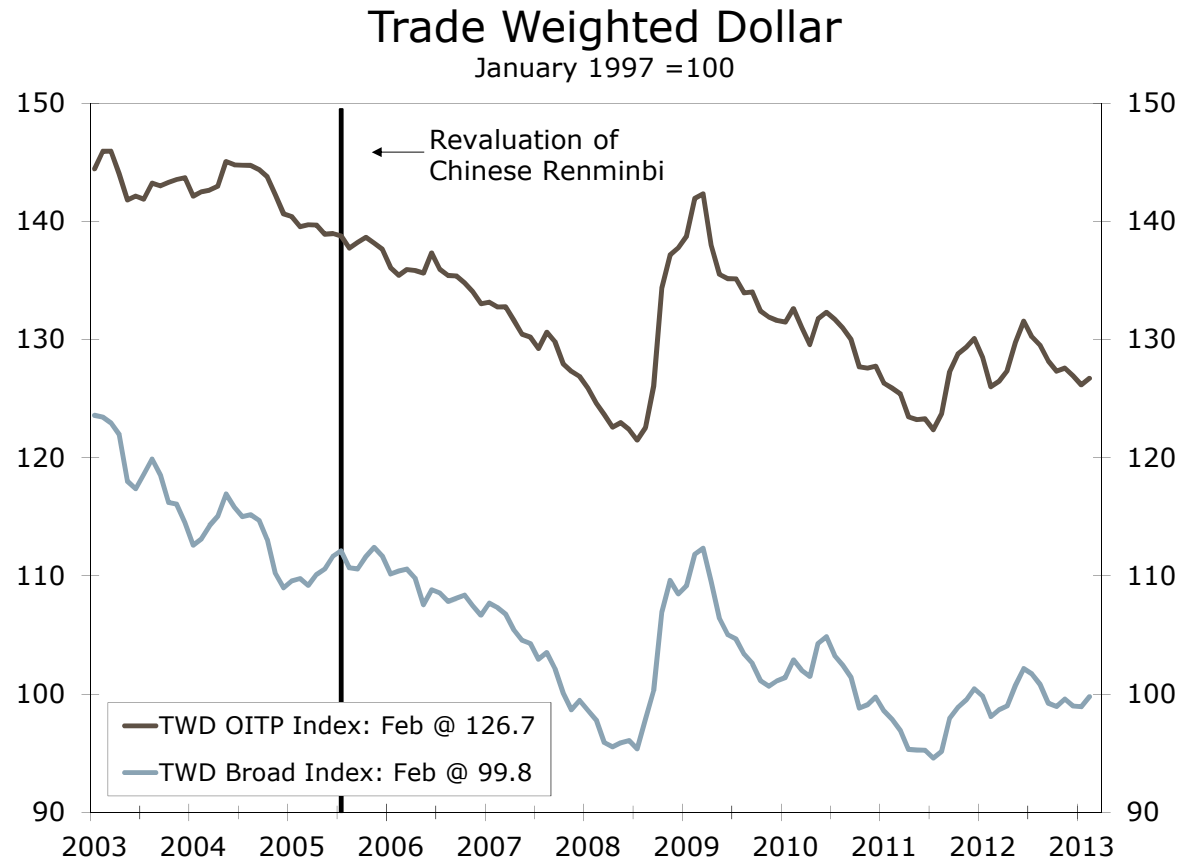
Eurozone Financial Markets: Structural Break in Risk Assessments

Tensions in European financial markets have subsided, at least for now



Source: IHS Global Insight and Wells Fargo Securities, LLC

Economic fundamentals and risks abroad will drive the dollar



Source: Federal Reserve Board and Wells Fargo Securities, LLC

What are the primary risks to the outlook?

Potential Challenges to the Outlook

- Easier 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
- 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		
	2012				2013				2010	2011	2012	2013	2014	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product ¹	2.0	1.3	3.1	0.4	2.5	2.2	2.3	2.2	2.4	1.8	2.2	2.0	2.4	
Personal Consumption	2.4	1.5	1.6	1.8	2.1	1.8	1.7	1.9	1.8	2.5	1.9	1.8	1.9	
Inflation Indicators ²														
PCE Deflator	2.4	1.6	1.5	1.6	1.3	1.6	1.6	1.6	1.9	2.4	1.8	1.5	1.9	
Consumer Price Index	2.8	1.9	1.7	1.9	1.8	2.4	2.3	2.3	1.6	3.1	2.1	2.2	2.2	
Industrial Production ¹	5.4	2.9	0.3	2.4	5.3	5.0	4.5	4.3	5.7	3.4	3.6	3.7	4.1	
Corporate Profits Before Taxes ²	10.3	6.7	7.5	3.1	4.8	5.2	5.3	5.7	26.8	7.3	6.8	5.3	6.4	
Trade Weighted Dollar Index ³	72.7	74.5	72.7	73.4	75.5	76.0	76.5	77.0	75.4	70.9	73.5	76.3	77.8	
Unemployment Rate	8.3	8.2	8.0	7.8	7.7	7.6	7.5	7.4	9.6	8.9	8.1	7.6	7.2	
Housing Starts ⁴	0.71	0.74	0.77	0.90	0.92	0.96	1.02	1.08	0.59	0.61	0.78	0.95	1.17	
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	0.25	
Conventional Mortgage Rate	3.95	3.68	3.50	3.35	3.47	3.70	3.80	3.90	4.69	4.46	3.66	3.72	4.30	
10 Year Note	2.23	1.67	1.65	1.78	1.87	2.10	2.20	2.30	3.22	2.78	1.80	2.12	2.70	

Forecast as of: March 29, 2013

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

Date	Title	Authors
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March-25	Sweden and Denmark: So Close, Yet So Far Apart	Bryson
March-21	Argentina's Economy Slows Down Considerably in 2012	Aleman
March-20	How Stationary Is My Economic North Star?	Silvia, Iqbal & Swankoski
March-20	Florida's Economic Recovery Continues To Build Momentum	Vitner & Silverman
March-15	Arizona: Back from the Brink	Aleman & Griffiths
March-11	Mexican Central Bank: Concerned By Slowing Inflation	Aleman
March-07	Government Spending: Three Faces of Change	Silvia & Brown
March-05	Commercial Real Estate Chartbook: Quarter 4	Vitner, Khan & Silverman
February-28	Emerging Market Debt: A Looming Problem?	Bryson
February-25	Economic Impact of Budget Sequestration	Silvia & Brown
February-20	Economic Outlook and the Banking Sector	Silvia
February-18	Sequestration: Which States Are Most Vulnerable?	Vitner & Brown
February-15	The Chinese Financial System: Year of the Turquoise?	Bryson
February-11	Student Loans: A Different Financial Market	Silvia & Watt
February-11	Strong Contraction in Mexican Industrial Production	Aleman
February-11	Housing Chartbook: January 2013	Vitner, Khan & Silverman
February-07	European Debt Dynamics: An Update	Bryson
February-05	Alabama's Big Wheels Keep on Turning	Vitner & Silverman
February-04	When Is This Time Different?	Silvia, Iqbal, Watt & Swankoski
February-04	The Brazilian Economy Continues to Struggle	Aleman
January-25	Bank of Japan Joins Other Central Banks	Quinlan
January-25	British Economy Remains Quite Weak	Bryson
January-24	Is Commercial Real Estate Still an Inflation Hedge?	Khan
January-15	A Decision Maker's View of Fiscal Policy	Silvia
January-15	California's Broadening Economic Recovery	Vitner
January-14	Peruvian Economy: Still Going Strong	Aleman
January-09	National Health Spending: Secular Growth Cyclical Slowdown	Silvia & Swankoski
January-04	Employment: So, Is This It?	Silvia & Watt
January-02	A Fiscal Cliff Resolution? Not Really	Silvia & Brown
December-19	Texas: Growth in a Weakening World Environment	Aleman & Griffiths
December-19	Canada: Economic Rock Star Faces Big Challenges	Quinlan
December-18	Fiscal Cliff and True Reform	Silvia
December-17	Housing Chartbook: November 2012	Vitner, Khan & Silverman
December-13	2013 Economic Outlook	
December-11	Commercial Real Estate Chartbook: Quarter 3	Vitner, Khan & Silverman
December-03	Industrial Production and Business Spending Outlook	Quinlan & Watt

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