WELLS FARGO SECURITIES

# Economic Outlook: Cyclical Recovery, Structural Challenges
# Detroit NABE

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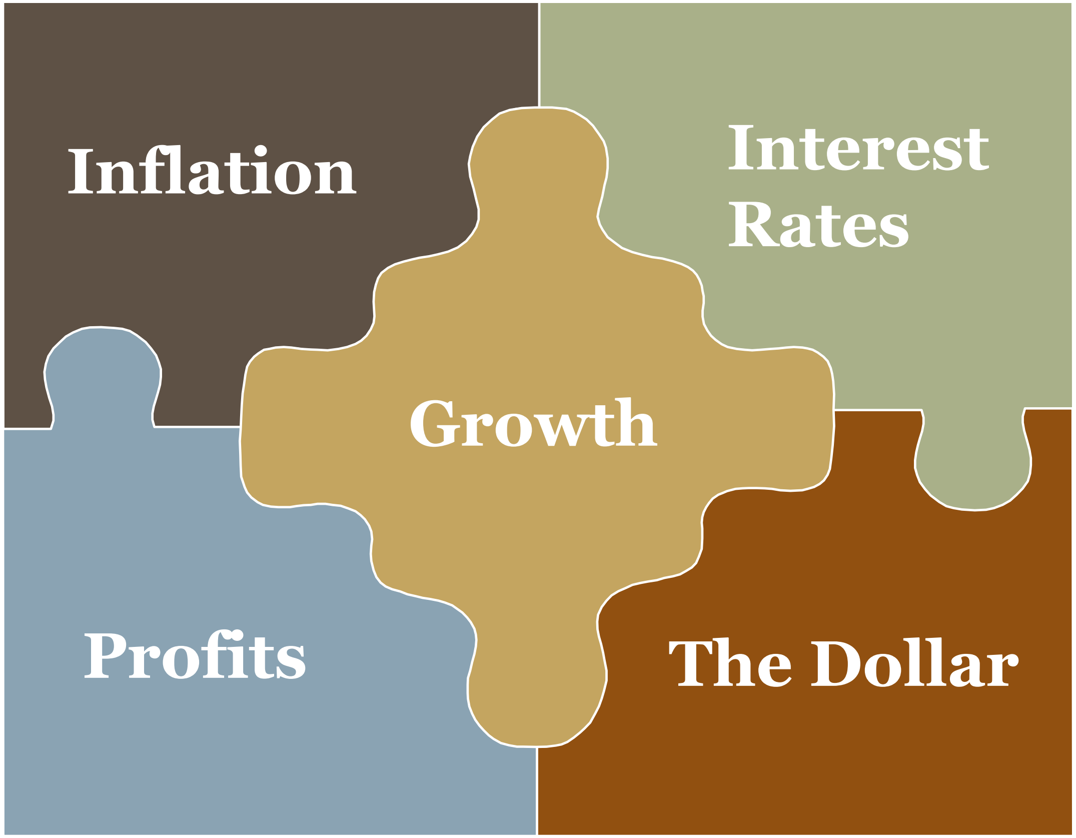
May 13, 2014

Together we'll go far

Five benchmarks for good decision making

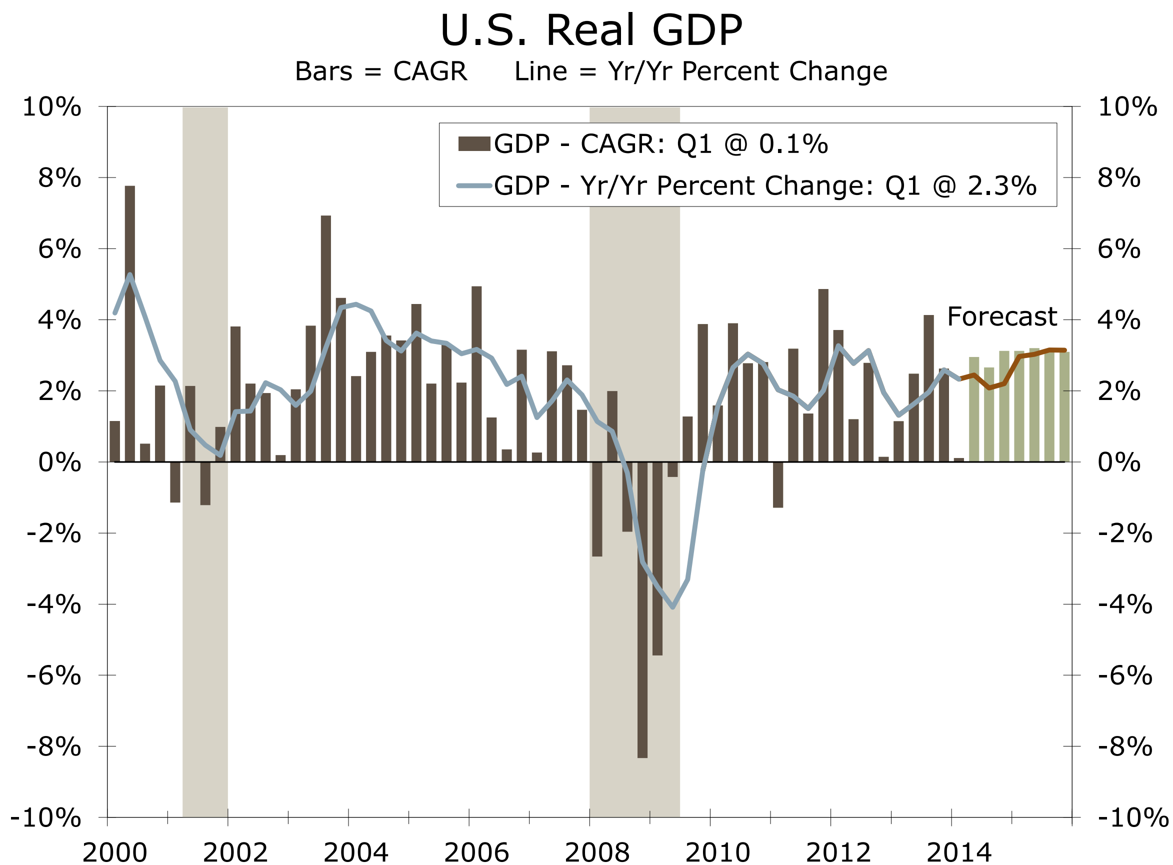


How do we differ from consensus?

| Expectations for the Future |
| --- |

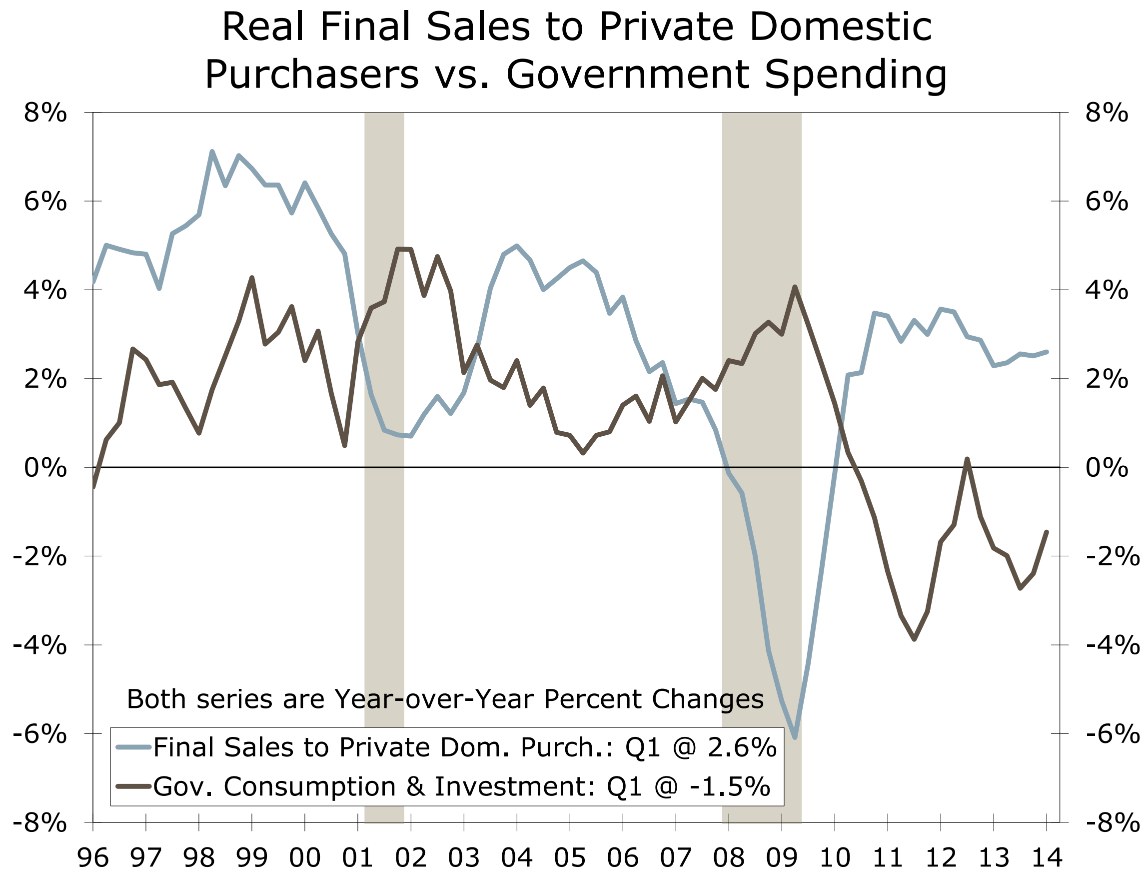
- Sustained-trend plus growth
- Employment—cyclical and structural change
- Still cautious on consumer segments
- Housing improving—multifamily especially
- State and local governments—still restructuring
- Unsustainable long-run fiscal policy
- Europe exits recession
- China growth stable at 7 percent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

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



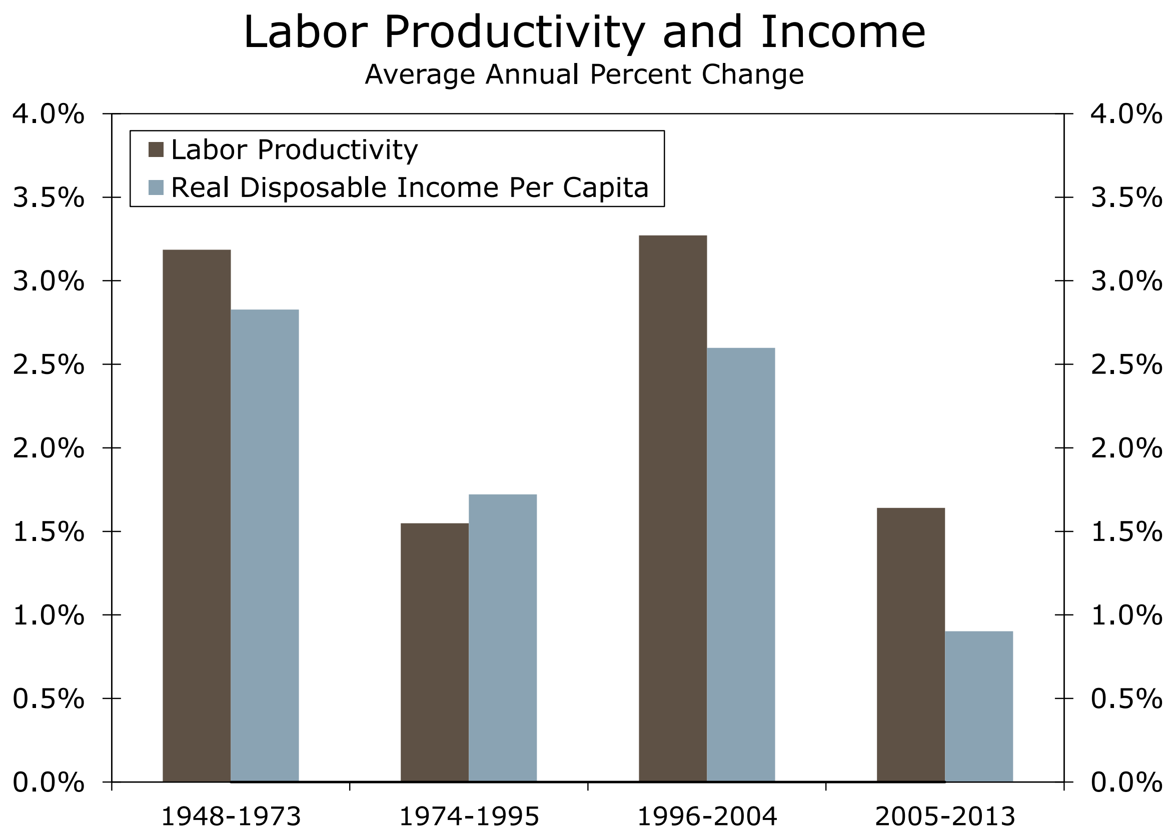

Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

The economy is rebalancing with steady private sector demand



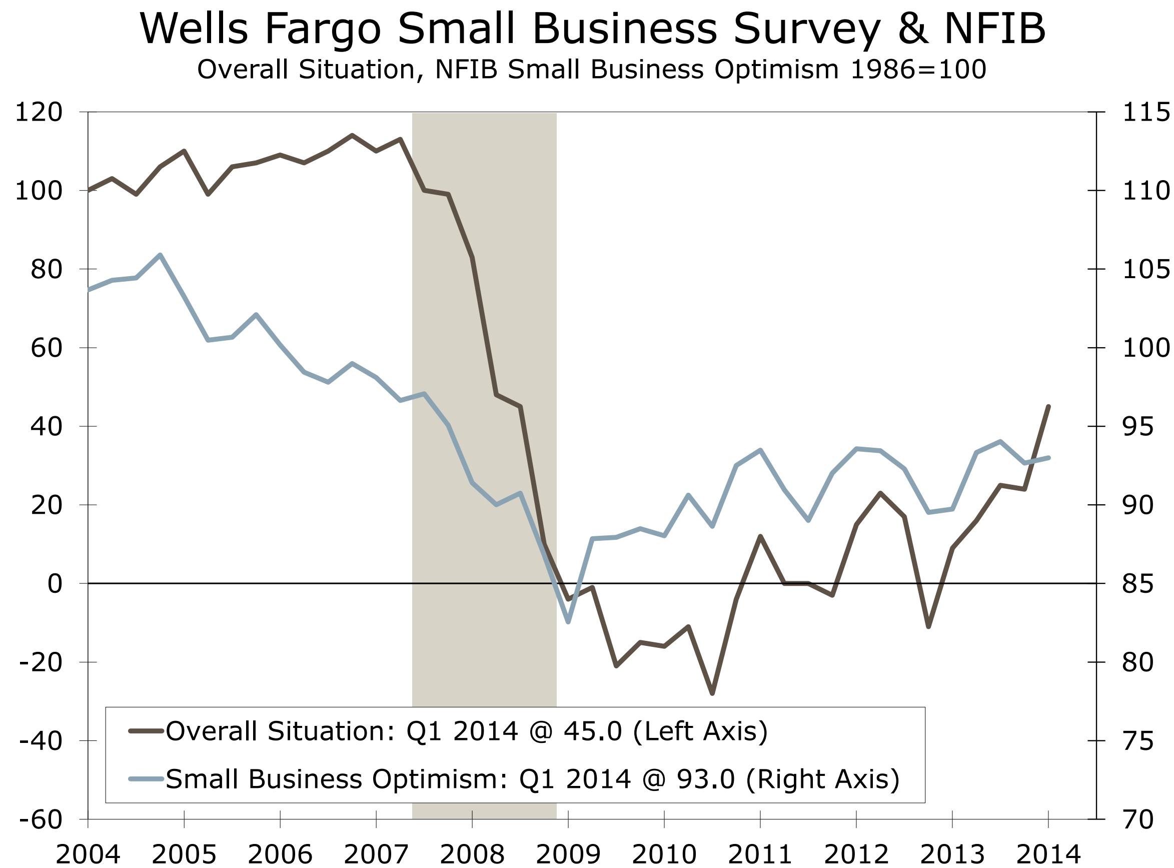

Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

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



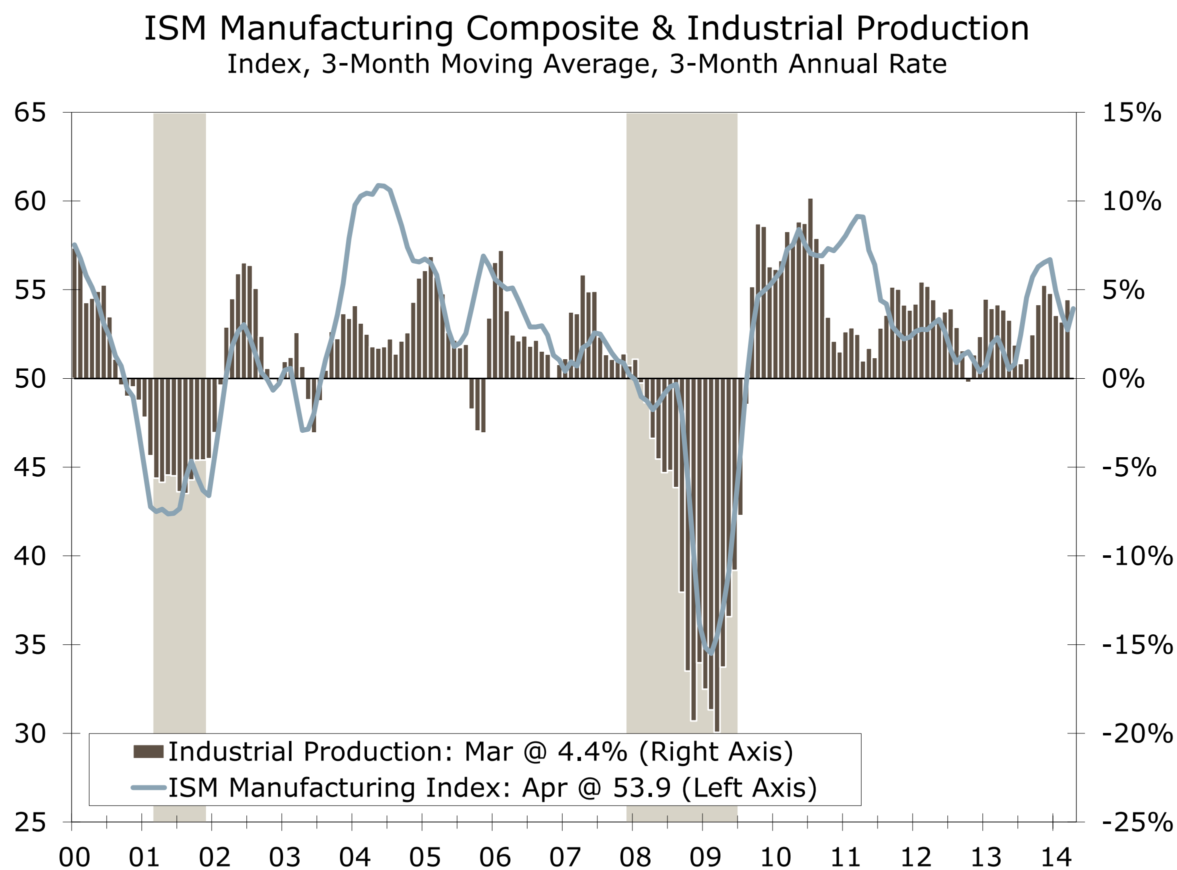

Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities, LLC

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



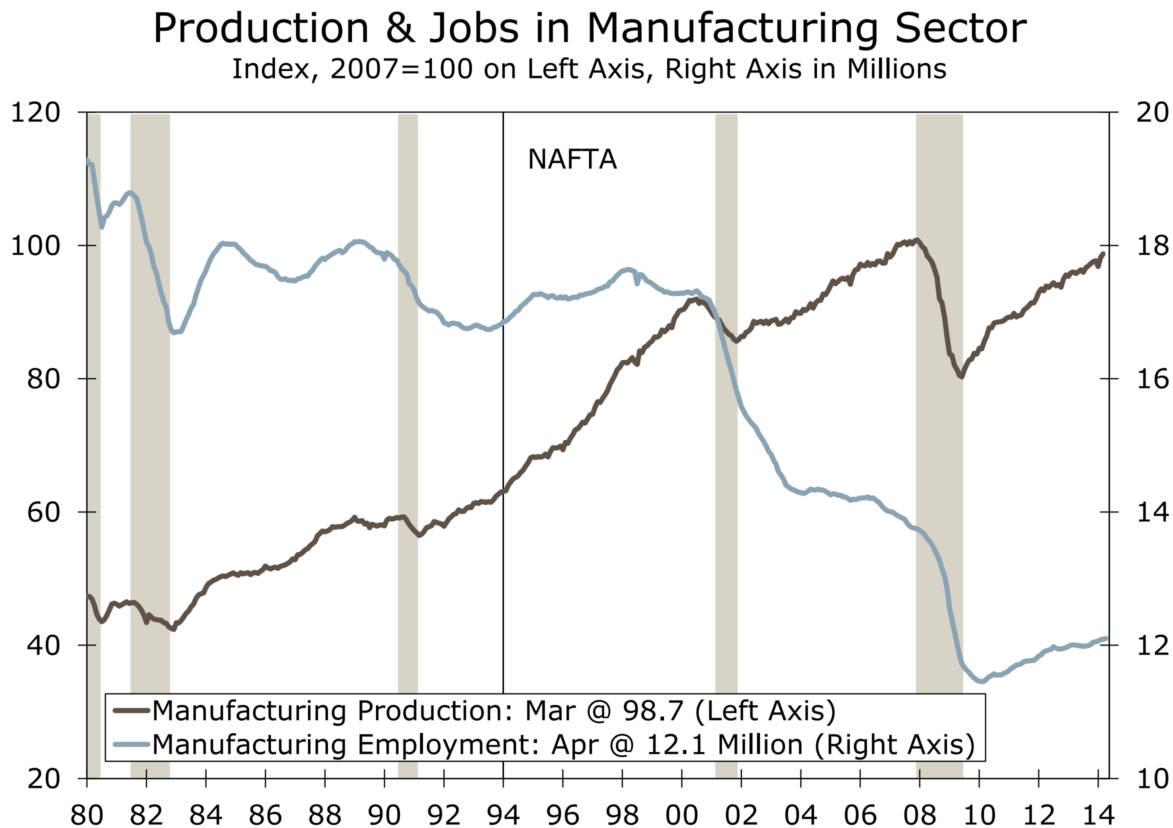

Source: National Federation of Independent Businesses, Gallup, Wells Fargo Bank and Wells Fargo Securities, LLC

Gains in ISM a plus for manufacturing



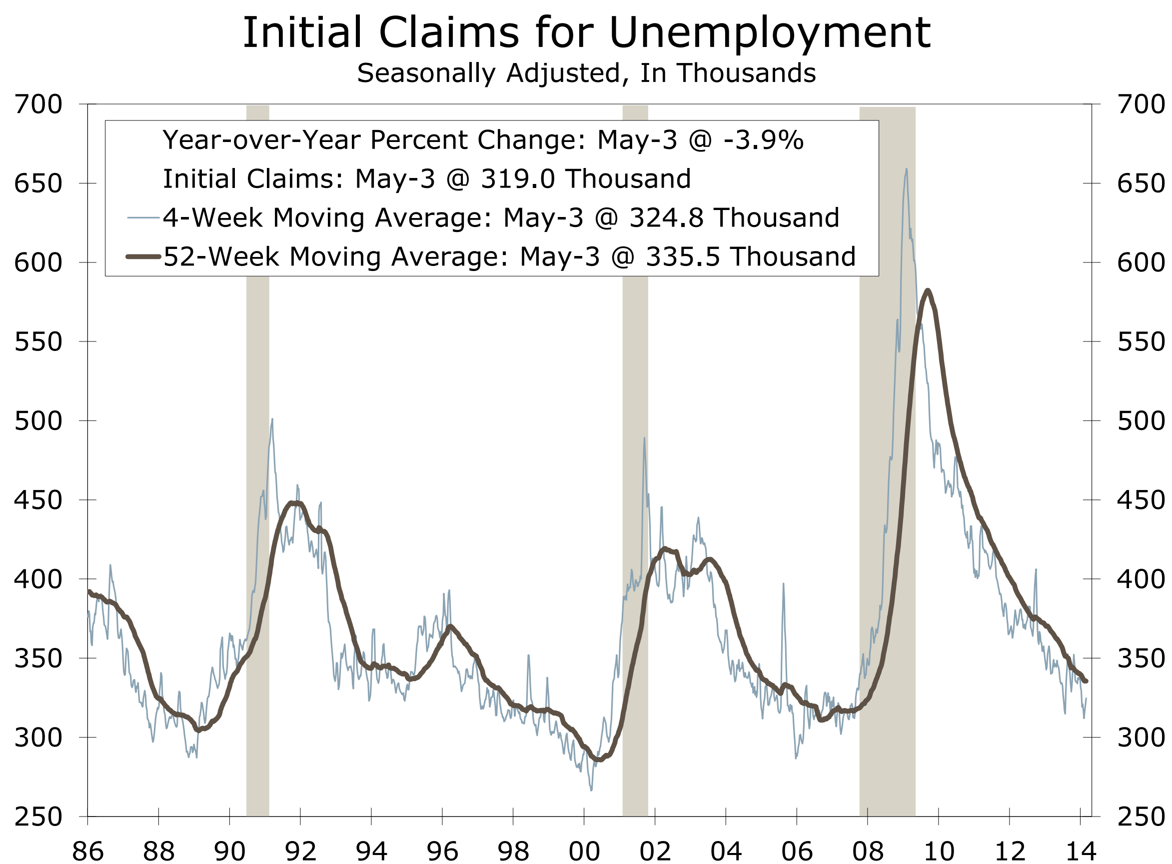

Source: Institute for Supply Management and Wells Fargo Securities, LLC

The gap between jobs and production in the manufacturing sector has become massive



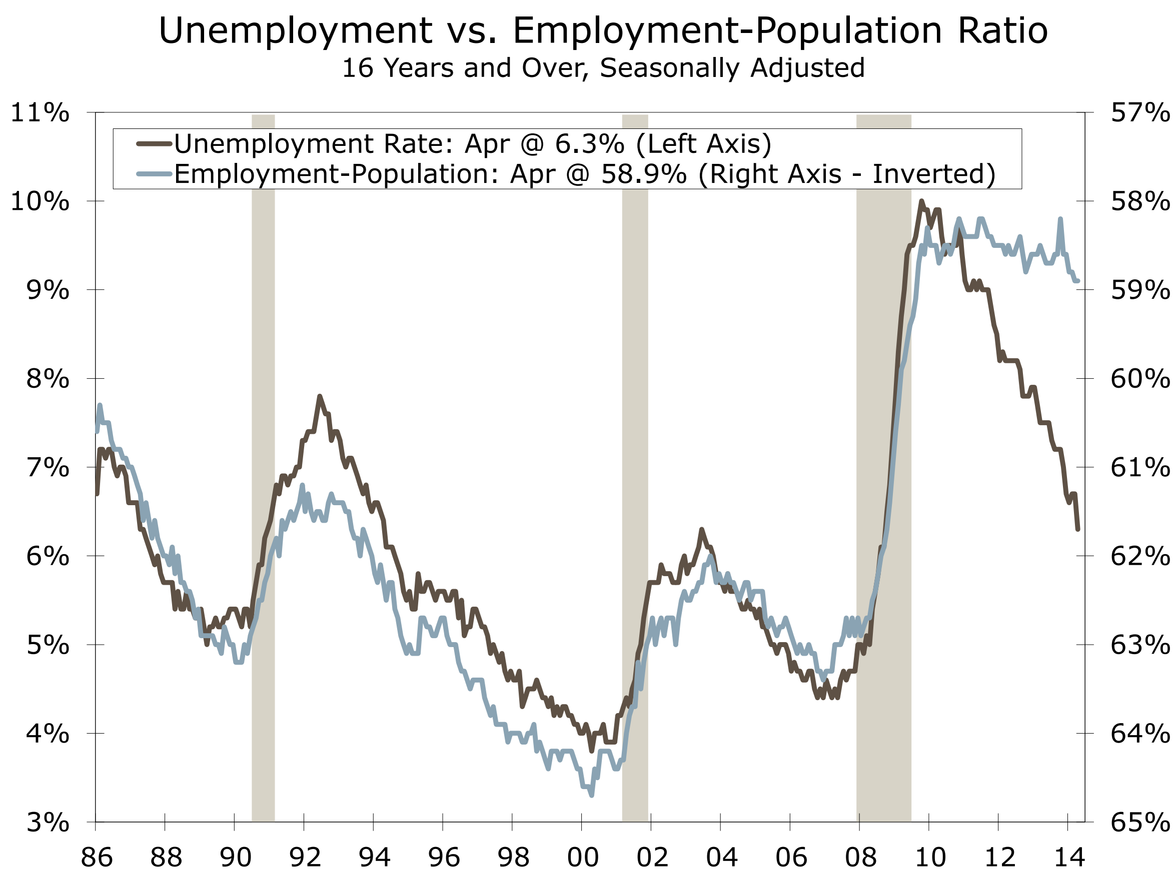

Source: Institute for Supply Management and Wells Fargo Securities, LLC

Signaling continued, moderate job gains ahead



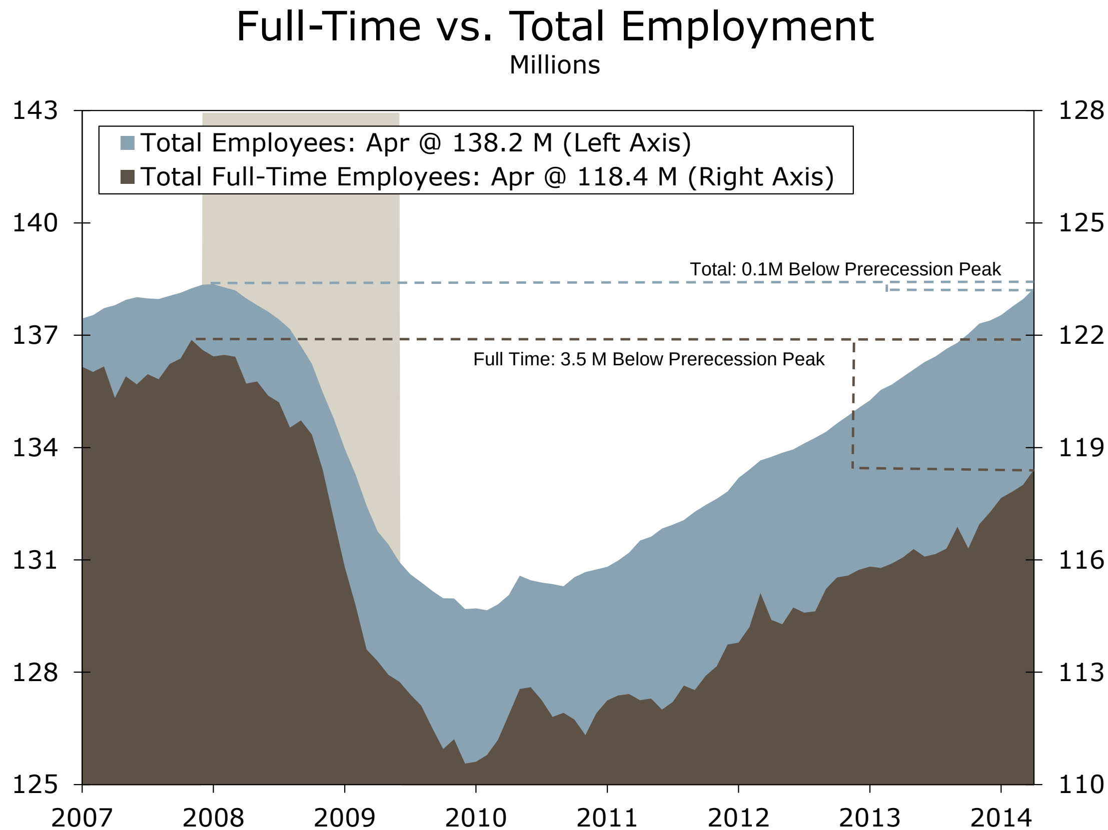

Source: U.S. Department of Labor and Wells Fargo Securities, LLC

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



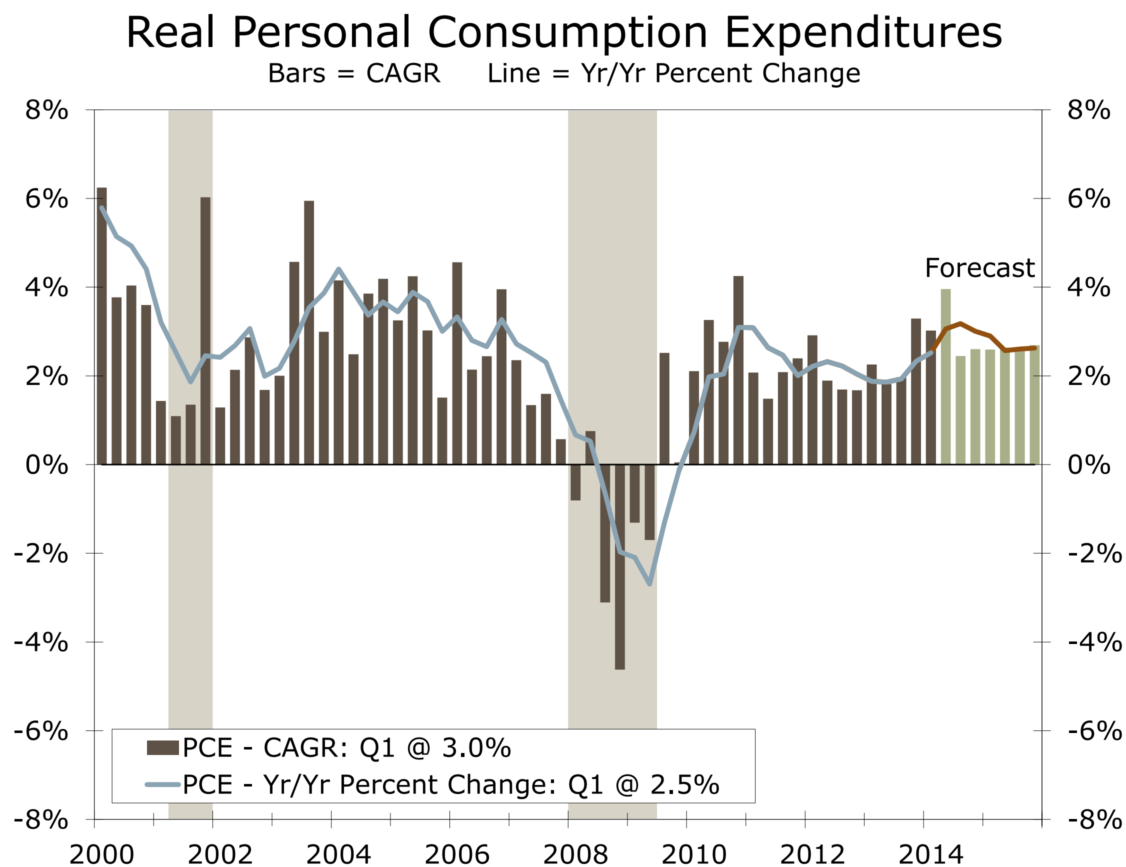

Source: U.S. Department of Labor and Wells Fargo Securities, LLC

We still have a ways to go before recovering all of the jobs lost in the most recent recession



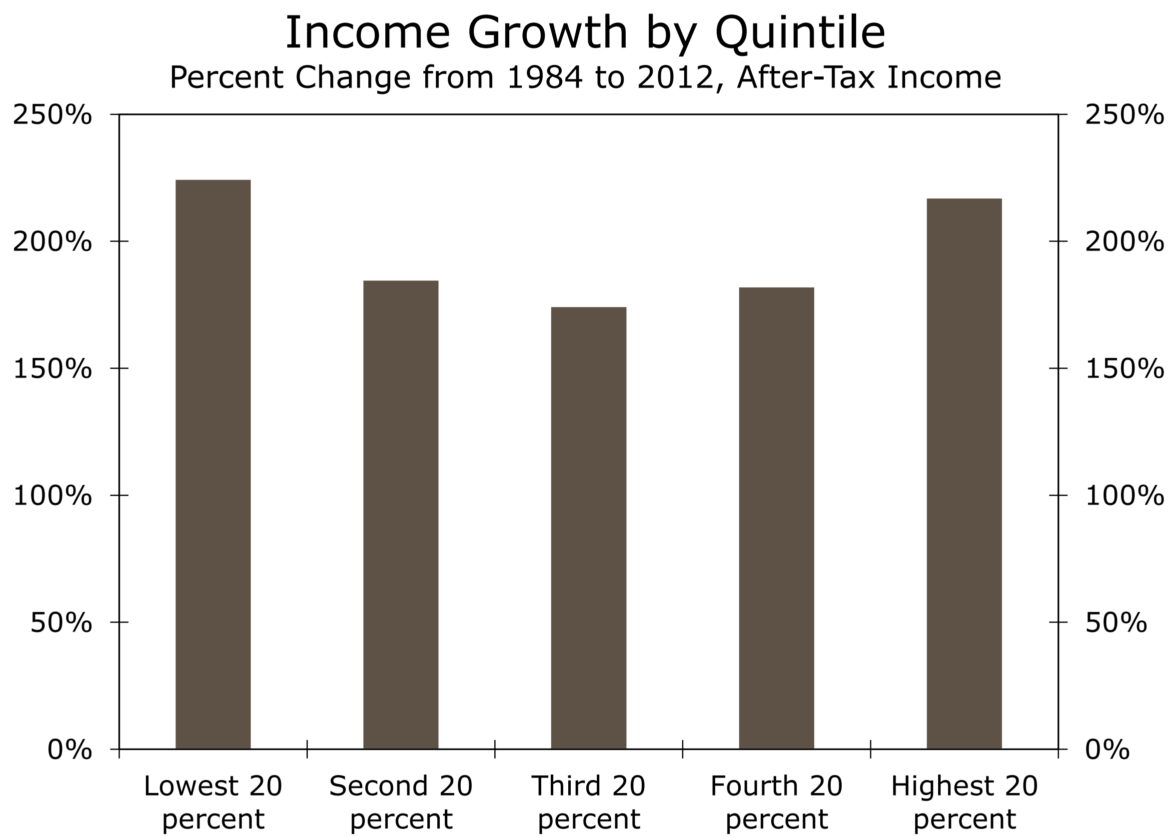

Source: U.S. Department of Labor and Wells Fargo Securities, LLC

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



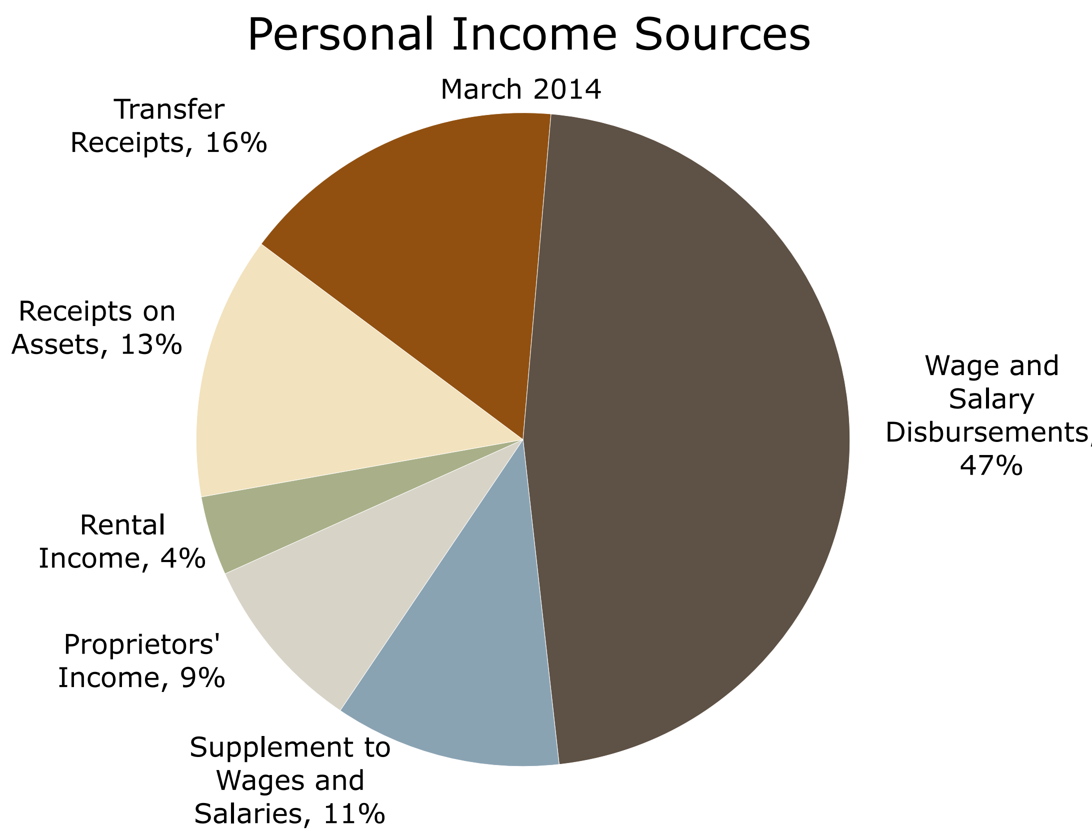

Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

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



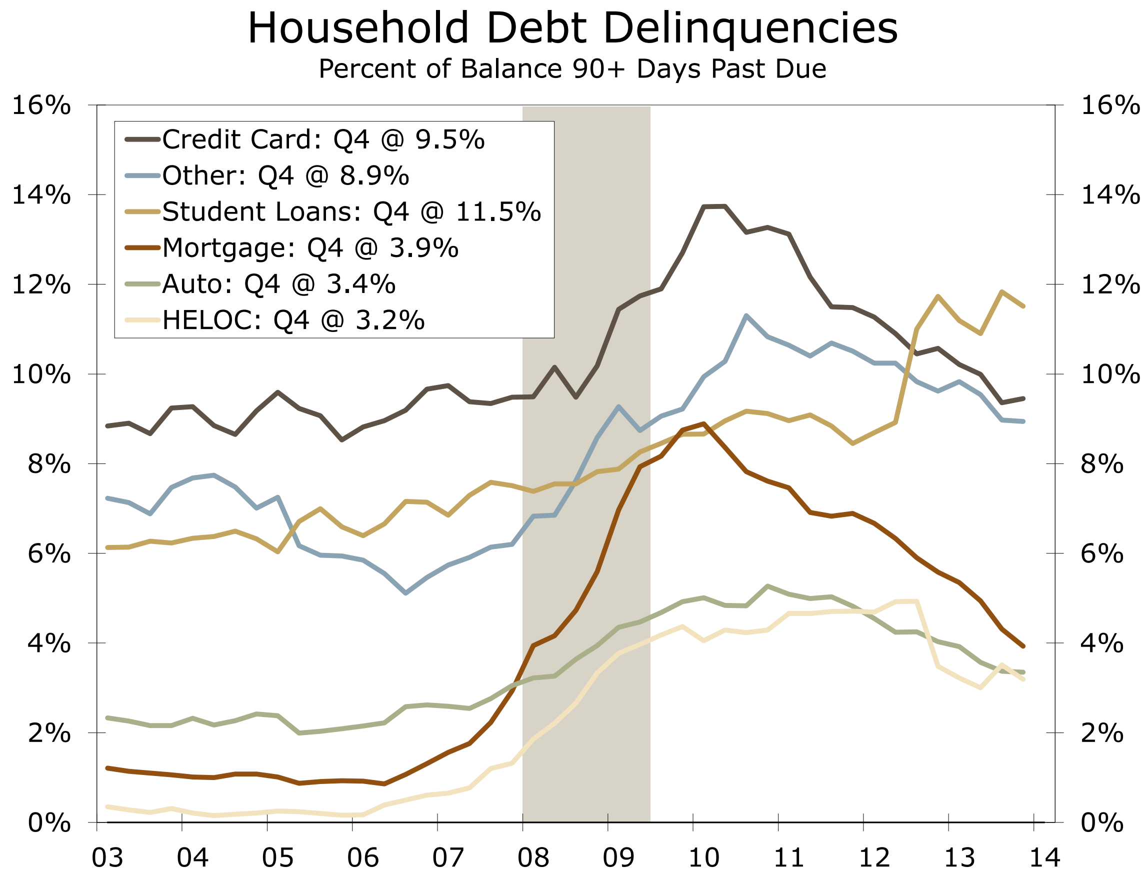

Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Wages and salaries make up less than 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

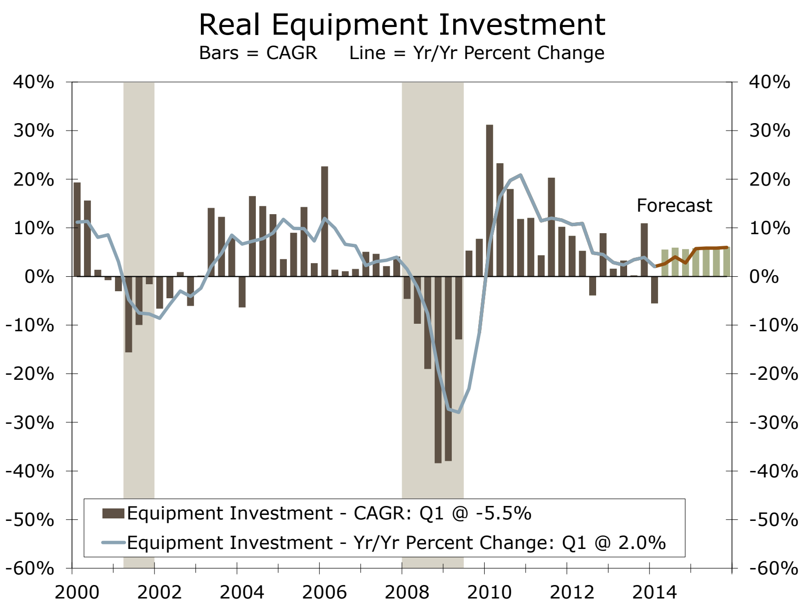
Tighter credit standards and a strengthening economy have helped to improve the credit position of households over the past 3 years



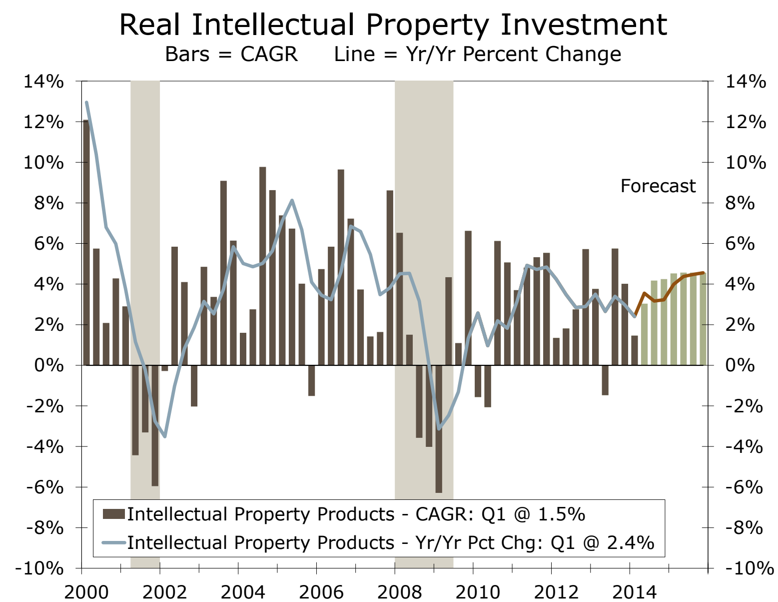

Source: Federal Reserve Bank of New York and Wells Fargo Securities, LLC

On an improving global demand outlook and diminishing fiscal policy headwinds, business leaders are becoming more comfortable with capex plans.

## Large-Ticket Spending Outlook Improves

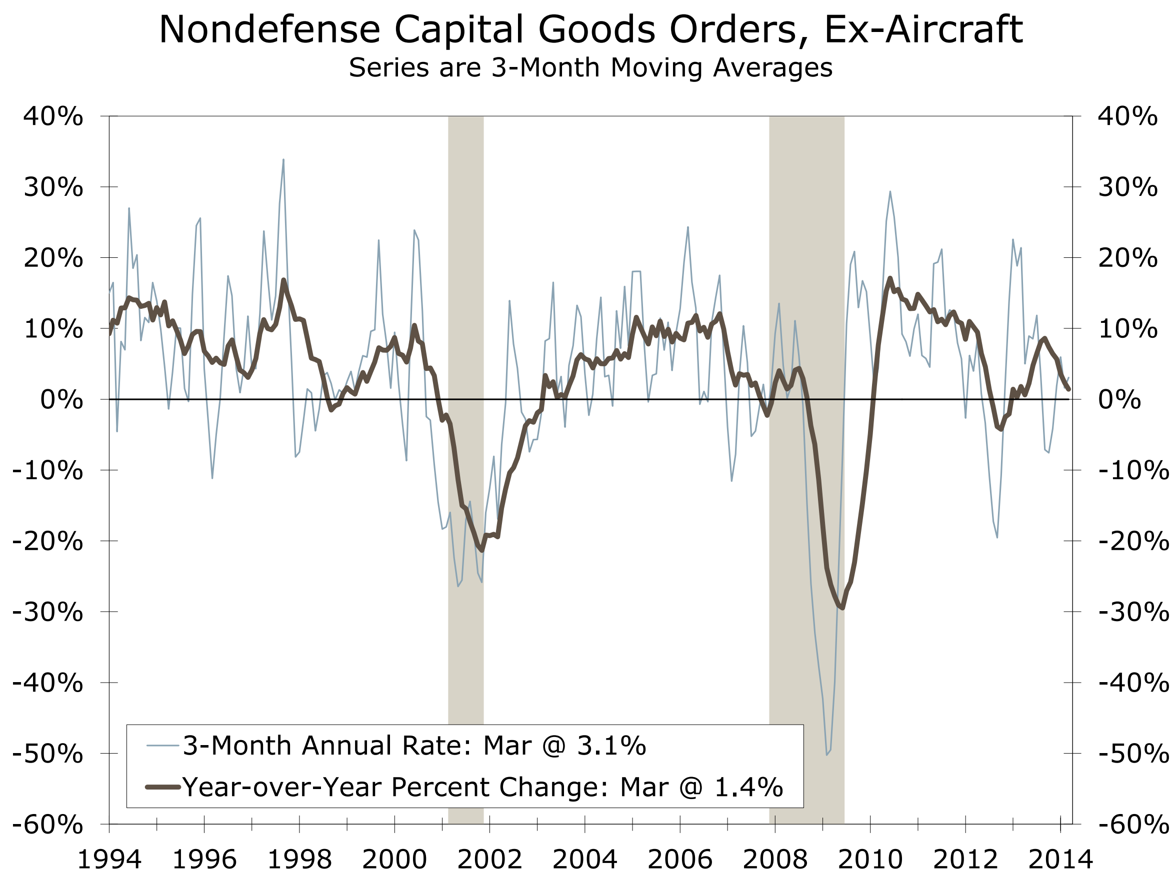



## Intellectual Investment Has Been Stable



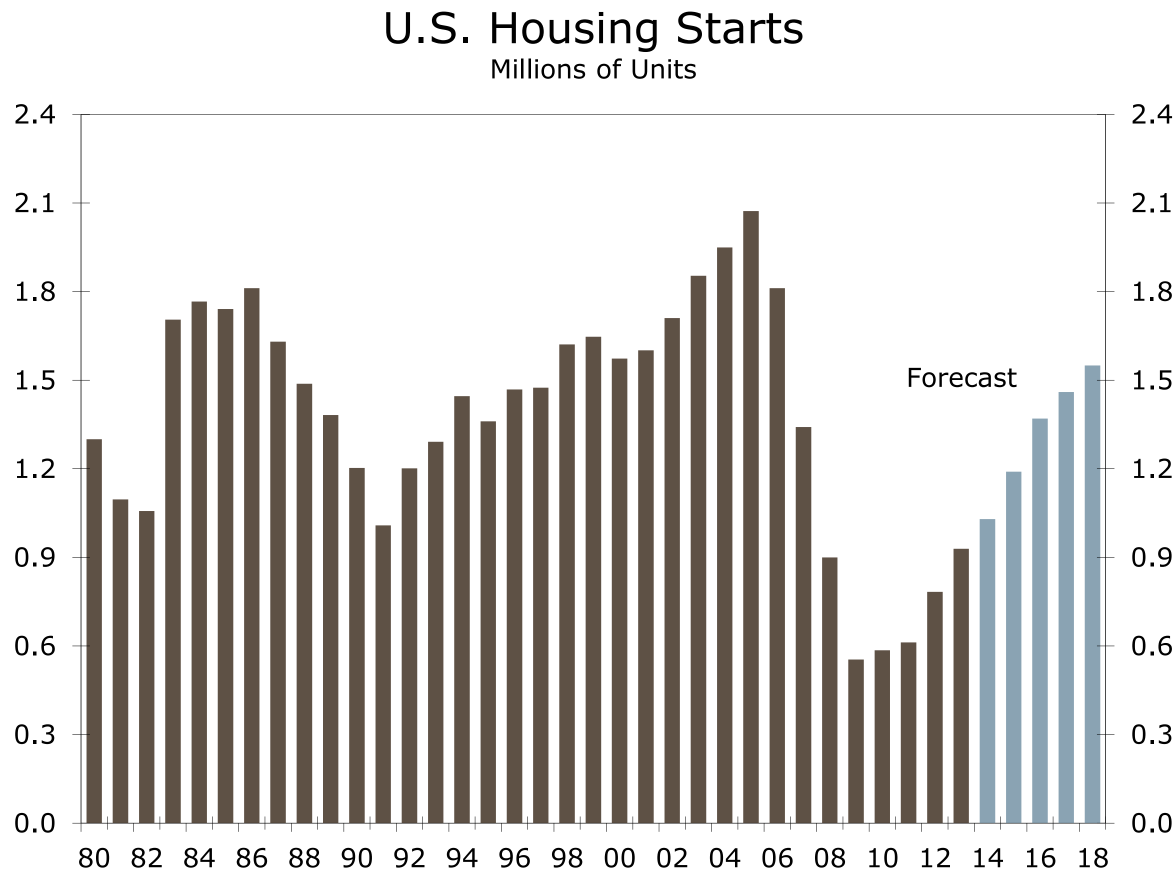

Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

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



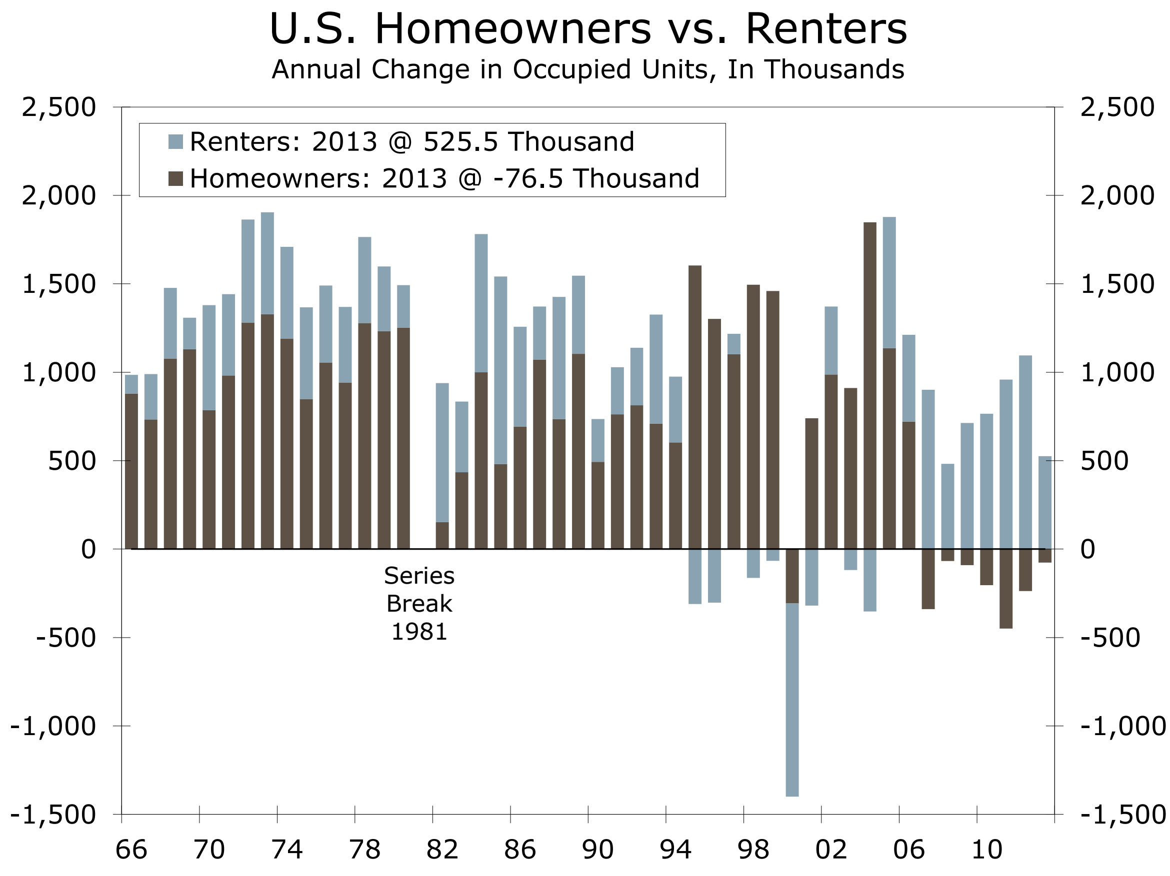

Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Continued improvement ahead




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



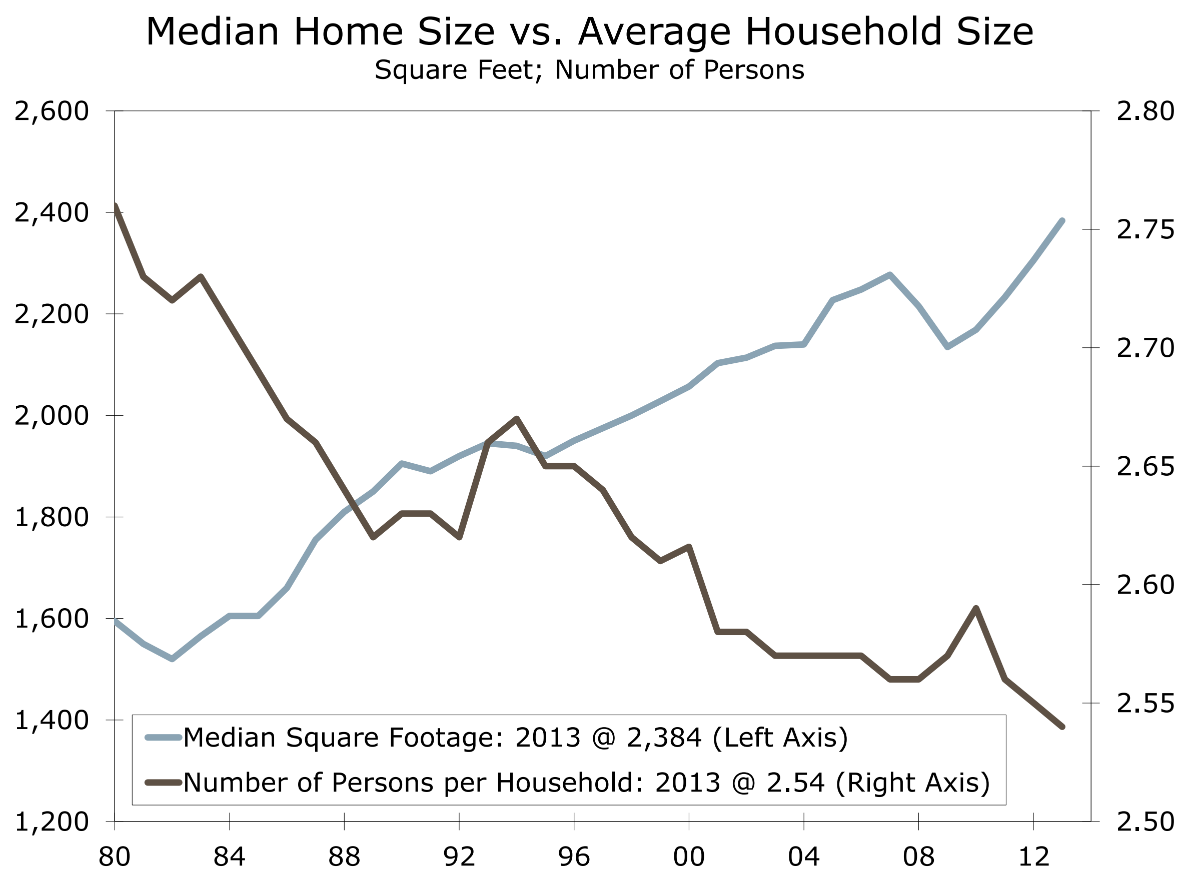

Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

What is the housing environment looking like now?

**Overview**

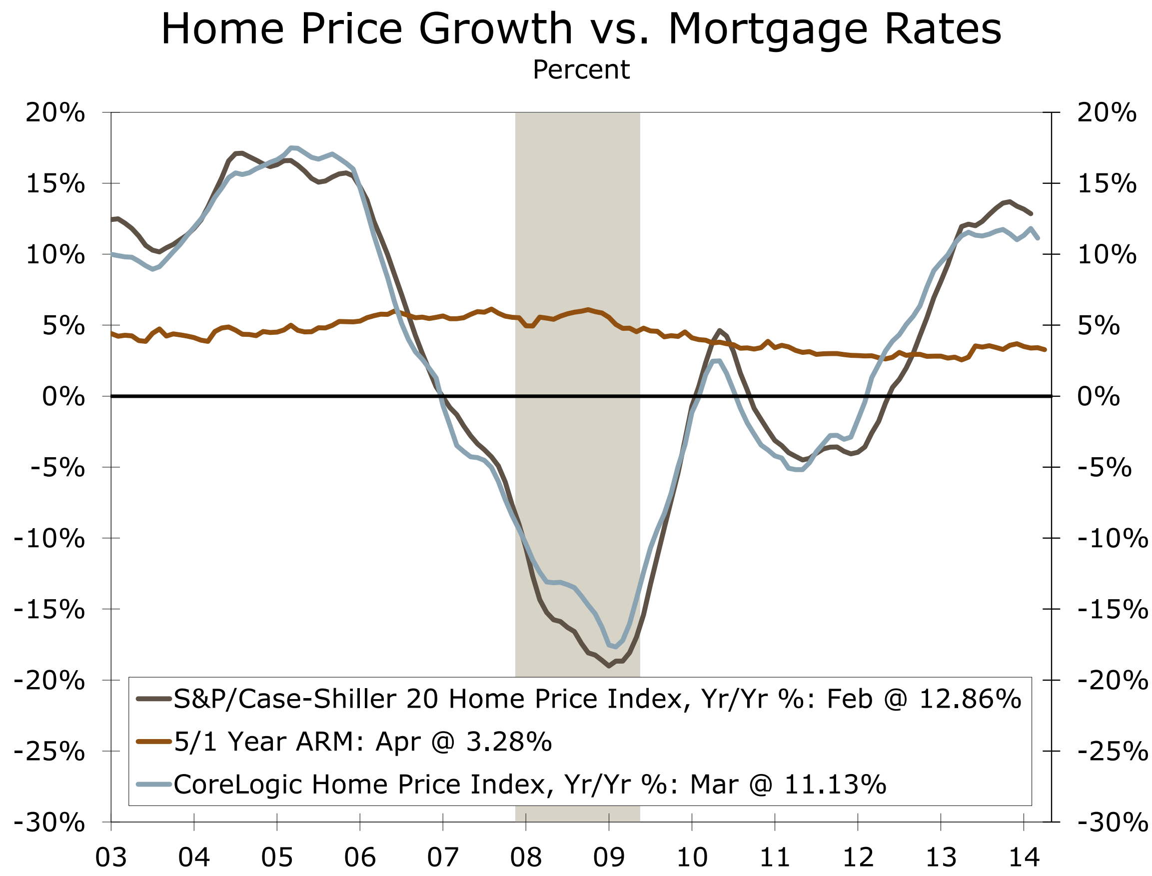
- Mortgage demand is up and lending standards have eased (Senior Loan Officers Survey)
- Housing Affordability: High
- Rental costs rise faster than cost of ownership
- Consumer confidence/ jobs rising
- Negative equity decline

Secular Shift?
Households were living in smaller homes with more people following the recession, but longer-term trends have returned



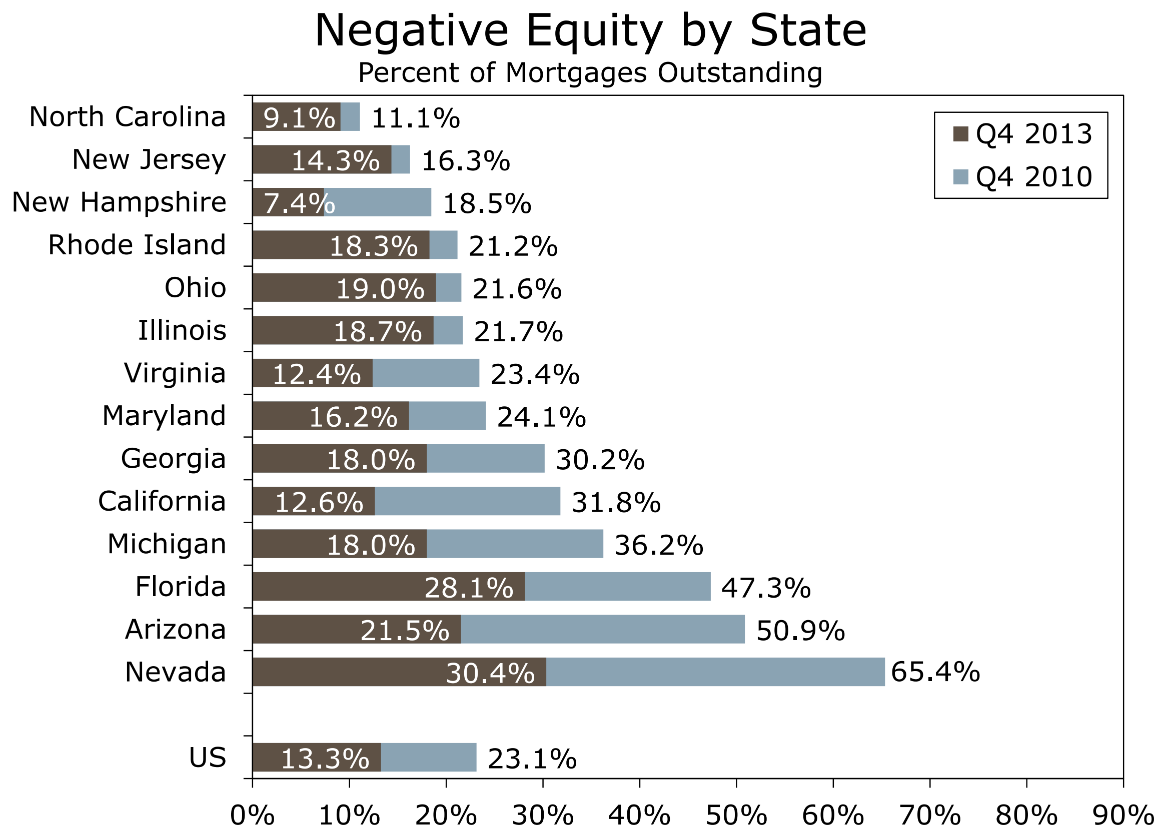

Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Home prices are rising faster than mortgage interest rates




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

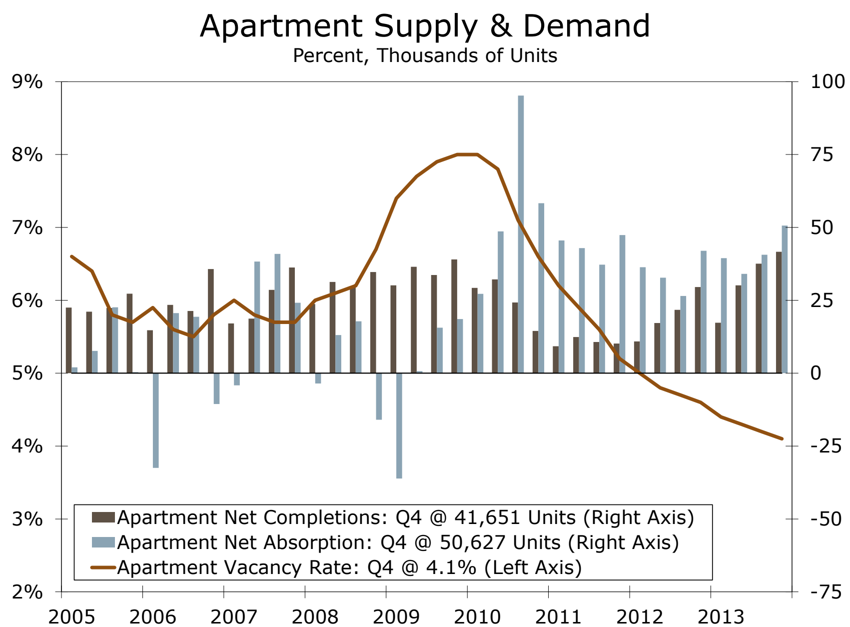
Negative equity in homes has contributed to foreclosures and reduced labor mobility, but much improvement has been seen since 3 years ago



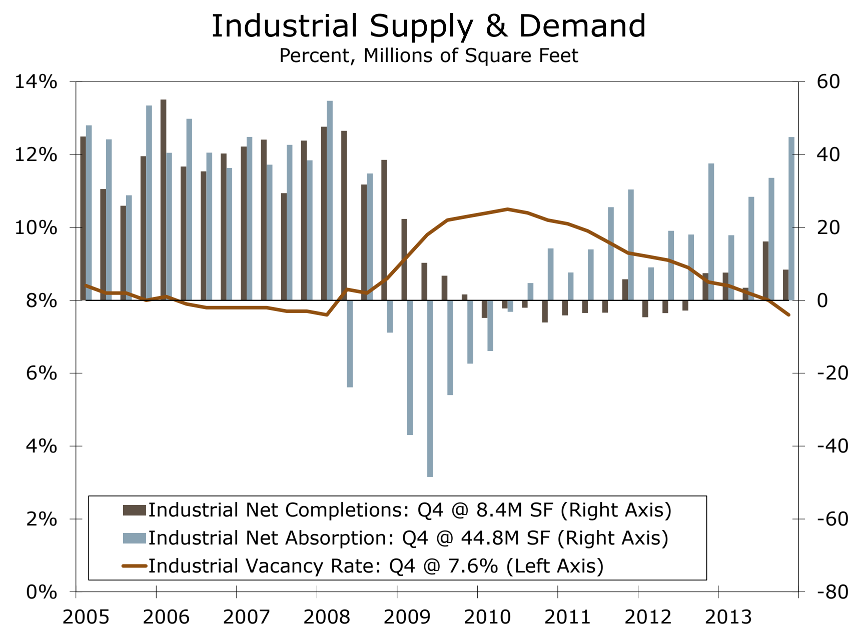

Source: CoreLogic and Wells Fargo Securities, LLC

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



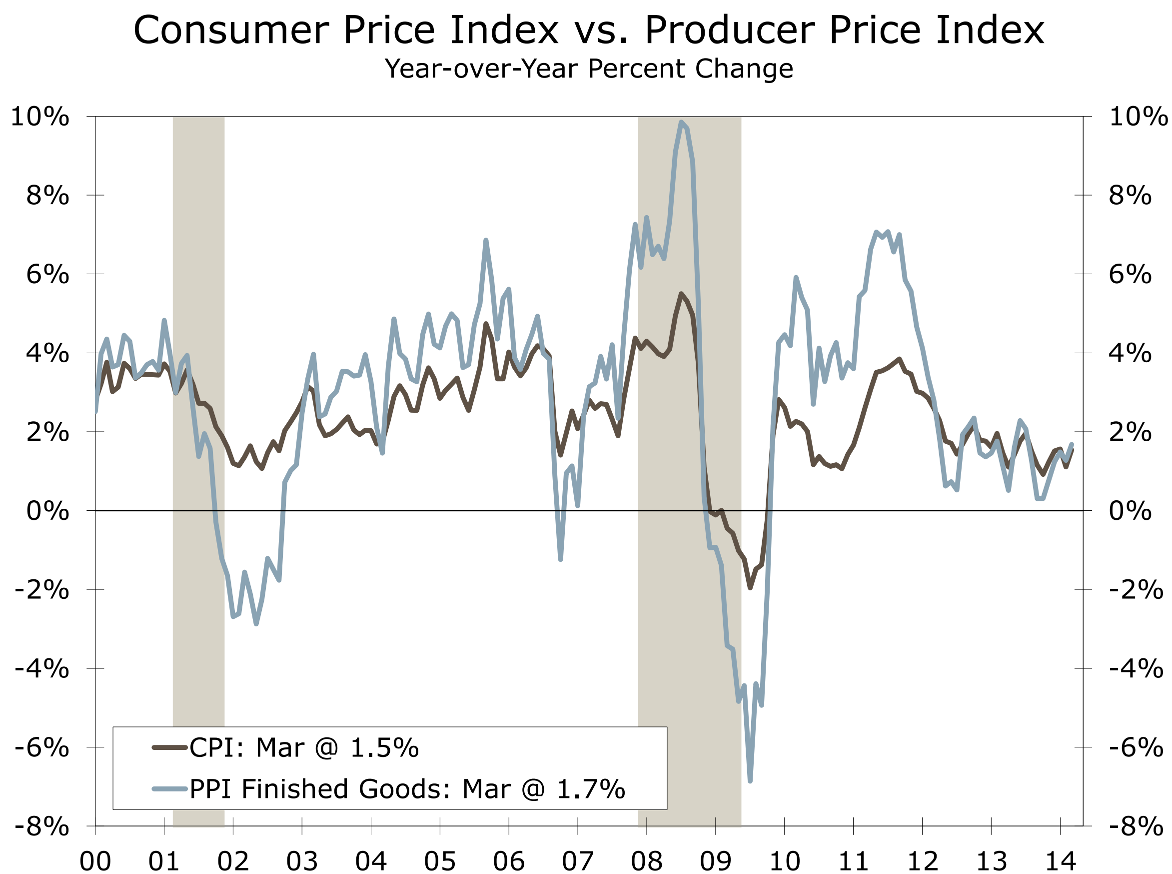

## Industrial Supply & Demand




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

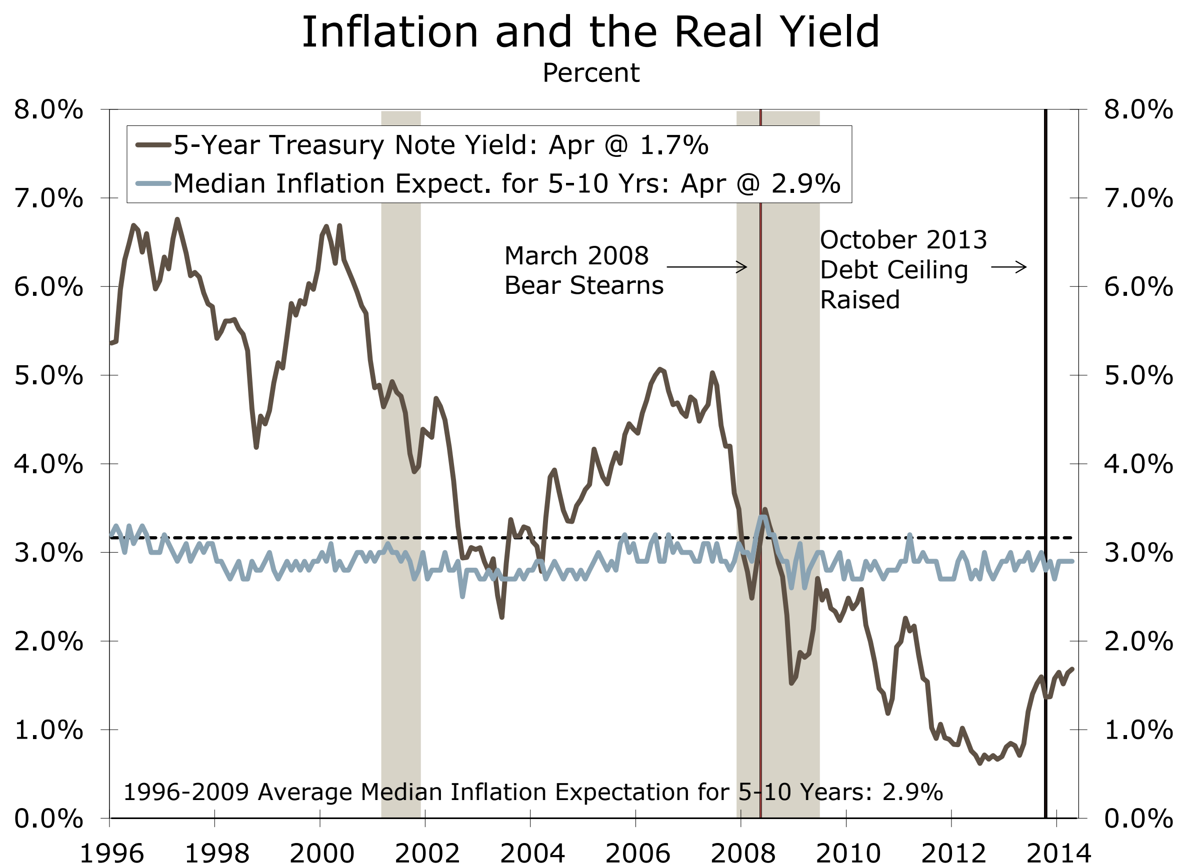

Core Inflation
Monetary Policy
Yield Curve
Key Drivers
Real Interest Rates
Wage-Price Spiral
Market Expectations

Overall price growth should not pose a barrier to continued easy monetary policy. CPI does not include sales or federal excise taxes.



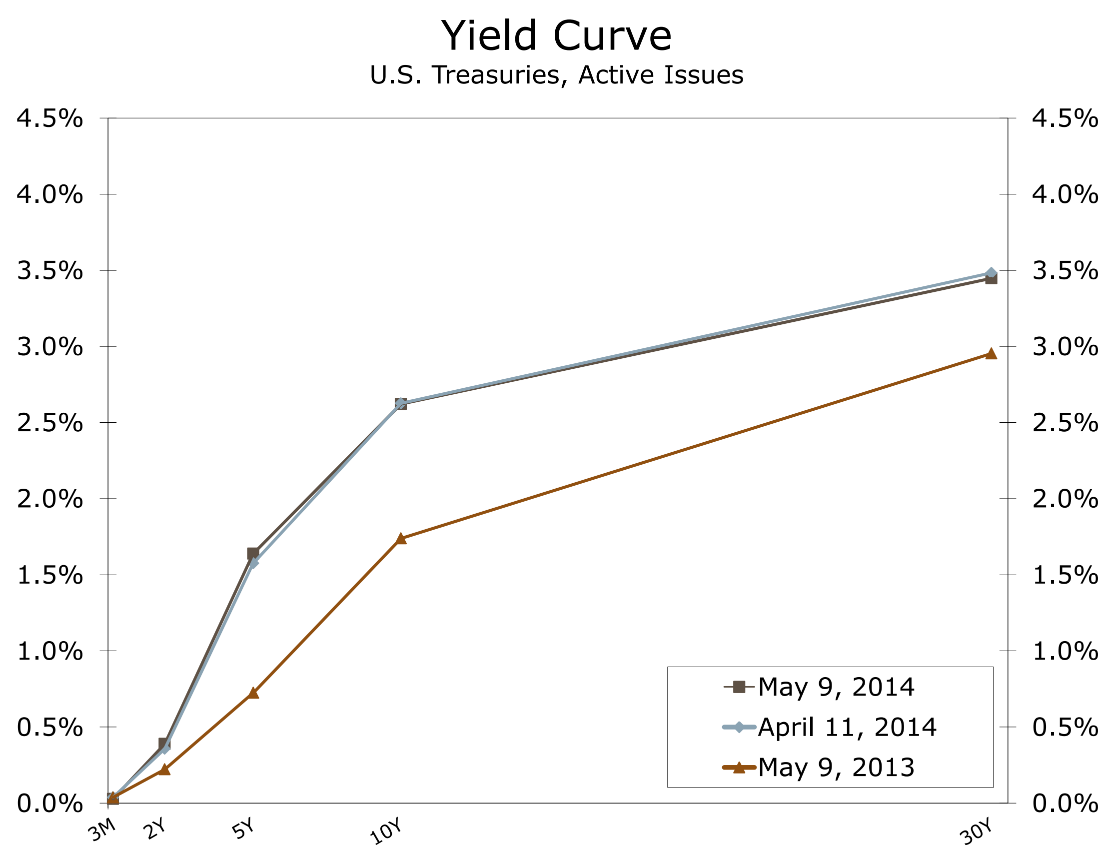

Source: U.S. Department of Labor and Wells Fargo Securities, LLC

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



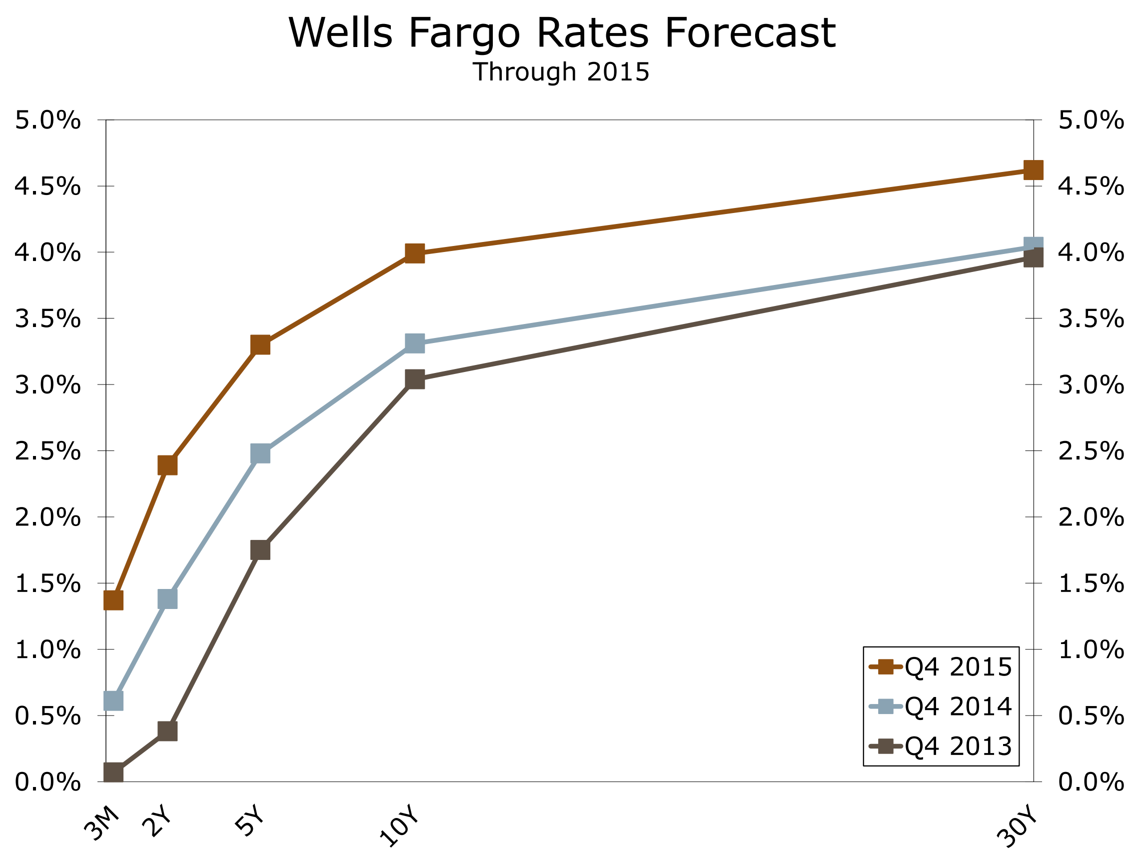

Source: Federal Reserve Board, University of Michigan and Wells Fargo Securities, LLC

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

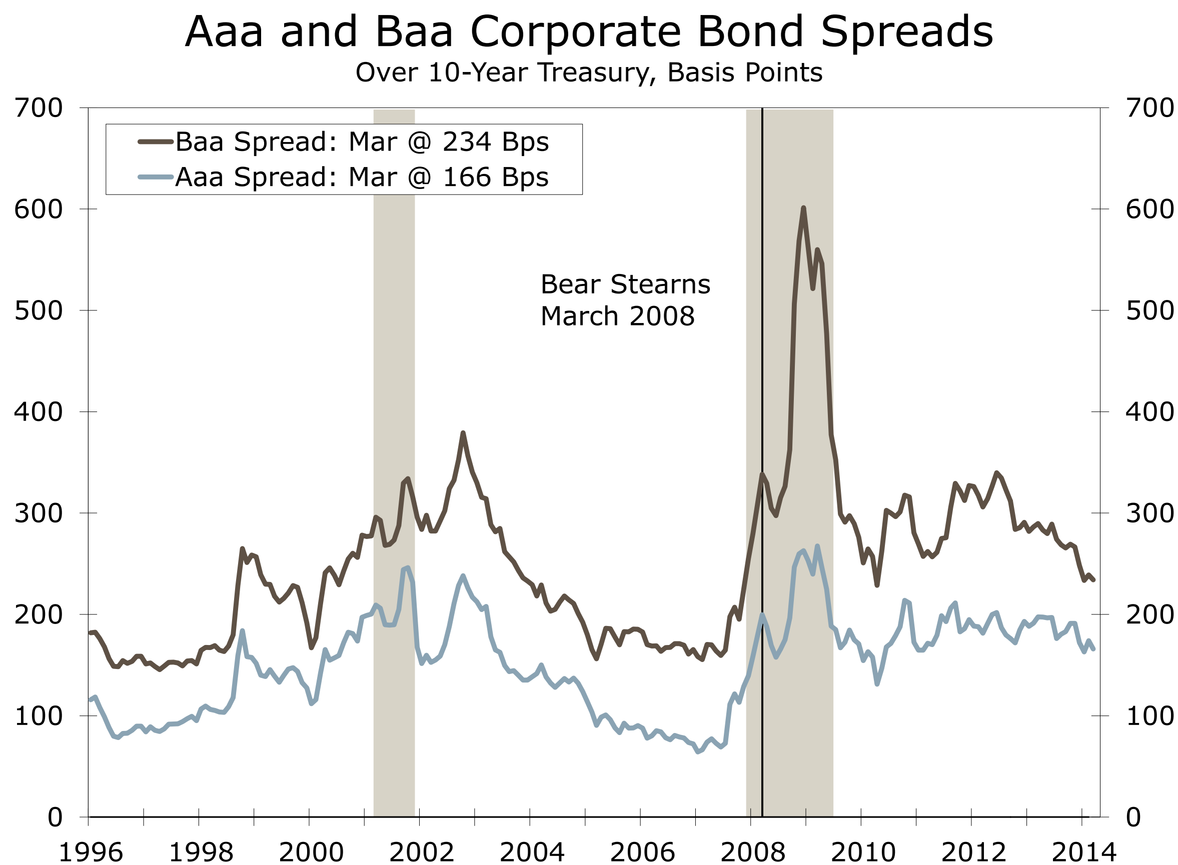
The Fed will continue easy policy in 2014. No change at short end of the curve, long rates rise modestly with Fed taper.




Source: Bloomberg LP and Wells Fargo Securities, LLC

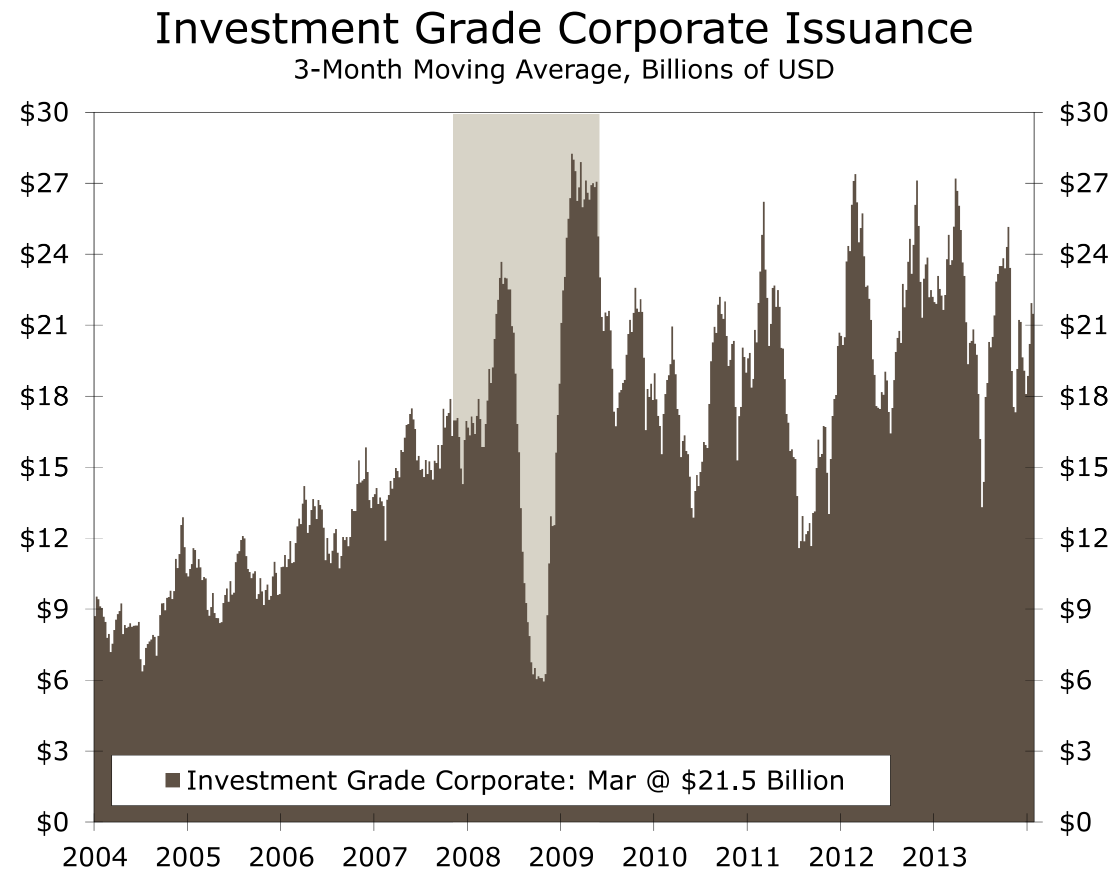
# Corporate Spreads: Positive for Issuance

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



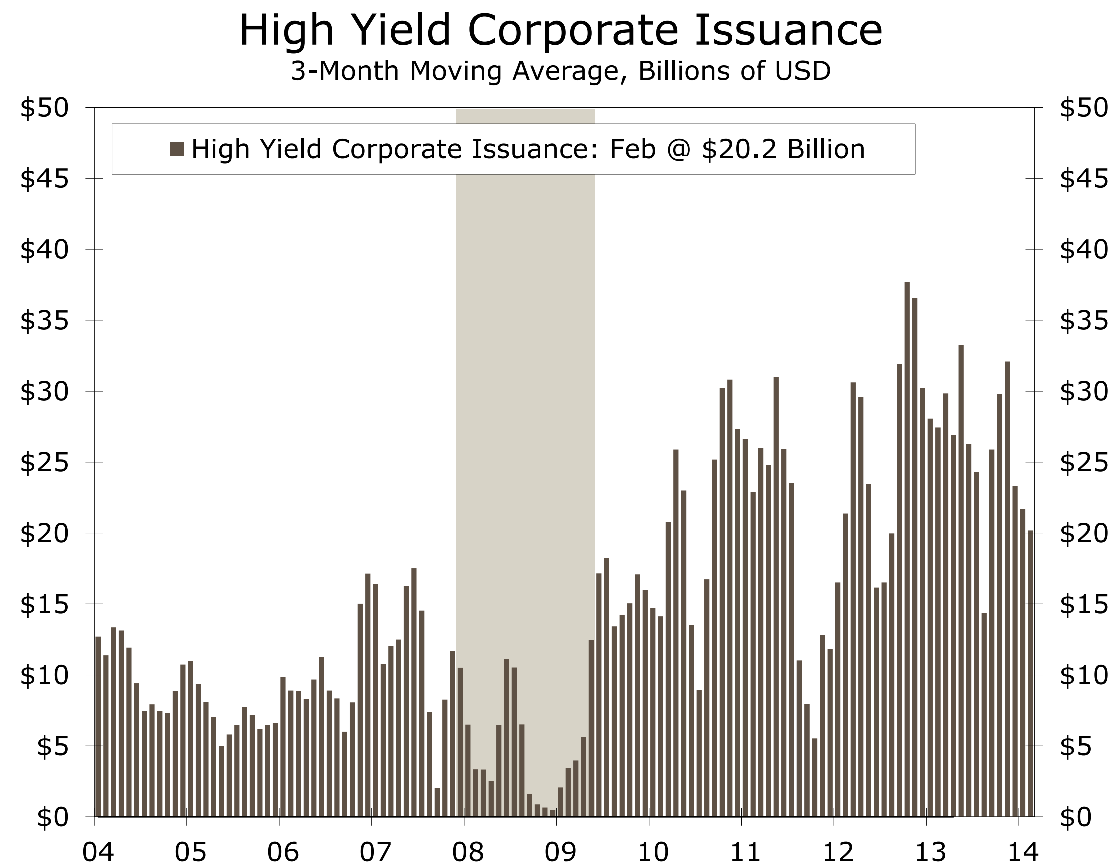

Source: Federal Reserve Board and Wells Fargo Securities, LLC

Businesses are taking advantage of low interest rates



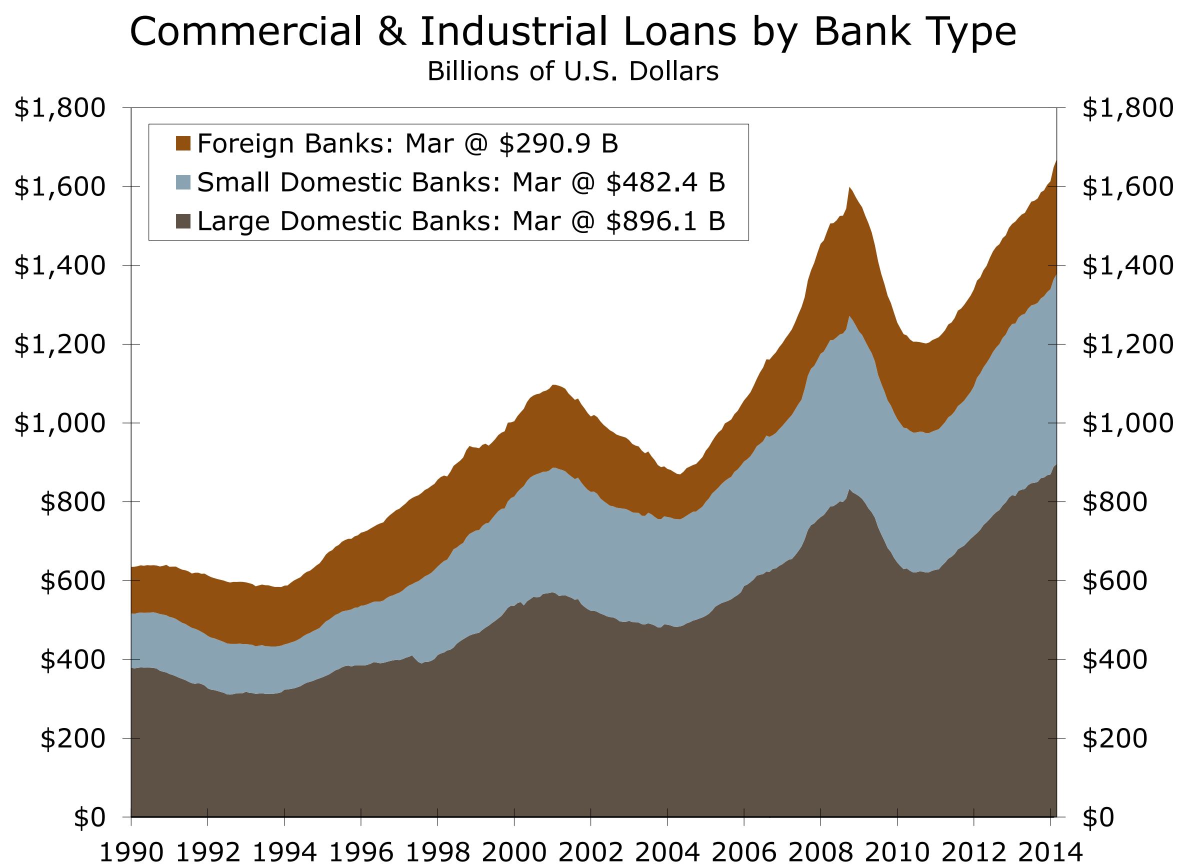

Source: IFR Markets and Wells Fargo Securities, LLC

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



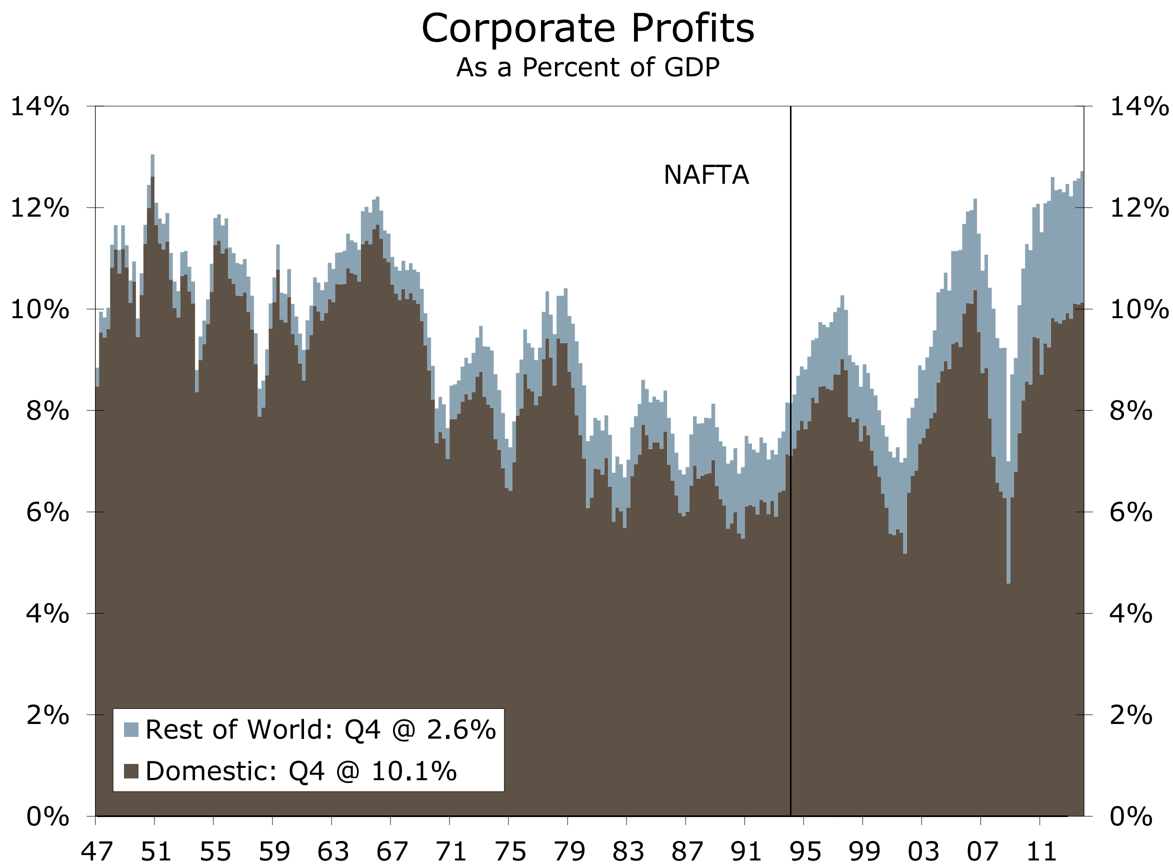

Source: IFR Markets and Wells Fargo Securities, LLC

Banks of all types are contributing to business lending




Source: Federal Reserve Board and Wells Fargo Securities, LLC

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



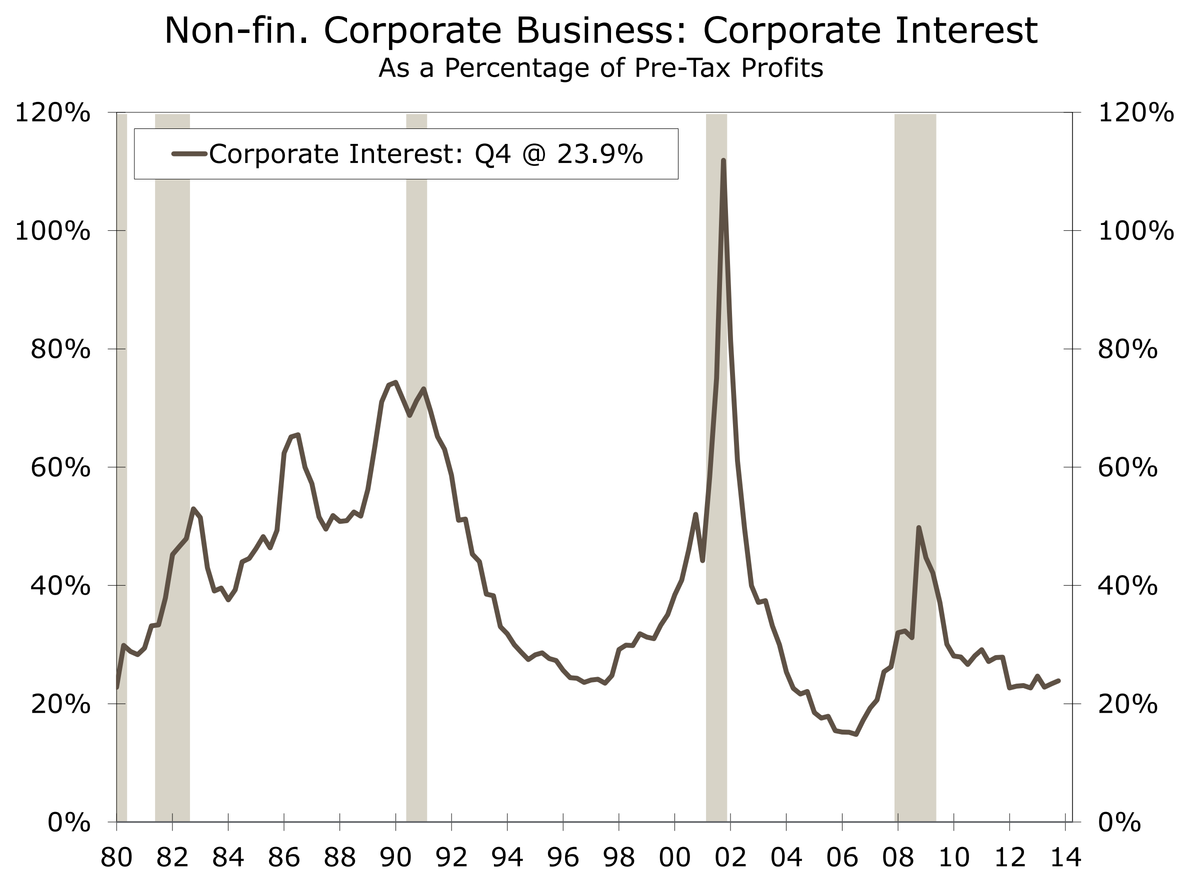

Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

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)**

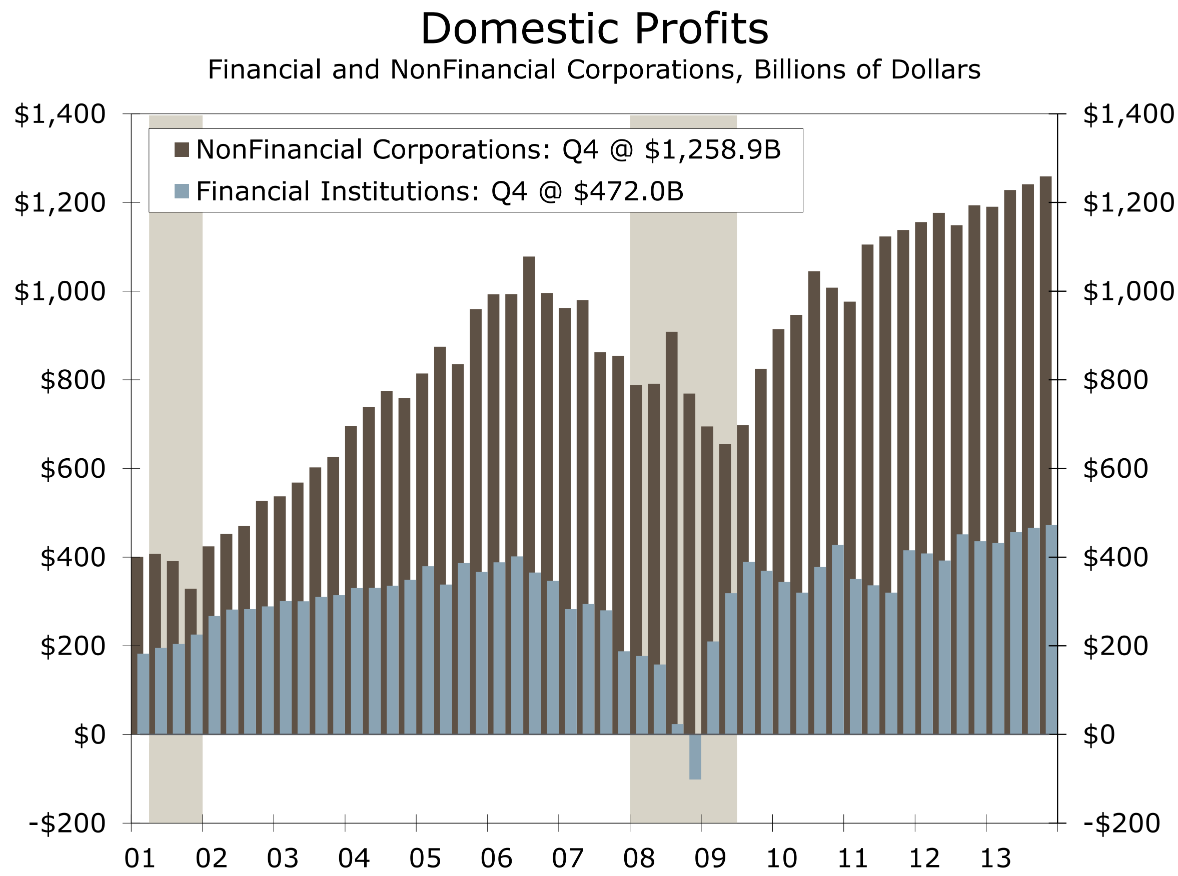
- Goodyear Tire
- BorgWarner
- Priceline.com
- Nike
- Coca-Cola
- Heinz
- Proctor & Gamble
- Avon
- Exxon Mobil
- AFLAC
- Intel
- Applied Materials
- Oracle
- Johnson & Johnson
- Merck
- Boeing
- Eaton Corp.
- Emerson Electric
- Fluor
- GE
- 3M
- Caterpillar
- Cisco
- Qualcomm
- Apple
- eBay
- IBM
-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

Corporate interest expenses remain low amid the low-rate environment



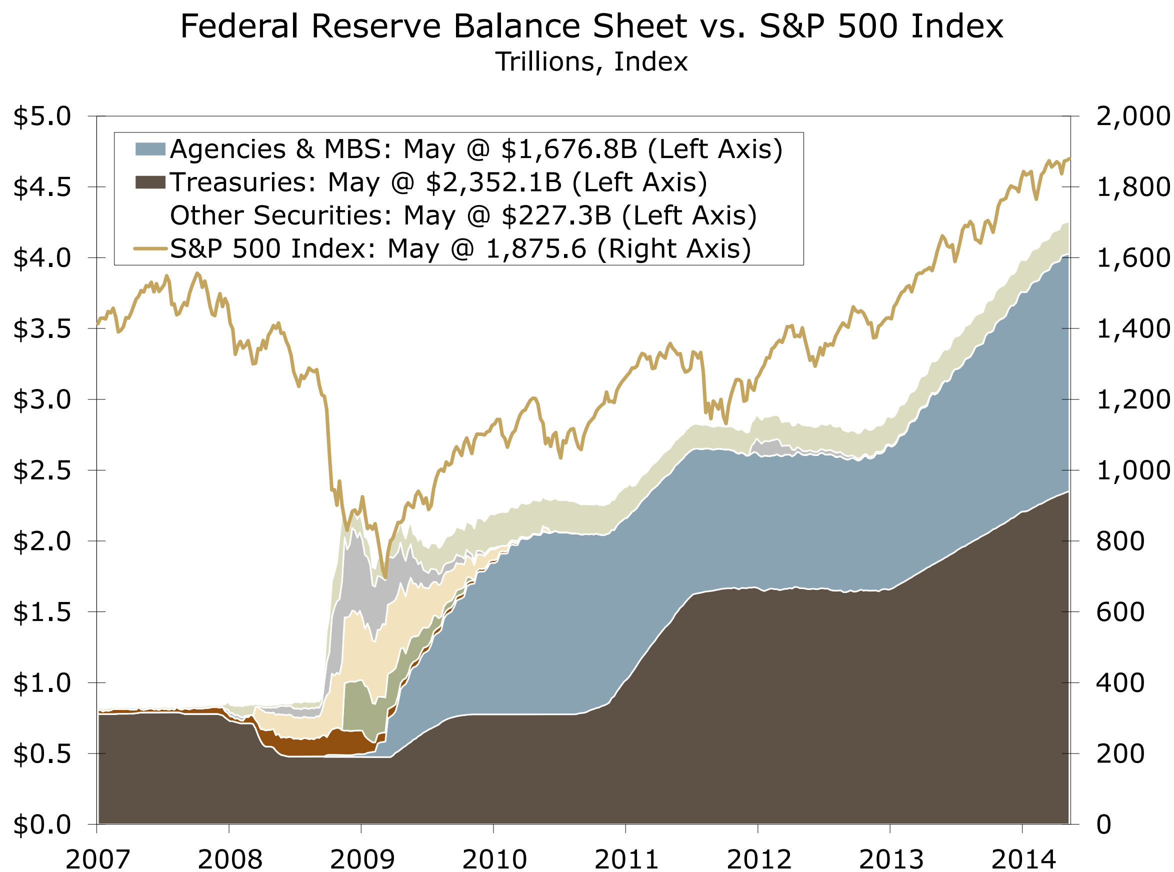

Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Big gains in profits have been from nonfinancial corporations



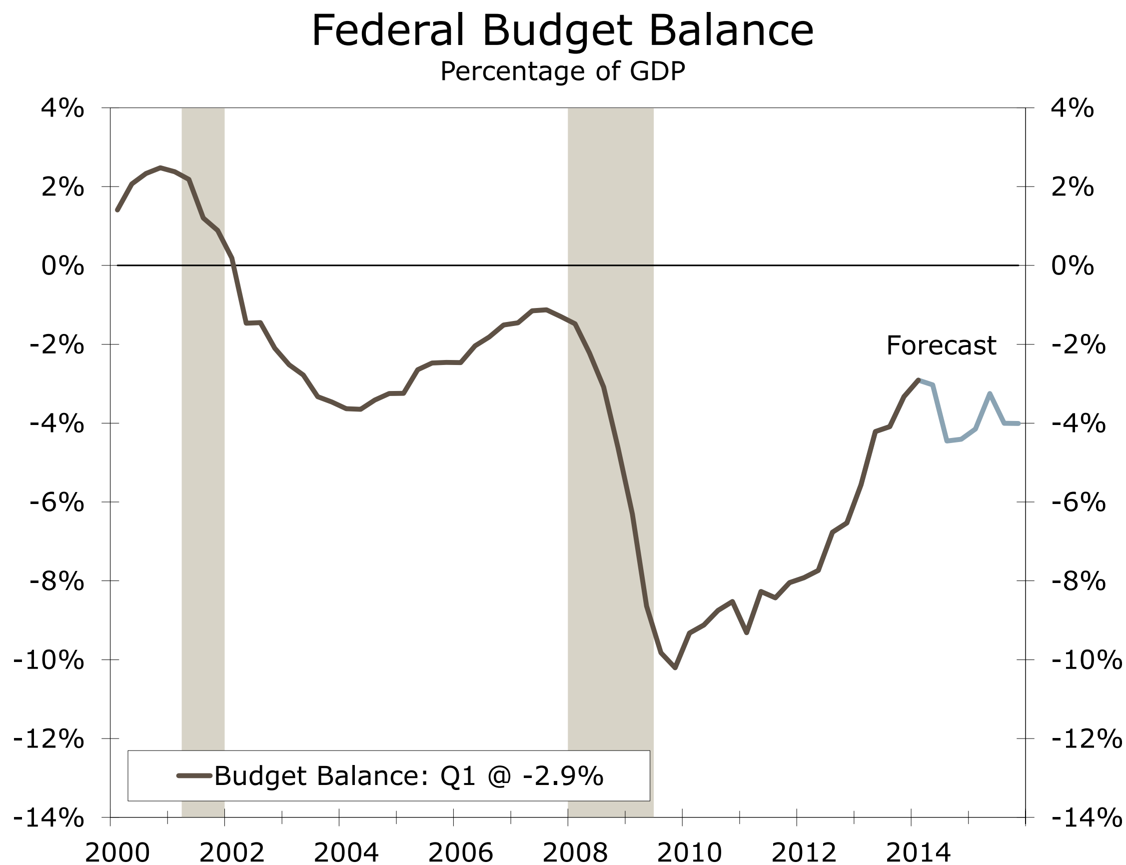

Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

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



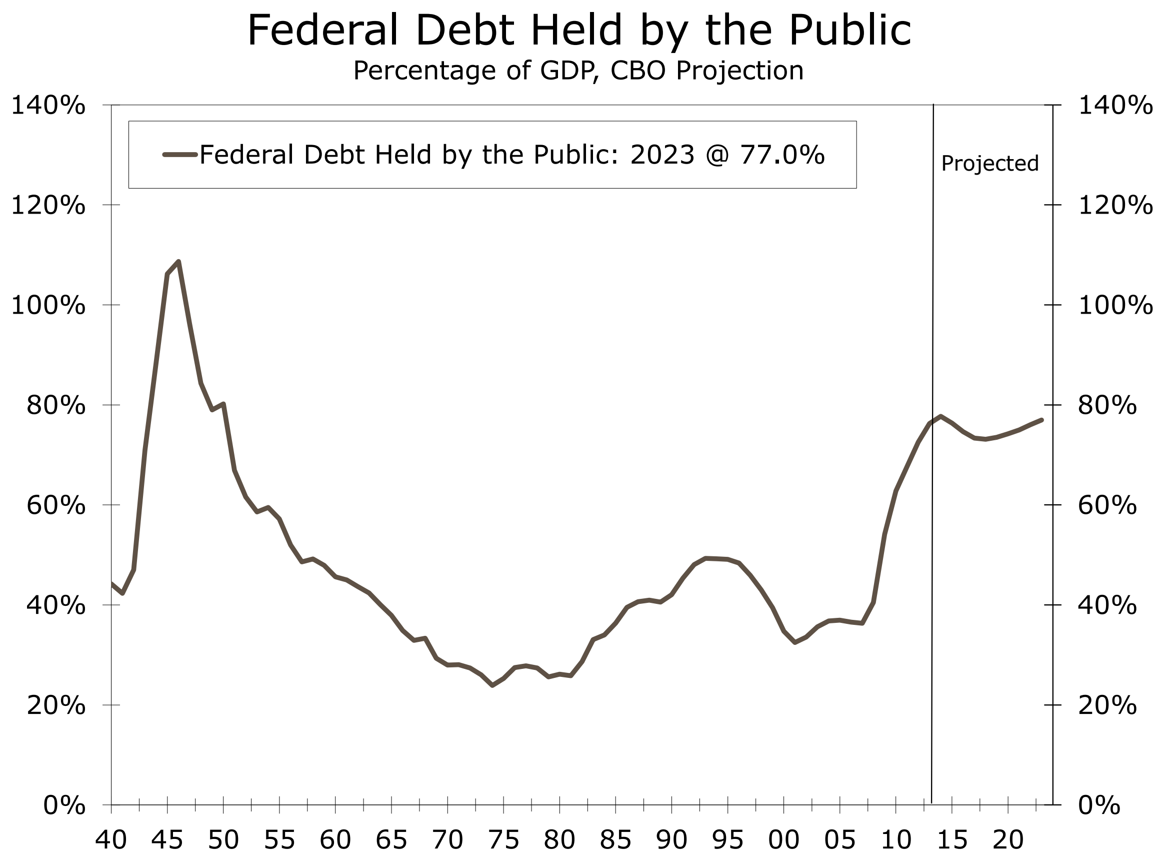

Source: Federal Reserve Board and Wells Fargo Securities, LLC

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



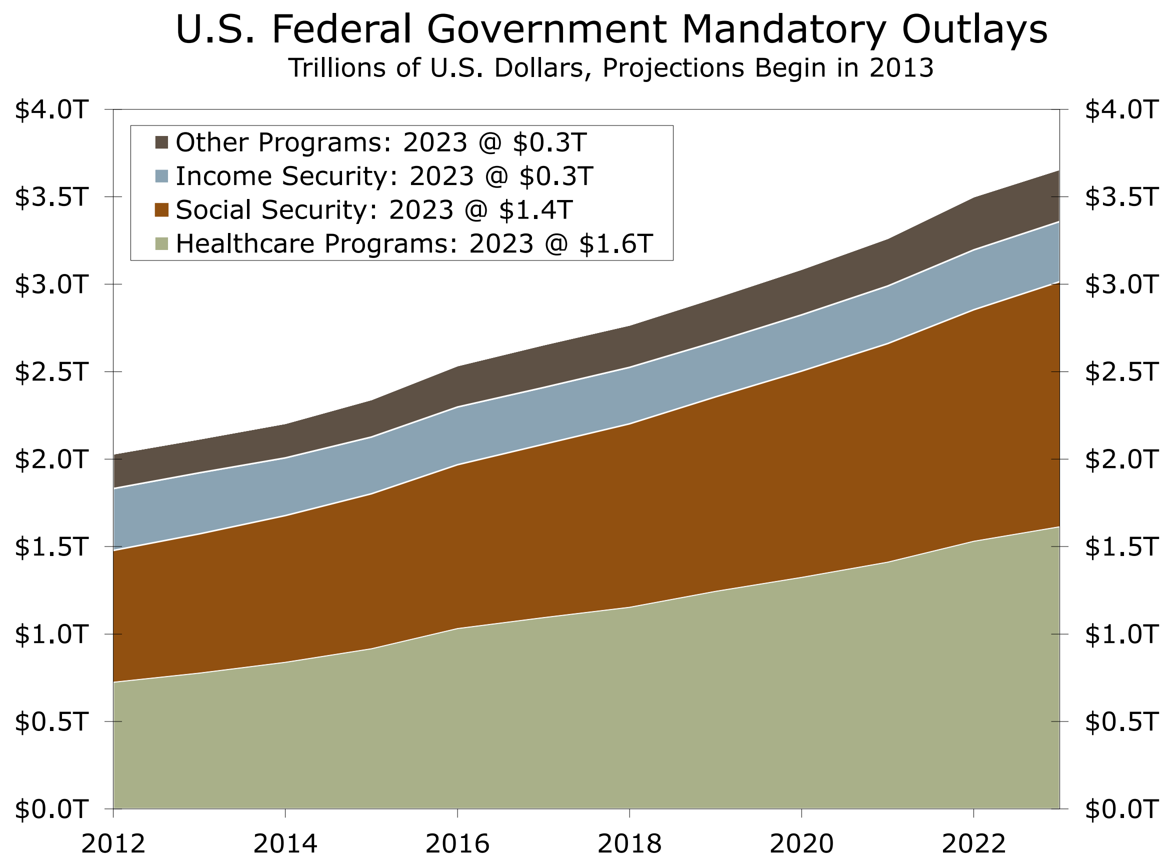

Source: U.S. Department of Commerce, U.S. Department of the Treasury and Wells Fargo Securities, LLC

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



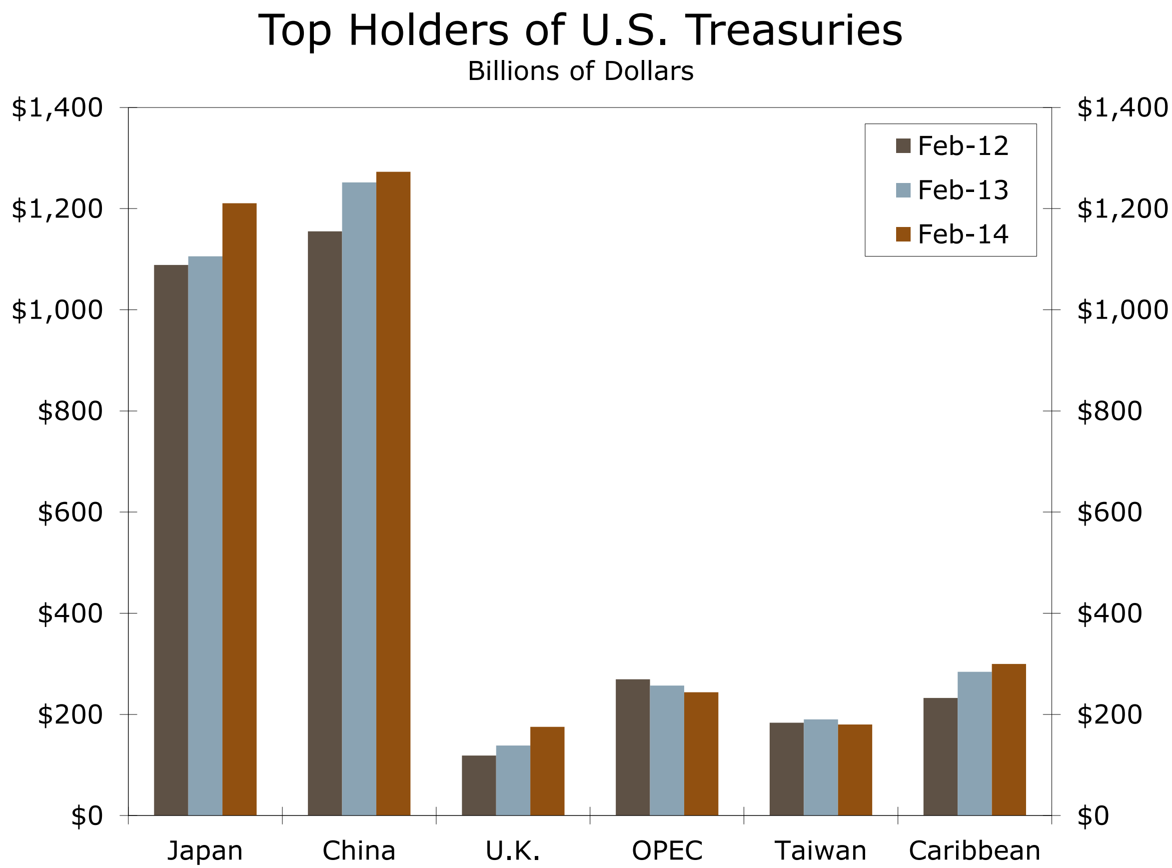

Source: Congressional Budget Office and Wells Fargo Securities, LLC

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



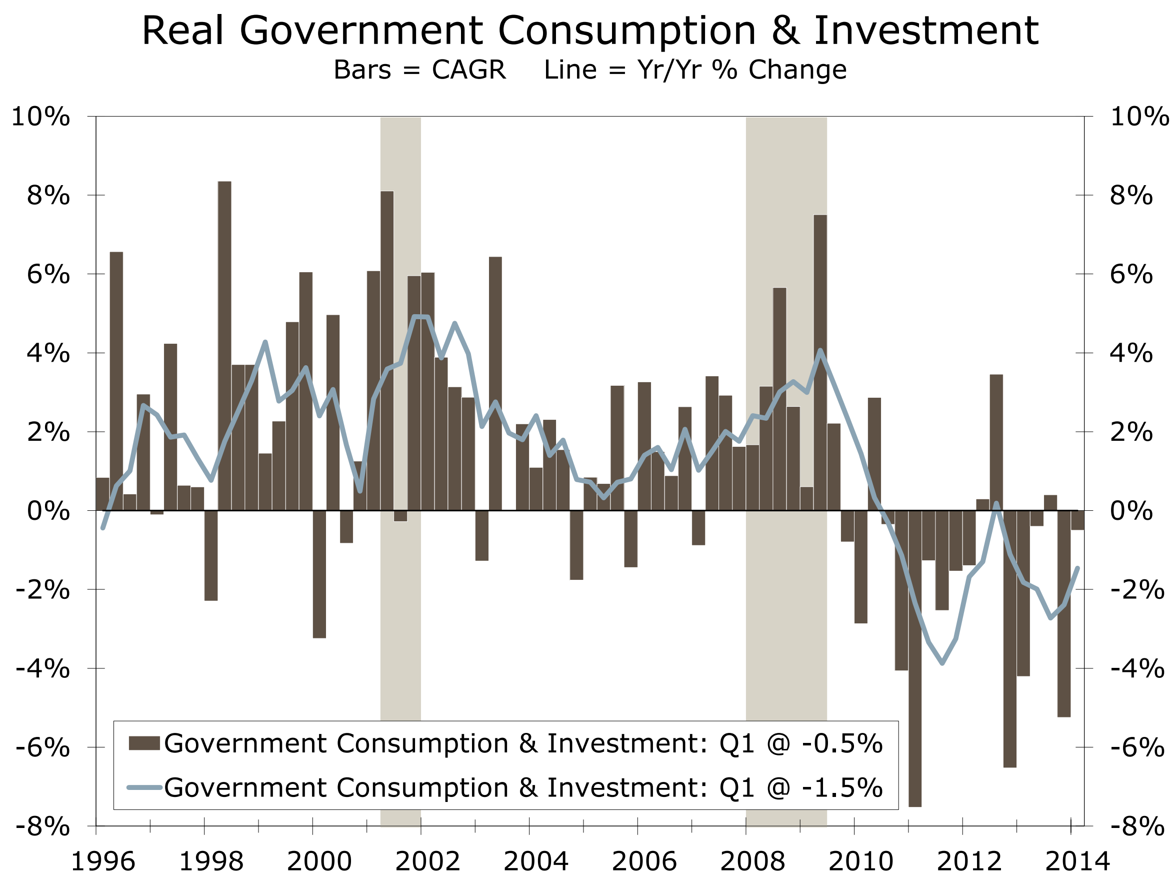

Source: Congressional Budget Office and Wells Fargo Securities, LLC

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




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

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

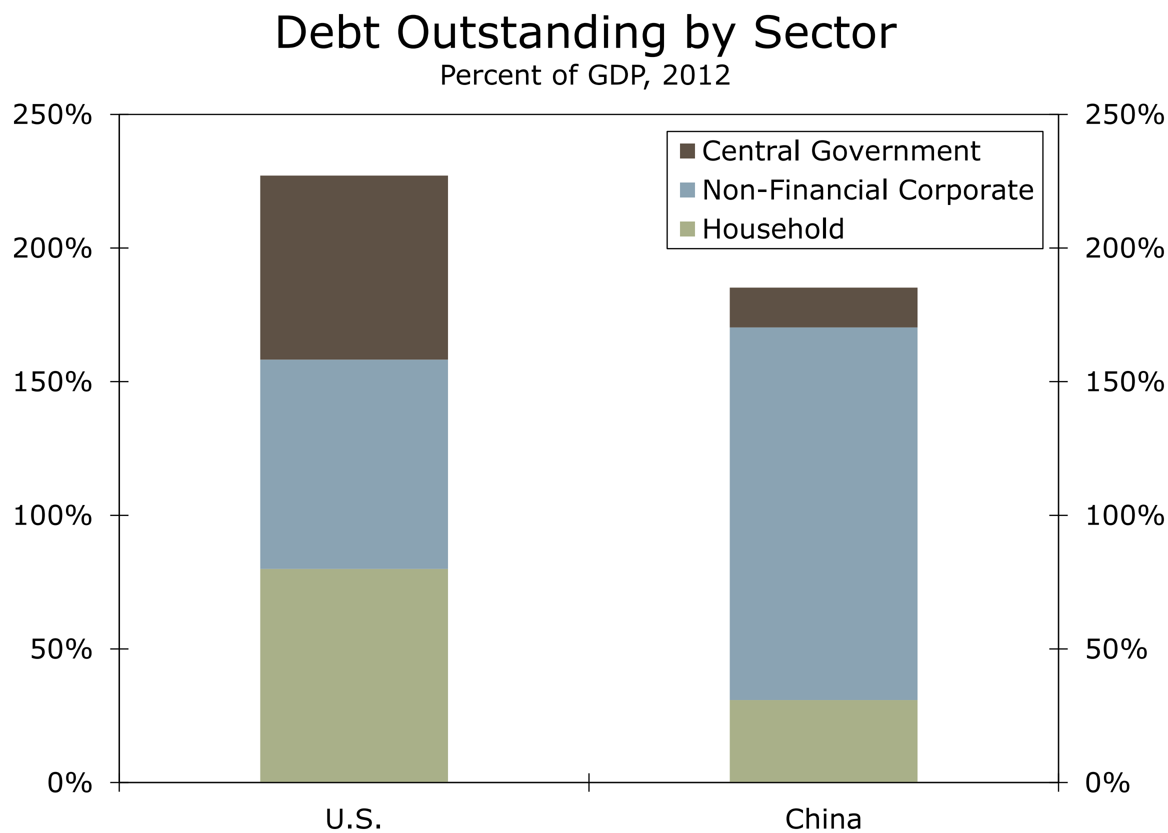
The global recovery is being driven by emerging markets, downshift ahead

| | 2014 | | | 2013 |
|---|---|---|---|---|
| | Wells Fargo Economics | Blue Chip Consensus | | Historical |
| Global (year-over-year unless otherwise specified) | | | | |
| Global Real GDP | 3.50% | 3.70%* | ⇧ | 3.00% |
| Eurozone Real GDP | 1.30% | 1.00% | ⇧ | -0.40% |
| United Kingdom Real GDP | 2.60% | 2.50% | ⇧ | 1.80% |
| China Real GDP | 7.50% | 7.50% | ⬇ | 7.70% |
| Japan Real GDP | 1.40% | 1.70% | ⬇ | 1.50% |
| Canada Real GDP | 2.10% | 2.30% | ⇧ | 2.00% |
| Mexican Real GDP | 2.70% | 3.40% | ⇧ | 1.10% |

* IMF Estimate

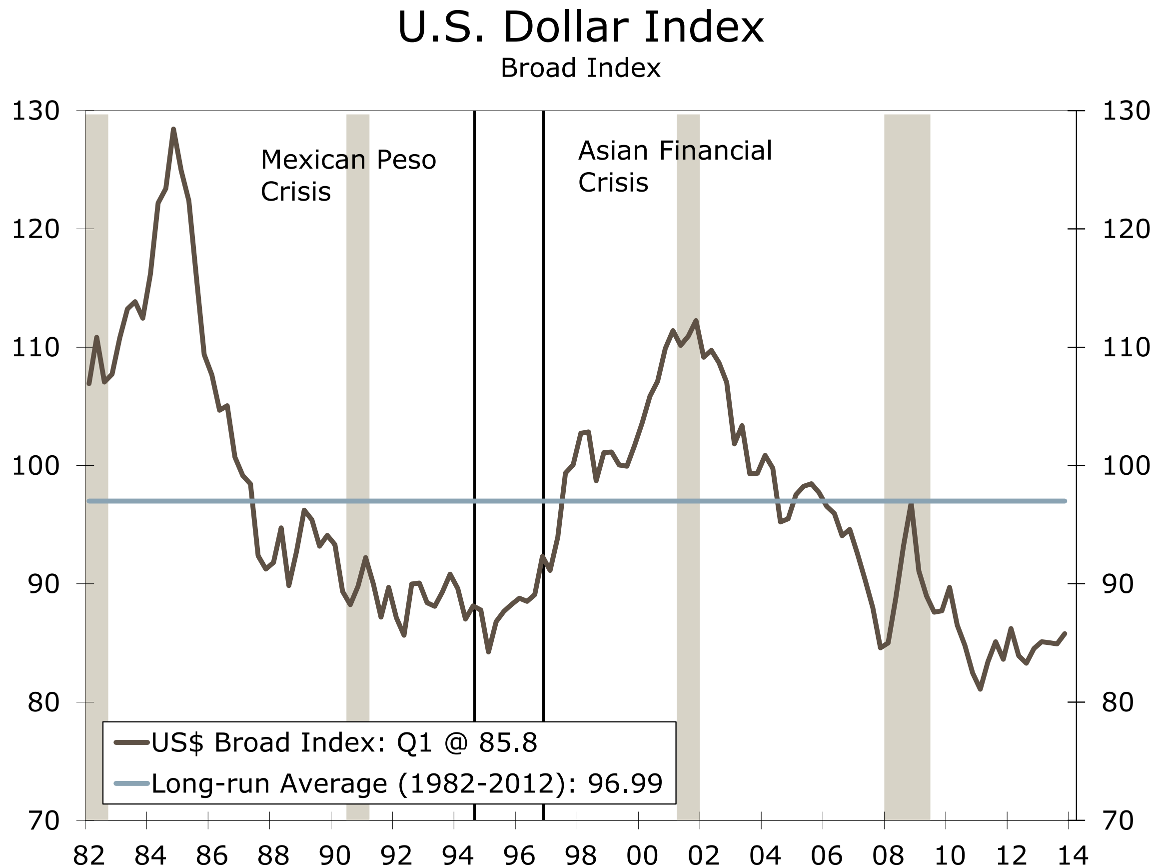
Source: International Monetary Fund and Wells Fargo Securities, LLC

Chinese debt outstanding is notably lower than in the United States and is concentrated in the non-financial corporate sector



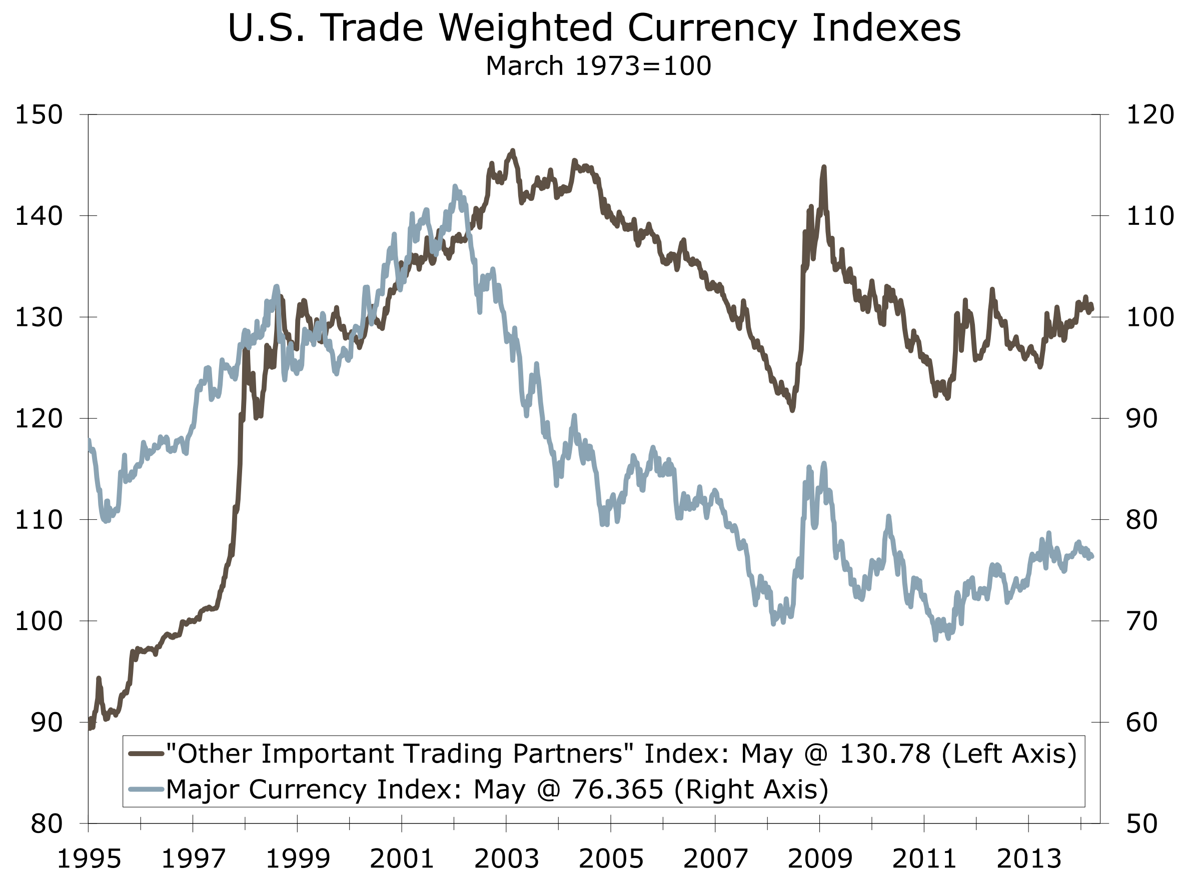

Source: CEIC, BIS, U.S. Department of Commerce and Wells Fargo Securities, LLC

Economic fundamentals and risks abroad will drive the dollar



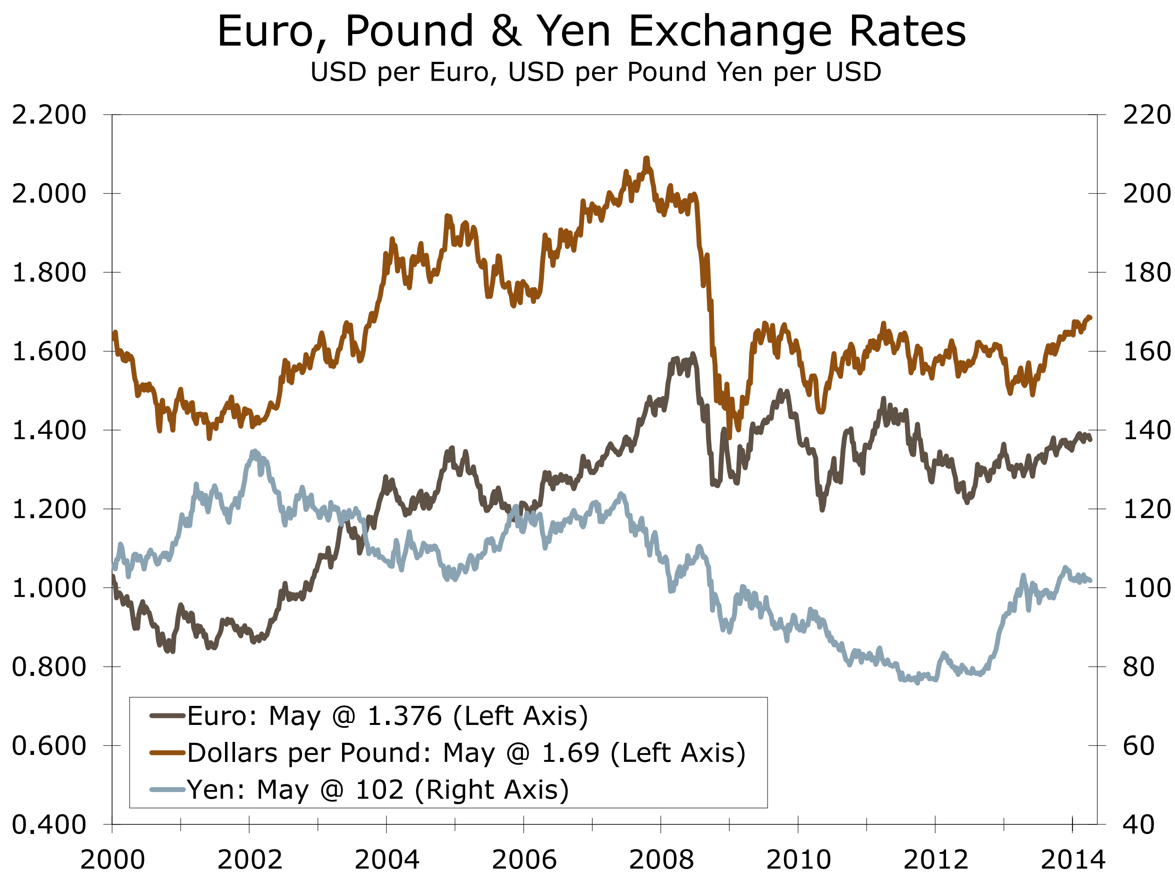

Source: Federal Reserve Board and Wells Fargo Securities, LLC

The dollar has experienced recent strength against both major and emerging currencies



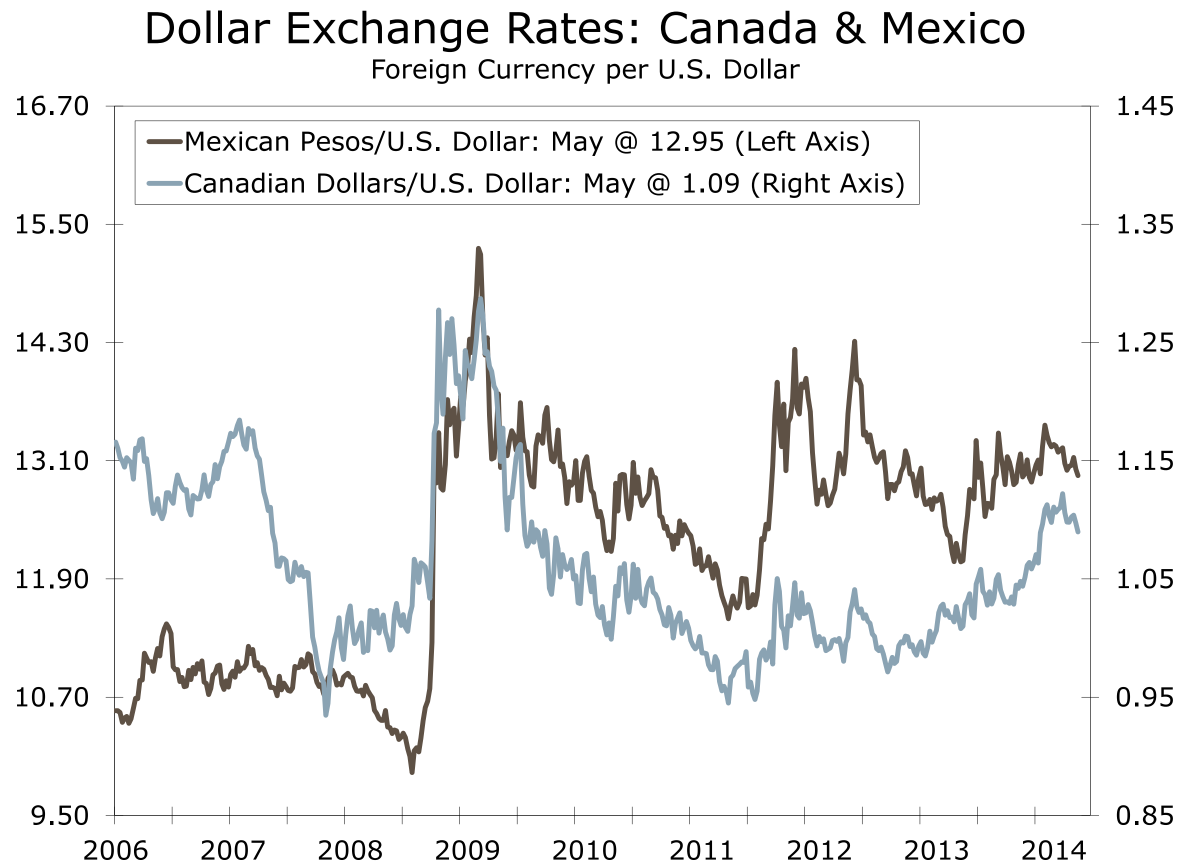

Source: Federal Reserve Board and Wells Fargo Securities, LLC

The euro and the pound have appreciated recently as the yen continues to decline




Source: Bloomberg LP and Wells Fargo Securities, LLC

The Canadian dollar and Mexican peso have both seen recent depreciation




Source: Bloomberg LP 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

## 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 | 0.1 | 3.0 | 2.7 | 3.1 | 1.8 | 2.8 | 1.9 | 2.3 | 3.1 |
| Personal Consumption | 2.3 | 1.8 | 2.0 | 3.3 | 3.0 | 4.0 | 2.4 | 2.6 | 2.5 | 2.2 | 2.0 | 2.9 | 2.7 |
| 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 | 2.1 | 3.1 | 2.1 | 1.5 | 1.8 | 2.2 |
| Industrial Production [1] | 4.2 | 1.9 | 2.5 | 4.8 | 4.4 | 8.5 | 5.1 | 4.3 | 3.3 | 3.8 | 2.9 | 4.9 | 5.1 |
| Corporate Profits Before Taxes [2] | 2.1 | 4.5 | 5.7 | 6.2 | 3.5 | 3.6 | 3.8 | 4.0 | 7.9 | 7.0 | 4.6 | 3.7 | 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] | 0.96 | 0.87 | 0.88 | 1.01 | 0.92 | 1.06 | 1.12 | 1.17 | 0.61 | 0.78 | 0.92 | 1.06 | 1.22 |
| 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 | 4.53 | 4.72 | 4.96 | 4.46 | 3.66 | 3.98 | 4.64 | 5.42 |
| 10 Year Note | 1.87 | 2.52 | 2.64 | 3.04 | 2.73 | 2.88 | 3.07 | 3.31 | 2.78 | 1.80 | 2.35 | 3.00 | 3.77 |

Forecast as of: May 2, 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

# Appendix

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|---|---|---|
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