WELLS FARGO

Weekly — April 1, 2022

Weekly Economic & Financial Commentary

United States: **Soaring Price Gauges Turn Up the Pressure on the Fed**

- The Fed's difficult job got harder this week. Its preferred inflation gauge set another fresh 40-year record high, while the ISM prices paid measure shot up 11.5 points to 87.1. Payrolls increased 431K in March with steep upward revisions that lifted the past two months' gains, but personal income is not quite keeping pace with price increases. Small wonder, the yield curve temporarily inverted, a sign the bond market is losing faith in a soft landing.
- Next week: Trade Balance (Tue.), ISM Services (Tue.), FOMC Meeting Minutes (Wed.)

International: **Eurozone Inflation Continues to Accelerate**

- Eurozone March CPI inflation quickened more than expected to 7.5% year-over-year, driven by higher energy prices, with other price gains more modest. Still, the overall rate of inflation should see a timely move by the European Central Bank to less accommodative monetary policy despite a mixed growth outlook. Sentiment surveys from China and Japan were soft in tone, suggesting subdued growth from those economies during the first quarter.
- Next week: Mexico CPI (Thu.), Brazil CPI (Fri.), Canadian Employment (Fri.)

Credit Market Insights: **Mortgage Rates Accelerate in March as Homebuyers Rush to Lock In**

- Thirty-year mortgage rates reached 4.67% this week, the highest level in over three years. The quarter-of-a-percent increase from last week's 4.42% reading has 30-year mortgage rates on a breakneck pace to reach the 5% mark, a level not seen since February 2011. The white-hot housing market, although resilient, has not been entirely immune to the effects of rising mortgage rates.

Topic of the Week: **Russia-Europe Gas Standoff Puts the Pressure on American Producers**

- The economic fallout from Russia's invasion of Ukraine continued this week with Putin targeting the EU's heavy dependence on Russian energy sources. President Biden has committed to ramping up U.S. production to cover the gap and released a historic 180 million barrels of oil to help lower domestic prices, but capacity constraints and soaring domestic inflation present headwinds.

Wells Fargo U.S. Economic Forecast

	Actual 2021				Forecast 2022				Actual		Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2020	2021	2022	2023
Real Gross Domestic Product [1]	6.3	6.7	2.3	6.9	0.8	1.5	2.9	2.7	-3.4	5.7	3.0	2.4
Personal Consumption	11.4	12.0	2.0	2.5	2.5	0.8	1.7	1.7	-3.8	7.9	2.6	1.7
Consumer Price Index [2]	1.9	4.8	5.3	6.7	8.0	8.2	7.5	6.3	1.2	4.7	7.5	2.6
"Core" Consumer Price Index [2]	1.4	3.7	4.1	5.0	6.3	5.8	5.7	5.2	1.7	3.6	5.8	3.2
Quarter-End Interest Rates [3]												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.50	1.00	1.50	1.75	0.50	0.25	1.19	2.31
Conventional Mortgage Rate	3.08	2.98	2.87	3.10	3.80	3.95	4.00	4.05	3.12	2.95	3.95	4.18
10 Year Note	1.74	1.45	1.52	1.52	1.95	2.10	2.20	2.25	0.89	1.45	2.13	2.38

Forecast as of: March 11, 2022

[1] Compound Annual Growth Rate Quarter-over-Quarter [2] Year-over-Year Percentage Change [3] Annual Numbers Represent Average

Source: U.S. Dept. of Commerce, U.S. Dept. of Labor, Federal Reserve Board and Wells Fargo Economics

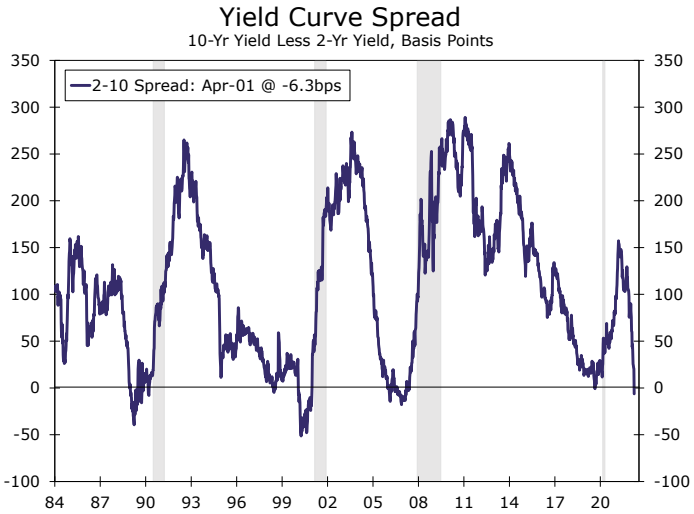
Please see our full U.S. Economic Forecast and our updated Consumer Dashboard and Pressure Gauge.

U.S. Review

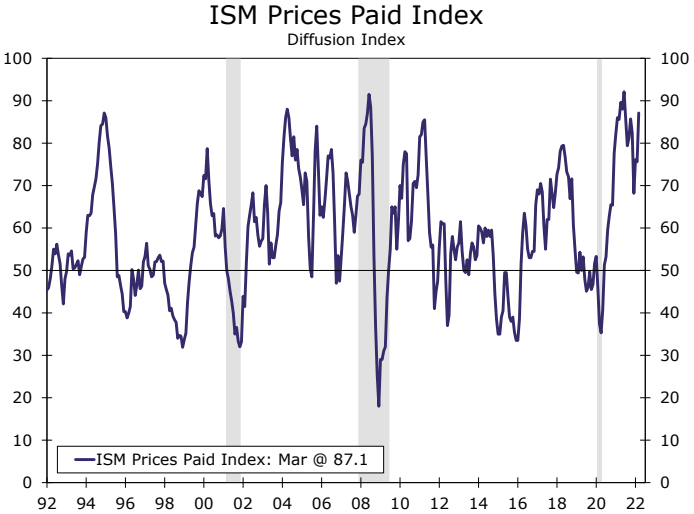
Soaring Price Gauges Turn Up the Pressure on the Fed

The strong jobs report for March and other data this week have only added more pressure on the Fed to quickly raise interest rates. The spread between the two-year and 10-year Treasury note yields inverted shortly after the release as traders anticipate an accelerated tightening timeline. Markets are currently close to fully pricing in a 50-bp hike in May, and we would not be surprised if the FOMC seizes the opportunity to accelerate the removal of monetary policy accommodation. The FOMC has become increasingly more hawkish amid persistently high inflation, and the most pressing question is whether policymakers will be able to guide inflation back toward target without undermining economic growth. The inversion of the yield curve this week suggests markets may be losing confidence that the Fed will be able to achieve such a soft landing. More broadly, the negative spread is typically viewed as an ominous sign preceding recession (chart). While an important indication of market expectations, it is important to consider recent curve flattening in the broader context of each cycle, which is different in its own way. That said, factoring in a broad array of factors, not just the yield curve, we do believe the chance of entering a recession by the end of 2023 has increased, though it is not our base case scenario. Our April monthly forecast update, set to be released next week, will convey our most current thinking on this question.

The rise in the 10-year yield in recent weeks has exerted upward pressure on mortgage rates. The 30-year mortgage rate reached 4.7% this week, and while that puts it roughly in line with 2018 levels, the steep ascent over the past three months was the fastest in 35 years. Higher rates coupled with continued home-price appreciation, with the S&P CoreLogic Case-Shiller 20-City Home Price Index (HPI) rising 1.8% in January, continues to demonstrate an erosion in affordability, which we discuss more in this week's Credit Market Insights section.



Source: Bloomberg Finance L.P. and Wells Fargo Economics



Source: Institute for Supply Management and Wells Fargo Economics

The temporary inversion of the yield curve was not the only ominous warning this week. The ISM manufacturing index slowed to 57.1 in March with most components moving in the wrong direction for anyone interested in seeing improvement with supply chain problems, high inflation and production bottlenecks. Supplier deliveries edged slightly lower to a still-elevated 65.4 in March. We had expected this measure to jump based on increased wait times reported in the regional PMIs. But there was plenty of evidence of those frustrations in the comments section in which most industries cited supply issues either persisting or getting worse. If any policymaker at the Federal Reserve were on the fence about the prospects for sustained inflation, the 11.5-point jump in the prices paid component to 87.1 might be enough to push them in favor of a 50-bp rate hike in May (chart). New orders and production were both down, raising doubts about the timing of a catch-up on all of the backlogged orders. The only clear bright spot is that the employment component climbed to 56.3; that is the second-highest reading of the pandemic era and a welcome sign that factories are at last better-able to find the help they need.

While the Fed is surely paying close attention to labor market developments, it is more keenly focused on the other half of its dual mandate and reining in high inflation. The surge in the prices paid component of the ISM signals continued price pressure throughout the supply chain, which will keep the heat turned up on consumer prices. The PCE deflator rose 0.6% in February, lifting the annual rate of inflation to 6.4%. But even as inflation has become more of a burden on households, the latest data suggest consumers have maintained a stiff upper lip in the face of raging prices. Consumer confidence inched higher in February amid an improvement in perceptions of present conditions as the solid jobs market are helping households shoulder the worsening burden of rising prices. That said, income is not quite keeping pace with price gains with February marking the seventh straight month in which inflation outpaced income. The trend decline in real disposable personal income emphasizes the hit to consumers purchasing power from higher inflation and is the main reason we expect consumer spending to slow quite rapidly this year. (Return to Summary)

U.S. Outlook

Weekly Domestic Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
4-Apr	Factory Orders (MoM)	Feb	-0.6%	-0.7%	1.4%
5-Apr	Trade Balance	Feb	-$89.0B	-$88.1B	-$89.7B
5-Apr	ISM Services Index	Mar	58.6	60.0	56.5

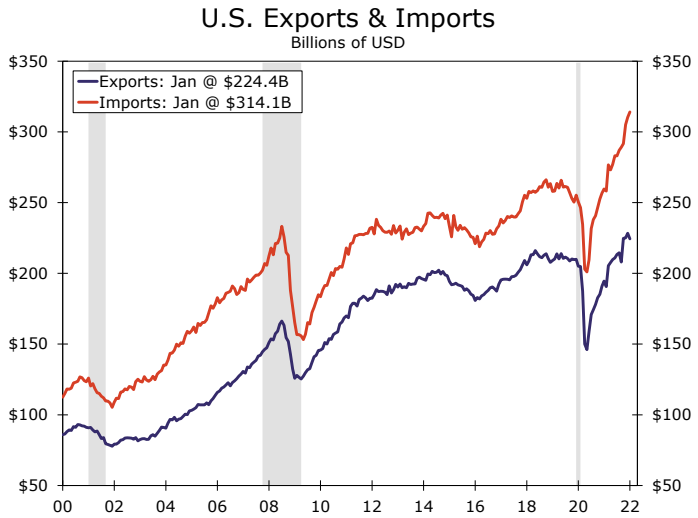
Forecast as of April 01, 2022

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Trade Balance • Tuesday

The U.S. trade deficit reached a new record in January, falling to $89.7B from $81.9B in December. Exports (-1.7%) came in weaker than imports (+1.2%) over the month. The broad strength in imports has in large part reflected exceptional domestic consumer demand, even in the face of quickly rising prices. On the export side, ongoing supply chain disruptions have weakened export flows, but bottlenecks seemed to be easing slightly at the start of the year. Just as some scope for normalization in trade flows appeared on the horizon, the Russian invasion of Ukraine and COVID surges across the globe clouded the outlook.

While we expect the war's direct effect on U.S. trade to be fairly minimal, we will keep a watchful eye on the evolution of categories directly or indirectly linked to energy. Advance trade data for February show goods exports (+1.2%) rising faster than goods imports (+0.3%). With that in mind, we forecast the trade balance narrowed to -$88.1B in February. Overall, the indirect effects from the war in Ukraine on European economies will likely weigh on overall export growth this year, suggesting we are still some time away from seeing any normalization in exports that steadies the U.S. trade gap.

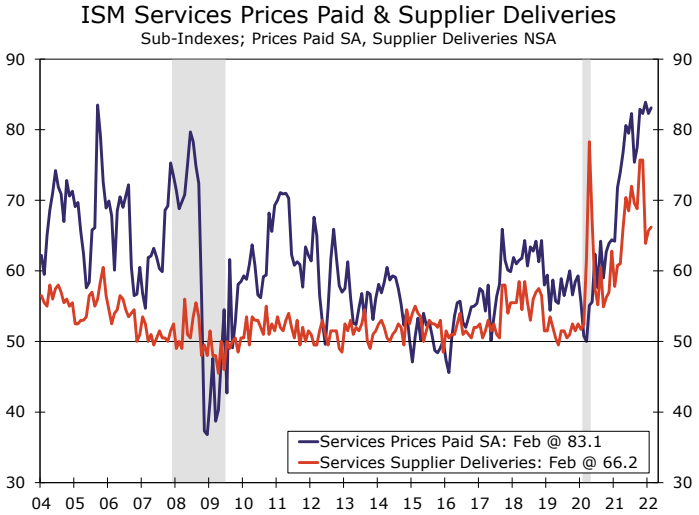


Source: U.S. Department of Commerce and Wells Fargo Economics

ISM Services • Tuesday

The service sector continues to struggle amid capacity constraints. Shortages of workers and materials weighed on February's ISM services index, which slid 3.4 points to 56.5 over the month. The business activity sub-component fell 4.8 points to 55.1, the slowest pace of expansion since coming out of the initial pandemic lockdown in 2020. The activity slowdown mirrors the sentiment of one survey respondent who said, "The challenges are at the highest point since COVID-19 began."

Looking ahead, we expect the ISM services index to increase to 60.0 in March, up from 56.5 in February. While the increase appears counterintuitive against the challenging economic environment, we suspect supplier delivery times will lengthen, which will show up as a boost to the headline index. In "normal" times, slower supplier deliveries are typically a sign of economic improvement, as suppliers have an increasingly difficult time delivering amid strong customer demand. In today's times, fresh lockdowns in China and the war in Ukraine have added more pressure to global supply chains, likely driving further delays in deliveries and pressuring prices even higher.

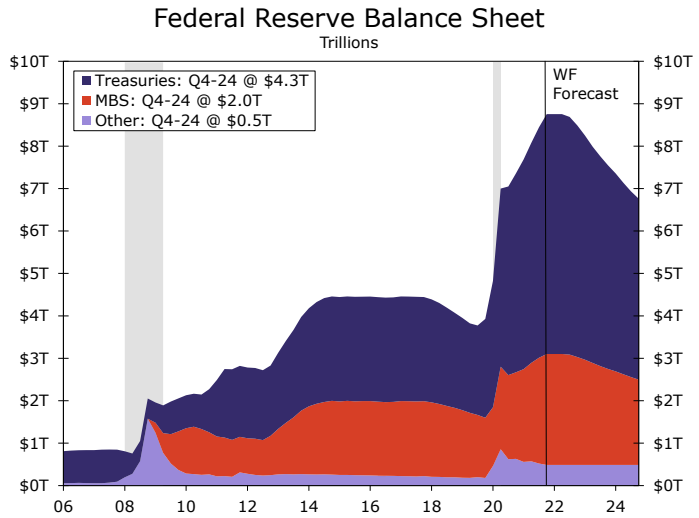


Source: Institute for Supply Management and Wells Fargo Economics

FOMC Meeting Minutes • Wednesday

The Federal Open Market Committee (FOMC) elected to raise rates by 25 bps at its March 15-16 meeting. At the conclusion of the meeting, the committee released its quarterly *Summary of Economic Projections* (SEP), in which all current members submit individual forecasts for key economic indicators and the path of policy. For example, the median forecast for 2022 PCE inflation jumped to 4.3% (on a Q4-over-Q4 basis) from 2.6% in December. Moreover, the median forecaster called for 175 bps of rate hikes in 2022, up from 75 bps in December. All told, the SEP indicated that the FOMC has broadly adopted a hawkish stance on policy.

Beyond rate hikes, the Fed has other tools at its disposal. As we described in a report in January, balance sheet reduction also acts as a form of monetary tightening. The statement from this past meeting said "the Committee expects to begin reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities at a coming meeting." Moreover, Chair Powell signaled that the meeting minutes, due for release on Wednesday, will contain additional information on the balance sheet runoff. While we previously expected the FOMC to decide on balance sheet reduction in June, the statement indicates that an announcement could very much be in play at the next meeting on May 3-4, depending on developments in coming weeks. (Return to Summary)

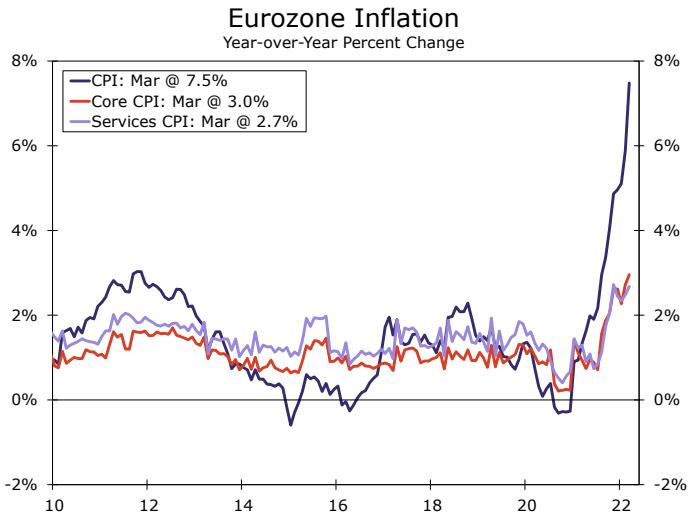


Source: Federal Reserve Board and Wells Fargo Economics

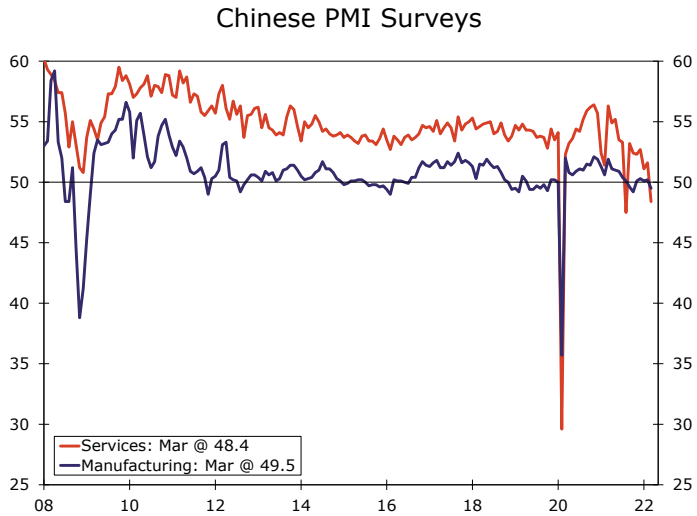
International Review

Eurozone Inflation Continues to Accelerate

Eurozone inflation accelerated further in March to a new record high. The headline CPI quickened much more than expected to 7.5% year-over-year, with a jump in oil prices in the wake of the Russia-Ukraine conflict a key driver as energy prices rose 44.7%. While there was also a pickup in inflation elsewhere, the acceleration was less marked, as the core CPI quickened to 3.0%, and services inflation also firmed to 2.7%. Rapid Eurozone inflation should, in our view, see the European Central Bank (ECB) move toward a less accommodative monetary policy stance in a reasonably timely manner. Indeed, we see an accelerated tapering of the ECB's bond purchases and anticipate quantitative easing coming to an end in July, with an initial Deposit Rate increase occurring by year-end. That adjustment in ECB monetary policy is expected even with a somewhat mixed growth outlook. Perhaps reflecting the mixed outlook for economic activity, this week's Eurozone data also showed March economic confidence falling to 108.5. Although, within the details, industrial confidence fell to 10.4, while services confidence rose to 14.4.



Source: Datastream and Wells Fargo Economics



Source: Datastream and Wells Fargo Economics

Softer Growth for Some Key Asian Economies

This week's data from Asia highlighted sluggish momentum for two of the region's key economies in early 2022. In China, the March PMIs fell more than forecasted as a renewed outbreak of COVID cases and associated restrictions weighed on activity. The manufacturing PMI fell to 49.5, with declines in the new orders and employment components, and additional details showed some inflationary pressures as the input and output price components both increased. Perhaps even more significant, the services PMI fell to 48.4. The details within the services PMI showed similar dynamics, as the new orders and employment components both fell, while the input and selling price components increased. GDP growth is likely to be subdued for Q1 and perhaps to some extent in subsequent quarters. Indeed, we have again lowered our GDP growth forecast and now see China's GDP growing 4.9% in 2022.

In Japan, the Q1 Tankan survey also signaled the likelihood of sluggish Q1 GDP growth, although the key diffusion indices were not as soft as expected. The Tankan survey showed a drop in the large manufacturers' diffusion index to +14 in Q1 from +17 in Q4, while the large non-manufacturers' diffusion index eased down to +9 in Q1 from +10 in Q4. Meanwhile, large company capital spending plans for fiscal 2022 anticipate just a 2.2% increase in spending. The survey was not the only Japanese data this week to hint at sluggish growth in early 2022. February retail sales fell 0.8% month-over-month, the third decline in a row, and while February industrial output edged up 0.1%, that small gain comes after declines in both January and December. Given subdued growth, and even with some increase in inflation, the Bank of Japan appears comfortable maintaining its accommodative monetary policy stance for the time being. (Return to Summary)

International Outlook

Weekly International Indicator Forecasts

Date	Indicator	Period	Consensus	Wells Fargo	Prior
7-Apr	Mexico CPI (YoY)	Mar	7.33%	--	7.28%
8-Apr	Brazil CPI (YoY)	Mar	11.00%	--	10.54%
8-Apr	Canada Employment	Mar	65.0K	--	336.6K
8-Apr	Canada Unemployment Rate	Mar	5.4%	--	5.5%

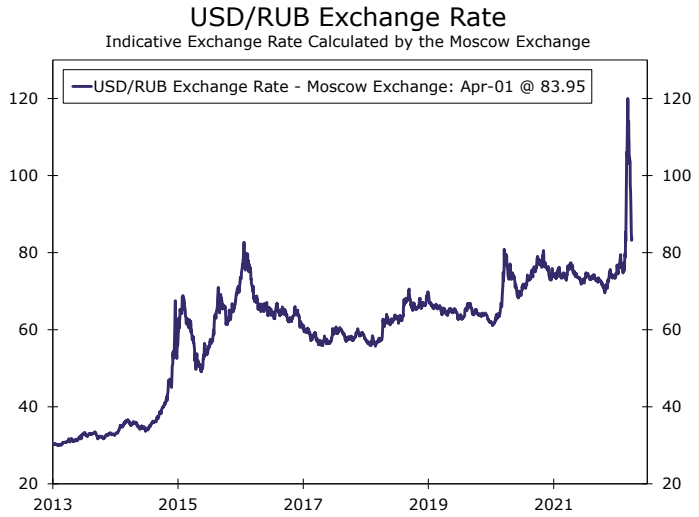
Forecast as of April 01, 2022

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Mexico CPI • Thursday

Mexico's March CPI due next week is likely to show ongoing price pressures, given the spike in oil and other commodity prices in the wake of the Russia-Ukraine war. Mexican inflation has already quickened sharply over the past several months and remains elevated at 7.28% year-over-year in February. Prices for food, furniture, health care, education and other services have all been contributors to the further firming of inflation in recent months. As a result, the core CPI has also quickened, rising 6.59% In February.

For March, the consensus forecast is for the headline CPI to remain elevated at 7.33% and for the core CPI to firm slightly to 6.71%. Those outcomes would keep inflation near the highs for the current cycle and, following a hawkish monetary policy announcement from Mexico's central bank last week, suggest further rate hikes will soon be forthcoming. Indeed, we expect Mexico's central bank to again hike its policy rate 50 bps to 7.00% at its next meeting in May.

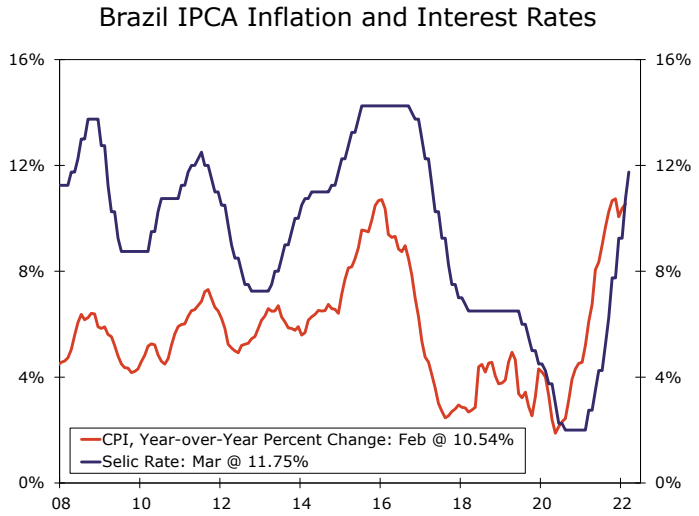


Source: Bloomberg Finance L.P. and Wells Fargo Economics

Brazil CPI • Friday

Brazil's March CPI is also due next week and, like Mexico, should show a further acceleration in prices. CPI inflation is already elevated, with February registering a 10.54% year-over-year pace. Over the past couple of months, education costs in particular, along with prices for food and beverage, housing, household goods and clothing, have all contributed to the firming of inflation.

For March, the consensus is for a further energy-driven quickening of inflation, given an announced increase in fuel prices, although a cut in fuel taxes should provide some offset over time. The March headline CPI is forecast to rise 11.00% year-over-year. Elevated inflation should see Brazil's central bank deliver another 100-bp rate hike at its May announcement, though we suspect that will be the peak for Brazil's policy rate during the current cycle.

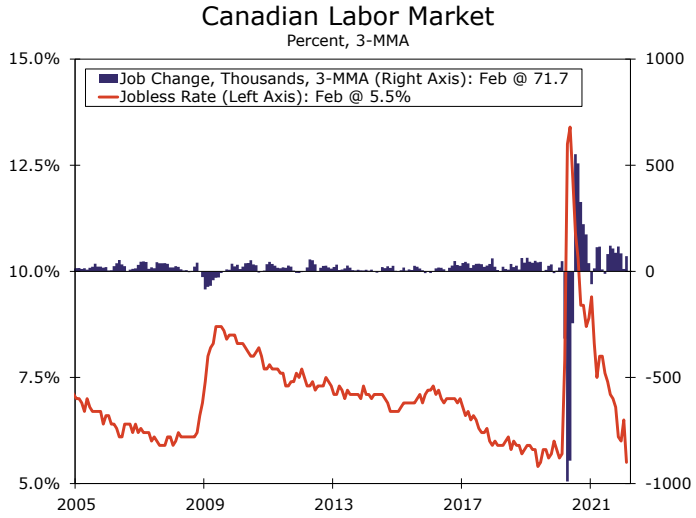


Source: Bloomberg Finance L.P. and Wells Fargo Economics

Canada Employment • Friday

Canada's employment report should offer some further insight into how the economy is rebounding from a brief COVID-related slowdown in activity in early 2022. After Canadian employment fell sharply in January, that decline was more than reversed in February as payrolls surged by 336,600, with full-time jobs rising by 121,500 and part-time jobs rising by 215,100. For March, the consensus forecast is for a more modest increase in jobs, though that would still represent a solid outcome after the large February gain. The consensus forecast is for employment to rise by 65,000 for the month, and for the unemployment rate to edge down to 5.4%.

The Bank of Canada kicked of its rate hike cycle with a 25-bp policy rate increase at its early March announcement. Since then, CPI inflation has quickened further, and elevated oil prices should also be supportive for the Canadian economy. Thus, a solid jobs report would be fully consistent with further monetary tightening from the Bank of Canada, and we expect another 25-bp rate increase from the central bank at its April meeting. (Return to Summary)



Source: Datastream and Wells Fargo Economics

Credit Market Insights

Mortgage Rates Accelerate in March as Homebuyers Rush to Lock In

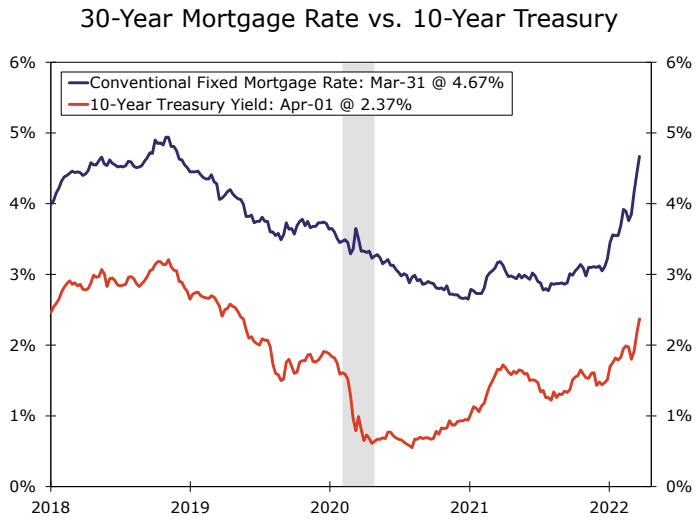
Thirty-year mortgage rates reached 4.67% this week, the highest level in over three years. According to Freddie Mac's March 31 Primary Mortgage Market Survey, rates for 30-year mortgages have continued their steep ascent in 2022 with the average 30-year now up 1.56 percentage points year-to-date. This marks the greatest three-month increase since 1987 and is a far cry from the record low of 2.65% seen in January 2021.

The quarter-of-a-percent increase from last week's 4.42% reading has 30-year mortgage rates on a breakneck pace to reach the 5% mark, a level not seen since February 2011. More than half of the year-to-date increase has come in March as rates accelerated in response to the FOMC's 25-bp rate hike and increasingly hawkish efforts to rein in inflation. The rapid rise in long-term Treasury yields alongside mortgage rates draws natural comparisons to the 2013 taper tantrum as 10-year yields have jumped 0.76 percentage points in 2022. However, this tightening cycle, the Fed has been exceedingly transparent in its plans for bond purchase tapering and eventual balance sheet roll off this year. With balance sheet shrinkage on the table at the Fed's May meeting, the Fed's MBS stockpile may soon be lifted, providing more room for mortgage rates to climb in the future.

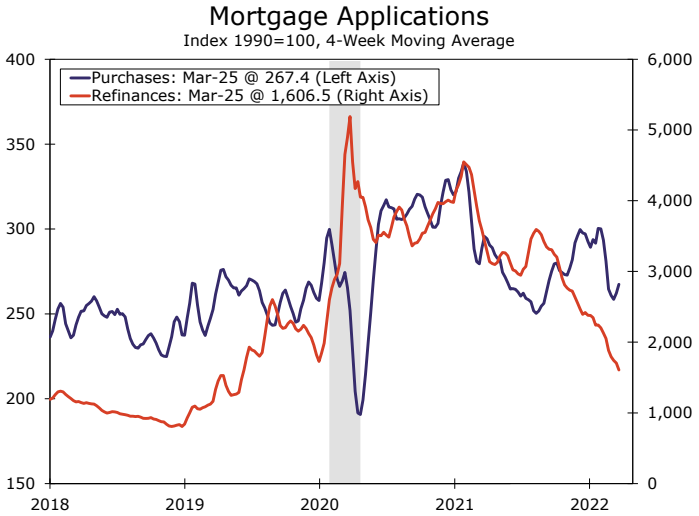
The white-hot housing market, although resilient, has not been entirely immune to the effects of rising mortgage rates. Mortgage applications faltered in February before picking back up slightly in March. Rapidly rising rates will likely spur buyers to lock-in purchases in the near term, which should provide a short-term counter to the increasing headwinds brought about by higher rates and double-digit price appreciation.

Rising mortgage rates are sure to erode affordability in the long term, but many buyers, particularly entry-level, have already been sidelined by rising rates. The National Association of Realtor's housing affordability index posted a 143.0 print in January, a pandemic low and a level more than 40 points lower from the pandemic peak seen in January 2021. The index is skirting close to its lowest level since the Great Recession, indicating the increasing hindrances facing homebuyers. Some builders have seen an uptick in cancellations due to rising borrowing costs; however, the rate is still well below historical norms.

The rise in mortgage rates has also taken a massive bite out of the market for secondary homes. According to Redfin's March report, mortgage-rate locks for second homes have reached their lowest level since 2020. However, financing/mortgage activity remains 35% above pre-pandemic levels, a point of resilience even in the face of waning enthusiasm in the housing market. (Return to Summary)



Source: Freddie Mac, Bloomberg Finance L.P. and Wells Fargo Economics

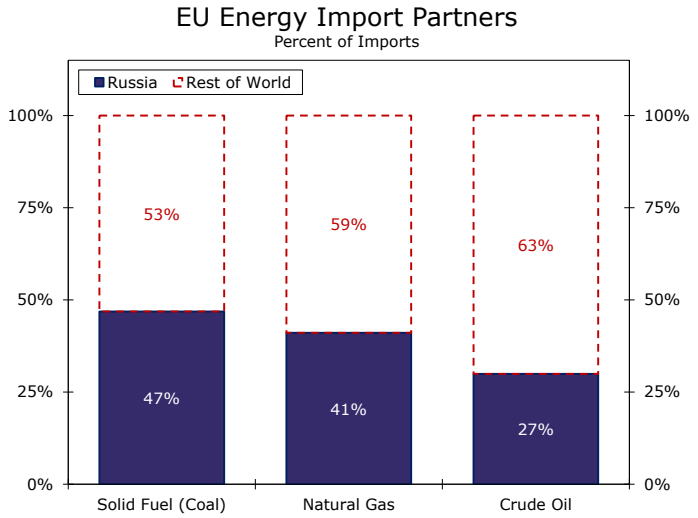


Source: Mortgage Banker's Association and Wells Fargo Economics

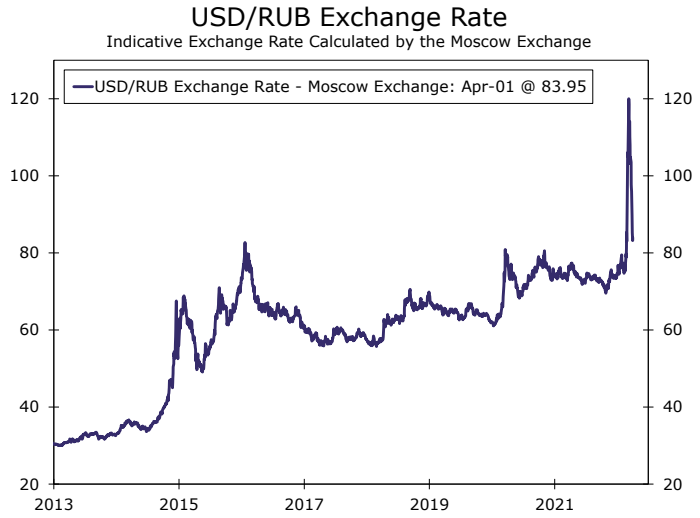
Topic of the Week

Russia-Europe Gas Standoff Puts the Pressure on American Producers

The economic fallout from Russia's invasion of Ukraine continued this week with Putin targeting the European Union's (EU) heavy dependence on Russian energy sources. The EU imports around 40% of its natural gas supply from Russia (chart), and its largest economy, Germany, receives more than half of its natural gas from Russia. Putin put this vulnerability on full display when he first began pressuring for payments in rubles earlier this week and declared yesterday that "unfriendly" countries that did not pay in rubles should expect to have their supply lines cut starting today. This demand comes as a bid to prop up the ruble, which was in freefall following the onset of the war and reached a low against the U.S. dollar in early March (chart). This occurred as many countries took a unified front against Russia and imposed sanctions cutting off Russia's access to SWIFT and the global financial system. However, in recent weeks the ruble has quickly recovered from its low point against the U.S. dollar and is now around where it was in February immediately preceding the invasion. Although it is not clear whether Putin will stick to this hard line approach or if he legally has the power to make such a change to pre-existing contracts, much still hangs in the balance as more details surface. Up to this point, the response in Europe has largely been a rejection of Putin's demands, but there has been much discussion of contingency plans in case he follows through on his threat.



Source: Eurostat and Wells Fargo Economics



Source: Bloomberg Finance L.P. and Wells Fargo Economics

One possible solution has been American producers supplying more fuel to Europe. President Biden and European Commission President Ursala von der Leyen have initiated a task force to pursue this avenue. Last Friday, the U.S. committed to providing 15 billion cubic meters more of liquefied natural gas (LNG) to Europe this year, which would amount to around one-tenth of European imports of Russian gas in 2021. Over the next 10 years, the U.S. has promised the EU market 50 billion cubic meters of fuel annually. However, ramping up production that much may put additional stress on U.S. producers due to infrastructure constraints and the concern that the LNG industry is already operating at capacity. However, in a recent analysis, we looked into whether the U.S. is capable of increasing its oil production and discovered that oil production is still down 1.1 million barrels a day compared to 2019 levels, which should allow some room for increased supply, particularly from states/regions that are still recovering. That said, in an era where the labor market is tight and materials are expensive, this may be easier said than done.

One-off releases from U.S. oil reserves may also help cover the gap. On Thursday, President Biden released a historic 180 million barrels of oil from the U.S. Strategic Petroleum Reserve (SPR) in an effort to provide relief, as not only have gas prices spiked in the EU but also have grown to record levels domestically. As the situation evolves, the U.S. will have to weigh both longer-term solutions to Europe's reliance on Russian gas, while ensuring that there is enough fuel to go around for both countries in the short term. (Return to Summary)

Market Data • Mid-Day Friday

U.S. Interest Rates

	Friday 4/1/2022	1 Week Ago	1 Year Ago
SOFR	0.29	0.27	0.01
3-Month LIBOR	0.96	0.97	0.19
3-Month T-Bill	0.51	0.52	0.01
1-Year Treasury	1.56	1.46	0.03
2-Year Treasury	2.45	2.27	0.16
5-Year Treasury	2.57	2.55	0.90
10-Year Treasury	2.42	2.47	1.67
30-Year Treasury	2.49	2.58	2.33
Bond Buyer Index	2.73	2.67	2.34

Foreign Exchange Rates

	Friday 4/1/2022	1 Week Ago	1 Year Ago
Euro ($/€)	1.104	1.098	1.178
British Pound ($/£)	1.311	1.318	1.383
British Pound (£/€)	0.842	0.833	0.851
Japanese Yen (¥/$)	122.850	122.050	110.620
Canadian Dollar (C$/$)	1.250	1.248	1.255
Swiss Franc (CHF/$)	0.926	0.930	0.942
Australian Dollar (US$/A$)	0.749	0.752	0.762
Mexican Peso (MXN/$)	19.823	20.034	20.295
Chinese Yuan (CNY/$)	6.363	6.366	6.565
Indian Rupee (INR/$)	75.786	76.373	73.113
Brazilian Real (BRL/$)	4.699	4.743	5.709
U.S. Dollar Index	98.693	98.789	92.929

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Foreign Interest Rates

	Friday 4/1/2022	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	-0.58	-0.59	-0.57
3-Month Sterling LIBOR	1.04	1.01	0.09
3-Month Canada Banker's Acceptance	1.26	1.14	0.44
3-Month Yen LIBOR	0.00	-0.01	-0.07
2-Year German	-0.05	-0.14	-0.71
2-Year U.K.	1.40	1.42	0.08
2-Year Canadian	2.37	2.35	0.22
2-Year Japanese	-0.03	-0.02	-0.11
10-Year German	0.58	0.59	-0.33
10-Year U.K.	1.64	1.70	0.80
10-Year Canadian	2.48	2.55	1.51
10-Year Japanese	0.23	0.24	0.11

Commodity Prices

	Friday 4/1/2022	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	99.99	113.90	61.45
Brent Crude ($/Barrel)	105.02	120.65	64.86
Gold ($/Ounce)	1925.84	1958.29	1729.31
Hot-Rolled Steel ($/S.Ton)	1596.00	1498.00	1335.00
Copper (¢/Pound)	470.00	468.80	399.05
Soybeans ($/Bushel)	16.16	17.08	14.44
Natural Gas ($/MMBTU)	5.72	5.57	2.64
Nickel ($/Metric Ton)	32,093	37,185	16,022
CRB Spot Inds.	684.18	679.67	567.04

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