

Economics Group

MONTHLY OUTLOOK

U.S. Overview

Sustained Growth, but Not Without Some Risks

Domestic demand continues to flow from better consumer spending, solid equipment and software spending and a turnaround in nonresidential construction. This is our traditional cyclical recovery. What continues to distinguish this recovery is the weakness in residential construction and municipal government spending. These are our structural impediments. In this way, we can see how one could characterize this period as a period of economic recovery and expansion, while also recognizing that weakness still remains in certain sectors.

Meanwhile, inflation, while well within the Federal Reserve's comfort zone, is clearly rising. Short-term interest rates remain low, but longer-term interest rates have already risen in response to expectations of better economic growth and higher commodity prices. With moderate gains in consumer demand and rising commodity prices, we suspect producers will have to absorb at least some of these higher input costs, resulting in a moderation in corporate profit growth.

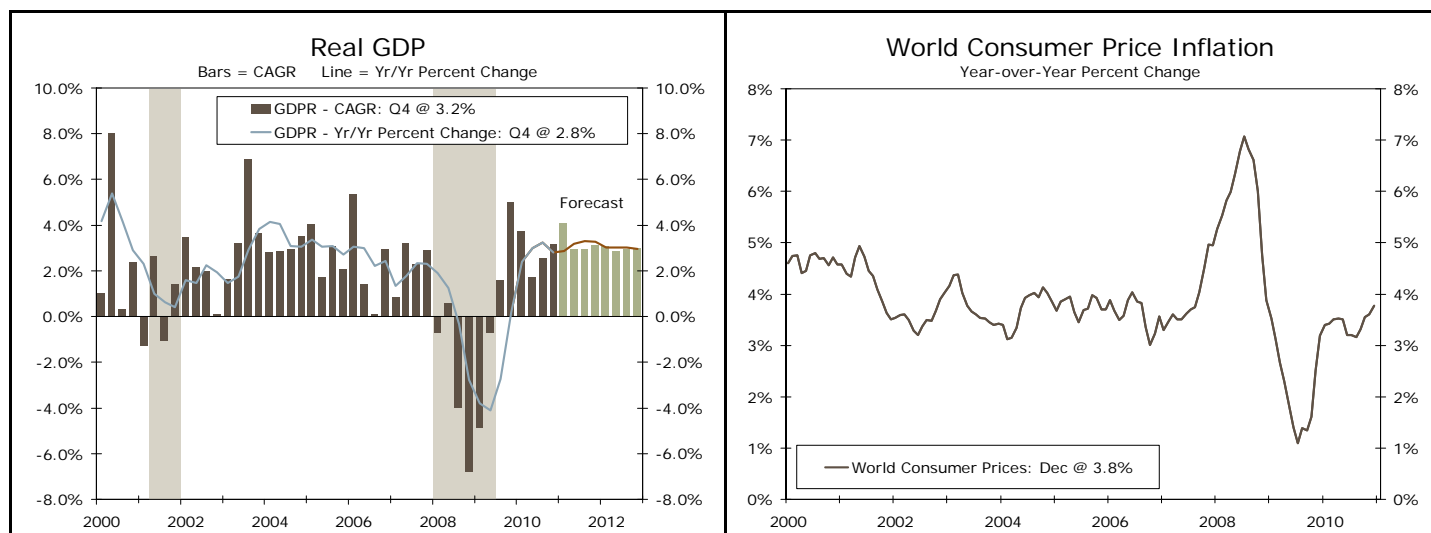
Two risks remain foremost in our view. First, inflation will rise sooner and faster than the consensus expectation embedded in current interest rates. In part, we have already witnessed some of this as producer prices and thereby 10-year Treasury rates are already up faster than many expected in just the first month of this year. Second, progress on addressing federal budget imbalances will stall in the face of political roadblocks.

International Overview

Does the World Have an Inflation Problem?

Could sharp increases in food and energy prices recently lead to a global inflation problem? If inflation becomes a problem for anybody, it likely will be more of an issue for the developing countries, where economic growth has been strong, than for most advanced economies. For example, food accounts for one-third of the Chinese consumer price index, and double-digit increases in food prices recently have caused the overall rate of Chinese CPI inflation to jump. Excluding food, CPI inflation in China is more contained. That said, there is a significant risk that inflationary pressures in China could become more widely entrenched. Therefore, the Chinese central bank likely will tighten policy further in the months ahead to insure that inflation does not get out of hand.

Inflation rates in most advanced economies, which suffered very deep recessions, are generally much lower than in developing countries. Moreover, it is difficult to envision significant increases in core rates of inflation, which are generally below 2 percent at present, in most advanced economies due to elevated unemployment rates that will keep a lid on wage increases. Although the elevated rate of core CPI inflation in the United Kingdom could conceivably induce the Bank of England to jump the gun this spring, we suspect that most major central banks will refrain from hiking rates until later this year when economic expansions are more firmly established.



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



Sustained Growth

Consumer spending continues to benefit from gains in employment along with the cut in the payroll tax. Our outlook is for a gain in real disposable income in 2011 of 3.0 percent compared to 1.4 percent in 2010. For 2011, we estimate average job growth of nearly 150,000 per month. A further benefit comes from the tax compromise reached in December, which helps lift real disposable income. Consumer spending will pick-up modestly over the next year as both the employment situation and real disposable incomes gradually improve. The additional disposable income should allow consumers to continue deleveraging while at the same time sustain a moderate level of consumer spending over the next year.

We expect equipment and software spending to continue to drive overall business fixed investment in 2011. Business equipment and software spending is expected to grow 14.5 percent in 2011, just a modest reduction from the 15.1 percent pace last year. A number of factors are behind this growth. Improving financial conditions and a recent history of depressed real capital spending accelerates the need to boost equipment and software spending. In addition, many firms are sitting on ample cash, credit availability is rapidly improving and private borrowing costs remain low by historical standards. Federal government spending will minimally support growth in 2011. However, we remain cautious on the extent of federal spending reductions during the next two years in the run-up to the next presidential election.

Structural Roadblocks

Residential investment and municipal government continue to provide evidence that the recovery/expansion is certainly not uniform across all sectors. Our expectation is that housing

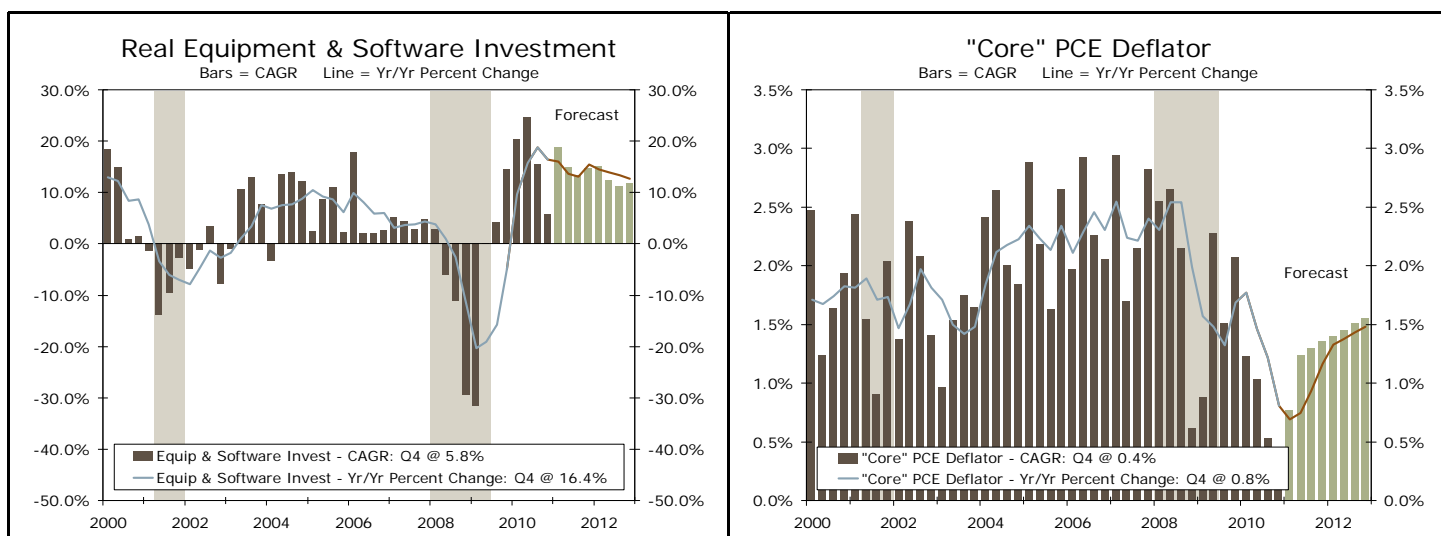
starts will improve to 710,000 at an annual rate by the fourth quarter of this year. Meanwhile, state and local spending will detract from both jobs and the economy all throughout this year. The unevenness of the recovery reflects the interesting patterns of a cyclical recovery combined with structural change in housing and municipal government.

Inflation and Interest Rates: Low but Rising

Economic cycles are also characterized by patterns in certain areas where levels and change convey very different messages over time. In the very short-run, inflation and interest rates are low, but the trend is upward. For inflation, the recent rise in the producer price indices and commodity prices indicate that the risk of inflation is on the upside and that has follow-on implications for Treasury benchmark rates. Although today, many analysts are comfortable with low interest rates, the trend for rates is clearly on the upside with the risk that, like 1994-1995, rates and inflation concerns can rise much quicker than the consensus has discounted. Our outlook remains for a modest rise of inflation and interest rates, but the risk is clearly on the upside in both cases.

Federal Spending Risk to the Outlook

Finally, we face the political risk that progress on long-run federal spending control will fall short of current market expectations. At present, we expect the federal deficit to remain above \$1.4 trillion for the current fiscal year with the expectation that some modest progress will be made to reduce the growth of federal spending over time. If not, the risks are a period of higher interest rates, a weaker currency and the long-run risk of higher inflation. Moreover, markets have been known to move quickly in the face of disappointment even in an economic recovery that appears to be sustained.



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

Wells Fargo U.S. Economic Forecast

	Actual								Forecast								Actual			Forecast	
	2009				2010				2011				2012				2008	2009	2010	2011	2012
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product (a)	-4.9	-0.7	1.6	5.0	3.7	1.7	2.6	3.2	4.1	3.0	3.0	3.1	3.1	2.9	3.0	3.0	0.0	-2.6	2.9	3.2	3.0
Personal Consumption	-0.5	-1.6	2.0	0.9	1.9	2.2	2.4	4.4	3.3	2.4	2.5	2.5	2.7	2.6	2.7	2.8	-0.3	-1.2	1.8	3.0	2.6
Business Fixed Investment	-35.2	-7.5	-1.7	-1.4	7.8	17.2	10.0	4.4	23.5	12.2	11.4	12.6	13.4	11.5	10.6	11.2	0.3	-17.1	5.5	13.3	12.1
Equipment and Software	-31.6	0.2	4.2	14.6	20.5	24.8	15.4	5.8	19.0	14.8	13.4	14.7	15.2	12.5	11.3	11.8	-2.4	-15.3	15.1	14.5	13.6
Structures	-41.0	-20.2	-12.4	-29.2	-17.8	-0.5	-3.6	0.9	1.0	3.0	4.0	5.0	6.5	7.5	8.0	8.5	5.9	-20.4	-14.0	1.3	6.2
Residential Construction	-36.2	-19.7	10.6	-0.8	-12.3	25.6	-27.3	3.4	-4.0	6.0	11.0	19.0	23.0	25.0	27.0	29.0	-24.0	-22.9	-3.0	0.5	21.0
Government Purchases	-3.0	6.2	1.6	-1.4	-1.6	3.9	3.9	-0.6	-0.1	-1.3	-1.1	-1.2	-1.3	-1.0	-0.7	-0.6	2.8	1.6	1.1	0.1	-1.1
Net Exports	-389.2	-342.0	-390.8	-330.1	-338.4	-449.0	-505.0	-392.2	-411.0	-413.4	-422.4	-435.7	-462.3	-489.5	-518.0	-552.7	-504.1	-363.0	-421.2	-420.6	-505.6
Pct. Point Contribution to GDP	2.9	1.5	-1.4	1.9	-0.3	-3.5	-1.7	3.4	-0.6	-0.1	-0.3	-0.4	-0.8	-0.8	-0.8	-1.0	1.1	1.1	-0.5	0.0	-0.6
Inventory Change	-125.8	-161.8	-128.2	-36.7	44.1	68.8	121.4	7.2	25.0	30.0	35.0	40.0	45.0	48.0	50.0	50.0	-37.6	-113.1	60.4	32.5	48.3
Pct. Point Contribution to GDP	-1.1	-1.0	1.1	2.8	2.6	0.8	1.6	-3.7	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.0	-0.5	-0.6	1.3	-0.2	0.1
Nominal GDP	-3.9	-0.4	2.3	4.7	4.8	3.7	4.6	3.4	5.5	4.3	4.2	4.5	4.5	4.4	4.6	4.7	2.2	-1.7	3.8	4.4	4.5
Real Final Sales	-3.9	0.2	0.4	2.1	1.1	0.9	0.9	7.1	3.6	2.8	2.8	3.0	2.9	2.8	2.9	3.0	0.5	-2.1	1.4	3.5	2.9
Retail Sales (b)	-9.4	-9.9	-7.0	1.6	5.7	6.9	5.8	7.8	6.6	6.2	6.1	3.8	3.6	3.9	4.4	4.4	-1.0	-6.4	6.6	5.7	4.1
Inflation Indicators (b)																					
"Core" PCE Deflator	1.6	1.5	1.3	1.7	1.8	1.5	1.2	0.8	0.7	0.7	0.9	1.2	1.3	1.4	1.4	1.5	2.3	1.5	1.3	0.9	1.4
Consumer Price Index	-0.2	-1.0	-1.6	1.5	2.4	1.8	1.2	1.2	1.6	2.3	2.4	2.4	2.2	2.3	2.6	2.8	3.8	-0.3	1.6	2.2	2.5
"Core" Consumer Price Index	1.7	1.8	1.5	1.7	1.3	1.0	0.9	0.6	0.9	1.1	1.1	1.4	1.6	1.6	1.7	1.8	2.3	1.7	1.0	1.1	1.7
Producer Price Index	-2.2	-4.1	-5.2	1.5	5.1	4.3	3.7	4.0	3.4	4.2	5.2	4.6	3.6	3.8	3.3	2.9	6.4	-2.5	4.3	4.4	3.4
Employment Cost Index	2.1	1.8	1.5	1.4	1.7	1.9	1.9	2.0	1.9	1.5	1.5	1.6	2.2	1.8	1.7	1.8	3.0	1.7	1.3	1.6	1.9
Real Disposable Income (a)	0.4	5.9	-4.4	0.0	1.3	5.6	0.9	1.7	4.0	3.4	3.2	3.0	-2.0	1.8	2.4	2.7	1.7	0.6	1.4	3.0	1.5
Nominal Personal Income (b)	-1.7	-2.1	-2.3	-0.9	2.1	2.6	3.5	3.9	7.7	7.0	6.9	6.4	2.2	2.2	2.3	2.5	4.0	-1.7	3.0	7.0	2.3
Industrial Production (a)	-17.6	-10.3	8.3	7.0	7.1	7.2	6.5	2.4	5.1	4.3	4.1	3.9	3.8	3.9	4.0	4.1	-3.3	-9.3	5.7	4.5	4.0
Capacity Utilization	70.5	68.5	69.9	71.1	72.5	73.9	75.1	75.5	76.2	76.7	77.1	77.3	77.6	78.0	78.3	78.5	77.9	70.0	74.2	76.8	78.1
Corporate Profits Before Taxes (b)	-17.3	-11.4	-3.9	42.5	37.6	37.0	26.4	12.5	8.2	6.2	6.2	6.7	6.8	7.0	7.2	7.1	-16.4	-0.4	27.5	6.8	7.0
Corporate Profits After Taxes	-10.1	-3.1	0.4	41.9	27.0	26.5	16.2	10.7	6.2	5.7	6.2	7.7	8.2	8.5	8.6	8.5	-10.4	5.1	19.6	6.5	8.5
Federal Budget Balance (c)	-448.9	-304.9	-329.4	-388.1	-328.9	-287.0	-290.2	-370.8	-515.0	-250.0	-345.0	-390.0	-400.0	-145.0	-165.0	-215.0	-454.8	-1415.7	-1294.2	-1480.8	-1100.0
Current Account Balance (d)	-95.6	-84.4	-97.5	-100.9	-109.2	-123.2	-127.2	-110.0	-125.0	-135.0	-140.0	-145.0	-160.0	-165.0	-175.0	-180.0	-668.9	-378.4	-469.6	-545.0	-680.0
Trade Weighted Dollar Index (e)	83.2	77.7	74.3	74.8	76.1	78.8	73.6	73.2	72.5	73.0	74.0	75.0	76.0	77.0	79.0	80.0	74.3	77.7	75.6	73.6	78.0
Nonfarm Payroll Change (f)	-780.7	-516.0	-255.7	-135.3	39.3	181.0	-45.7	128.3	110.3	150.0	165.0	170.0	170.0	175.0	175.0	180.0	-295.9	-421.9	75.8	148.8	175.0
Unemployment Rate	8.2	9.3	9.7	10.0	9.7	9.6	9.6	9.6	9.3	9.4	9.3	9.2	9.1	9.0	8.9	8.8	5.8	9.3	9.6	9.3	9.0
Housing Starts (g)	0.53	0.54	0.59	0.56	0.62	0.60	0.59	0.54	0.56	0.61	0.66	0.71	0.75	0.81	0.87	0.90	0.90	0.55	0.59	0.64	0.83
Light Vehicle Sales (h)	9.6	9.7	11.6	10.8	11.0	11.3	11.6	12.3	12.8	13.2	13.5	13.6	13.7	13.9	14.1	14.3	13.2	10.4	11.5	13.3	14.0
Crude Oil - WTI - Front Contract (i)	43.08	59.62	68.30	76.19	78.72	78.03	76.20	85.17	90.19	92.67	92.00	92.00	93.00	93.00	94.00	95.00	99.65	61.80	79.53	91.71	93.75
Quarter-End Interest Rates (j)																					
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	0.50	1.00	1.25	1.88	0.25	0.25	0.25	0.75
3 Month LIBOR	1.19	0.60	0.29	0.25	0.29	0.53	0.29	0.30	0.30	0.30	0.35	0.40	0.40	0.60	1.10	1.40	2.93	0.69	0.34	0.34	0.88
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.50	4.00	4.25	4.88	3.25	3.25	3.25	3.75
Conventional Mortgage Rate	5.00	5.42	5.06	4.93	4.97	4.74	4.35	4.71	4.90	5.15	5.15	5.20	5.40	5.60	5.70	5.80	6.04	5.04	4.69	5.10	5.63
3 Month Bill	0.21	0.19	0.14	0.06	0.16	0.18	0.16	0.12	0.15	0.20	0.25	0.30	0.30	0.40	0.90	1.10	1.40	0.15	0.14	0.23	0.68
2 Year Note	0.81	1.11	0.95	1.14	1.02	0.61	0.42	0.61	0.70	0.90	1.00	1.20	1.40	1.60	1.80	2.00	2.01	0.96	0.70	0.95	1.70
5 Year Note	1.67	2.54	2.31	2.69	2.55	1.79	1.27	2.01	2.30	2.45	2.50	2.50	2.60	2.90	3.00	3.10	2.80	2.20	1.93	2.44	2.90
10 Year Note	2.71	3.53	3.31	3.85	3.84	2.97	2.53	3.30	3.60	3.75	3.75	3.80	3.90	4.10	4.20	4.30	3.66	3.26	3.22	3.73	4.13
30 Year Bond	3.56	4.32	4.03	4.63	4.72	3.91	3.69	4.34	4.70	4.80	4.80	4.90	4.90	5.00	5.10	5.20	4.28	4.08	4.25	4.80	5.05

Forecast as of: February 9, 2011

Notes: (a) Compound Annual Growth Rate Quarter-over-Quarter

(f) Average Monthly Change

(b) Year-over-Year Percentage Change

(g) Millions of Units

(c) Quarterly Sum - Billions USD - Annual Data Represents Fiscal Yr.

(h) Quarterly Data - Average Monthly SAAR - Annual Data - Actual Total Vehicles Sold

(d) Quarterly Sum - Billions USD

(i) Quarterly Average of Daily Close

(e) Federal Reserve Major Currency Index, 1973=100 - Quarter End

(j) Annual Numbers Represent Averages

Does the World Have an Inflation Problem?

Anyone who has gone to grocery stores and gasoline stations lately knows that food and energy prices are rising. Do sharp increases in the prices of these important goods portend an inflation problem for the global economy? On one hand, the current global inflation rate of 3.8 percent does not seem overly threatening (see chart on front page). Yes, the current global inflation rate is higher than it was a year or two ago. However, the global recession caused a collapse in commodity prices that led, in 2009, to the lowest rate of global inflation in at least four decades. Now that the global economy is in recovery, it is not surprising that global inflation has risen somewhat. Moreover, the current rate of global inflation is significantly lower than the 7 percent rate that was reached in 2008. On the other hand, however, recent inflation dynamics are not favorable, at least in some countries.

Inflation Is a Potential Problem in Developing World

In general, inflation seems to be more of a problem at present in the developing world than in advanced economies. Because most developing countries did not experience financial crises, the developing world has generally experienced very strong growth rates. In that regard, China serves as an interesting example of inflationary pressures in the developing world. The overall rate of CPI inflation in China has risen to about five percent (bottom chart). Much of the rise in the overall rate of inflation reflects sharp increases in food prices. Indeed, food prices, which account for one-third of the Chinese consumer price index, are up about 10 percent over the past 12 months. Excluding food, Chinese CPI inflation is a bit north of just two percent at present, hardly an inflationary outbreak.

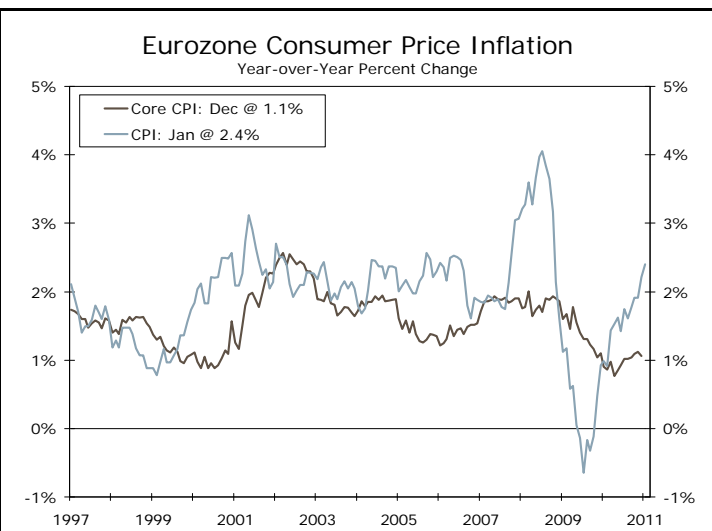
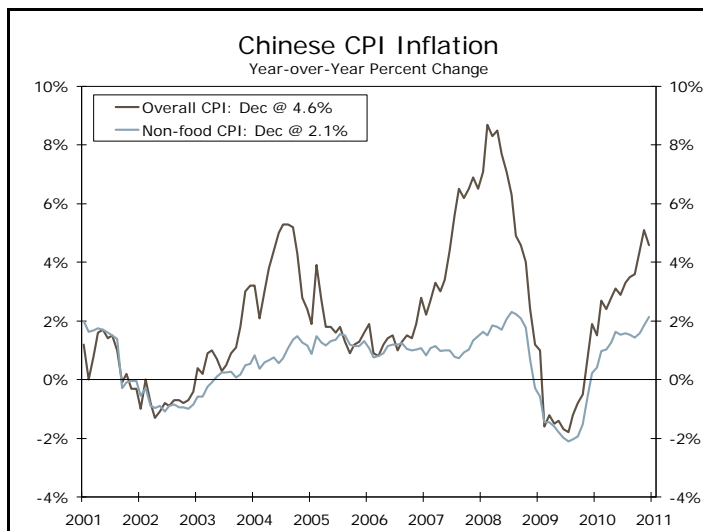
However, there is a risk that strong economic growth in China could cause inflationary pressures to become more widely entrenched. The rate of non-food price inflation is as high now

as it was in 2008. Unless another global financial crisis were to strike now and weaken global economic growth, which does not seem very likely, the rate of non-food price inflation in China probably will continue to rise. Therefore, the People's Bank of China will likely tighten policy further in the months ahead in an attempt to insure that inflation does not get out of control.

Benign Inflation in Most Advanced Economies

Due in part to the deep recessions that most advanced economies suffered, the inflation situation in most developed countries is much more benign. Take the Eurozone, for example. The "flash" estimate showed that the overall rate of CPI inflation in the euro area was 2.4 percent in January, which is above the ECB's implicit target of 2 percent (bottom chart). Excluding food and energy prices, however, core CPI inflation is running at only one percent at present. Moreover, due to slack in the labor market—the unemployment rate stands at a 13-year high of 10 percent at present—there is little risk that wages will accelerate sharply in the near term. Without significant increases in wages, a marked increase in the rate of core CPI inflation does not seem very likely. Although the United Kingdom has an elevated rate of core CPI inflation at present (2.9 percent in December), most other advanced economies, including the United States, Canada and Japan currently have core inflation rates that are significantly less than two percent (less than one percent in some cases).

With benign core CPI inflation, most major central banks probably will keep monetary policy accommodative for the foreseeable future. Although the elevated rate of core CPI inflation in the United Kingdom could conceivably induce the Bank of England to jump the gun this spring, we expect most major central banks to refrain from hiking rates until later this year when economic expansions are more firmly established.



Source: CEIC, IHS Global Insight and Wells Fargo Securities, LLC

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2010	2011	2012	2010	2011	2012
Global (PPP weights)	4.9%	4.2%	4.4%	4.2%	4.7%	4.5%
Global (Market Exchange Rates)	3.8%	3.0%	3.2%	n/a	n/a	n/a
Advanced Economies ¹	2.9%	2.5%	2.7%	1.4%	2.0%	2.1%
United States	2.9%	3.2%	3.0%	1.6%	2.2%	2.5%
Eurozone	1.7%	1.7%	2.3%	1.6%	2.0%	2.1%
United Kingdom	1.4%	1.7%	2.4%	3.3%	3.6%	2.2%
Japan	4.4%	1.3%	1.6%	-0.7%	-0.3%	-0.2%
Korea	6.1%	4.0%	4.2%	3.0%	3.9%	3.0%
Canada	2.9%	2.7%	3.1%	1.8%	2.4%	2.1%
Developing Economies ¹	7.4%	6.1%	6.4%	7.7%	7.9%	7.3%
China	10.4%	9.0%	9.3%	3.3%	4.6%	3.6%
India	8.6%	7.5%	8.0%	12.4%	7.9%	7.1%
Mexico	5.3%	4.1%	3.8%	4.2%	5.0%	5.5%
Brazil	7.8%	5.1%	5.4%	5.0%	5.4%	5.0%
Russia	4.2%	4.0%	4.5%	6.9%	9.7%	9.3%

Forecast as of: February 9, 2011

¹Aggregated Using PPP Weights

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2011				2012		2011				2012	
	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q2	Q3	Q4	Q1	Q2
U.S.	0.30%	0.30%	0.35%	0.40%	0.40%	0.60%	3.60%	3.75%	3.75%	3.80%	3.90%	4.10%
Japan	0.20%	0.20%	0.20%	0.20%	0.25%	0.25%	1.20%	1.20%	1.15%	1.20%	1.25%	1.30%
Euroland*	1.05%	1.10%	1.15%	1.40%	2.25%	3.00%	3.10%	3.20%	3.60%	3.90%	4.20%	4.40%
U.K.	0.75%	0.75%	0.80%	1.00%	1.75%	2.75%	3.60%	3.80%	4.10%	4.40%	4.60%	4.80%
Canada	1.20%	1.25%	2.00%	2.75%	3.25%	3.75%	3.40%	3.75%	4.00%	4.20%	4.30%	4.40%

Forecast as of: February 9, 2011

*10-year German Government Bond Yield

Wells Fargo Securities, LLC Economics Group

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