March 15, 2012

Economics Group

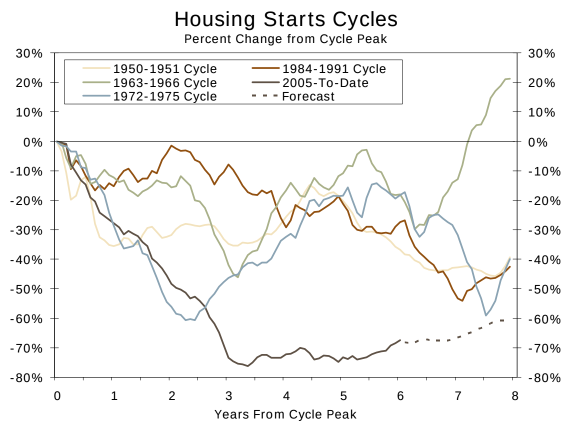
John E. Silvia, Chief Economist
john.silvia@wellsfargo.com • (704) 374-7034

Three Hard Realities Continue to Limit the Cyclical Expansion

Our current expansion contains a mixture of a cyclical recovery and structural issues that are yet to be resolved and are not addressed by economic growth alone. Hard realities require hard decisions ahead.

Housing: Rethinking Qualification and the Desirability of Homes

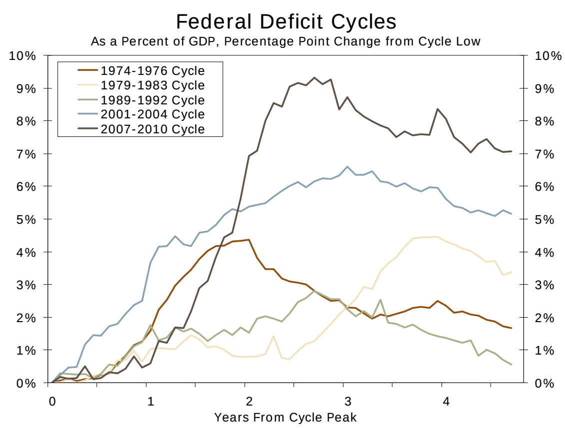
Persistent weakness in the housing recovery (top graph) reflects the changing calculus on home ownership and mortgage lending. For the past 40 years, the eligibility of homeownership has been supported by increasing leverage of the household balance sheet as well as significant federal sponsorship of financing that leverage. This approach worked as long as the value of the underlying asset—the house—rose consistently in price. However, that crucial assumption no longer can be taken with a probability of one. Without the certainty of home price appreciation, the extensive leverage of the past decades does not work. Supply and demand has also shifted as lenders are more stringent with credit and potential buyers worry about the asset's value and how it may affect future mobility. Furthermore, the oversized ex-urban home has lost some of its allure with the rise in gas prices over time.



Federal Deficits: Running out of Road

Time has begun to take its toll on the federal budget. After years of kicking the can down the road and ignoring the long-run warnings from numerous Social Security commissions (as well as others), we are running out of road. At this point in prior recoveries, the federal deficit had clearly been lower and improving more rapidly than the current recovery (middle graph). Now, the aging of the baby boom generation and the weak pace of the recovery have produced current deficits in cash flow for Social Security.

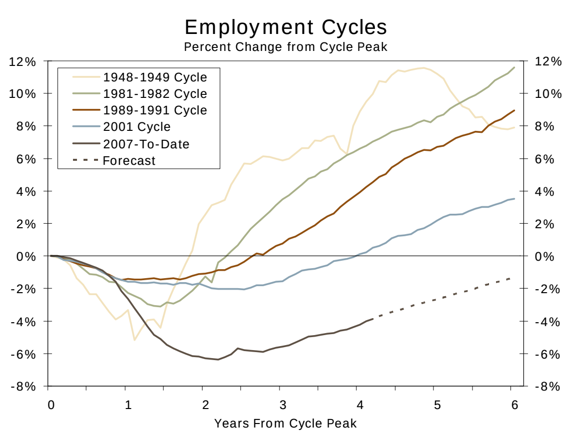
Moreover, our continued dependence on strangers in the form of foreign capital inflows and now the assistance of the Federal Reserve produce interest rate sensitivity in the budget. A return to "normal" interest rates would produce a rapid rise in federal debt service that would increase the burden of the debt. The burden of 40 plus years of overpromising by political policymakers will not be solved by the current modest pace of the recovery.



Jobs: Skills Mismatch and the Complexities of Education

Job gains during the current recovery (bottom graph) have been dramatically inferior to the jobless recoveries of the past. Since the early 1980s, the globalization of production and the growth of emerging market economies have altered the competitiveness of many businesses both in the United States and Europe. Moreover, the push for competitiveness and productivity has altered the combination of capital and labor as well as the skills demanded by many industries of workers today.

For some time we have written on the skills and education issues in our reports. These are long-term issues that have been building for decades. They will not be resolved by the economic expansion alone and are a source of rising income disparities in our nation.



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

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 715-0314	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economist	(704) 374-4407	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 715-0569	michael.a.brown@wellsfargo.com
Joe Seydl	Economic Analyst	(704) 715-1488	joseph.seydl@wellsfargo.com
Sarah Watt	Economic Analyst	(704) 374-7142	sarah.watt@wellsfargo.com
Kaylyn Swankoski	Economic Analyst	(704) 715-0526	kaylyn.swankoski@wellsfargo.com

WELLS FARGO SECURITIES