August 3, 2012

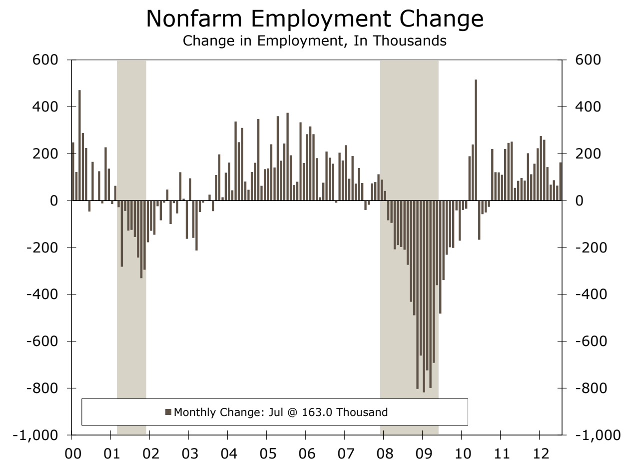
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Another Week of Mixed Reports

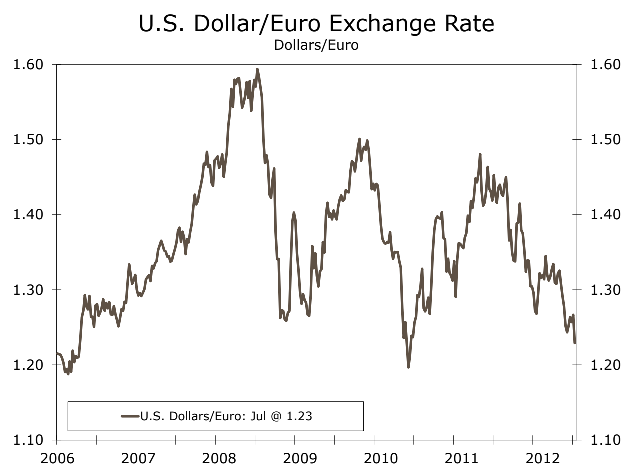
- A welcomed surprise was the nonfarm payrolls report, which came in well above consensus estimates registering an increase of 163,000 jobs in July. Household employment, however, dropped by 195,000 jobs and the unemployment rate edged a notch higher to 8.3 percent.
- One disappointing release was the ISM manufacturing report, which remained in negative territory for the second consecutive month. While disconcerting, it does not portend a recession and is consistent with our real GDP forecast of around 1.0 percent in the second half of the year.



Global Review

Euro Uncertainties Continue to Rattle Markets

- The euro crisis continues to affect economic growth across the world and there is still no clear solution in sight.
- Markets have been very perceptive during the past week, trying to gauge the potential effects of the ECB president's, Mario Draghi, comments that the institution he presides over would do everything in its power to defend the euro currency.
- The role of the ECB president is to defend the euro, so the market's reaction seems a little overdone. The biggest question is, probably, what can the ECB do to defend the euro?



Wells Fargo U.S. Economic Forecast

	Actual 2011 1Q	2Q	3Q	4Q	Forecast 2012 1Q	2Q	3Q	4Q	Actual 2009	2010	2011	Forecast 2012	2013
Real Gross Domestic Product [1]	0.1	2.5	1.3	4.1	2.0	1.5	1.3	1.1	-3.2	2.4	1.8	2.1	1.4
Personal Consumption	3.1	1.0	1.7	4.1	2.4	1.5	1.2	1.4	-2.0	1.8	2.5	1.8	1.2
Inflation Indicators [2]													
PCE Deflator	1.8	2.6	2.8	2.5	2.4	1.6	1.2	1.1	0.4	1.9	2.4	1.6	1.1
Consumer Price Index	2.1	3.3	3.8	3.3	2.8	1.9	1.2	1.2	-0.3	1.6	3.1	1.8	1.7
Industrial Production [1]	4.4	1.2	5.6	5.1	5.8	2.2	2.7	2.2	-11.3	5.4	4.1	4.1	2.4
Corporate Profits Before Taxes [2]	4.6	10.8	4.7	9.2	10.3	6.0	5.7	5.3	7.5	26.8	7.3	6.7	5.5
Trade Weighted Dollar Index [3]	70.6	69.4	72.8	73.3	72.7	74.5	72.5	74.0	77.7	75.6	70.9	73.4	76.5
Unemployment Rate	9.0	9.0	9.1	8.7	8.3	8.2	8.3	8.3	9.3	9.6	9.0	8.3	8.1
Housing Starts [4]	0.58	0.57	0.61	0.68	0.71	0.74	0.76	0.75	0.55	0.59	0.61	0.74	0.85
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	4.84	4.51	4.11	3.96	3.95	3.68	3.10	3.20	5.04	4.69	4.46	3.48	3.55
10 Year Note	3.47	3.18	1.92	1.89	2.23	1.67	1.50	1.60	3.26	3.22	2.78	1.75	1.85

Forecast as of: August 3, 2012
[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

Inside

U.S. Review 2
U.S. Outlook 3
Global Review 4
Global Outlook 5
Point of View 6
Topic of the Week 7
Market Data 8

U.S. Review

The Dog Days of Summer Serve Up a Mixed Bag

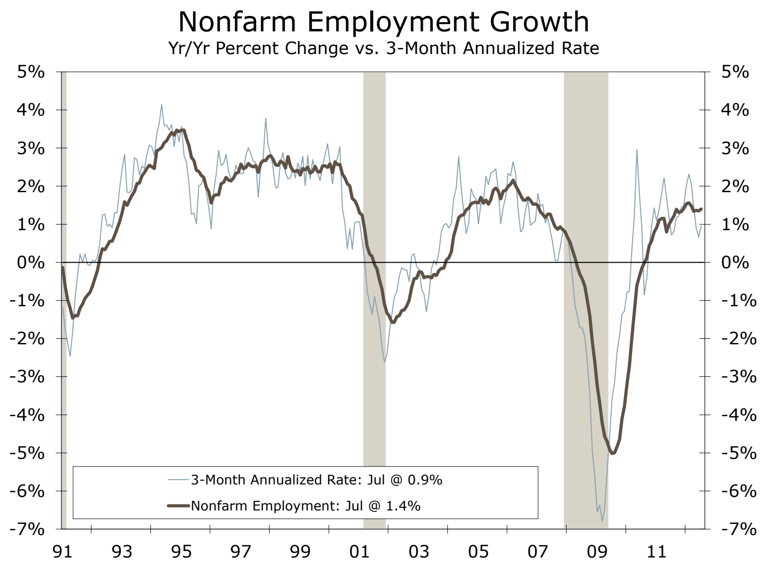
Nonfarm payrolls came in well above consensus estimates, registering an increase of 163,000 jobs in July, with fairly broad-based gains (the government sector remains weak). It appears the payback period from gains earlier in the year has run its course and employment could be on stronger ground in the coming months. Indeed, since the beginning of the year, nonfarm payrolls have averaged 151,000 per month, which is in line with the 153,000 average posted last year. Downward revisions over the past two months were somewhat trivial.

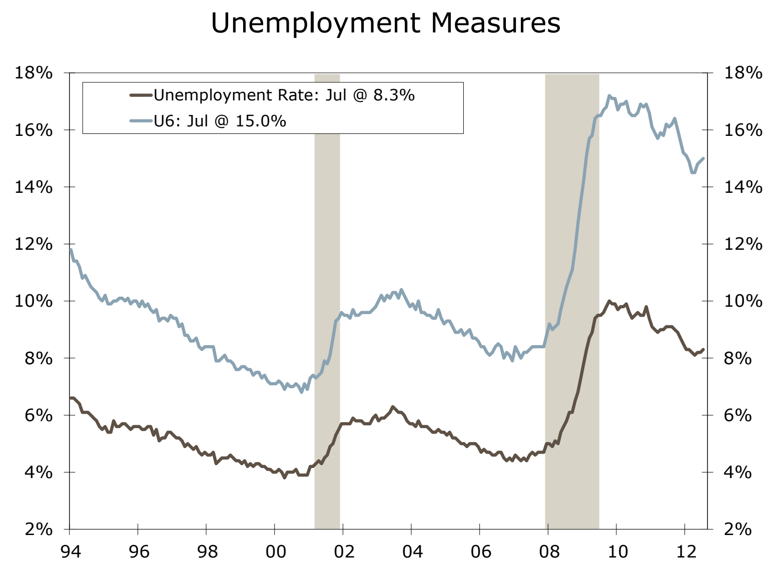
There were a few bright spots in the report including the continued increase in professional and business services and a rebound in education and health services. Moreover, the forward-looking temporary jobs component also showed an increase and suggests more positive job news could be on the horizon.

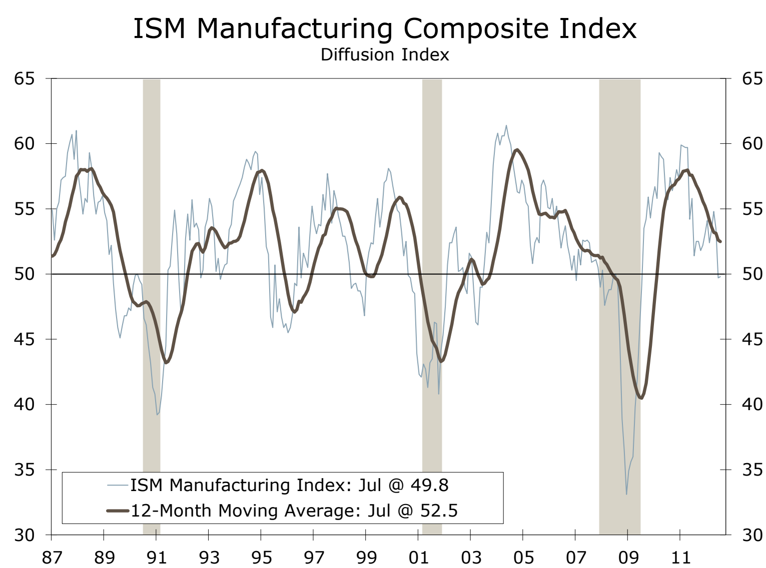
Despite the gains, however, there were a few concerns in the report. First, the average workweek remained unchanged and average hourly earnings rose only 0.1 percent, which translates into tepid income growth for those still employed. Second, household employment dropped by 195,000 jobs and the unemployment rate edged a notch higher to 8.3 percent. Much of the gain in the unemployment rate continues to be among teenagers (16 to 19 years old), which rose to 23.8 percent in July. Finally, the U6 underemployment series rose to 15.0 percent.

Other economic indicators released during the week continue to illustrate a U.S. economy that is still improving, but in concert with the mixed nonfarm payrolls report, the pace remains well below trend. While the ADP employment report nearly pin-pointed the gain in private sector payrolls (a clear anomaly), more telling is the size of business. Large business hiring continues to lag with only 96,000 jobs added since the beginning of the year, constituting just 9.3 percent of total job gains. In contrast, small businesses have contributed the lions' share of the growth, posting 592,000 jobs, making up more than 57.5 percent of the job gains during the same period. Large businesses may be hesitating due to continued uncertainty in the Eurozone and the unknown fiscal landscape that will force policymakers to make tough decisions in the last quarter of the year.

A similar sentiment also showed up in the ISM manufacturing report with purchasing managers also noting slower growth due to economic uncertainty. The ISM manufacturing index remained in negative territory for the second consecutive month with the forward-looking new orders component also below the breakeven line of 50. Another disconcerting point in the report was the pullback in exports, while imports remained in positive territory. That said, trade in the third quarter appears to be off to a slow start. While the report is disappointing, it does not portend a recession. The ISM Manufacturing Index would need to fall below 42.6 to be consistent with negative real GDP. Taken together, the week's data remain consistent with our real GDP forecast of around 1.0 percent in the second half of the year.





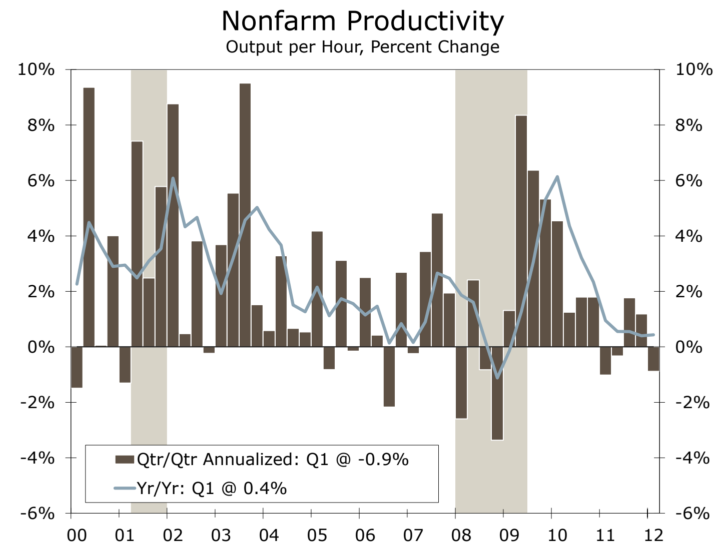


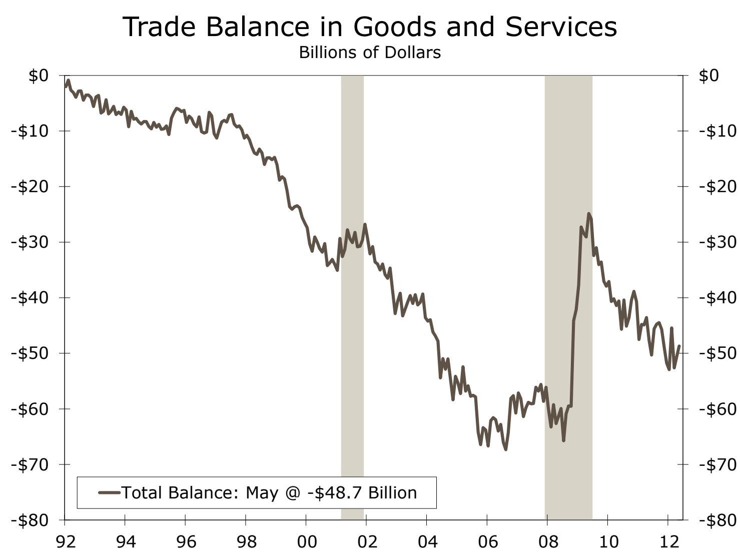
Nonfarm Productivity • Wednesday

Nonfarm productivity declined in the first quarter of the year as the number of hours worked by employees rose at a faster pace than output. Productivity fell at an annualized rate of 0.9 percent and is up only 0.4 percent compared to a year earlier for the second quarter in row—the slowest rate since the end of the recession. The slowdown reflects tougher year-to-year comparisons typical in later stages of a recovery; in the wake of the past recession productivity soared as employers shed jobs and squeezed additional output out of current employees. Since the recession ended, nonfarm productivity has increased 3.4 percent. Productivity gains likely picked up in the second quarter as aggregate hours worked rose at a slower pace than the initial estimate of GDP. Unit labor costs rose at a 1.3 percent annualized rate in the first quarter, and will likely post another increase in the second quarter as early readings on employment costs showed compensation outpacing output growth.

Previous: -0.9% **Wells Fargo: 0.9%**

Consensus: 1.4% (Annualized Rate)





Trade Balance • Thursday

The trade deficit narrowed to $48.7 billion in May from $50.6 billion in April. The smaller deficit was driven by a decline in imports, which fell 0.7 percent on the heels of a $3.2 billion reduction in petroleum products imports. Imports of consumer goods also fell in May as consumer spending has softened in recent months. Exports also contributed to a lower deficit, rising 0.2 percent over the month on a gain in services. We suspect the trade deficit narrowed further in June. The ISM manufacturing index on export orders suggests exports also fell in June, as the recession in Europe and sluggish growth in other parts of the world are taking a toll on U.S. trade. However, this decline should be offset by a greater decline in imports. Imports of petroleum likely fell again over the month, while demand for consumer products remains weak amid slower consumer spending.

Previous: -$48.7 B **Wells Fargo: -$46.7 B**

Consensus: -$48.0 B

Jobless Claims • Thursday

Initial jobless claims rose to 365,000 the week of July 28, a 2.2 percent increase over the prior week. Seasonal shutdowns at auto manufacturing plants have added increased volatility to jobless claims over the past month, making the measure a less reliable read on the labor market than usual. In July, weekly jobless claims ranged from 352,000 - 388,000. Despite the noise over the past few weeks, the four-week moving average has trended lower to 365,000 from 387,500 in mid-June. This is consistent with the swifter pace of hiring in July, evidenced by today's print of nonfarm employment. Next week's reading on claims will be the first since the end of the summer shutdown season, providing a cleaner look at the most recent employment conditions and the current pace of hiring.

Previous: 365,000

Consensus: 370,000

Global Review

Euro Uncertainties Continue to Rattle Markets

The euro crisis continues to affect economic growth across the world and there is still no clear solution in sight. So far, the fiscal tightening implemented across the region has not been able to reverse the risks associated with some of the countries within the Eurozone. For example, yields on Italian and Spanish bonds continue to hover around levels that make these countries' debts unsustainable.

This is why markets have become so coused on Mario Draghi's comments during the past week. Mario Draghi said that the ECB, the institution he presides over, would do everything in its power to defend the euro currency. This comment is not really anything extraordinary. If the ECB president is not willing to say that he would defend the euro currency at all costs then he probably has no business being the ECB president in the first place. The existence of the euro currency is the basis for the ECB and the ECB president to exist. Thus, there should not be any doubt that the job of the ECB president is to defend the euro from disappearing.

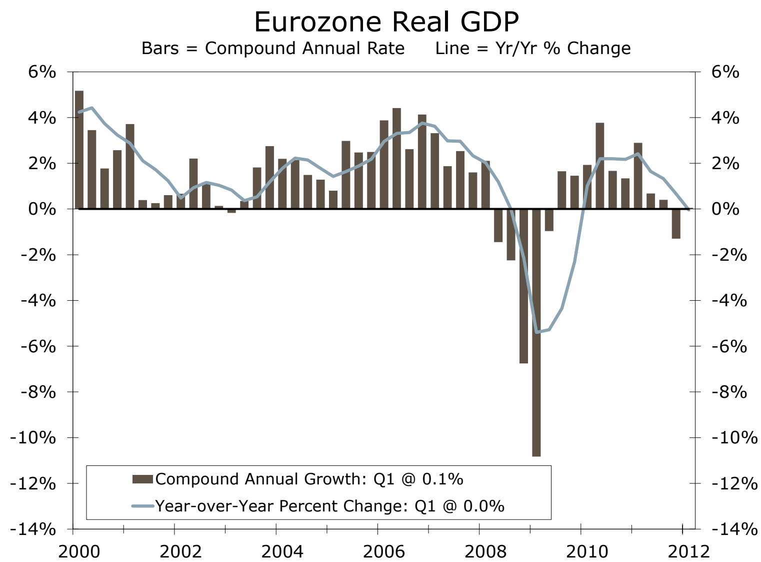
The issue is: What can the ECB do? It can print more money to achieve a weaker currency and provide the countries of the region a chance to export their way out of the recession. Such a move would likely be met with similar responses by other central banks, which would see that as a challenge to their own countries' exports. Thus, printing more money is a "beggar-thy-neighbor" type of policy, which would probably be matched by other countries' central banks, which would minimize its effects.

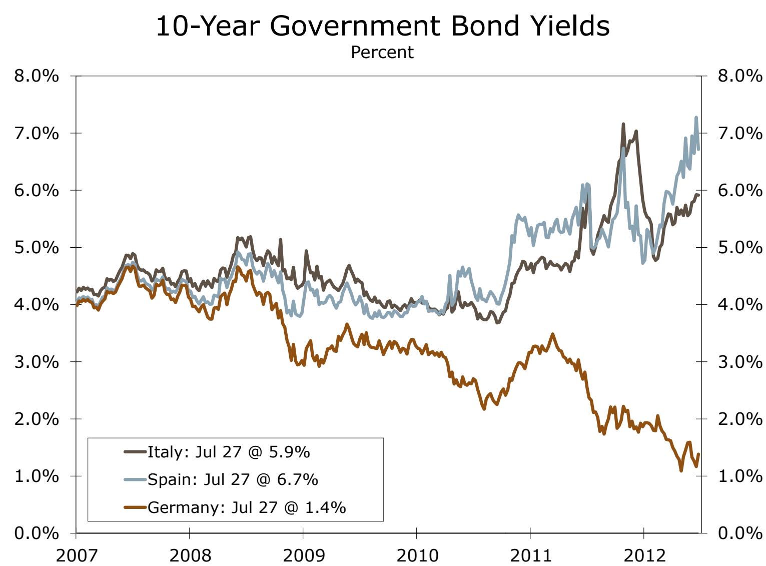
The ECB could also push Eurozone governments to buy each other's bonds or inject money into a fund that would buy sovereign bonds in order to lower the cost of Italy's and Spain's financing needs. This policy might not push yields down far enough, however, and it is not even certain that Germany, which opposes more ECB intervention, would be on board with such strategy. Thus, expect, as we have said for many months, this crisis to linger over time and, from time to time, to ramp back up with a vengeance that rattles and haunts the world economy.

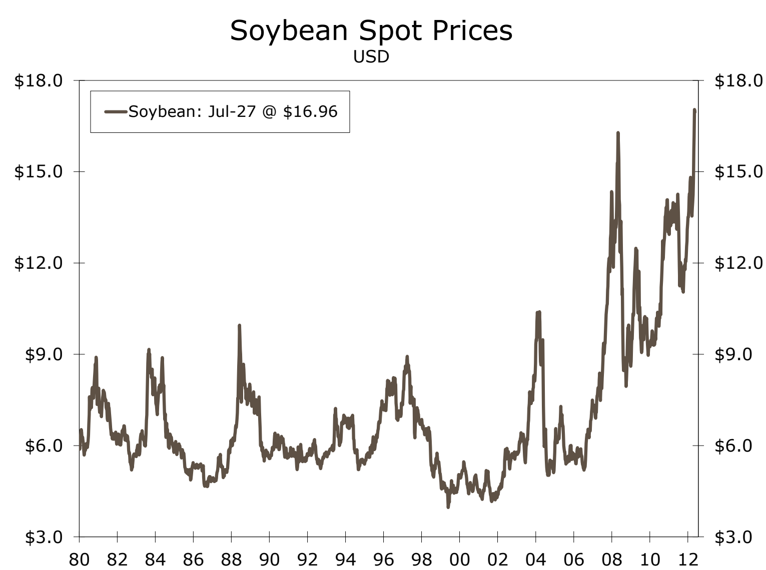
U.S. Drought to Benefit South America

The Brazilian and Argentine economies have been severely affected by the European crisis. The news of the drought in the United States is bringing good news to the South American agricultural sector and, at least in Argentina, will potentially add more money to a cash-strapped government. The United States, Brazil and Argentina are the world's three largest producers of soybeans, accounting for approximately 80 percent of all production. Thus, the recent increase in agricultural prices could lift these economies at a time that other sectors, like the industrial sector are being affected by the slower economic growth across the world.

Since Argentina taxes agricultural exports there has been speculation that the cash-strapped government is planning to increase agricultural taxes to take full advantage of this temporary bonanza in agricultural prices.







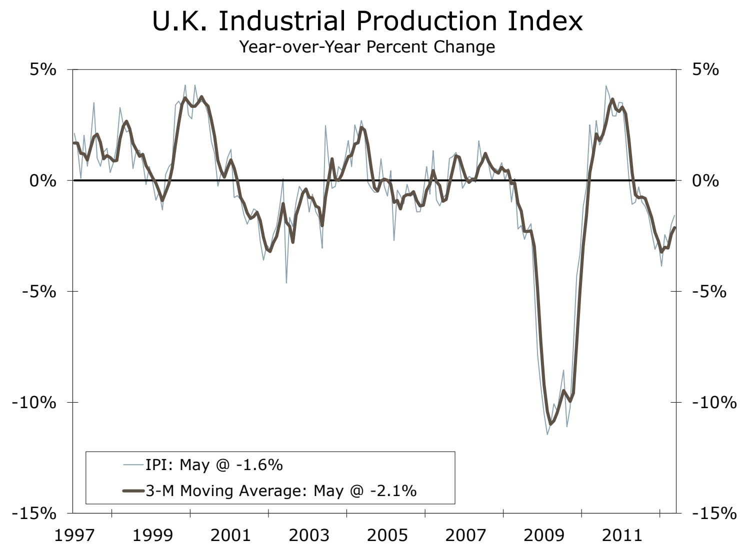
U.K. Industrial Production • Tuesday

Real GDP in the United Kingdom fell 0.7 percent in the second quarter of 2012. The economy there is very weak at present, though there are some signs of life. A better-than-expected jobs report in May helped bring down the unemployment rate. The improvement in the job market was followed by indications of consumer spending growth as retail sales have now posted back-to-back monthly gains.

Will these early improvements breathe some life into the U.K. factory sector? Despite a modest increase in May, industrial production has fallen in three out of the first five months of the year and the gain partially reflects the timing of a holiday that was moved to June. That boosted output in May but will drag on output in June. The manufacturing PMI in the United Kingdom has been in contraction territory for three straight months. Against that backdrop, a sustained period of growth seems unlikely.

Previous: 1.0%

Consensus: -3.5% (Month-over-month)



Chinese Ind. Production • Friday

The year-over-year rate of Chinese economic growth slowed to a 7.6 percent rate in the second quarter. Not only is that the sixth consecutive quarter in which the rate of growth has slowed, it marks the weakest growth rate for the world's second largest economy since the global recession in 2009.

Mirroring the slowdown in the broader economy, Chinese industrial production, which had been growing at a more that 12 percent year-over-year rate the past few years, slowed to just 9.3 percent through April. Since then, production has stabilized somewhat with a 9.5 percent year-over-year return reported in June. Manufacturing PMI in China, at 50.1, is barely in expansion territory. We find out on Friday of next week how industrial production shaped up in July. The consensus is looking for a modest pickup in output.

Previous: 9.5%

Consensus: 9.7% (Year-over-year)

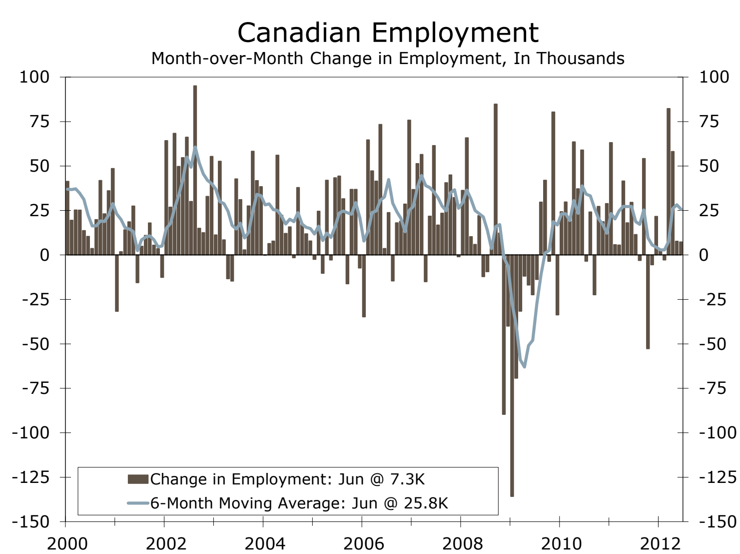
Canadian Payrolls • Friday

The Canadian economy continues to fair better than most large, developed economies. Real GDP grew at a 1.9 percent annual rate in both the fourth quarter of 2011 and the first quarter of this year. Monthly reports of GDP growth reveal that the economy continued to expand in the second quarter of 2012, though the official number will not be available until the end of August. As export growth is constrained by slow growth in the United States and a hobbled global economy, domestic demand has been picking up the slack. Steady job growth in Canada has kept the unemployment rate there close to 7 percent and prevented consumers from retrenching as they have in the United States.

Having said that, job growth has been tepid the past two months after robust hiring earlier in the year. We will learn how the job market changed in July when that figure hits the wire on Friday.

Previous: 7.3K

Consensus: 9.0K



Interest Rate Watch

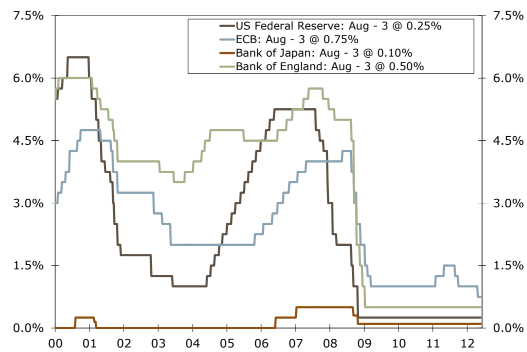
FOMC Stays The Course

The statement from the FOMC's meeting this week indicated that the committee will not provide further monetary accommodation at this time. The committee noted the slower pace of employment growth and the decelerating pace of economic growth. The committee also cited the decline in inflation since the beginning of the year with future inflation below the rate consistent with the committee's dual mandate. The committee expects growth conditions to improve, however the pace of improvement in the short term will remain moderate. In addition, the ongoing European Debt crisis continues to "pose significant downside risks to the economic outlook." The committee chose to maintain the low Federal Funds rate environment through the end of 2014, language that has been consistent since the January meeting of the FOMC.

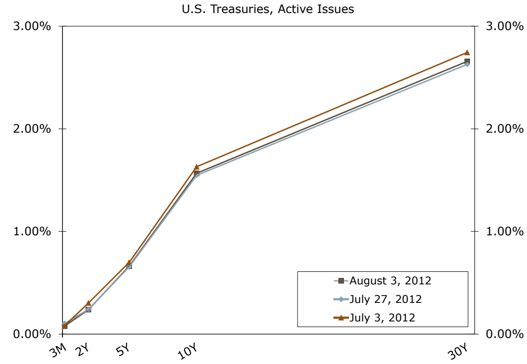
In general, the committee's statement was relatively unchanged from the previous meeting. There was, however, somewhat stronger language around the path of future committee actions which suggested that the committee may be willing to take additional measures in the September meeting if economic conditions continue to deteriorate. The committee indicated that it would "closely monitor incoming information on economic and financial developments" and "will provide additional accommodation as needed to promote a stronger economic recovery." This somewhat stronger language leaves the door open to further easing of monetary policy at the September meeting.

We continue to believe that the committee will only make further changes to monetary policy should economic conditions deteriorate further. Both the type and scope of the Fed's stimulative actions, should they occur, will be dependent on the pace of job gains over the next month along with the reaction of financial markets to the Eurozone situation. In short, the low-rate environment is here at least through the end of 2014.

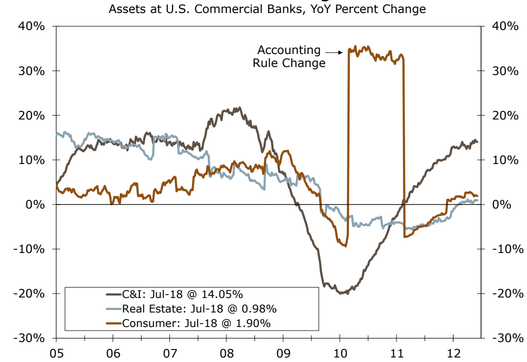
Central Bank Policy Rates



Yield Curve
U.S. Treasuries, Active Issues



Bank Lending
Assets at U.S. Commercial Banks, YoY Percent Change



Credit Market Insights

Nonperforming Loans Spike in 2010

Data from the Federal Deposit Insurance Corporation's (FDIC) Quarterly Banking Profile show uncharacteristic spikes in nonperforming loans during the most recent recession. While loan performance is cyclical in nature and we expect such a decline in loan performance during bad economic times, the extent to which loans went bad during the last recession was something to ponder. Specifically, let's look at lending to the real estate sector.

The 2008 - 2009 recession was marked by the bursting of the housing bubble in 2006. Lending standards eased up considerably over the last decade as confidence, driven by strong economic growth during the 1990s and 2000s, helped to caste real estate as an ever-appreciating asset. But, when the housing bubble burst and home values began a 30 percent descent, delinquency rates for mortgage loans shot up. Specifically, delinquency rates for mortgage loans on 1 - 4 unit family residential properties, which make up about 43 percent of all real estate secured loans, rose to 11.4 percent in Q1 2010. Furthermore, net charge-offs rose to 2.0 percent of total loans. Historically net charge-offs have remained around 0.10 percent, and only jumped to a high of 0.24 percent during the 2001 recession. While progress has been made on bringing the rate of nonperforming loans down, net charge-off rates, as well as past due loans, remain well above historical levels.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.55%	3.49%	3.62%	4.39%
15-Yr Fixed	2.83%	2.80%	2.89%	3.54%
5/1 ARM	2.75%	2.74%	2.79%	3.18%
1-Yr ARM	2.70%	2.71%	2.68%	3.02%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$1,448.9	19.48%	12.76%	14.05%
Revolving Home Equity	$535.2	-6.68%	-6.66%	-4.43%
Residential Mortgages	$1,573.4	-1.39%	11.59%	5.80%
Commerical Real Estate	$1,412.1	-6.82%	-2.57%	-1.90%
Consumer	$1,110.8	-5.48%	3.01%	1.90%

Source: Freddie Mac, Federal Reserve Board and Wells Fargo Securities, LLC

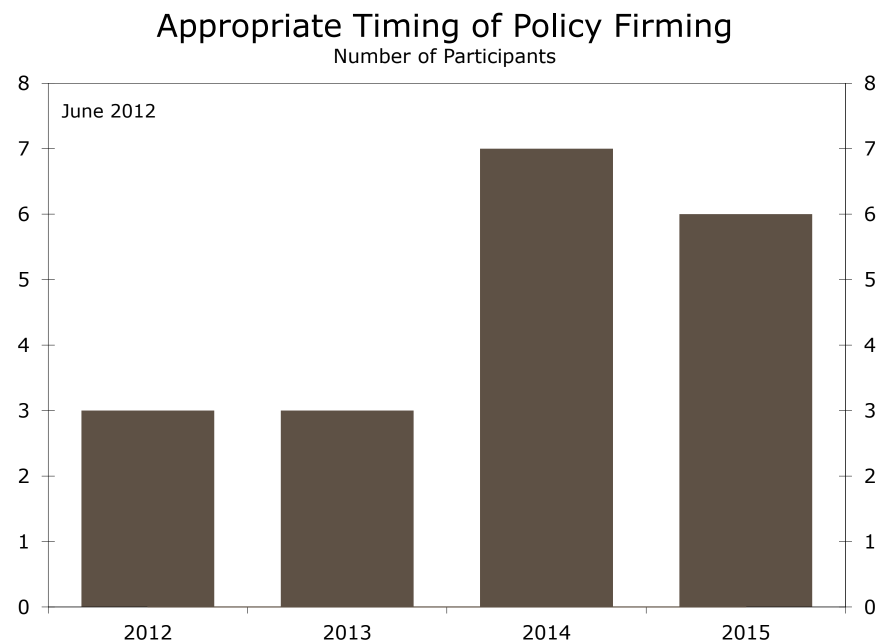
Topic of the Week

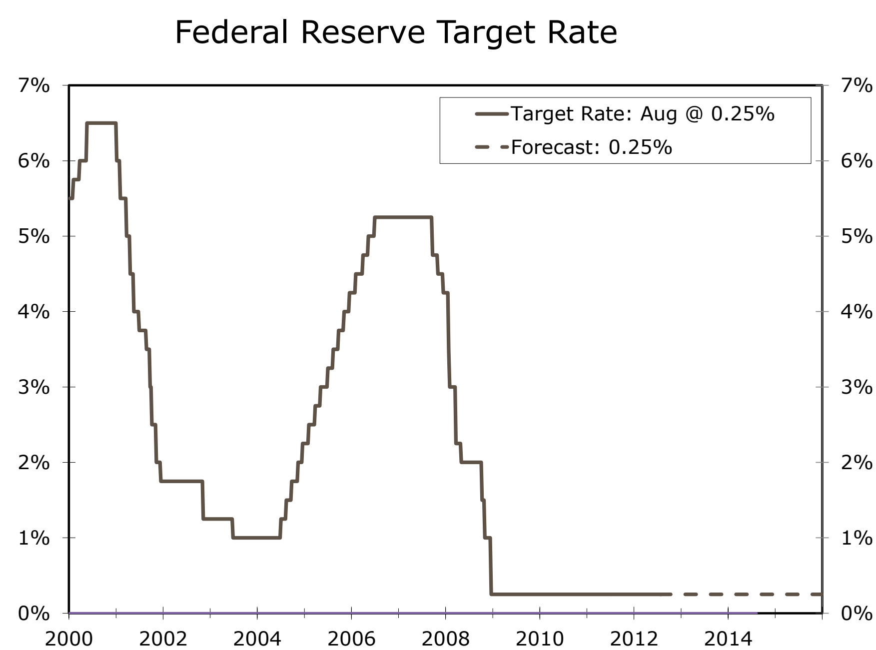
Still Searching for that Magic Arrow

Both the Fed and the ECB managed to dash expectations this week. Hopes were sky high that the Fed would signal it is poised to take some other decisive action and that the ECB would in fact announce some sort of decisive action. So far, it has been all talk and no action. At least in the Fed's case, this was expected. The policy statement released following the Aug. 1 meeting acknowledged that economic activity has "decelerated somewhat" and suggest the Fed is poised to do something at its Sept. 12 - 13 meeting. Just how decisive that move will be will depend on whether the data deteriorate further between now and then.

There are few viable arrows left in the Fed's quiver. The four most likely policy moves are expanding the Fed's balance sheet through another round of securities purchases, extending the time period that the Fed intends to keep interest rates at their current near-zero level, reducing the interest rate paid on bank reserves and using the discount window to promote bank lending. None of these measures are likely to move the needle all that much. Additional securities purchases may shave 10 bps off long-term yields, but if Mario Draghi actually does do something to bolster confidence in the Eurozone, the reversal in the fear premium currently in long-term Treasuries would actually send yields up by much more than that.

Extending the time period for holding the federal funds rate at "exceptionally low levels" out to 2015 would also provide little additional benefit and create another potential hurdle for the Fed. If the federal funds rate remains at its current level through the end of 2015, it would have been near zero for at least six years, which is a year longer than the average postwar business expansion has lasted. The implication is that, based on recent history, there is a very good chance that whenever the next recession begins the federal funds rate may still be at or near zero. Unconventional monetary policy may then become the norm, which means the Fed needs to find better arrow to put in their quiver.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/3/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.08	0.10	0.01
3-Month LIBOR	0.44	0.45	0.27
1-Year Treasury	-0.03	0.00	0.20
2-Year Treasury	0.24	0.24	0.33
5-Year Treasury	0.66	0.65	1.26
10-Year Treasury	1.57	1.55	2.62
30-Year Treasury	2.66	2.63	3.90
Bond Buyer Index	3.66	3.61	4.19

Foreign Exchange Rates

	Friday 8/3/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.233	1.232	1.432
British Pound ($/₤)	1.559	1.575	1.643
British Pound (₤/€)	0.791	0.782	0.872
Japanese Yen (¥/$)	78.650	78.460	77.060
Canadian Dollar (C$/$)	1.000	1.003	0.962
Swiss Franc (CHF/$)	0.974	0.975	0.770
Australian Dollar (US$/A$	1.055	1.048	1.076
Mexican Peso (MXN/$)	13.158	13.239	11.819
Chinese Yuan (CNY/$)	6.373	6.381	6.434
Indian Rupee (INR/$)	55.755	55.341	44.314
Brazilian Real (BRL/$)	2.031	2.022	1.560
U.S. Dollar Index	82.604	82.709	74.044

Foreign Interest Rates

	Friday 8/3/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.25	0.29	1.55
3-Month Sterling LIBOR	0.73	0.75	0.83
3-Month Canadian LIBOR	1.29	1.30	1.16
3-Month Yen LIBOR	0.20	0.20	0.20
2-Year German	-0.03	-0.03	1.05
2-Year U.K.	0.09	0.12	0.63
2-Year Canadian	1.12	1.11	1.25
2-Year Japanese	0.09	0.10	0.15
10-Year German	1.41	1.40	2.40
10-Year U.K.	1.54	1.54	2.74
10-Year Canadian	1.76	1.75	2.67
10-Year Japanese	0.74	0.75	1.02

Commodity Prices

	Friday 8/3/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	90.63	90.13	91.93
Gold ($/Ounce)	1596.70	1622.90	1661.75
Hot-Rolled Steel ($/S.Ton)	640.00	630.00	670.00
Copper (¢/Pound)	334.25	342.60	432.60
Soybeans ($/Bushel)	16.58	16.75	13.66
Natural Gas ($/MMBTU)	2.90	3.01	4.09
Nickel ($/Metric Ton)	15,190	15,825	24,761
CRB Spot Inds.	494.80	497.01	596.28

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	6	7	8	9	10
U.S. Data		**Consumer Credit** May $17.118B June $10.500B (C)	**Nonfarm Productivity** 1Q -0.9% 2Q 0.9% (W) **Unit Labor Costs** 1Q 1.3% 2Q 0.5% (W)	**Trade Balance** May -$48.7B June -$46.7B (W) **Wholesale Inventories** May 0.3% June 0.3% (C)	**IPI (YoY)** June -2.6% July -2.9% (W) **Monthly Budget** June -$59.7B July -$103.0B (C)
Global Data		**U.K.** **IP (YoY)** Previous (May) -1.6% **Canada** **Ivey PMI** Previous (Jun) 49.0	**Germany** **IP (YoY)** Previous (May) 0.0% **China** **CPI (YoY)** Previous (Jun) 2.2%	**China** **IP (YoY)** Previous (Jun) 9.5% **Japan** **BOJ Target Rate** Previous (Jul) 0.10%	**Canada** **Employment Change** Previous (Jun) 7.3K

Note: (W) = Wells Fargo Estimate (C) = Consensus Estimate

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