January 06, 2012

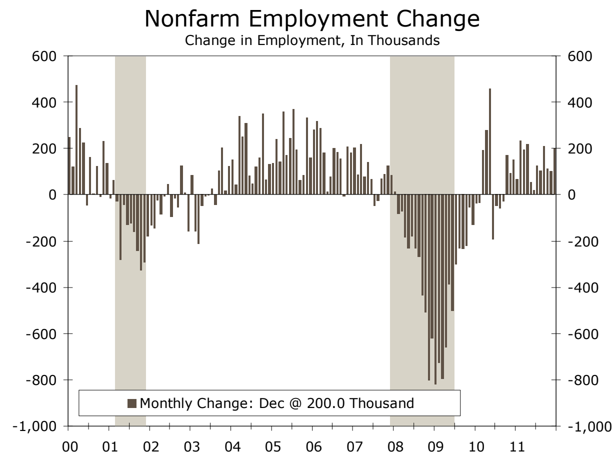
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Great Car, Just Be Sure to Look Under the Hood

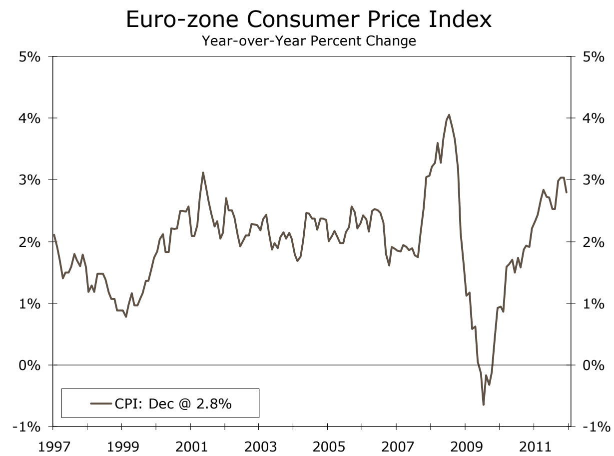
- Total nonfarm payrolls jumped 200,000 in December and the unemployment rate dropped to a cycle-low 8.5 percent. Coming on the heels of several weeks of improvement in unemployment insurance claims and improving business sentiment, this seems to put an exclamation point on recent firming in the labor market.
- To be sure, the job market is healing but we suspect the jump in December may overstate the extent of this improvement. In this week's U.S. Review, we point to some one-off factors and benchmark revisions affecting the job numbers.



Global Review

Reassuring News Coming from Europe

- Recent data releases from the Eurozone and Britain have been relatively reassuring, or at least are pointing to no further deterioration in economic activity.
- The best news coming from Europe came from the U.K.'s service sector PMI, where the number came in at a higher-than-expected 54 in December.
- The ongoing Eurozone recession is finally making a dent on the region's inflation numbers. This is good news for the inflation-hawks at the European Central Bank as they consider where to go from here in terms of monetary policy.



Wells Fargo U.S. Economic Forecast

	Actual				Forecast				Actual		Forecast		
	2011				2012				2009	2010	2011	2012	2013
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	0.4	1.3	1.8	3.7	1.4	1.8	2.2	2.2	-3.6	3.0	1.8	2.1	1.8
Personal Consumption	2.1	0.7	1.7	3.7	1.3	1.5	1.7	1.7	-2.0	2.0	2.2	1.7	1.3
Inflation Indicators [2]													
"Core" PCE Deflator	1.1	1.3	1.6	1.7	1.7	1.5	1.4	1.5	1.5	1.4	1.4	1.5	1.6
Consumer Price Index	2.2	3.3	3.8	3.3	2.4	1.9	1.5	1.7	-0.3	1.6	3.2	1.9	2.0
Industrial Production [1]	4.8	0.7	6.1	2.7	2.8	3.6	3.0	2.2	-11.1	5.3	4.1	3.2	2.3
Corporate Profits Before Taxes [2]	8.8	8.5	7.5	6.4	6.2	6.0	6.4	6.6	9.1	32.2	7.8	6.3	7.0
Trade Weighted Dollar Index [3]	70.6	69.4	72.8	73.3	74.0	74.5	75.0	76.0	77.7	75.6	70.9	74.9	77.3
Unemployment Rate	9.0	9.0	9.1	8.7	9.0	9.1	9.0	8.9	9.3	9.6	9.0	9.0	8.9
Housing Starts [4]	0.58	0.57	0.62	0.66	0.66	0.70	0.69	0.70	0.55	0.58	0.61	0.69	0.80
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	4.00	4.10	4.10	4.20	5.04	4.69	4.46	4.10	4.30
10 Year Note	3.47	3.18	1.92	1.89	2.00	2.10	2.20	2.30	3.26	3.22	2.78	2.15	2.45

Forecast as of: January 6, 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

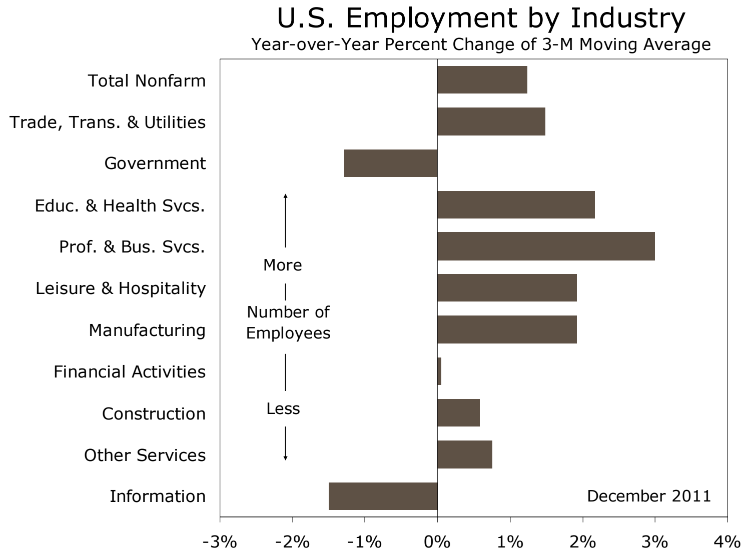
Overstating the Might of the Labor Market?

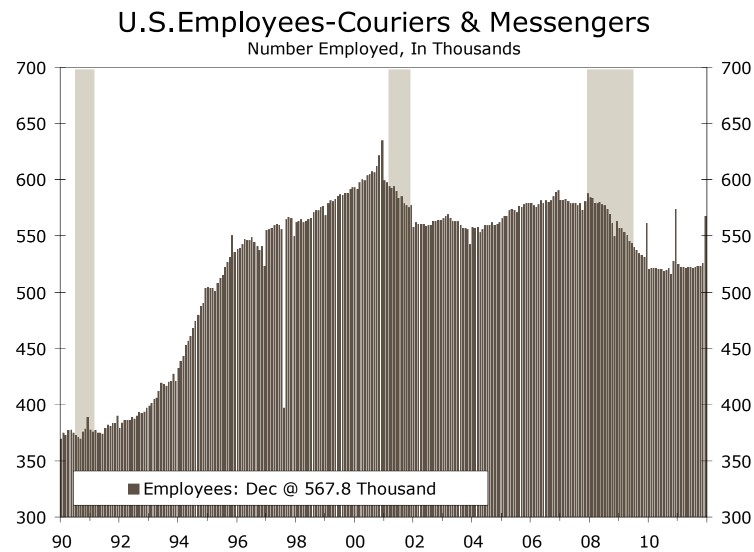
The economic indicators released in the first week of 2012 offered a mixed, but mostly positive assessment on the near-term trajectory of the U.S. economy. Of course, the headline-grabbing developments of the week were all about the remarkable improvement in the employment situation. Without a doubt, we are seeing some legitimate firming in the labor market, but we suspect that some of this week's numbers overstate the actual improvement in the labor market.

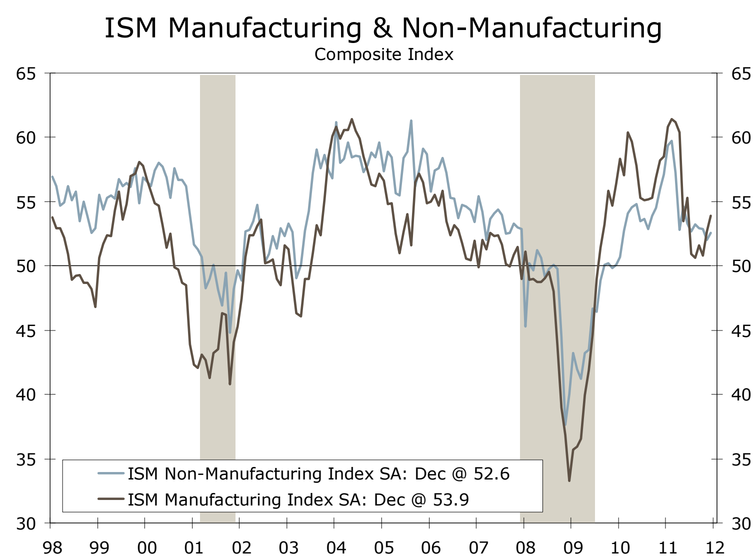
The big number of the week was the 200,000 increase in nonfarm payrolls. Not only was the outturn better than consensus estimates, the unemployment rate fell to a new cycle low of 8.5 percent. There are a few things worth noting here. First, the gains were broad-based, with only two sectors (government and temporary jobs) posting declines, suggesting that this is more than just a flash in the pan. That said, there are a few one-off factors that take the shine of the apple a bit. The first is that a surge in hiring of couriers (+42,000) is likely more reflective of a shift to online holiday shopping than a pickup in business deliveries. Some of theses delivery men and women may be looking for other part-time work after the holiday rush has passed. Delivery companies always ramp up hiring around the holidays, so the seasonal adjustment factors help smooth these trends, but with anecdotal evidence of more people shopping online in recent years, the surge has been greater than the seasonal factors anticipated.

With next month's employment report, the Bureau of Labor Statistics (BLS) will be announcing the annual benchmark revision to the establishment survey employment series. Each year, the estimates are benchmarked to comprehensive counts of employment. These counts are derived from state unemployment insurance tax records. For national employment series, the annual benchmark revisions over the past 10 years have averaged plus or minus three-tenths of one percent of total nonfarm employment. A slight upward revision to the jobs numbers is expected. We will offer a detailed analysis of the revisions once they become available. At that point, we may also have a better sense of whether the recent strength in the labor market will continue. The fact that the employment component of the ISM nonmanufacturing report remains below 50 suggests that, despite this week's splashy headlines, many businesses are still reticent to add to payrolls in a substantive way.

Looking at this week's ISM reports, there seems to be a fair amount of mixed feelings among purchasing managers as well. The headline ISM index rose to 53.9 in December from 52.7 in November with gains in production, orders and employment. ISM nonmanufacturing came in at 52.6, a slight improvement from the 52.0 reading in November, though short of the 53.0 expected by the consensus. Taken together, the sentiment measures suggest the slow growth we have seen in recent months should continue into the New Year.





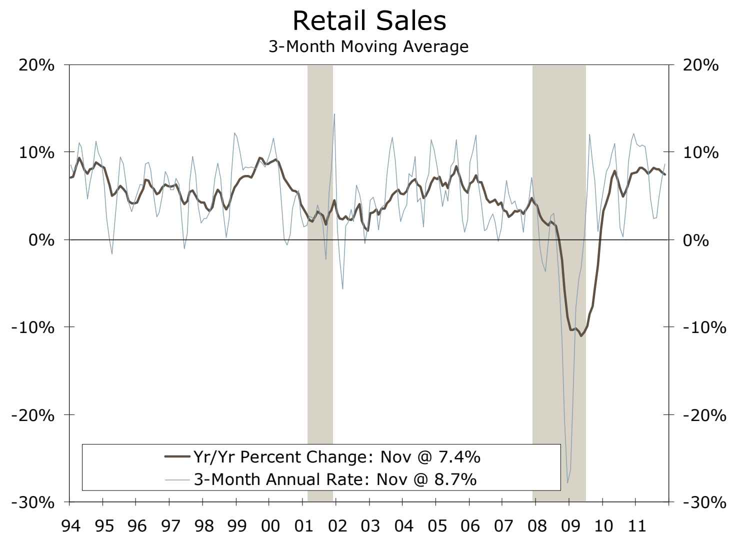


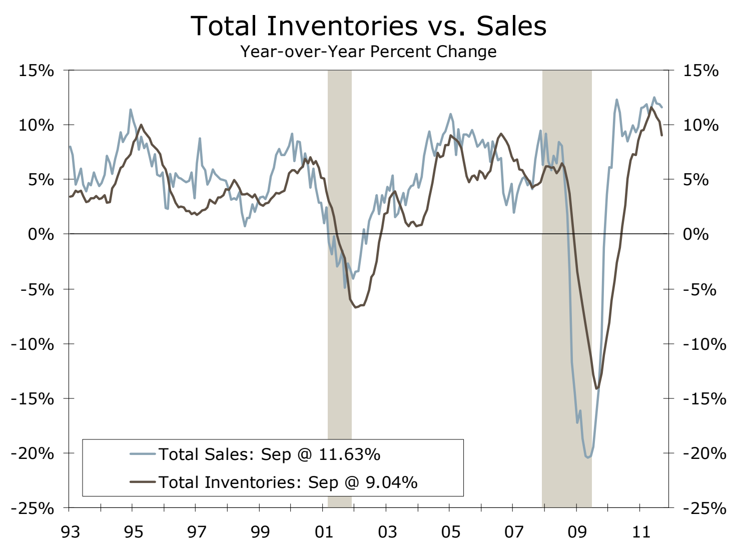
Retail Sales • Thursday

Retail sales posted a disappointing increase of 0.2 percent in November following solid gains of 0.6 percent in October and 1.3 percent in September. However, spending rose across most categories typically associated with the holiday season. While most reports show impressive Black Friday sales, especially for electronics, many postponed holiday shopping until the last hour. That said, we continue to expect sales in December to show improvement. Moreover, sales over the past three months are up 8.7 percent on an annualized basis and core retail sales, which exclude gasoline stations, building materials and motor vehicles, are up 6.6 percent. The strong gains suggest real personal consumption should rise at around a 2.8 percent annual rate, even if sales rise only modestly in December. We continue to expect real personal consumption to rise at a 1.7 percent pace in 2012 and a 1.3 percent rate in 2013.

Previous: 0.2% **Wells Fargo: 0.1%**

Consensus: 0.2% (Month-over-Month)





Business Inventories • Thursday

Business inventories rose 0.8 percent in October and are up 8.7 percent on a year-ago basis. Much of the gain has been concentrated in wholesalers' and manufacturing inventories. Retailers' inventories were flat on the month and excluding autos were down 0.1 percent. The October increase suggests the fourth quarter is off to a good start and inventory investment could make a positive contribution. In fact, we expect inventory investment to add 0.3 percentage points to real GDP growth in the fourth quarter and continue to make a small contribution in 2012 and 2013. Total sales rose 0.7 percent in October and are up 10.9 percent year over year with broad-based gains. The inventory-to-sales ratio remained near its historic low range at 1.27 suggesting businesses continue to keep inventories in line with demand.

Previous: 0.8% **Wells Fargo: 0.5%**

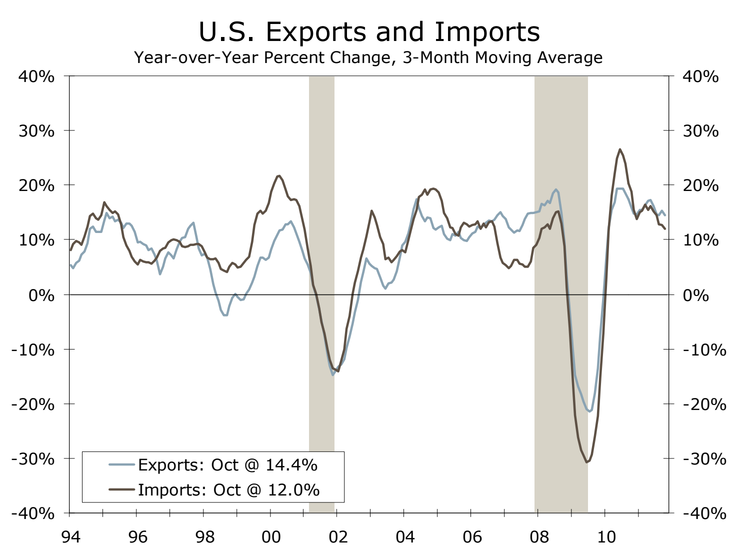
Consensus: 0.4% (Month-over-Month)

Trade Balance • Friday

The U.S. trade deficit declined to $43.5 billion in October as exports fell by $1.5 billion, but imports slipped even more, dropping by $2.1 billion. Much of the decline in exports occurred in industrial supplies and materials, which is highly sensitive to commodity prices. The drop in value of industrial supplies reflects the plunge in commodity prices in August and September. In fact, the value of exports, which declined during the month, and the volume of exports, which rose in October, reflects a decline in export prices. The decline in imports is largely attributable to a drop in petroleum imports due to lower oil prices in the previous two months. That said, while the fourth quarter is off to a good start, the global slowdown that is underway will surely have an adverse effect on U.S. exporters in the months ahead. Net exports may not add much to real GDP growth in the fourth quarter, but probably they will not slice a significant amount from headline real GDP either.

Previous: -$43.5B **Wells Fargo: -$42.7B**

Consensus: -$44.6B



Global Review

Reassuring News Coming from Europe. Will It Last?

Recent data releases from the Eurozone and Britain have been relatively reassuring, or at least are pointing to no further deterioration in economic activity, and this is probably the reason why markets have been relatively calm during the last days of 2011 and the early days of 2012. However, everybody is probably wondering if this moderation in Europe's economic weakness is here to stay or if we may see some further deterioration.

The best news coming from Europe came from the U.K.'s service sector PMI, where the number came in higher than expected at 54 in December from 52.1 in November. Markets expected a weaker report in December than in November, which came in at 51.5.

Meanwhile, the ongoing Eurozone recession is finally making a dent on the region's inflation numbers and this is good news for the inflation-hawks at the European Central Bank as there may be more windows opening for the institution to continue to push the envelope in terms of monetary policy in the months to come (For more insight on this topic please refer to the Interest Rate Watch section on this report).

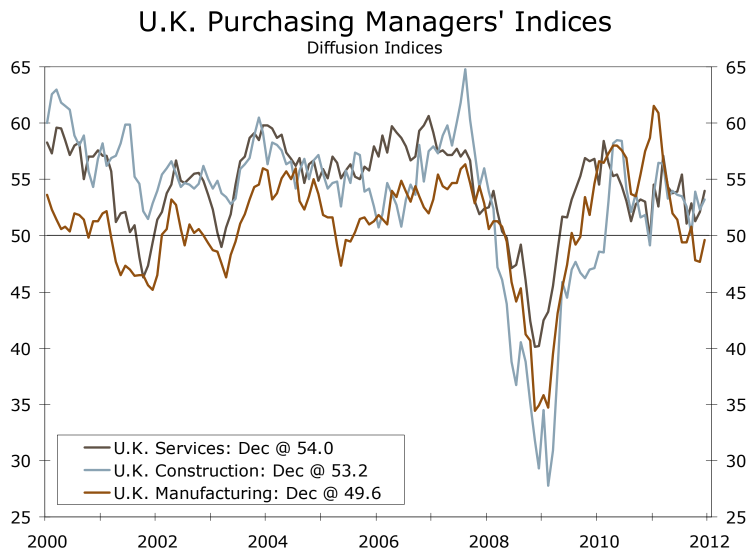
What is noteworthy is that this new world of highly heterodox monetary policy experiments is not going to be over any time soon, either in the United States or in the rest of the world. The long-term consequences of these experiments are anybody's guess. What is clear is that there will be consequences, but those consequences would have to be dealt with whenever that time comes. For now, expect monetary policy creativity, championed by the U.S. Federal Reserve, to remain in vogue for some time.

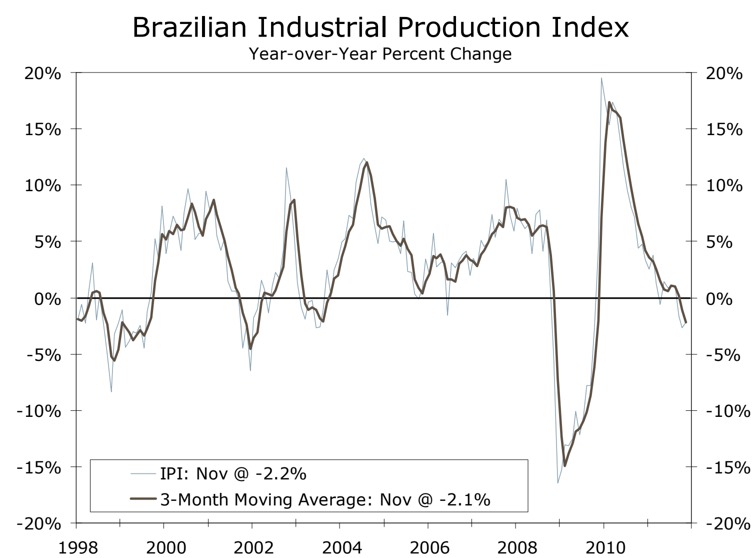
With this backdrop we should expect the world economy to continue to grow, albeit slowly, as central bankers continue to inject money.

Brazil and Mexico: Different Strokes...of Luck

The slowdown in economic activity in Europe has continued to affect some emerging economies. One of these economies is the Brazilian economy. Brazilian industrial production increased by only 0.3 percent in November, a tad lower than the 0.5 percent markets were expecting while posting a 2.5 percent year-over-year drop, down from a rate of 2.2 percent for the 12 months ended in October 2011. Automobile production, while higher on a seasonally adjusted basis in November was down by 4.4 percent on a year-earlier basis. Europe is an important market for the Brazilian automobile industry and the slowdown in that region is showing in production numbers.

Meanwhile, Mexico is in the opposite camp as its automobile industry's dependence on the U.S. consumer market is enjoying some type of renaissance as there has been a shift in automobile production from plants in the United States to plants in Mexico. Thus, the slowdown in economic activity in Mexico, while also occurring, has not had the intensity that it has had in Brazil. However, the Brazilian economy should start to recover some growth in the near term as the central bank continues to pursue expansionary monetary policies.





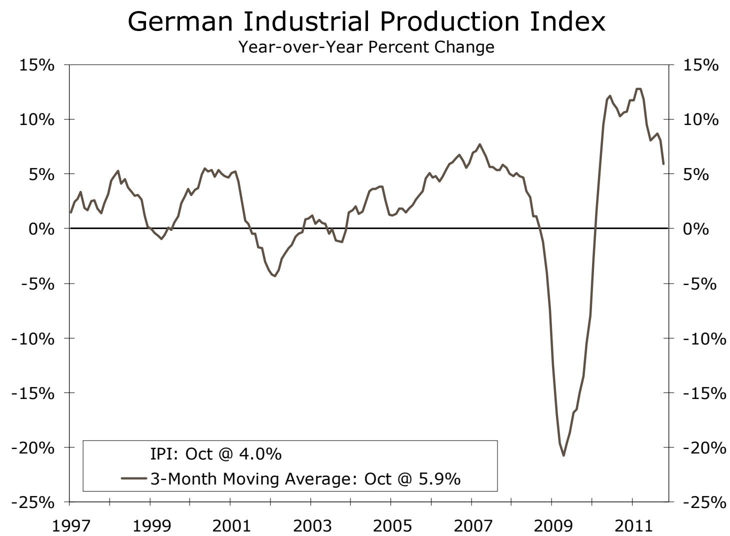
German Industrial Production • Monday

Following a 2.8 percent decline in September German industrial production (IP) rebounded 0.8 percent in October, and the November IP data that are on the docket on Monday will give investors a better insights into the state of the German economy at the end of last year. On Wednesday, statistical authorities will release an initial estimate of German GDP growth in 2011. Analysts can use the estimate for the entire year to infer the rate of GDP growth in the fourth quarter.

France also releases IP data for November on Tuesday, and an estimate for IP growth in the overall euro area will print on Thursday. Also on Thursday, the European Central Bank (ECB) will hold its first policy meeting of the year. See the "Interest Rate Watch" on page 6 for more discussion on the ECB.

Previous: 0.8%

Consensus: -0.5% (Month-over-Month)



China Trade Balance • Tuesday

Data released over the past few months indicate that the pace of economic growth in China has downshifted. One of the reasons behind the apparent deceleration in China is the slowdown in the rest of the world that has weighed on Chinese export growth. Early in 2011, the value of Chinese exports was growing roughly 25 percent on a year-ago basis. By November, export growth had slipped to less than 15 percent. December trade data will be released on Tuesday.

In addition, rising inflationary pressures led Chinese authorities to tighten economic policies. Consequently, growth in domestic demand also has slowed. Data on the money supply and bank lending in December that are on the docket next week will shed some light on the pace of economic growth in China at the tail end of last year.

Previous: $14.53B

Consensus: $8.80B

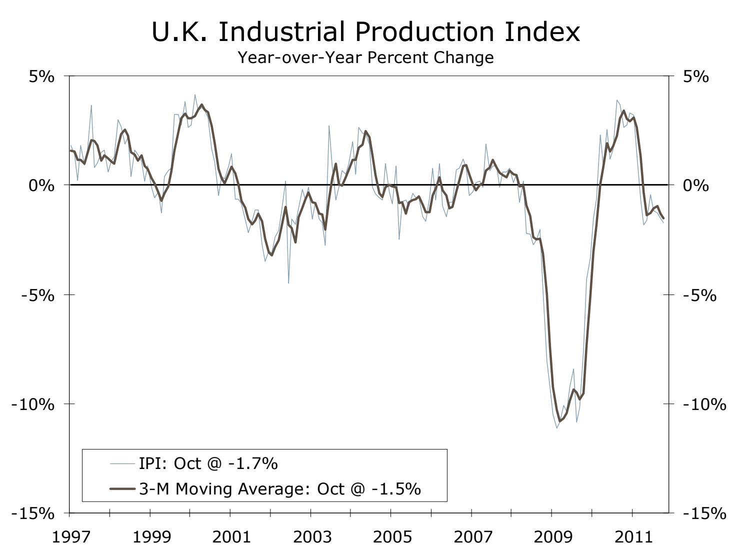
U.K. Industrial Production • Thursday

Recent data suggest that the industrial sector in the United Kingdom is contracting again. Industrial production (IP) in October fell 0.7 percent relative to the previous month, and the sub-50 reading on the manufacturing PMI in both November and December suggest that the industrial sector ended the year on a weak note. "Hard" data on November IP that are slated for release on Thursday will offer clearer insights into the current state of factory output in the United Kingdom.

Also on Thursday, a respected research institute will release its estimate of GDP growth in the fourth quarter. Although the estimate is not "official," it will help analysts form their own estimates of British real GDP growth in the fourth quarter. The Bank of England holds a policy meeting on Thursday, which we discuss in more detail on the next page.

Previous: -0.7%

Consensus: 0.1% (Month-over-Month)



Interest Rate Watch

Will the ECB Ease Again?

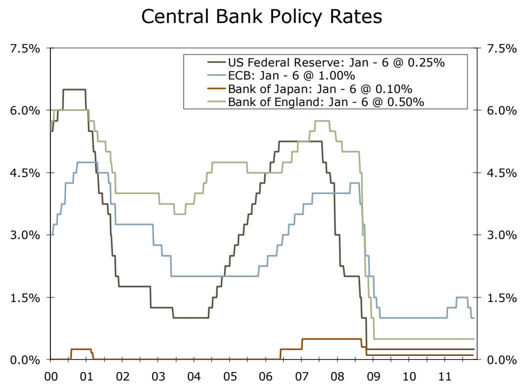
After hiking its main policy rate by 50 bps between April and July, the European Central Bank (ECB) has reversed course with an equal amount of rate cuts in the past two months. Will the ECB cut rates again at its next policy meeting on Thursday? Although we would not be totally surprised by another rate cut on Thursday, we believe the ECB will remain on hold next week. That said, we look for further ECB easing in the months ahead.

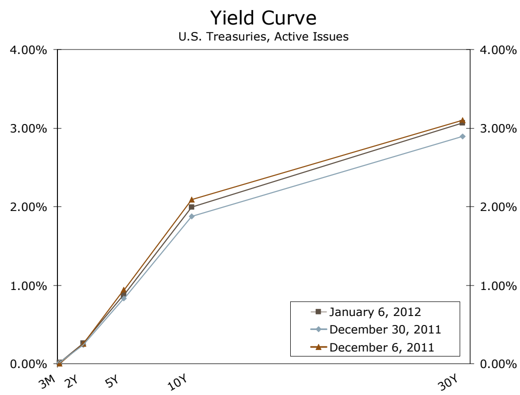
A modest recession appears to be underway in the Eurozone, although recent PMI data suggest that the rate of contraction may be stabilizing. Therefore, we think the ECB will pause next week as it awaits more incoming economic data. However, the European sovereign debt crisis shows few signs of abating, which we think will keep businesses and consumers cautious in the months ahead. In our view, more ECB rate cuts will be forthcoming in the months ahead.

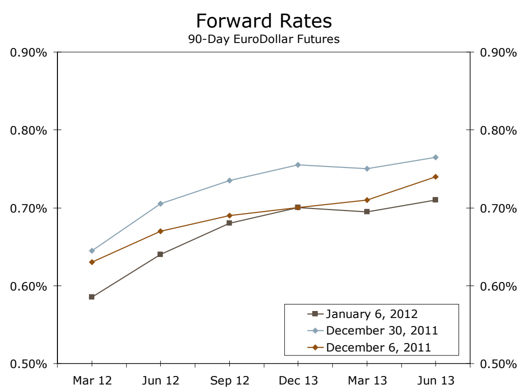
More Asset Purchases by the BoE?

The Bank of England (BoE), which has maintained its main policy rate at only 0.50 percent since March 2009, also meets on Thursday and another rate cut from this already low level does not seem likely. Rather than cutting rates further, the BoE has implemented its own quantitative easing (QE) program. The program had an initial size of £75 billion when it began in March 2009, and it has subsequently expanded to £275 billion. The most recent £75 billion increase in the QE program occurred in October.

Could the BoE increase the size of its QE program yet again on Thursday? Perhaps, but we reckon the BoE will choose to keep the amount of QE unchanged next week. The British economy clearly is weak at present, but the manufacturing, construction and service sector PMIs for December suggest that perhaps economic activity is starting to stabilize. In our view, the BoE may wait until February when its next Inflation Report, which updates the bank's forecasts, is prepared before deciding whether another increase in its QE program is warranted.







Credit Market Insights

2012 State Legislative Outlook

As state general assemblies around the country begin their legislative sessions over the next couple of weeks their attention will likely again be focused on state fiscal issues. This time around many states are in much better fiscal condition after a tough year of budget-cutting measures that have rebalanced state spending with the slower pace of revenue growth, providing much needed confidence to municipal investors.

While the concerns over budget gaps have subsided there is still a need for caution among state policy makers. With U.S. economic growth slated to be roughly the same in 2012, revenue estimates for the year ahead will likely remain conservative, in turn, keeping state government spending restrained. Furthermore, the uncertainty surrounding how federal funding to states may be affected beginning in 2013 has led many states to begin planning for the impending federal budget cuts.

The other major issues likely to be on the docket in the upcoming sessions will be how to fund increasing needs in a slow revenue growth environment. Funding mechanisms will likely be reformed for many states for items such as the Medicaid program, education funding and infrastructure funding, which could have implications for municipal investors in the year ahead. The fact that many states are seriously considering funding reforms should serve to provide further confidence to the municipal credit market.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	3.91%	3.95%	3.99%	4.27%
15-Yr Fixed	3.23%	3.24%	3.27%	3.72%
5/1 ARM	2.86%	2.88%	2.93%	3.47%
1-Yr ARM	2.80%	2.78%	2.80%	3.40%
MBA Applications				
Composite	634.5	661.4	650.4	472.1
Purchase	163.9	181.4	208.0	199.8
Refinance	3,448.3	3,535.0	3,268.7	2,115.4

Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

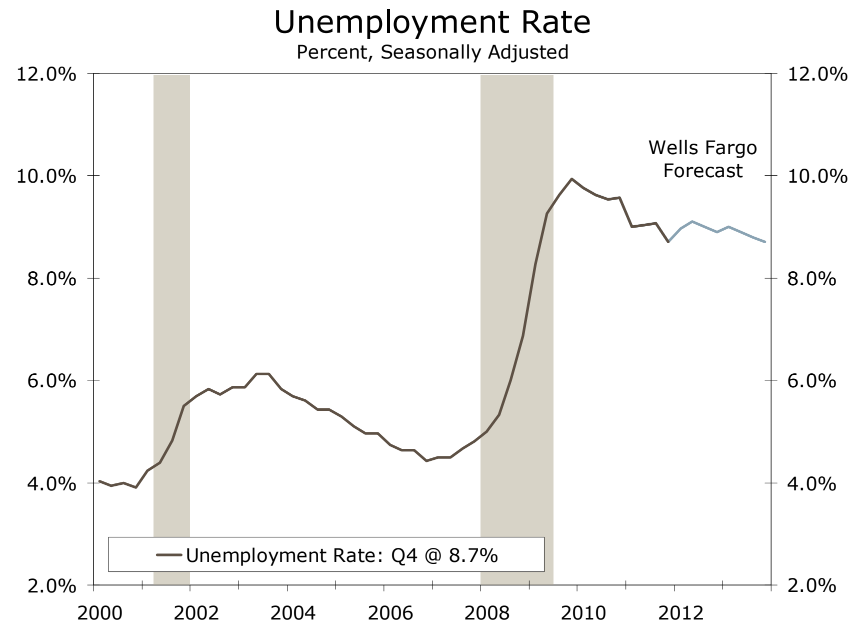
Topic of the Week

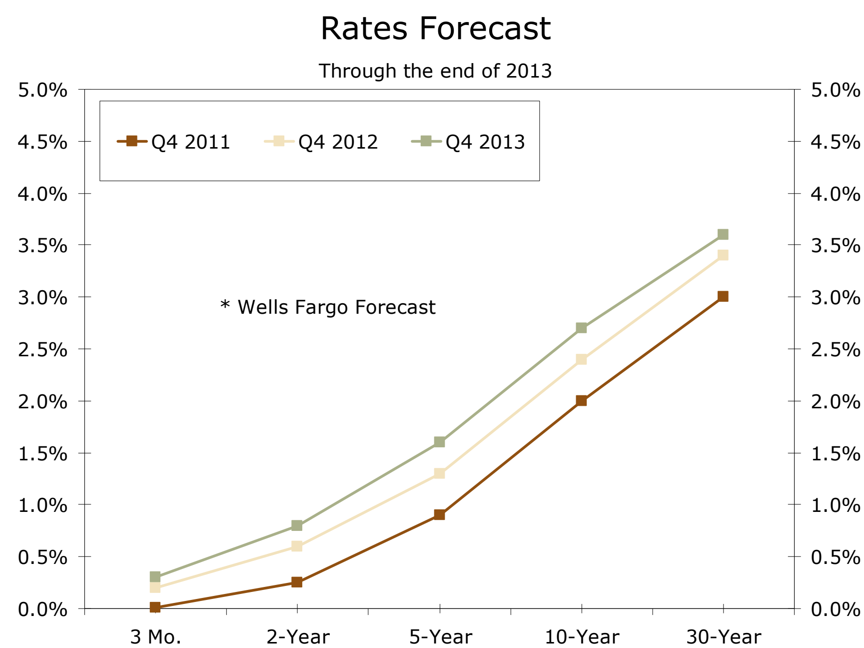
Fed Shifts Its Communication Strategy Slightly

The Fed released minutes from its December FOMC meeting this week. Those minutes showed that Fed officials continue to expect a moderate pace of economic growth in the coming quarters, leading to only a gradual reduction in the unemployment rate. The European sovereign debt crisis remains the most significant risk to the economic outlook, according to the Fed.

Given this outlook, Fed officials indicated that there will be a change in the FOMC's communication strategy, which is to take effect this month. Four times a year, the FOMC publishes economic projections for real GDP growth, the unemployment rate and inflation. Beginning this year, the FOMC will add a projection for the Federal Funds target rate. The FOMC's projections typically include a forecast horizon of three years, plus a "longer run" forecast. The FOMC's quarterly projection for the Federal Funds target rate will likely embrace a similar forecast horizon. In addition, FOMC members will be asked to specify when the first target rate hike is likely to occur. The Fed's hope is that by more clearly communicating forward guidance about monetary policy, investors will be able to price risk premiums better. This could have the effect of lowering longer-term Treasury yields, especially if the FOMC's projections indicate that a rate hike may occur at a later date than what was previously expected.

Although this enhanced communication strategy will probably not have a significant effect on economic growth, it is a step in the right direction. When short-term interest rates reach their lower bound, expectations about monetary policy become especially important. To the extent that this communication change leads to other strategies that enhance the perceived credibility of the Fed in terms of lifting the economy out of its current liquidity trap state, the effect on economic growth could be more meaningful. Other enhanced communication strategies to watch for may include a linking of unemployment rate movements to inflation rates or the adoption of an explicit target range for nominal GDP.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 1/6/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.01	0.01	0.14
3-Month LIBOR	0.58	0.58	0.30
1-Year Treasury	0.09	0.10	0.27
2-Year Treasury	0.25	0.24	0.66
5-Year Treasury	0.85	0.83	2.07
10-Year Treasury	1.95	1.88	3.39
30-Year Treasury	3.01	2.89	4.51
Bond Buyer Index	3.83	3.88	5.08

Foreign Exchange Rates	Friday 1/6/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.272	1.296	1.300
British Pound ($/£)	1.543	1.554	1.547
British Pound (£/€)	0.825	0.833	0.840
Japanese Yen (¥/$)	77.060	76.910	83.330
Canadian Dollar (C$/$)	1.026	1.021	0.997
Swiss Franc (CHF/$)	0.956	0.938	0.966
Australian Dollar (US$/A$)	1.023	1.021	0.994
Mexican Peso (MXN/$)	13.731	13.936	12.221
Chinese Yuan (CNY/$)	6.310	6.295	6.625
Indian Rupee (INR/$)	52.723	53.065	45.253
Brazilian Real (BRL/$)	1.851	1.867	1.687
U.S. Dollar Index	81.266	80.486	80.791

Foreign Interest Rates	Friday 1/6/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.23	1.29	0.93
3-Month Sterling LIBOR	1.09	1.08	0.76
3-Month Canadian LIBOR	1.36	1.35	1.24
3-Month Yen LIBOR	0.20	0.20	0.19
2-Year German	0.17	0.14	0.90
2-Year U.K.	0.40	0.33	1.19
2-Year Canadian	0.93	0.96	1.75
2-Year Japanese	0.13	0.14	0.19
10-Year German	1.85	1.83	2.91
10-Year U.K.	2.02	1.98	3.53
10-Year Canadian	1.94	1.94	3.23
10-Year Japanese	0.98	0.99	1.22

Commodity Prices	Friday 1/6/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	101.22	99.65	88.38
Gold ($/Ounce)	1618.11	1563.70	1371.60
Hot-Rolled Steel ($/S.Ton)	730.00	720.00	700.00
Copper (¢/Pound)	343.20	337.00	432.95
Soybeans ($/Bushel)	11.89	11.78	13.67
Natural Gas ($/MMBTU)	3.05	3.03	4.43
Nickel ($/Metric Ton)	18,686	17,881	24,710
CRB Spot Inds.	520.38	515.62	583.21

Next Week's Economic Calendar

	Monday 9	Tuesday 10	Wednesday 11	Thursday 12	Friday 13
U.S. Data	**Consumer Credit** October $7.65B November $7.00B (C)	**Wholesale Inventories** October 1.6% November 0.5% (C)	**Fed's Beige Book**	**Retail Sales** November 0.2% December 0.1% (W) **Business Inventories** October 0.8% November 0.5% (W) **Monthly Budget** December '10 -$79.9B December '11 -$79.0B (C)	**Import Price Index** November 0.7% December 0.3% (W) **Trade Balance** October -$43.5B November -$42.7B (W)
Global Data	**Germany** **IP (MoM)** Previous (Oct) 0.8%	**China** **Trade Balance** Previous (Nov) $14.53B	**China** **CPI (YoY)** Previous (Nov) 4.2%	**Eurozone** **IP (MoM)** Previous (Oct) -0.1% **U.K.** **IP (MoM)** Previous (Oct) -0.7%	

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

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