February 17, 2012

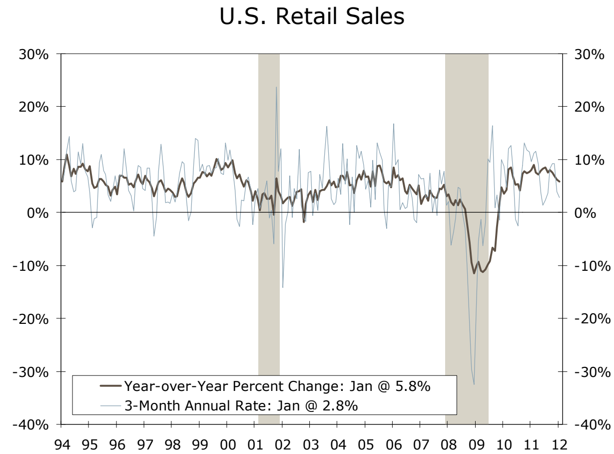
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

A Few Disappointments Enter The January Data

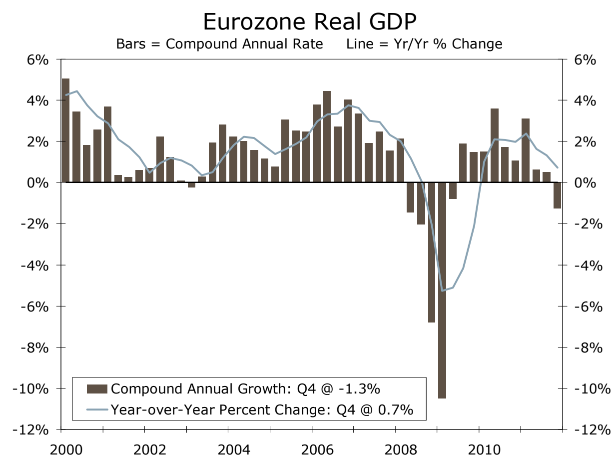
- The tone of U.S. economic releases softened a bit this week, though there is no sign that growth in Q1 is about to hit a brick wall. Advance retail sales for January came in at about half the growth rate the consensus had expected- up 0.4 percent, signaling a U.S. consumer that continues to watch their budgets.
- U.S. industrial production did not grow at all in January though the manufacturing sector is stronger than the industrial production headline might suggest, since most of the weakness came from utilities and the warmer-than-average weather in January.



Global Review

Has the Eurozone Slipped Back into Recession?

- Real GDP in the Eurozone contracted in the fourth quarter for the first time since the end of the last recession. Although France managed to eke out a positive growth rate, the countries with well-publicized debt problems generally experienced sharp contractions at the end of last year.
- The jury is still out on whether the Eurozone is in a "technical" recession or not at present. The larger point, however, is that economic growth in the Eurozone is likely to remain sluggish for the foreseeable future.



Wells Fargo U.S. Economic Forecast

	Actual 2011				Forecast 2012				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2009	2010	2011	2012	2013
Real Gross Domestic Product [1]	0.4	1.3	1.8	2.8	1.8	1.5	2.3	2.5	-3.6	3.0	1.7	2.0	2.1
Personal Consumption	2.1	0.7	1.7	2.8	1.8	1.5	1.6	1.8	-2.0	2.0	2.2	1.7	1.4
Inflation Indicators [2]													
PCE Deflator	1.8	2.5	2.9	2.6	2.0	1.7	1.6	1.9	0.6	1.8	2.4	1.8	1.9
Consumer Price Index	2.1	3.3	3.8	3.3	2.6	2.0	1.6	1.8	-0.3	1.6	3.1	2.0	2.0
Industrial Production [1]	4.8	0.7	6.2	3.9	4.1	3.6	3.0	2.2	-11.1	5.3	4.2	3.8	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	6.6
Trade Weighted Dollar Index [3]	70.6	69.4	72.8	73.3	72.0	73.0	74.0	75.0	77.7	75.6	70.9	73.5	76.3
Unemployment Rate	9.0	9.0	9.1	8.7	8.3	8.2	8.4	8.4	9.3	9.6	9.0	8.3	8.3
Housing Starts [4]	0.58	0.57	0.62	0.67	0.67	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	4.00	4.10	4.10	5.04	4.69	4.46	4.05	4.25
10 Year Note	3.47	3.18	1.92	1.89	1.90	2.00	2.10	2.20	3.26	3.22	2.78	2.05	2.35

Forecast as of: February 17, 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

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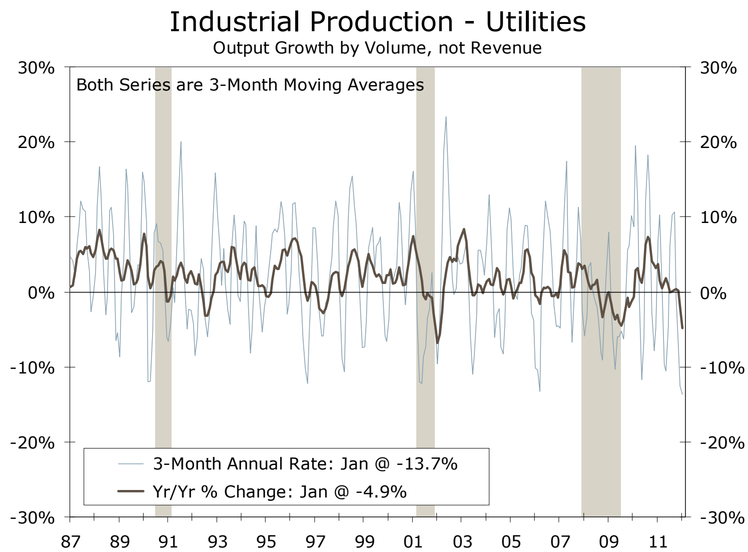
U.S. Review

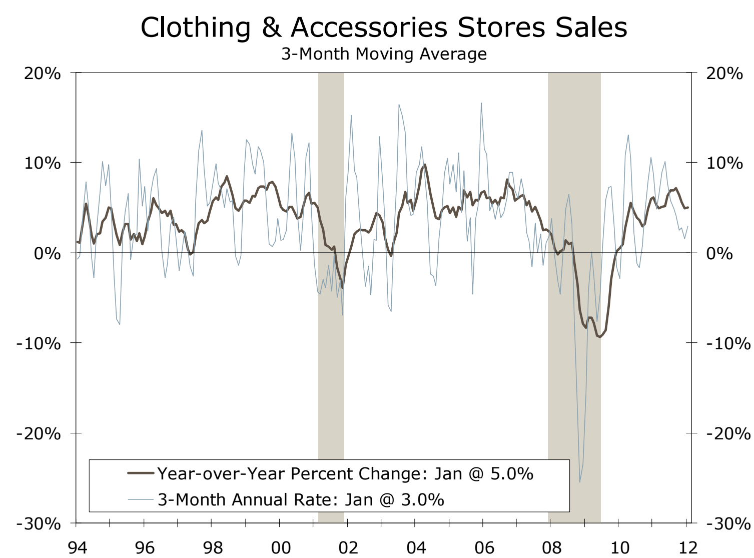
Is U.S. Weather Skewing the January Data?

The latest economic data out of the United States was a bit of a let down to some who were hoping a virtuous economic cycle was just getting revved up. The retail sales and industrial production data for January suggest that economic growth may slow down a bit in the first quarter. This is certainly consistent with our current economic growth forecast for Q1 GDP of around 2.0 percent annualized pace from a 2.8 percent annualized pace in the fourth quarter. But there are also signs that some of the disappointing data on retail sales and industrial production may have been at least partly weather-related.



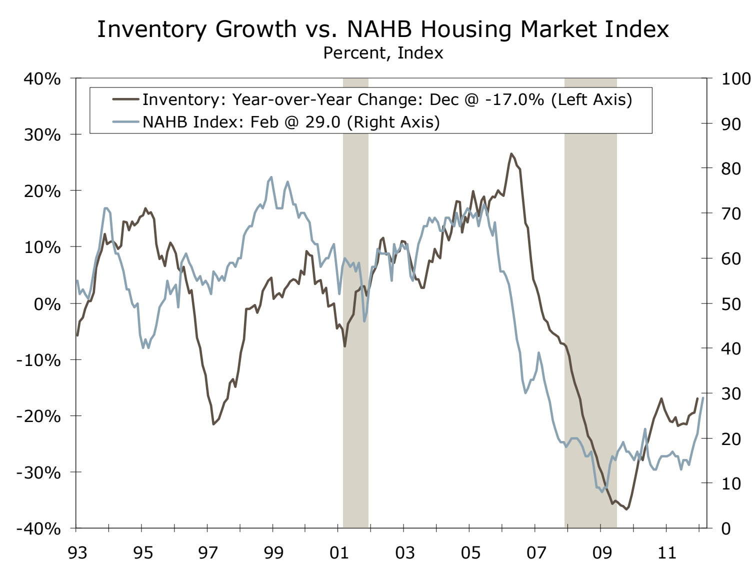
No-Heating Degree Days Hurts Industrial Production

For example, industrial production was flat in the month of January as utilities production plunged 2.5 percent. Overall, manufacturing still managed to expand at a 0.7 percent pace, although that too was moderate compared to December's 1.5 percent increase. Nondurable consumer goods production remained robust with strong gains in autos, appliances, furniture, and carpeting production. At the same time, business equipment production continued to hum along at a sizzling pace with strong gains in information processing, industrial equipment and transit. The expansion in manufacturing is expected to at least continue at a moderate pace in February. The early read on manufacturing for February from the Empire manufacturing survey showed a solid gain in general business conditions and shipments, but a weaker trend in new orders expansion, which could indicate a bit more softening ahead.



Can't Sell Winter Coats When Flowers Are Blooming

How hot was January compared to other Januarys? According to the National Climate Data Center, January 2012 was the fourth warmest on record. So, spring came early to many parts of the country and snow cover for much of the continental United States was especially lacking. This seems to have weighed heavily on clothing sales in January. Clothing sales were flat on the month. Higher gas prices probably also stole sales from other retailers, as consumers found their January budget had not accounted for higher prices at the pump and the holiday credit card bills all coming due at once. The weaker retail sales trends in January also likely clipped small business confidence. The NFIB Small Business Optimism Index barely budged, rising just 0.1 percent in January with slightly fewer small businesses planning to hire and fewer seeing positive earnings trends.



Homebuilders Liking the Warm Weather

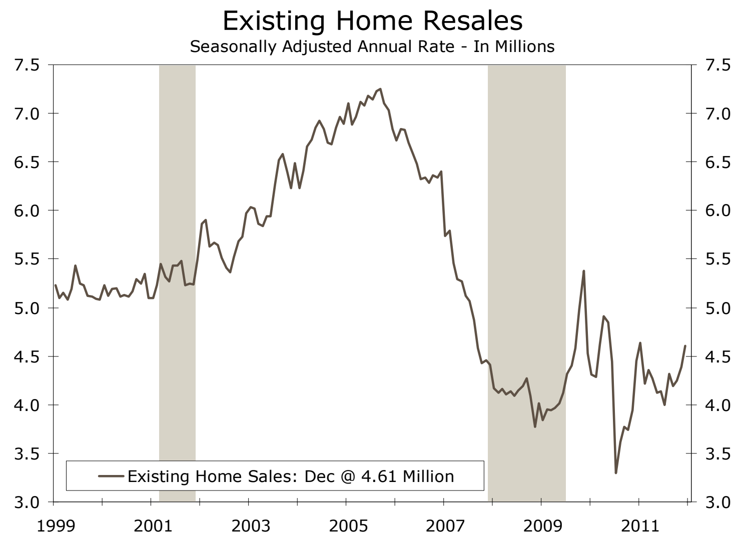
Not all sectors of the economy have been hurt by the weather. In fact, housing and homebuilding appear to be off to a strong start thanks in part to the balmy weather and low mortgage rates. The NAHB/Wells Fargo Housing Market Index improved again in early February to a positive 29, the highest reading since May 2007. Solid gains were seen in both the present and future single-family sales components and buyer traffic continued to recover.

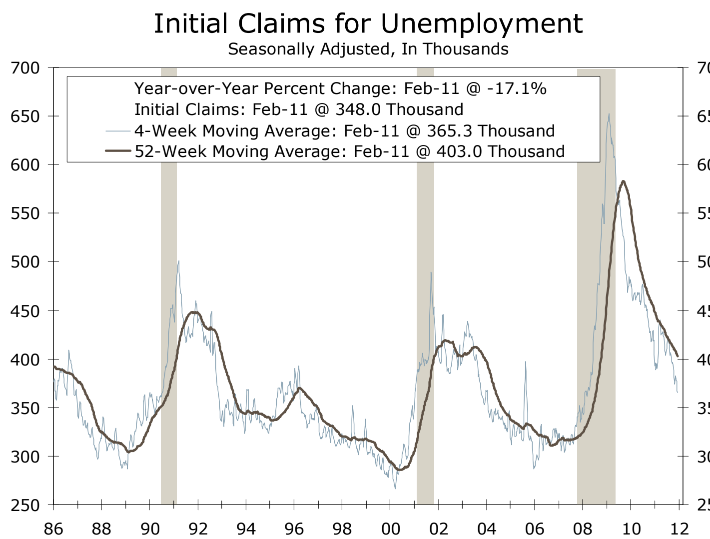
Existing Home Sales • Wednesday

Existing home sales have shown an impressive run over the past few months, increasing in four out of five months. On a year-ago basis, existing home sales are up 3.6 percent, but we do not think the improvement suggests a true recovery just yet. A good portion of transactions continue to be distressed with all-cash sales making up 31 percent of total sales. Many investors are buying discounted properties in select markets and renting them out. Investor sales activity is helping to whittle down some of the excess supply of the vacant homes, but we still have a long way to go. Indeed, total housing inventory fell 9.2 percent to 2.38 million, which represents a 6.2-month supply. Another roadblock for sales activity continues to be contract failures. Failed contracts, which are largely due to declined mortgage applications and low appraised values, remained elevated at 33 percent. Moreover, mortgage applications for purchase have been down in five out of the past six months.

Previous: 4.61M **Wells Fargo: 4.61M**

Consensus: 4.65M





Initial Jobless Claims • Thursday

Initial jobless claims have begun an impressive downward trend in recent weeks suggesting continued improvement in the labor market. In fact, jobless claims have come in below the threshold of 400k for 13 out of 15 weeks. For the week ended Feb. 10, jobless claims fell by 13K to 348K, the lowest level since March 2008. On a trend basis, the four-week moving average is now 365.3K, the lowest level in four years. While claims are moving in the right direction, the underlying structural issues in the labor market will likely keep the unemployment rate elevated for the foreseeable future. That said, we continue to expect improvement in the labor market. Other early labor market indicators, such as regional purchasing manager surveys continued to show improvement in February, but the pace has slowed. Indeed, manufacturing has added 28K jobs over the past three months, and we continue to expect modest job gains in the coming months.

Previous: 348K

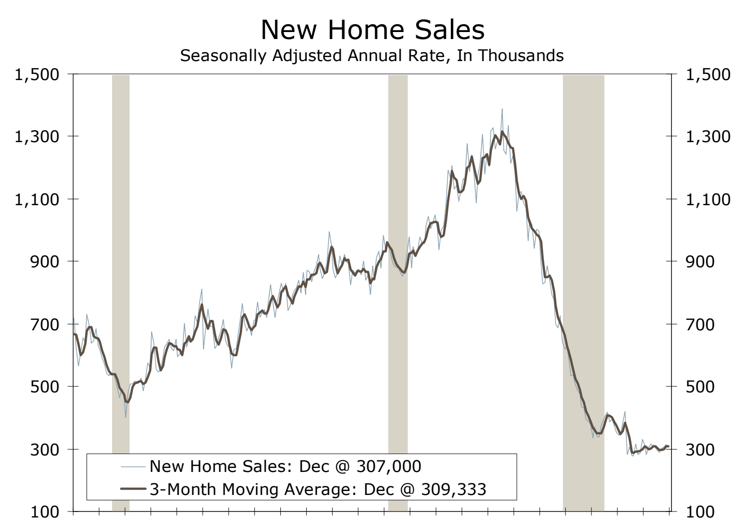
Consensus: 355K

New Home Sales • Friday

New home sales ended last year on a down note with sales activity still bouncing along the bottom. New home sales registered the lowest level on record in 2011 rising at only a 303,000-unit pace. Builder confidence, however, rose for the fifth consecutive month and is now at the highest level in nearly five years. Builders are gaining traction in select markets. That said, we continue to believe a meaningful increase will likely not occur until the slide in existing home prices dissipates. Distressed transactions still comprise a significant portion of total sales at 32 percent which suggests home prices will remain under pressure for some time. Indeed, according to CoreLogic, home prices including distressed sales declined 4.3 percent on a year-ago basis. The pipeline of shadow inventory remains elevated at an estimated 1.6 million units. We continue to expect modest improvement in 2012 and 2013.

Previous: 307K **Wells Fargo: 310K**

Consensus: 315K



Global Review

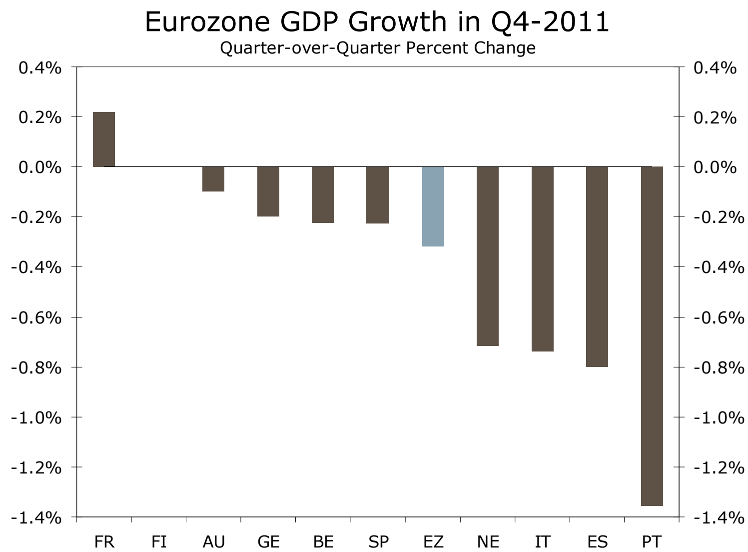
Has the Eurozone Slipped Back into Recession?

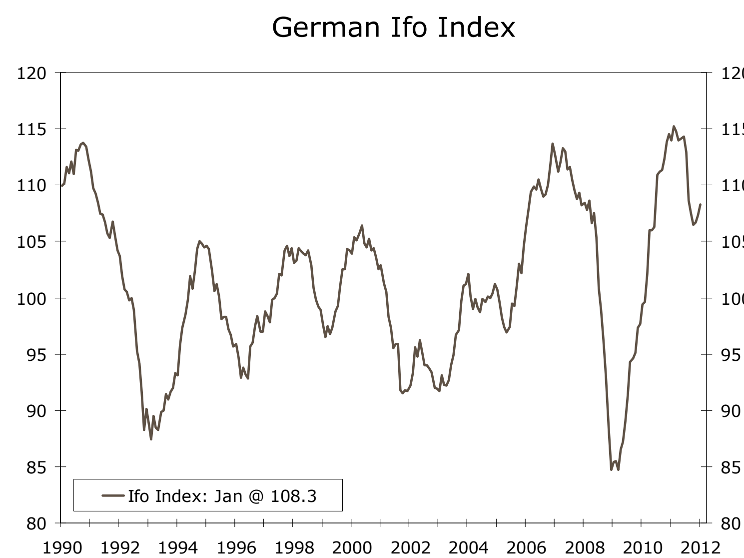
Data released on Tuesday showed that industrial production in the Eurozone tumbled 1.7 percent in the fourth quarter relative to the previous quarter, which reinforced expectations that overall economic activity in the Eurozone contracted in the last three months of 2011. Therefore, it came as little surprise when data showed that real GDP in the Eurozone indeed declined in the fourth quarter (see graph on front page). Although the 0.3 percent drop (1.3 percent at an annualized rate) in real GDP in the fourth quarter was not as severe as expected, it marked the first economic contraction in the Eurozone since Q2 2009.

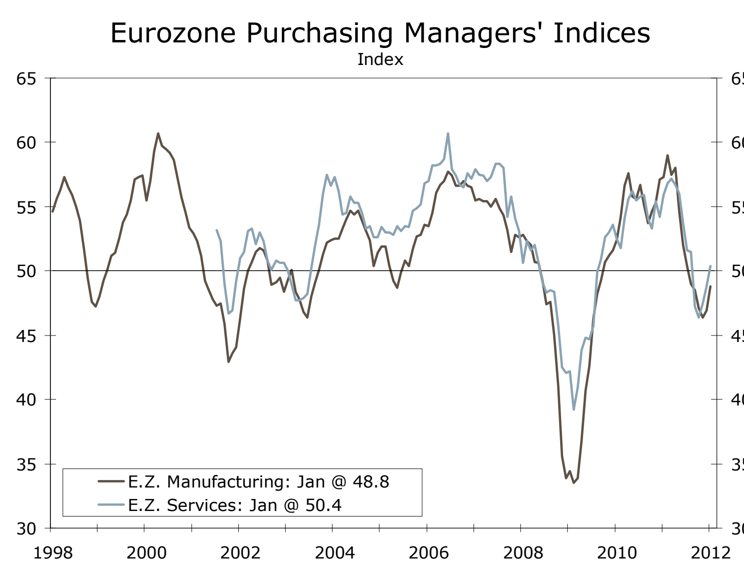
This week, 10 of the 17 individual countries that comprise the Eurozone released GDP data for the fourth quarter. (These 10 countries account for 95 percent of total GDP in the Eurozone.) However, the outturns from these 10 economies show that growth differed widely across the Eurozone. On a positive note, France managed to eke out a 0.2 percent growth rate (not annualized) in the fourth quarter. However, the Portuguese economy contracted 1.3 percent in the fourth quarter (top chart). Greece did not release a sequential growth rate, but it reported that real GDP in the fourth quarter was down 7.0 percent on a year-ago basis. Generally, the economies with the most acute debt problems experienced the largest contractions in the fourth quarter.

Will GDP contract again in the current quarter, signaling that the Eurozone is in a "technical" recession? (A common rule of thumb equates two consecutive quarterly declines in real GDP with recession.) We currently project that real GDP in the Eurozone will decline in the current quarter at roughly the same rate as it did in the fourth quarter, but acknowledge the upside risk to our forecast. Although there is little "hard" data from the first quarter at this point, sentiment indicators in January generally stabilized or improved. For example, the widely-followed Ifo index of German business sentiment has looked up over the past few months (middle chart). The Eurozone purchasing managers' indices also moved higher in January, although the manufacturing index remains below the demarcation line separating expansion from contraction (bottom chart). The "hard" data that will eventually be released may show that economic activity in the overall Eurozone is inching higher in the current quarter or falling less rapidly than it did in the last three months of 2011.

Therefore, the jury is still out on whether the Eurozone is in a "technical" recession or not at present. The larger point, however, is that economic growth in the Eurozone is likely to remain sluggish for the foreseeable future. Greece has years of fiscal consolidation ahead of it, but the Hellenic Republic accounts for only 2 percent of GDP in the Eurozone. However, Spain (10 percent) and Italy (16 percent) are much larger economies that also will be tightening fiscal policy this year and next. Although we look for the economic expansion to resume in the next quarter or two, we expect that the pace of recovery will remain modest.







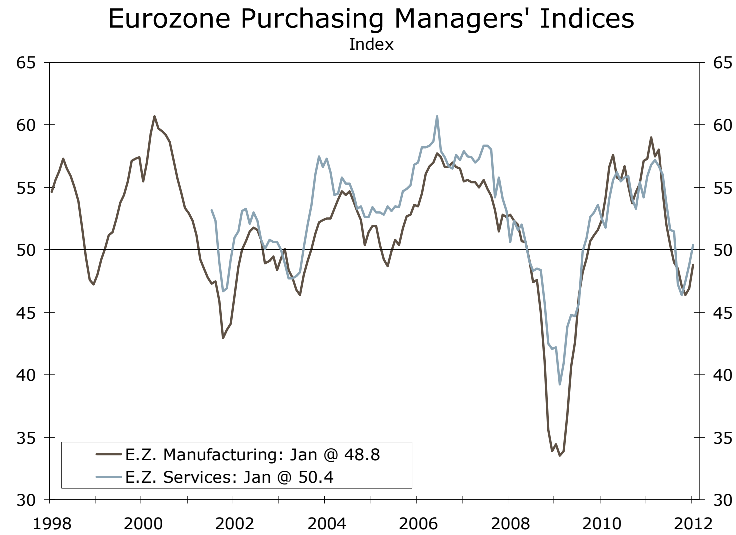
Eurozone PMIs • Tuesday

The sovereign debt situation in Europe remains a threat to global growth but some of the pressure in the European financial markets seems to have eased somewhat in recent weeks. Sovereign bond yields in troubled southern European economies other than Greece have come down. The Italian 10-year government bonds, for example, are yielding less than 6 percent at present, compared to more than 7 percent at the outset of the year.

The easing in financial market pressures has businesses breathing a sigh of relief. At the end of 2011, business sentiment, as measured by the various Purchasing Managers' Indices, was plunging below 50 signaling a coming slowdown but has since turned around. Fourth quarter GDP seemed to bear that out with a slowdown in economic output that was somewhat less than the consensus had feared. Next week, fresh PMI readings will give a more current look at business sentiment.

Previous: 50.4

Consensus: 50.5



Canadian Retail Sales • Tuesday

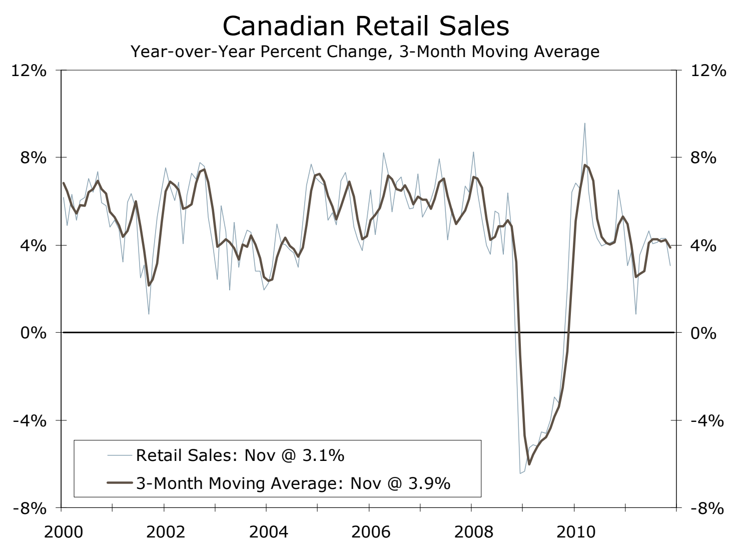
With Europe still struggling with its sovereign debt problems and tepid economic expansion in the United States, Canada is looking to domestic demand to sustain the economic expansion there.

So far the consumer has proved to be rather resilient. Despite rising unemployment and weak job growth, Canadian retail sales have increased for four straight months. That said, the 0.3 percent increase in November was the smallest sequential gain and even that paltry increase was largely due to increased sales at gasoline stations reflecting higher prices at the pump.

Given the ongoing weakness in the labor market and the slowing momentum in Canadian consumer spending, it is hard to hold out hope for a fifth straight increase in retail sales. The December report is due out on Tuesday.

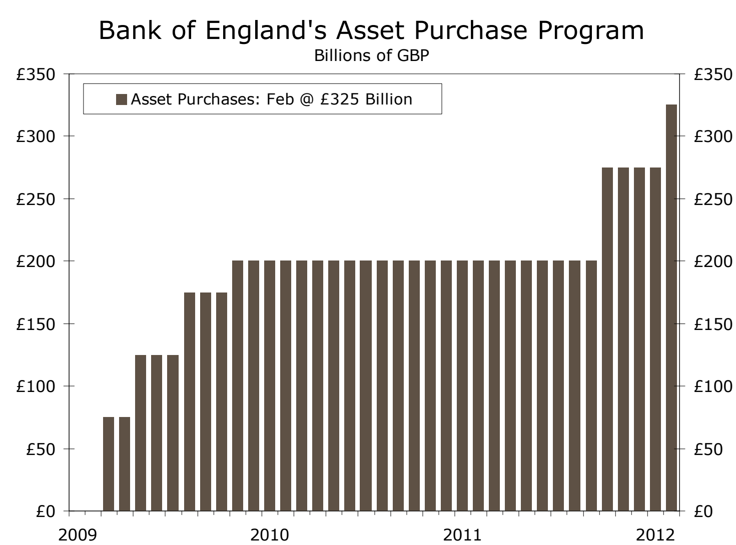
Previous: 0.3%

Consensus: -0.2% (Month-over-Month)



Bank of England Minutes • Wednesday

As we detailed in last week's Global Review, the Bank of England's (BoE) Monetary Policy Committee (MPC) recently expanded its asset purchase program due to "the weak near-term growth outlook." Real GDP contracted at an annualized pace of 0.8 percent in the fourth quarter. The BoE's inflation report issued this week reveals the Bank's expectation that inflation will return to target by the end of the forecast period. While this does not rule out further quantitative easing, it certainly does not seem imminent. The minutes from the BoE meeting will be released on Wednesday and may tell us whether or not there is any dissention in the ranks within the MPC. A 5-4 vote would indicate that some committee members would have preferred no further expansion of the asset purchases; whereas a unanimous 9-0 vote (which we think would be unlikely) might lift market expectations for additional easing.



Interest Rate Watch

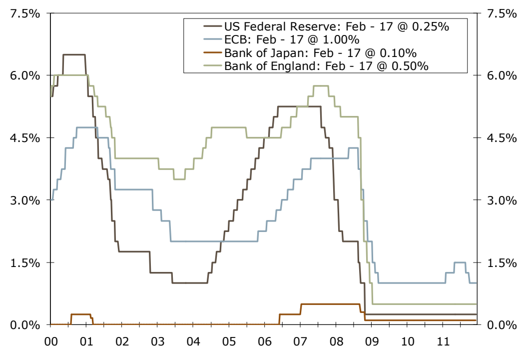
Is "QE3" in Store?

At its policy meeting on Jan. 24-25, the FOMC surprised many market participants by extending its commitment to keep the Federal Funds rate at "exceptionally low levels" through late 2014. Up until that meeting, the FOMC had committed to keep rates low only until mid-2013. The minutes of the Jan. 24-25 policy meeting, which were released this week, shed some more light on the FOMC's current thinking.

The FOMC decided to extend its commitment to keep rates low because several members believe that unemployment would remain "well above" its "longer-term normal rate" and "inflation would be at or below the committee's longer-run objective" in late 2014. Due to its dual mandate to set monetary policy to achieve "maximum employment" and "stable prices," these members thought it was only appropriate to keep rates "exceptionally low" until late 2014.

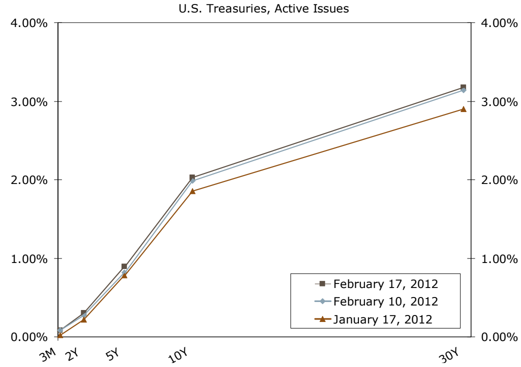
The minutes also provide some insights into whether the FOMC will engage in a third round of asset purchases. The first round started in late 2008 when the economy was plunging into a deep recession. The second round (QE2) started in November 2010 when it appeared that the economy was stalling and when the Fed's preferred measure of inflation was falling toward only 1 percent. Although the FOMC has not ruled out "QE3" there is evident disagreement within the FOMC that more is needed at this time. Although a "few" members believe that further purchases are needed, "other members indicated that such policy action could become necessary if the economy lost momentum or if inflation seemed likely to remain below its mandate-consistent rate of 2 percent over the medium run." Although unanimous agreement is not needed to change policy, the FOMC usually does so in a broadly consensual fashion. Therefore, the outlook for QE3 will likely depend on the incoming data over the next few months. Economic stagnation or rapidly receding inflation will lead to QE3, while policy likely will remain on hold if the economy continues along its current trajectory. Stay tuned.

Central Bank Policy Rates



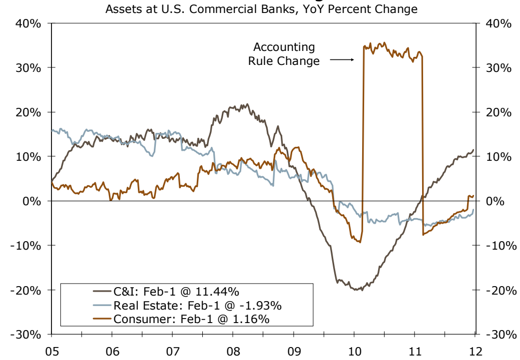
Yield Curve

U.S. Treasuries, Active Issues



Bank Lending

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



Credit Market Insights

Fed's Impact on Housing, Limited

Mortgage applications fell 1.0 percent for the week ended Feb. 10 as the average 30-year fixed mortgage rate rose just above the record low. While refinance applications rose 0.8 percent, purchase applications plunged 8.4 percent. Since the Fed began Operation Twist in early October, mortgage rates have declined 25 bps, but the four-week moving average of purchase applications is up only 3.5 percent. Meanwhile, refinancing has surged to the highest levels in over a year. Moreover, according to Freddie Mac, 49 percent of refinanced loans in the fourth quarter were "cash-in" refinances that reduced principal, the highest share on record, rather than "cash-out" refinances that can fuel spending, which were the lowest share on record. This suggests that the main effect of Operation Twist so far has been a reduction of debt rather than an increase in demand for homes or a lift in consumer spending. Although debt reduction is a good thing, a pickup in sales activity was the Fed's main intent. Stronger sales activity would help to whittle down inventories, support home prices and eventually lead to increased consumer confidence, spending and job growth. It is true that home sales have risen recently, but the simultaneous weakness in purchase applications suggests home sales have improved due to low prices attracting cash transactions by investors rather than due to lower interest rates attracting buyers using mortgages to finance a purchase. At this point, the Fed will take what it can get.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.87%	3.87%	3.88%	5.00%
15-Yr Fixed	3.16%	3.16%	3.17%	4.27%
5/1 ARM	2.82%	2.83%	2.82%	3.87%
1-Yr ARM	2.84%	2.78%	2.74%	3.39%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,360.0	30.30%	9.88%	11.44%
Revolving Home Equity	$548.0	7.55%	0.06%	-4.87%
Residential Mortgages	$1,543.8	88.79%	12.08%	1.10%
Commerical Real Estate	$1,425.7	99.86%	11.62%	-3.91%
Consumer	$1,087.0	18.52%	-16.24%	1.16%

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

Topic of the Week

Education and Structural Unemployment

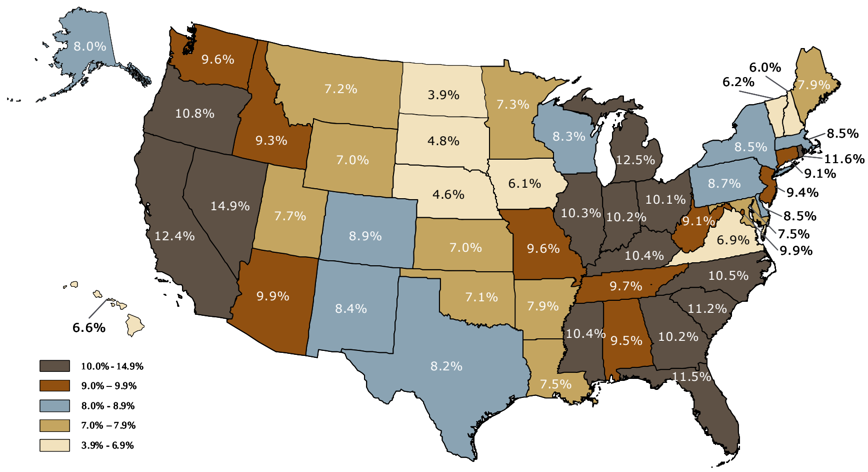
There is a noticeable disconnect between the skills among the U.S. workforce and those demanded by companies today. This disconnect has resulted in prolonged high unemployment rates and growing income disparities among the population. However, the degree of structural unemployment varies considerably across states. In a recent report, we argued that one major factor contributing to disparities in structural unemployment across states is directly related to the education of the state's labor force and the concentration of high-skilled workers within a state's working-age population.

Using a standard regression analysis we evaluate the effect of a state's skills ratio (higher-skilled to lower-skilled individuals in the working-age population) on the change in their unemployment rate from 2006 to 2010. We define higher-skilled workers as those with a bachelor's degree or greater and lower-skilled workers as those with less than a high school diploma.

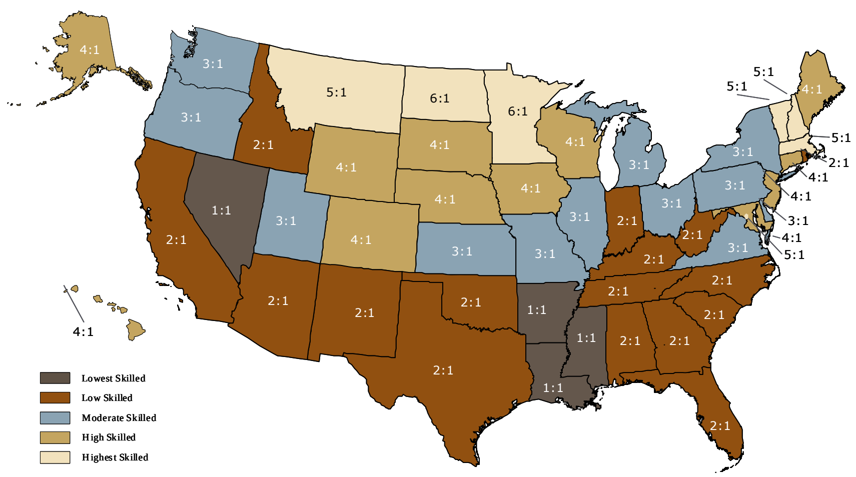
We find that states that are further along in addressing their structural unemployment issues—those states with a greater concentration of high-skilled workers to lower-skilled workers—had changes in their unemployment rates that were 0.5 percentage points lower than states with lower concentrations of high-skilled workers. This relationship implies that those states with a higher concentration of high-skilled workers will have lower unemployment rates than states with lower concentrations of high-skilled workers. Indeed, when we extend our analysis and look at state unemployment rates throughout 2010 and 2011 we find that the relationship holds. Thus, states where skills concentration is the highest will have lower long-run unemployment rates and by extension lower levels of structural unemployment.

For our full analysis, see our report, *Skills Disconnect at the State Level: Disparities of Education and Structural Unemployment*, which can be found on our website.

2010 State Unemployment Rates



2010 Skills Ratio-Education Concentration of a State's Working-Age Population



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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 2/17/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.08	0.08	0.09
3-Month LIBOR	0.49	0.51	0.31
1-Year Treasury	0.23	0.18	0.36
2-Year Treasury	0.30	0.27	0.76
5-Year Treasury	0.89	0.82	2.27
10-Year Treasury	2.02	1.99	3.57
30-Year Treasury	3.17	3.14	4.67
Bond Buyer Index	3.65	3.70	5.10

Foreign Exchange Rates

	Friday 2/17/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.316	1.320	1.361
British Pound ($/£)	1.583	1.576	1.617
British Pound (£/€)	0.831	0.838	0.841
Japanese Yen (¥/$)	79.330	77.610	83.310
Canadian Dollar (C$/$)	0.995	1.001	0.984
Swiss Franc (CHF/$)	0.918	0.917	0.950
Australian Dollar (US$/A$)	1.076	1.067	1.012
Mexican Peso (MXN/$)	12.785	12.802	12.020
Chinese Yuan (CNY/$)	6.299	6.300	6.583
Indian Rupee (INR/$)	49.275	49.410	45.348
Brazilian Real (BRL/$)	1.713	1.722	1.661
U.S. Dollar Index	79.263	79.114	77.995

Foreign Interest Rates

	Friday 2/17/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.97	0.99	1.04
3-Month Sterling LIBOR	1.07	1.08	0.80
3-Month Canadian LIBOR	1.39	1.39	1.21
3-Month Yen LIBOR	0.20	0.20	0.19
2-Year German	0.24	0.24	1.32
2-Year U.K.	0.45	0.38	1.46
2-Year Canadian	1.10	1.07	1.90
2-Year Japanese	0.11	0.13	0.25
10-Year German	1.91	1.91	3.18
10-Year U.K.	2.19	2.11	3.76
10-Year Canadian	2.06	2.05	3.48
10-Year Japanese	0.95	0.98	1.35

Commodity Prices

	Friday 2/17/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	102.80	98.67	86.36
Gold ($/Ounce)	1730.35	1722.00	1384.10
Hot-Rolled Steel ($/S.Ton)	728.00	720.00	810.00
Copper (¢/Pound)	379.50	386.20	448.40
Soybeans ($/Bushel)	12.53	12.20	13.41
Natural Gas ($/MMBTU)	2.68	2.48	3.87
Nickel ($/Metric Ton)	19,813	21,424	28,542
CRB Spot Inds.	546.43	549.43	621.43

Next Week's Economic Calendar

	Monday 20	Tuesday 21	Wednesday 22	Thursday 23	Friday 24
U.S. Data			**Existing Home Sales** December 4.61M January 4.61M (W)	**House Price Index** November 1.0% December 0.4% (C)	**New Home Sales** December 307K January 310K (W)
Global Data		**Canada** **Retail Sales (MoM)** Previous (Nov) 0.3%	**Eurozone** **PMI Manufacturing** Previous (Jan) 48.8 **Eurozone** **PMI Services** Previous (Jan) 50.4	**Germany** **IFO Business Climate** Previous (Jan) 108.3	

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

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