February 25, 2011

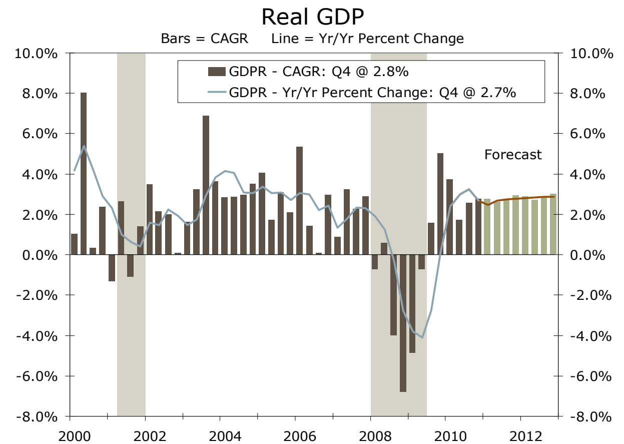
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

The Recovery Should Ride Through Higher Oil Prices

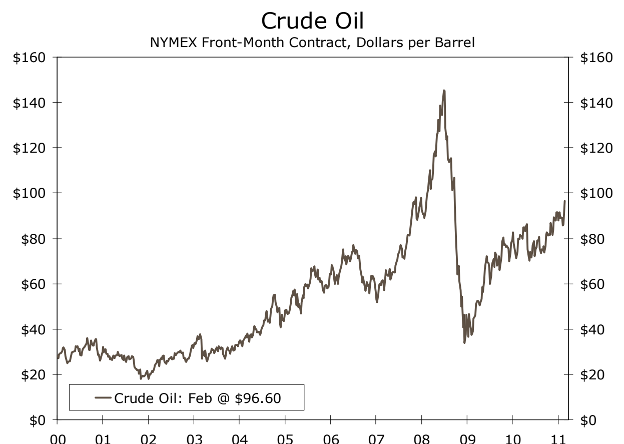
- Heightened unrest in the Middle East sent oil prices up to $100 a barrel this week, raising fears that higher energy prices would undermine the still fragile recovery.
- Most of this past week's reports on housing showed continued weakness, with an onslaught of foreclosures driving prices lower and little underlying demand.
- Weekly first-time unemployment claims fell sharply during this week, continuing their recent volatile pattern, which is likely weather-related.
- Real GDP grew at a 2.8 percent pace in Q4.



Global Review

How High Could Petroleum Prices Go?

- When the Egyptian crisis erupted we argued that the potential effects of a change in regime in that country would have limited effects on the U.S. economy as our international trade ties with Egypt are insignificant.
- The biggest problem going forward is what will be the inflationary consequences of these oil price levels for the world economy? With the global economy awash in liquidity, we could see rising inflation across the world, which could prompt central bankers across the world to tighten monetary policy faster than our current expectation.



Wells Fargo U.S. Economic Forecast

	Actual 2010				Forecast 2011				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2008	2009	2010	2011	2012
Real Gross Domestic Product [1]	3.7	1.7	2.6	2.8	2.8	2.6	2.7	2.9	0.0	-2.6	2.8	2.7	2.8
Personal Consumption	1.9	2.2	2.4	4.1	2.4	2.4	2.5	2.9	-0.3	-1.2	1.8	2.7	2.6
Inflation Indicators [2]													
"Core" PCE Deflator	1.8	1.5	1.2	0.8	0.8	0.8	1.0	1.3	2.3	1.5	1.3	1.0	1.4
Consumer Price Index	2.4	1.8	1.2	1.2	1.8	2.6	2.7	2.6	3.8	-0.3	1.6	2.4	2.6
Industrial Production [1]	7.1	7.2	6.2	3.2	4.5	4.5	4.1	3.7	-3.3	-9.3	5.7	4.5	3.8
Corporate Profits Before Taxes [2]	37.6	37.0	26.4	12.5	8.2	6.2	6.2	6.7	-16.4	-0.4	27.5	6.8	7.0
Trade Weighted Dollar Index[3]	76.1	78.8	73.6	73.2	72.5	73.0	74.0	75.0	74.3	77.7	75.6	73.6	78.0
Unemployment Rate	9.7	9.6	9.6	9.6	9.3	9.6	9.4	9.2	5.8	9.3	9.6	9.4	9.0
Housing Starts[4]	0.62	0.60	0.59	0.53	0.58	0.61	0.66	0.71	0.90	0.55	0.59	0.64	0.83
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	1.88	0.25	0.25	0.25	0.75
Conventional Mortgage Rate	4.97	4.74	4.35	4.71	4.90	5.15	5.15	5.20	6.04	5.04	4.69	5.10	5.63
10 Year Note	3.84	2.97	2.53	3.30	3.60	3.75	3.75	3.80	3.66	3.26	3.22	3.73	4.13

Forecast as of: February 25, 2011
[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

Higher Oil Prices Will Cut Into Growth

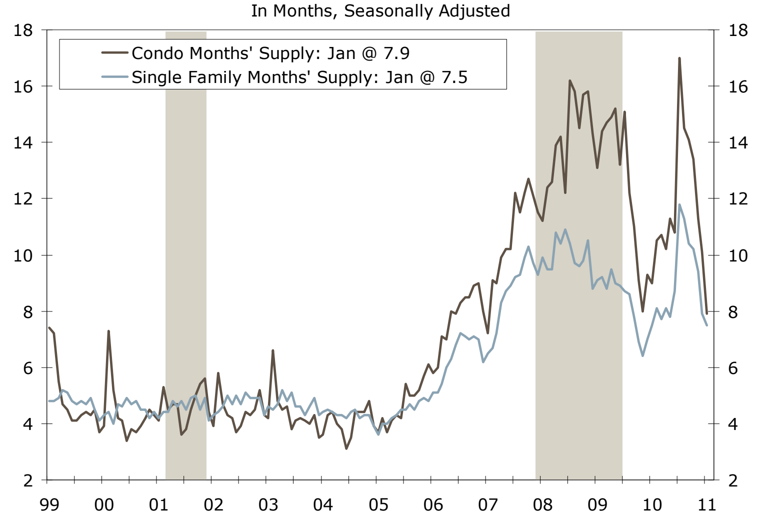
The turmoil in the Middle East took center stage this week. West Texas Intermediate briefly rose above $100 a barrel, setting off alarms about the likely implications for near-term economic growth. Although energy prices are likely to be higher than previously expected, we believe the worst-case fears should not be the basis for our forecast or business plans. Without actual supply disruptions, oil prices should subside, albeit at a higher level than we previously projected. The rise in energy prices is already affecting consumer spending, leading to weaker retail sales in January. The impact will grow this spring, when driving picks up significantly. We have a more detailed analysis of the impact of higher energy prices in our Topic of the Week (Page 7).

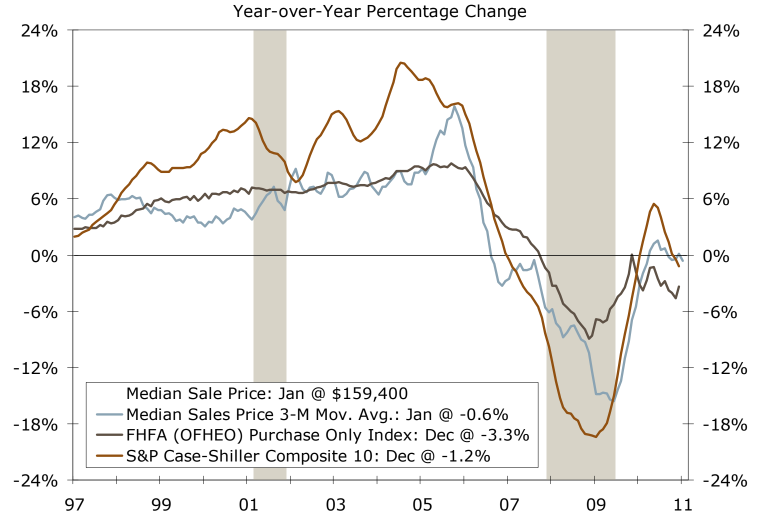
Housing data accounted for much of this week's other economic news. Sales of existing homes posted a surprising 2.7 percent increase in January. An increase in distressed sales appears to have pushed overall activity slightly higher in this normally slow month, which caused the seasonally adjusted numbers to post a modest gain. With the increase in sales, the months' supply of single-family homes on the market fell to 7.5 months. This figure is deceiving because a large number of homes are believed to be being held off the market and December usually marks the low for the year.

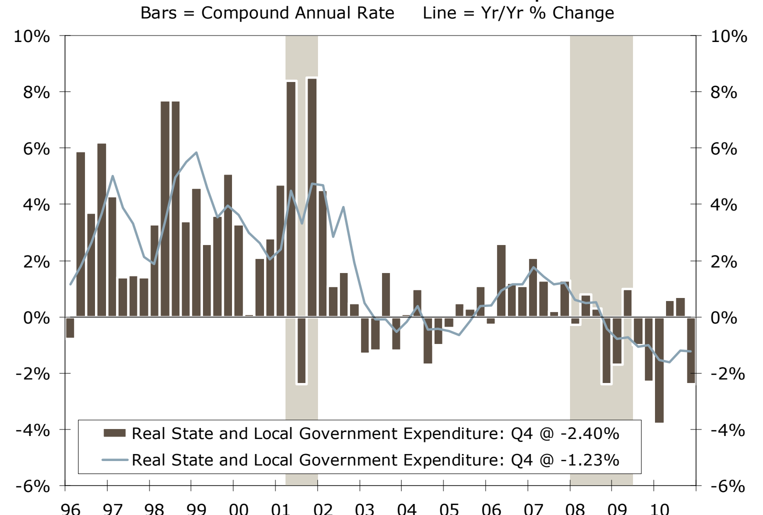
The rise in existing home sales was about the only positive news for the housing market this week. Home prices continue to tumble and virtually all of the key price measures posted declines for December and January. The Case-Shiller Index fell 0.4 percent in December, marking its sixth consecutive decline. Prices hit new cycle lows in 11 of the 20 markets tracked. The 20-city index has fallen 3.7 percent over the past six months, while the 10-city index has decline 3.0 percent. We expect both to fall an additional five to six percent over the next six months.

The recent slide in home prices raises the specter of another vicious downward spiral in housing activity. Falling home prices are causing appraisals to come in more conservatively and causing lenders to increase down-payment requirements. Homebuyer traffic has been stagnant for the past six months and new homes sales have been stuck near their cycle lows ever since the homebuyers' tax credit program ended.

Revised fourth-quarter GDP figures came in below expectations. Real GDP grew at just a 2.8 percent pace in the fourth quarter, compared to a 3.2 percent gain reported earlier. About half of the downward revision was due to a sharp reduction in state and local outlays. Apparently the winding down of the Build America bonds program led to more substantial cuts in spending than previously thought. We have built in substantial cuts in state and local spending in future quarters. In addition, consumer spending rose slightly less than first reported, with a downward adjustment to household services accounting for much of the revision. Imports were also revised higher, so there was less improvement in the trade deficit than first reported. Private sector growth still held up relatively strongly; however, climbing at a 3.1 percent pace.





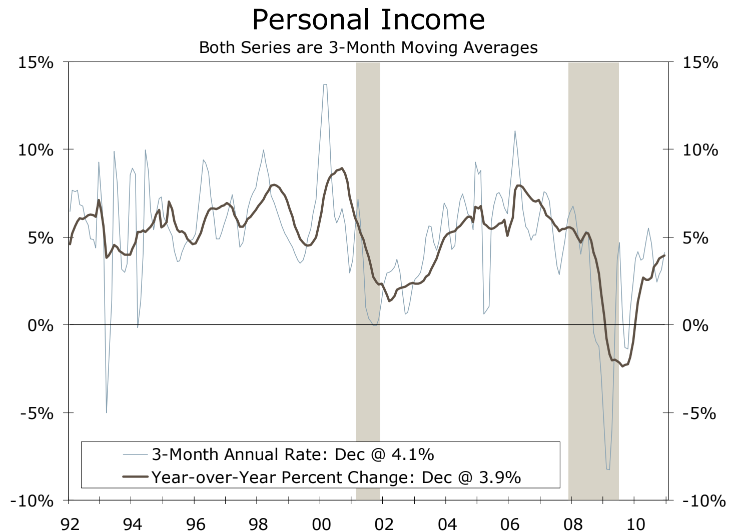


Personal Income • Monday

Marking the sixth monthly gain, nominal spending rose a solid 0.7 percent in December as nominal income increased 0.4 percent. Growth in spending has outpaced income in three of the past four months, which suggests this robust pace of spending will likely slow in the coming months. Consumers appear to be using cash to pay for recent transactions which is evidenced in the drop of the saving rate. The saving rate peaked at more than six percent in early 2010 and slipped to 5.3 percent in December. As consumers continue to unwind unprecedented debt levels, we expect the saving rate to remain north of five percent, however. The core PCE deflator was unchanged on the month bringing the year-over-year rate to its lowest level in a half century at 0.7 percent. While headline inflation continues to increase due to rising commodity prices, the pass through to consumers should remain relatively low.

Previous: 0.4% **Wells Fargo: 1.4%**

Consensus: 0.4% (Month-over-Month)

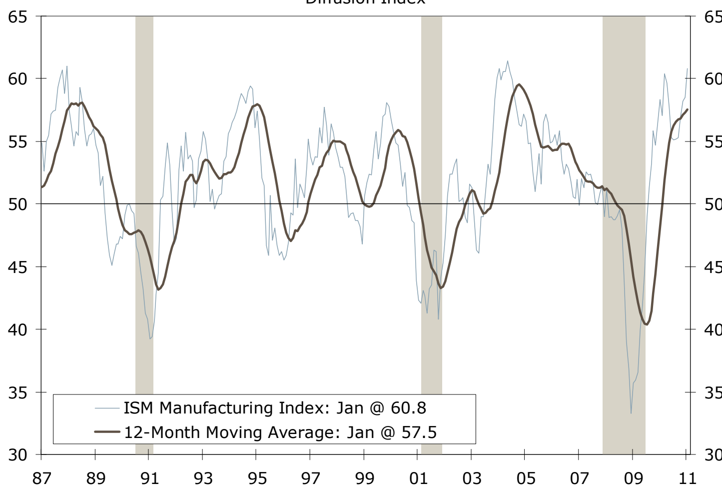


ISM Manufacturing • Tuesday

ISM manufacturing jumped to 60.8 in January suggesting continued strength in the factory sector. Much of the increase was due to a 5.8 point increase in new orders, which rose to a new cycle high. Other components that make up the headline including production, employment and supplier deliveries also rose on the month. Fourteen of 18 manufacturing industries reported growth in January. Prices paid, however, surged in January to 81.5, which continues to signal input cost pressure. With consumer demand still tepid, many producers will be unable to pass on the additional costs, which will continue to squeeze corporate profits. Recent regional manufacturing surveys including Richmond, Empire and Philadelphia showed solid growth in February suggesting we will likely continue to see further expansion in the manufacturing sector in the coming month.

Previous: 60.8 **Wells Fargo: 60.5**

Consensus: 60.8

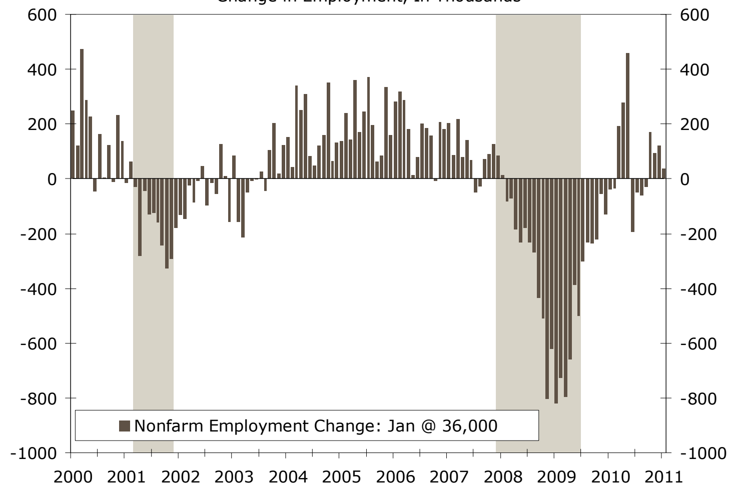


Nonfarm Employment • Friday

With recent nonfarm payroll reports sending mixed signals between the establishment and household surveys, market watchers are looking intently at other employment indicators to decipher the true underlying trend in employment. One reliable forward-looking indicator, the four-week moving average for initial jobless claims, has edged lower in recent weeks. While weather may be a factor, the consistent downward trend in claims is still encouraging and suggests an improving labor market. Another good sign is the strength in private-sector payrolls. Although the private sector added only 32,000 jobs in January, we expect hiring to pick up. Private-sector employment should average around 150,000 jobs in 2011, which should be enough to sustain the recovery. We expect nonfarm payrolls to increase by 180,000 jobs in February and the unemployment rate to remain unchanged at nine percent.

Previous: 36K **Wells Fargo: 180K**

Consensus: 183K



Global Review

How High Could Petroleum Prices Go?

When the Egyptian crisis erupted we argued that the potential effects of a change in regime in that country would have limited effects on the U.S. economy as our international trade ties with Egypt are insignificant while at the same time Egypt's production of petroleum was minimal in terms of total world production.

However, the continuation or extension of Egypt's crisis to include Libya changes the whole Middle East/North Africa-oil game and puts the world, once again, at the edge of another surge in petroleum prices, with all the implications that such an environment implies.

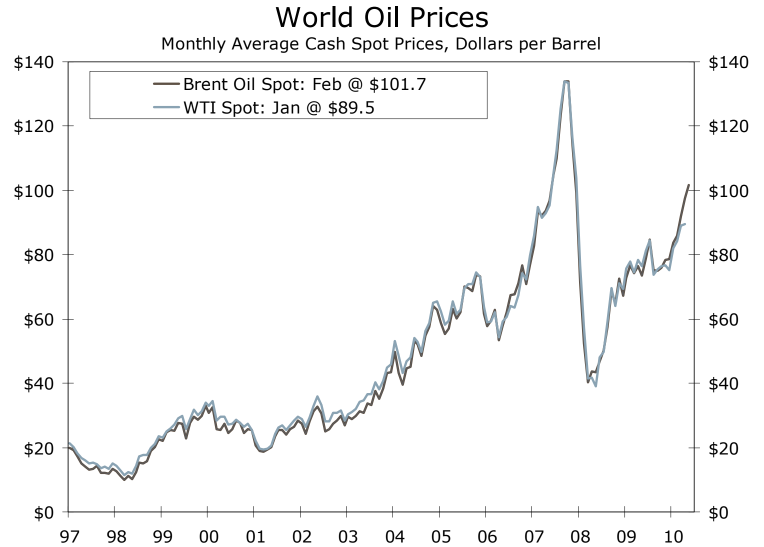
While Libya is not a very large producer of oil, at about 2 percent of total world output, versus 0.8 percent for Egypt, the problem is that the current crisis could continue to spread across the region and more production could go off-line in the near term. This is, perhaps, what has markets on the edge and the price of petroleum skyrocketing. Furthermore, while the majority of the petroleum producing countries of the region depends heavily on state-owned enterprises to produce oil, Libya has depended more on foreign investment to develop its vast oil reserves, which are the largest of all the countries in North Africa. Thus, a major crisis that continues to spread across the region has the potential to be a big drag on world economic growth.

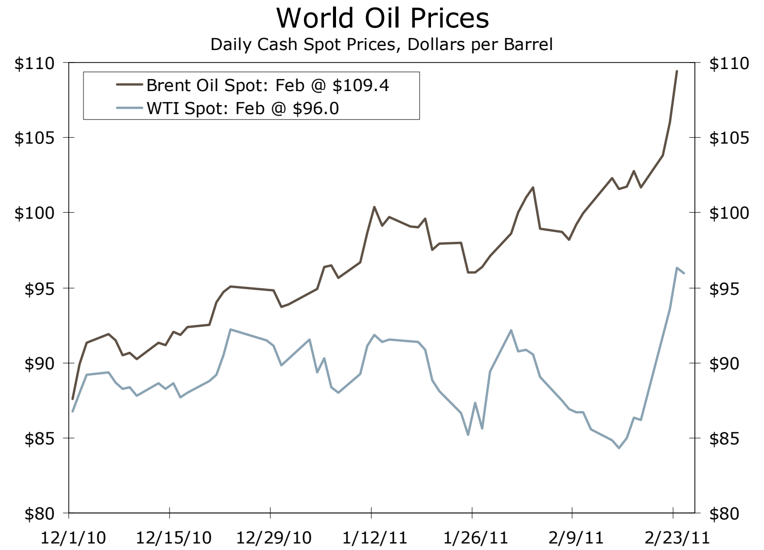
Going back to the previous surge in petroleum prices in July 2008, crude prices approaching $150 dollars will act as a drag on world economic growth when governments across the world are trying to put their fiscal accounts in order and are cutting subsidies normally established to prevent increasing prices from affecting the most needy sectors of the economy.

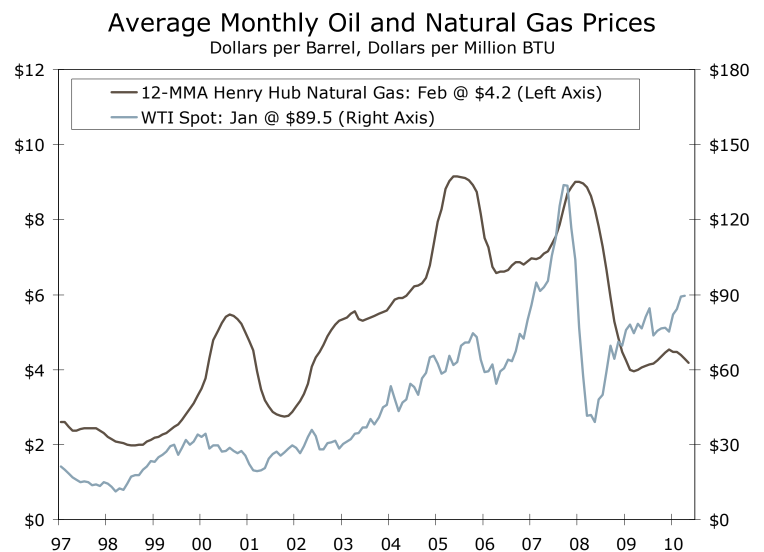
In fact, much of the current upheaval in the Middle East and North Africa has its roots on increasing food and energy prices, very similar to what happened during the previous surge in commodity prices in 2008.

Today, markets are speculating on the level of petroleum prices and on how high they could go. While it is very difficult to give a specific price for petroleum, the only certainty is that petroleum prices will likely remain elevated. However, as it is always the case, the increase in prices is bound by what consumers are willing to pay. In the United States, given what happened in 2008, $4.00 per gallon gasoline was enough to put downward pressure on quantity demanded for gasoline. Thus, while many are talking about oil prices doubling from current levels, if that ever happens, that price level will not last for long as lower worldwide growth will start putting downward pressure on prices.

The biggest problem, going forward, will be the inflationary consequences of these oil price levels for the world economy. With the world economy awash in liquidity we could see accelerating inflation across the globe as we are seeing today, which may prompt central bankers across the world to tighten monetary policy faster than our current expectation. If this happens, then world economic growth is probably bound to slow down going forward.





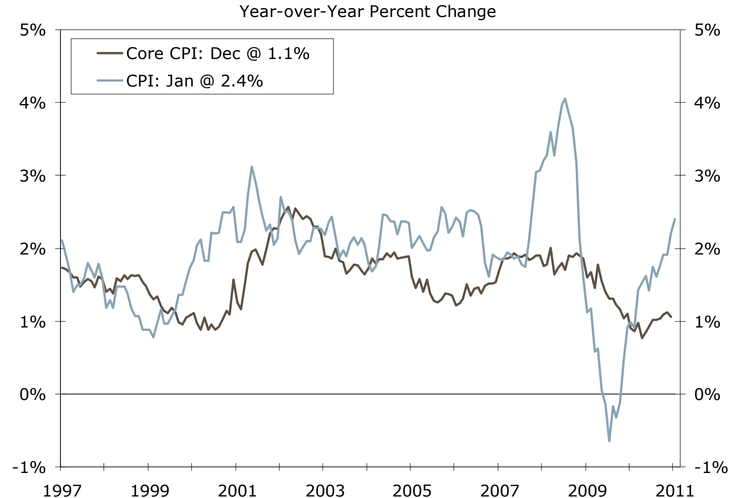


Eurozone CPI • Monday

Eurozone inflation continued to rise in December, up 2.2 percent from a year ago. The biggest contributor was fuels for transport, which accounted for about a quarter of the increase, followed by heating oil, vegetables and gasoline. While the recent increase in core inflation to 1.1 percent from a low of 0.8 percent in April suggests price increases are gradually being passed on to consumers, core inflation remains very low by historical standards. Thus, despite the recent surge in energy and food prices, the ECB has kept the main policy rate unchanged at 1.0 percent. Stubbornly high unemployment and austerity measures aimed at reducing sovereign budget deficits are further justifications for keeping rates low. The ECB is expected to keep rates unchanged at its March 4 meeting. However, further increases in core inflation may push up the time table for rate hikes. The flash estimate for February showed that the overall rate of inflation rose to 2.4 percent.

Previous: 2.2% **Wells Fargo: 2.38%**

Consensus: 2.4% (Year-over-Year)

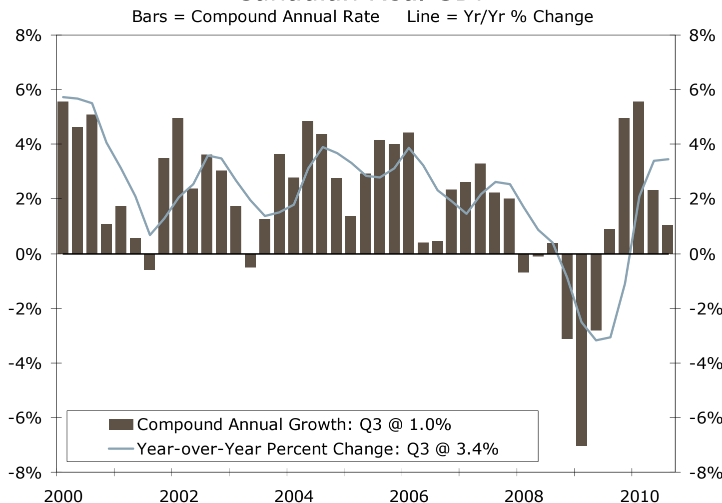


Canada GDP • Monday

Canada's economic growth slowed to a 1.0 percent annualized rate in the third quarter from 2.3 percent in the second quarter. The strong Canadian dollar restrained exports while supporting imports, led by robust growth in imports of machinery and equipment. Housing was also a drag on growth as residential investment fell 1.3 percent. A 0.9 percent rise in consumer spending and a 4.6 percent increase in business investment supported growth. Improving labor market conditions helped consumer spending while continued emphasis on productivity fueled business investment. Rising metals prices boosted mining output. The economy continued to strengthen in October and November as mining and oil extraction remained strong, while business investment and retailing also contributed. Trade also likely contributed to Q4 growth on very strong year-end exports. Home sales have risen, but residential construction remains weak.

Previous: 1.0% **Wells Fargo: 2.1%**

Consensus: 3.0% (CAGR)

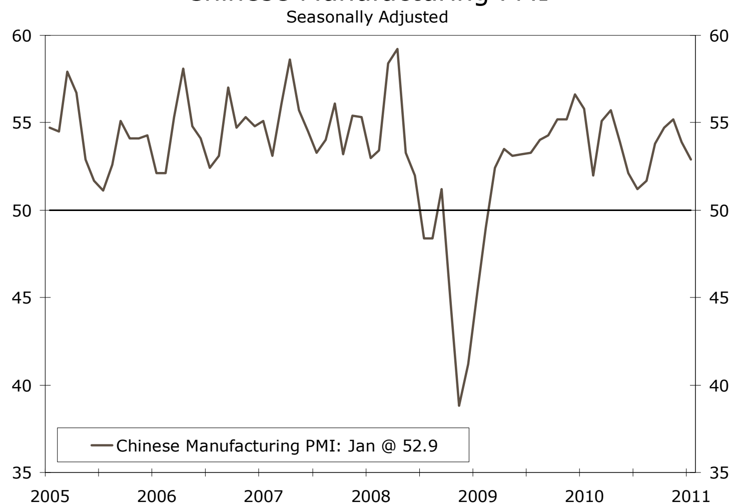


China Manufacturing PMI • Monday

China's manufacturing purchasing managers index (PMI) fell for the second straight month to 52.9 in January from 53.9 in December. Output, new orders, work backlogs and employment all fell. However, the data may have been somewhat distorted by the Chinese New Year. Nevertheless, the slowdown in Chinese manufacturing is welcome news to policy makers as they try to rein in inflation, which rose to 4.9 percent year over year in January, far outpacing the 1.4 percent rise seen in the United States, as China's growth continues to drive the global economic recovery. In an effort to restrain inflation, the central bank has raised interest rates three times by a total of 75 bps since October, while reserve requirements have repeatedly been raised and now stand at the highest in more than two decades. We expect the PMI to show another drop in February as the effects of these measures are felt.

Previous: 52.9

Consensus: 52.1



Interest Rate Watch

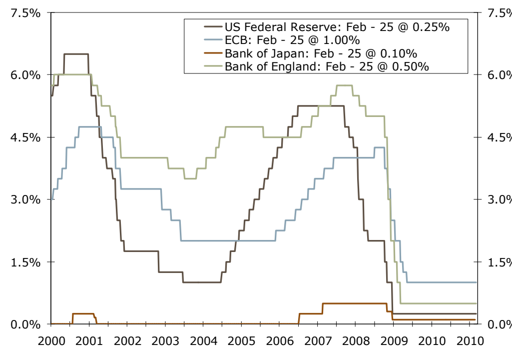
Risks Are Being Re-priced Again

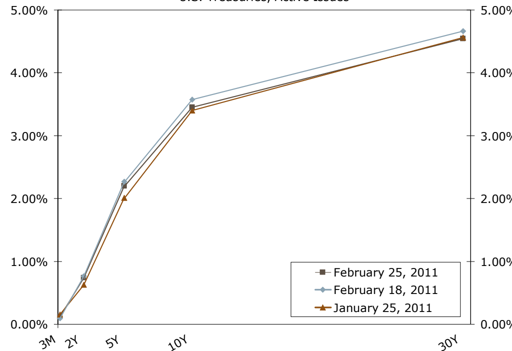
Lots of folks can be heard muttering that we should have seen it coming this week; as the protests that began in Tunisia late last year continue to spread throughout North Africa and the Middle East. The violent response to protests in Libya in Bahrain have raised the prospect that the transformation sweeping through the Arab world might create actual oil supply disruptions, which helped send oil prices up to $100 a barrel this week.

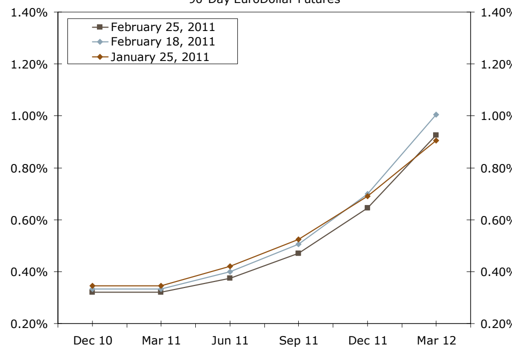
With the risks increasing, short-term risk premiums have risen over the past few days and the stock market has sold off. In comparison to the risk premium movements that followed the violent Greek street protests last spring, financial markets have been relatively resilient. As long as markets continue to re-price risks in an orderly fashion, the likelihood of the Federal Reserve pursing a third round of quantitative easing will actually decrease. The financial markets appear to have enough liquidity to withstand the current crisis and even held up well when unfounded rumors swept through the market.

The dollar has not behaved as would be expected. There has been no apparent flight to safety. Since the outset of the events in the Middle East/North Africa, the U.S. dollar has actually declined, falling 0.4 percent since Monday.

Even with a weaker dollar, Treasury prices have rallied. The yield on the Treasury's 10-year note fell 14 bps over the past week to 3.45 percent. The yield on the two-year note was essentially unchanged. The flatter yield curve likely reflects reduced expectations for economic growth in 2011 and, ironically, somewhat less concern about inflation. Our own expectations for inflation are a little higher than the Fed's, with the year-to-year change in the core CPI expected to rise 1.6 percent by the end of this year. We continue to believe the Fed will remain on hold through the early part of 2012. If oil prices rise substantially more than currently expected, economic growth would likely be lower and the Fed's first tightening would likely occur a bit later.







Consumer Credit Insights

Municipal Market Uncertainty

The municipal bond market has been ripe with fears about state and local bond defaults over the past few months. Since these fears were first introduced, several municipal analysts, including our own, have found little evidence to suggest that widespread municipal defaults will actually materialize. In recent weeks, government leaders have begun to provide their solutions to address growing concerns over budget gaps. These budget concerns have led some investors to question the relative risk of municipal bonds.

As the economy continues to turn around, most state and local governments have experienced a modest increase in revenue collections. However, the pace of revenue growth in the absence of federal stimulus dollars has made state and local budgeting increasingly more difficult. In addition, employment growth continues to add volatility to consumer-dependent tax revenues. The slower rate of revenue growth combined with increased fiscal demands from areas such as pension liabilities and healthcare program costs have resulted in another year of budget gaps that need to be addressed. Faced with these challenges, these governments have proposed significant spending cuts in order to adapt to the new slower growth environment. Until these governments finalize their budget decisions, uncertainty about the risk within the municipal market will likely persist.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.95%	5.00%	4.80%	5.05%
15-Yr Fixed	4.22%	4.27%	4.09%	4.40%
5/1 ARM	3.80%	3.87%	3.70%	4.16%
1-Yr ARM	3.40%	3.39%	3.26%	4.15%
MBA Applications				
Composite	476.0	420.4	441.8	549.5
Purchase	184.1	175.1	172.3	196.8
Refinance	2,177.2	1,848.6	2,025.2	2,605.3

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

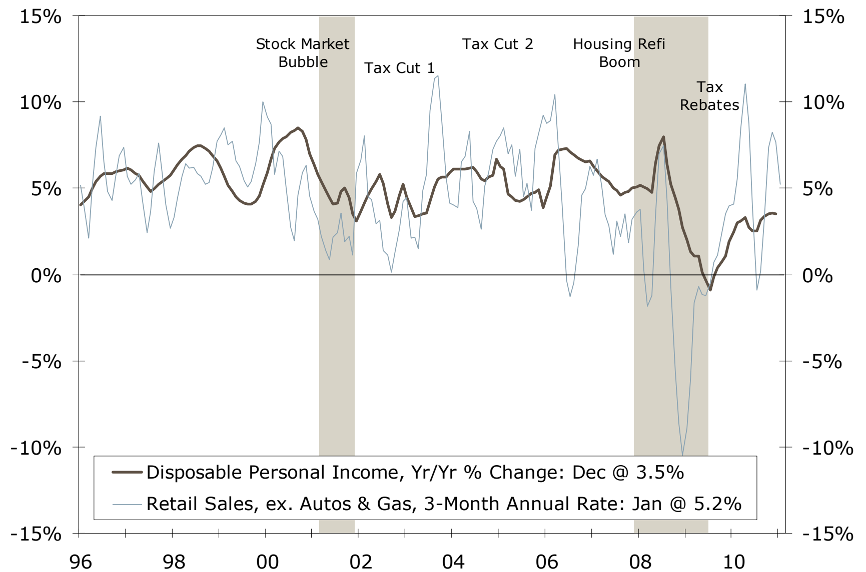
Topic of the Week

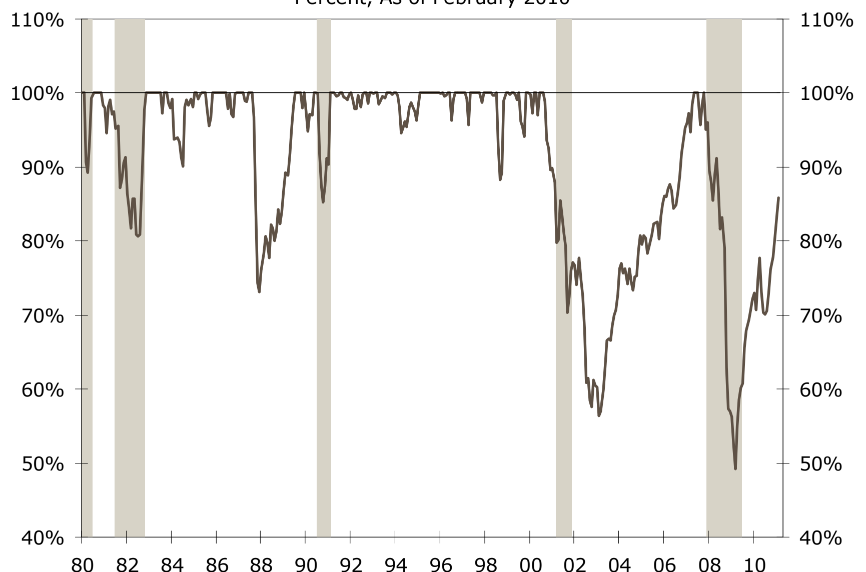
Sustained Higher Oil Prices Would Hurt Growth

As mentioned in our Global Review section on page 4, the continuation or extension of Egypt's crisis to include Libya changes the whole Middle East/North Africa-oil game. While Libya and Egypt are not large producers of oil with respect to global oil production, the problem is that the current crisis could continue to spread into other important oil-producing regions, such as Saudi Arabia, and more production could go off-line. If this happens and oil prices continue to rise on a sustained basis, our outlook for U.S. economic growth would be negatively affected.

If oil prices rise above $115 per barrel and remain there, discretionary income will take a hit from higher gasoline prices and rising transportation costs, affecting food prices, both directly and indirectly. Real after-tax income would be about 0.6 percent lower for 2011 if prices were to remain above $115 per barrel through the end of the year. Reduced after-tax income would restrain the rebound in consumer spending, shaving at least 0.3 percentage points off 2011 growth. The largest impact on consumer spending from a sustained increase in oil prices would be in the second quarter, when driving increases. With oil at $115 a barrel, second quarter real GDP growth could be a full percentage point lower than we currently project, putting growth at around 2 percent.

As long as conditions in the Middle East are worsening, short-term risk premiums will rise. The Federal Reserve will closely monitor financial markets to see if there is enough liquidity to withstand an energy shock and a flight to safety among investors. While a similar risk premium shock occurred in the wake of the Greek street protest last Spring, instability in the Middle East is far more important to the U.S. economy. The orderly re-pricing of risk that has taken place so far in markets, however, is an argument against another round of quantitative easing by the Fed. A sustained rise to above $150 for a barrel of oil would likely change this as the hit to short-term economic growth would be greater.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 2/25/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.12	0.09	0.11
3-Month LIBOR	0.31	0.31	0.25
1-Year Treasury	0.31	0.36	0.34
2-Year Treasury	0.74	0.75	0.82
5-Year Treasury	2.19	2.27	2.32
10-Year Treasury	3.44	3.58	3.63
30-Year Treasury	4.53	4.68	4.57
Bond Buyer Index	4.95	5.10	4.36

Foreign Exchange Rates

	Friday 2/25/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.373	1.369	1.355
British Pound ($/₤)	1.604	1.625	1.527
British Pound (₤/€)	0.856	0.843	0.888
Japanese Yen (¥/$)	81.810	83.180	89.080
Canadian Dollar (C$/$)	0.982	0.987	1.061
Swiss Franc (CHF/$)	0.932	0.945	1.080
Australian Dollar (US$/A$)	1.015	1.015	0.888
Mexican Peso (MXN/$)	12.119	12.033	12.805
Chinese Yuan (CNY/$)	6.576	6.575	6.827
Indian Rupee (INR/$)	45.325	45.210	46.414
Brazilian Real (BRL/$)	1.661	1.662	1.824
U.S. Dollar Index	77.357	77.664	80.787

Foreign Interest Rates

	Friday 2/25/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.05	1.03	0.60
3-Month Sterling LIBOR	0.80	0.80	0.64
3-Month Canadian LIBOR	1.21	1.21	0.40
3-Month Yen LIBOR	0.19	0.19	0.25
2-Year German	1.55	1.40	0.94
2-Year U.K.	1.42	1.53	0.96
2-Year Canadian	1.80	1.90	1.29
2-Year Japanese	0.25	0.24	0.16
10-Year German	3.16	3.25	3.11
10-Year U.K.	3.63	3.81	4.03
10-Year Canadian	3.30	3.48	3.40
10-Year Japanese	1.25	1.31	1.31

Commodity Prices

	Friday 2/25/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	96.92	86.36	78.17
Gold ($/Ounce)	1403.73	1389.53	1106.35
Hot-Rolled Steel ($/S.Ton)	845.00	810.00	630.00
Copper (¢/Pound)	437.65	448.00	319.25
Soybeans ($/Bushel)	12.93	13.41	9.43
Natural Gas ($/MMBTU)	3.87	3.87	4.77
Nickel ($/Metric Ton)	27,478	28,463	20,396
CRB Spot Inds.	612.19	621.43	484.04

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	28	1	2	3	4
U.S. Data	**Personal Income** December 0.4% January 1.4% (W)	**ISM Manufacturing** January 60.8 February 60.5 (W)		**ISM Non-Mfg** January 59.4 February 60.5 (W)	**Nonfarm Payrolls** January 36K February 180K (W)
	Personal Spending December 0.7% January 0.2% (W)	**Construction Spending** December -2.5% January -0.5% (W)		**Nonfarm Productivity** 4Q 2.6% 4q (F) 2.8%	**Unemployment Rate** January 9.0% February 9.0% (W)
	PCE Deflator December 1.2% January 1.3% (W)	**Total Vehicle Sales** January 12.54M February 12.60 (W)		**Unit Labor Cost** 4Q -0.6% 4q (F) -0.5%	**Factory Orders** December 0.2% January 1.7% (W)
Global Data	**China** **PMI (Manufacturing)** Previous (Jan) 52.9	**U.K** **PMI (Manufacturing)** Previous (Jan) 62.0	**Eurozone** **PPI (YoY)** Previous (Dec) 5.3%	**Eurozone** **GDP (QoQ)** Previous (Q3) 0.3%	
	Canada **GDP (CAGR)** Previous (Q3) 1.0%	**India** **Exports (YoY)** Previous (Dec) 36.4%	**U.K.** **PMI (Construction** Previous (Jan) 53.7	**Brazil** **GDP (QoQ)** Previous (Q3) 0.5%	

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

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