April 01, 2011

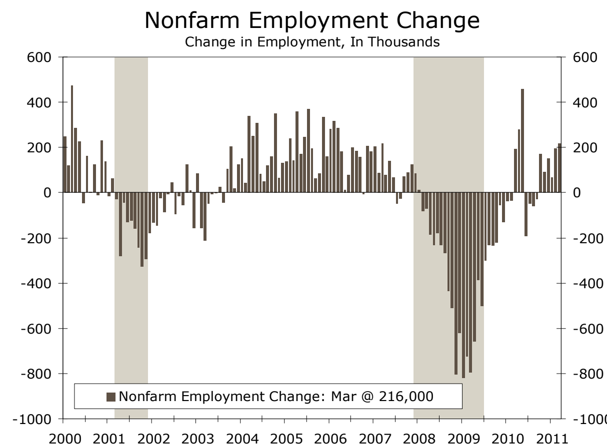
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

The Economic Expansion: Sustainable

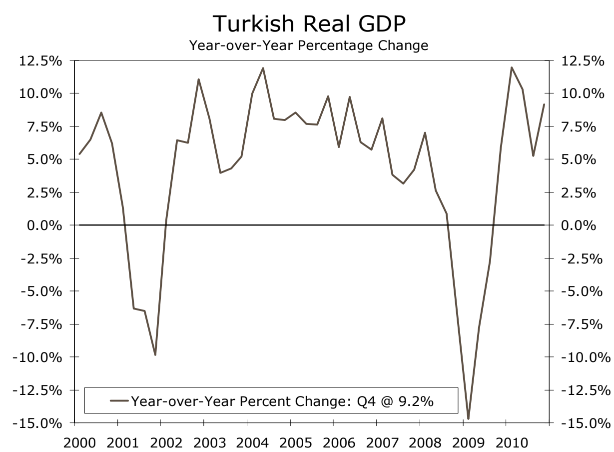
- Nonfarm employment grew by a better-than-expected 216,000 jobs in March. Private-sector jobs rose 230,000, with nearly broad-based gains and the unemployment rate fell to 8.8 percent with the labor force participation rate unchanged at 64.2 percent.
- Consumer confidence dropped sharply in March to its lowest level since December, following five straight monthly increases. The decline was entirely due to consumer expectations, which dropped more than 16 points in March and was likely fueled by rising gasoline prices.



Global Review

Turkey's Q4 GDP Jump Suggests Overheating

- Turkey's economic growth accelerated in the fourth quarter as strong domestic demand outweighed the continued drag from trade. Fixed investment and government spending also contributed to growth.
- Credit growth and the current account deficit are concerns for the central bank. The central bank hopes recent increases in required reserves will tamp down credit growth and help cool the economy. Low inflation has allowed the central bank to keep interest rates at record lows and prevent lira appreciation, which would hurt exports and widen the current account deficit.



Wells Fargo U.S. Economic Forecast

	Actual				Forecast				Actual			Forecast	
	2010				2011				2008	2009	2010	2011	2012
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	3.7	1.7	2.6	3.1	2.4	2.1	2.6	3.0	0.0	-2.6	2.9	2.5	2.9
Personal Consumption	1.9	2.2	2.4	4.0	1.8	1.9	2.2	3.0	-0.3	-1.2	1.7	2.4	2.5
Inflation Indicators [2]													
"Core" PCE Deflator	1.8	1.5	1.2	0.8	0.8	0.9	1.1	1.3	2.3	1.5	1.3	1.0	1.4
Consumer Price Index	2.4	1.8	1.2	1.2	2.2	3.3	3.5	3.4	3.8	-0.3	1.6	3.1	2.6
Industrial Production [1]	8.1	7.1	6.7	3.7	5.7	3.9	4.1	3.9	-3.3	-11.1	5.3	4.9	3.9
Corporate Profits Before Taxes [2]	37.6	37.0	26.4	18.3	8.2	6.2	6.2	6.7	-16.4	-0.4	29.2	6.8	7.0
Trade Weighted Dollar Index[3]	76.1	78.8	73.6	73.2	70.5	73.0	74.0	75.0	74.3	77.7	75.6	73.1	78.0
Unemployment Rate	9.7	9.6	9.6	9.6	8.9	8.7	8.5	8.4	5.8	9.3	9.6	8.6	8.2
Housing Starts[4]	0.62	0.60	0.59	0.53	0.55	0.58	0.64	0.70	0.90	0.55	0.59	0.62	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	4.95	5.20	5.25	5.30	6.04	5.04	4.69	5.18	5.63
10 Year Note	3.84	2.97	2.53	3.30	3.47	3.70	3.75	3.80	3.66	3.26	3.22	3.68	4.13

Forecast as of: April 1, 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

Inside

Together we'll go far

U.S. Review

The Economic Expansion Is Gaining Momentum

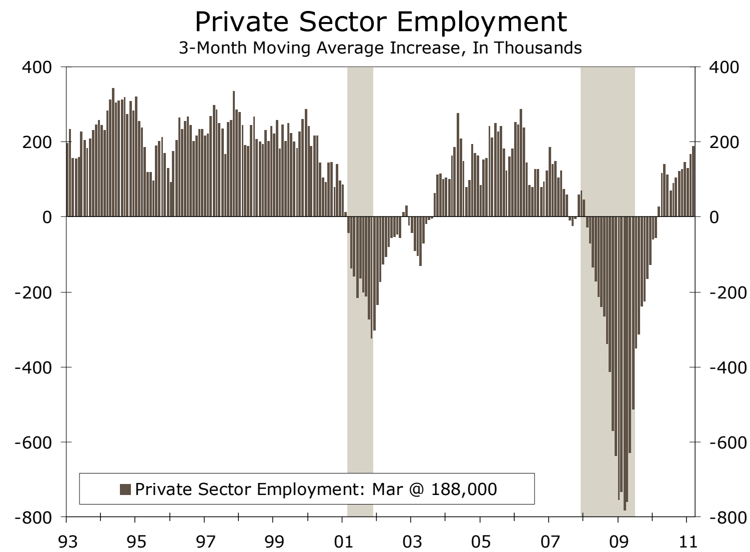
This week's schedule of economic reports continues to suggest economic expansion. Some of the more leading indicators, such as initial jobless claims and pending home sales, posted solid gains, providing a glimmer of hope for upcoming economic data. The most encouraging news was the increase in nonfarm employment, which grew by a better-than-expected 216,000 jobs in March. Private-sector jobs rose 230,000, with nearly broad-based gains. The unemployment rate fell to 8.8 percent with the labor force participation rate unchanged at 64.2 percent.

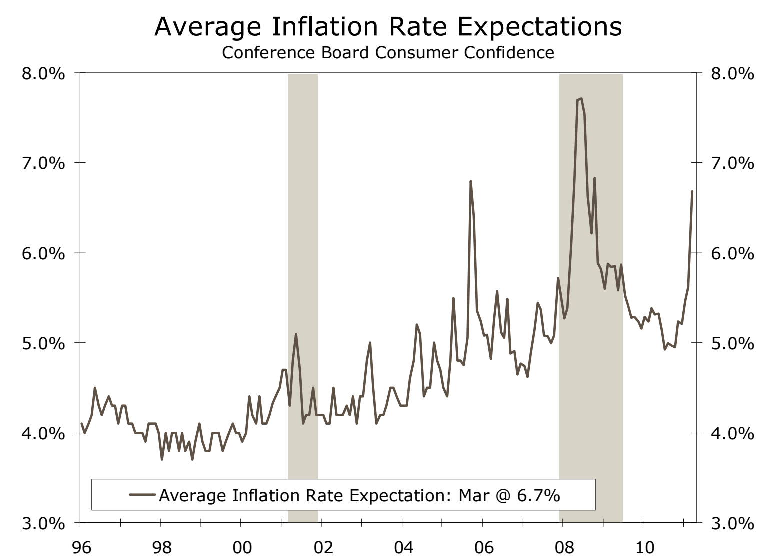
While these reports are encouraging, consumer confidence painted a far more cautious picture. Consumer confidence dropped sharply in March to its lowest level since December, following five straight monthly increases. The decline was due to consumer expectations, which dropped more than 16 points in March. Rising gasoline prices and uncertainty on Japan and the Middle East likely helped drive the significant decline.

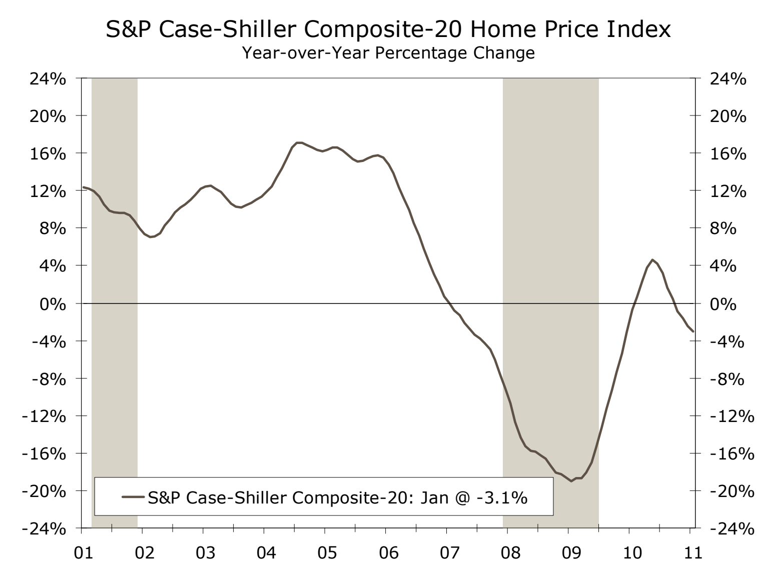
Along with a more pessimistic consumer economic outlook, inflation expectations over the next year jumped to their highest level since July 2008. Inflation expectations are a key driver of inflation and long-term rates, so a significant increase warrants further interest. That said, the personal income and spending report was also released this week, which includes the Fed's preferred inflation gauge, the core PCE deflator. On a year-ago basis, the core PCE deflator, which excludes food and energy, rose 0.9 percent, which remains on the low side of the Fed's comfort zone. On the headline, however, the PCE deflator increased 1.6 percent. Consumers are seeing higher prices at the pump and at the grocery store, which are fueling higher inflation expectations. While we expect the rate of inflation to pick up this year, we are looking for only modest gains.

We also do not expect to see a jump in interest rates at the long end of the curve. A simple regression between the consumer confidence inflation expectations over the next year and the 10-year Treasury yield tells us that a one basis point increase in inflation expectations could lead to a 20 basis point increase in the yield on the 10-year U.S. Treasury over the next year. The results suggest the 10-year Treasury yield, which now sits at 3.5 percent, could reach 3.7 percent next year, which is in line with our 2011 forecast.

With the exception of pending home sales, housing market indicators released during the week continue to show weakness. The S&P/Case Shiller 20-City Index fell 0.2 percent on a seasonally adjusted basis in January. Home prices are expected to continue to decline over the next six to nine months, eventually bringing the peak-to-trough decline to 38 percent. The Achilles' heel for home prices continues to be the increasing amount of homes in foreclosure, which put downward pressure on home prices. Even more troubling is the amount of shadow inventory yet to hit the market. According to CoreLogic, pending supply (seriously delinquent loans, foreclosures and real estate owned by lenders not listed) is estimated at 1.8 million units.





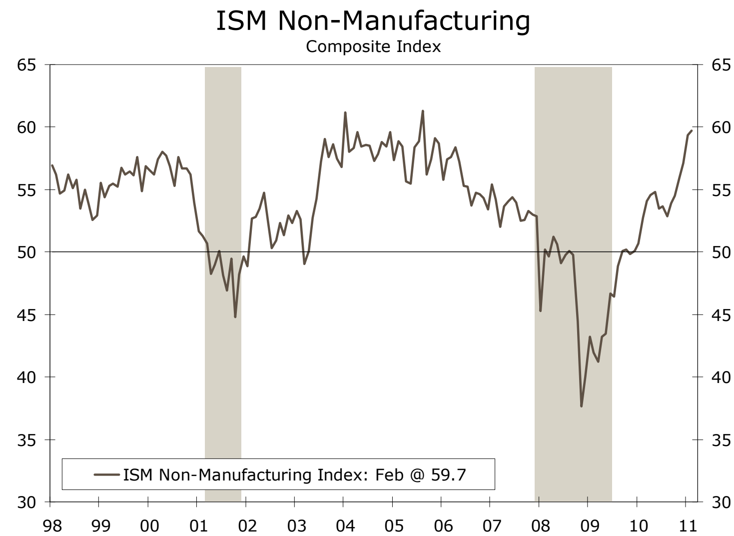


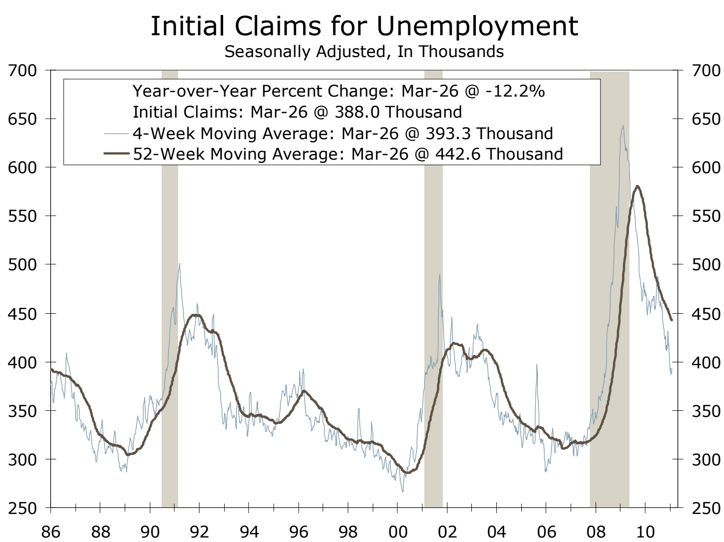
ISM Non-Manufacturing • Tuesday

The ISM non-manufacturing index rose further in February to 59.7 from January's 59.4. Several subcomponents of the index rose for the month, most notably the business activity index, which climbed to 66.9, a 2.3 percent increase for the month. New orders continued to grow in February, but at a slower pace, as the index value slipped from 64.9 to 64.4 in February. One trend that is starting to emerge is the increase in the prices paid component, which rose for the sixth straight month in February. This is one of many indictors that have begun to point toward high input costs over the past few months, which, in turn, may put some downward pressure on corporate profits in the first half of this year. The employment component increased to 55.6 from 54.5, continuing to signal strong job growth in the service sector. We forecast that the ISM non-manufacturing index continued to climb in March, increasing to 60.0.

Previous: 59.7 **Wells Fargo: 60.0**

Consensus: 59.9





Initial Jobless Claims • Thursday

Last week, jobless claims continued to trend downward, declining to 388,000 from the prior week's 394,000. The four-week moving average, at 394,000, remains below the critical 400,000 level that typically signals stronger job growth. Looking at the claims data on a regional basis, California, which makes up 17.2 percent of the claims as of last week, has posted a 9.8 percent decline on a year-over-year basis. Other notable states that have posted significant declines in jobless claims include Michigan, declining by 5.6 percent, Florida, declining by 3.9, and Georgia, declining 3.7 percent on a year-over-year basis. The continued downward trend in initial claims across several states with diverse employment bases supports our view of greater job growth that is more widespread across different industries and regions of the country.

Previous: 388K

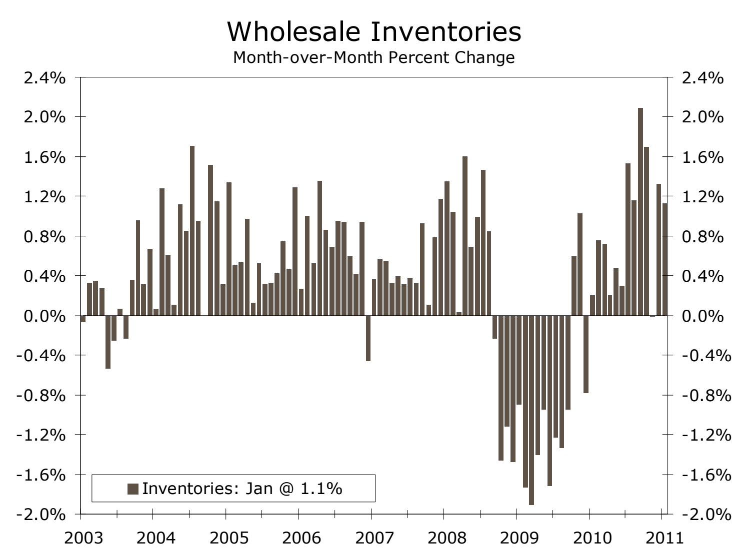
Consensus: 384K

Wholesale Inventories • Friday

Wholesale inventories rose 1.1 percent in January, led by increases in durable and nondurable goods. Automotive inventories rose 4.1 percent, while computer inventories edged upward by 4.1 percent. Sales among wholesalers climbed 3.4 percent for the month, which can be attributed to stronger auto and petroleum sales. The inventory-to-sales ratio, a measure of the number of months of inventory on hand, declined slightly to 1.13 months from 1.15 in December. The stronger sales numbers pulled the ratio down, which should translate to stronger industrial production over the next few months. This is consistent with our view of modest industrial production growth and inventory building over the next few quarters as consumer demand begins to pick up at the same time that demand for capital goods remains strong.

Previous: 1.0%

Consensus: 1.1% (Month-over-Month)



Global Review

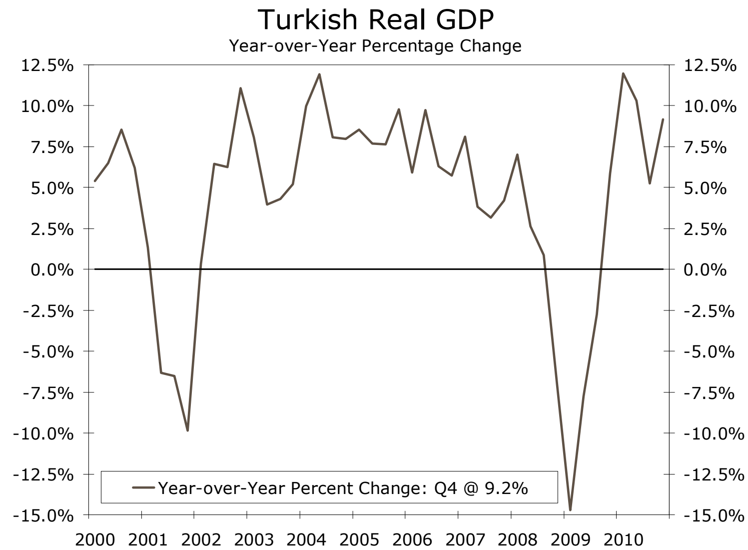
Possibility of Overheating in Turkey Presents Challenges

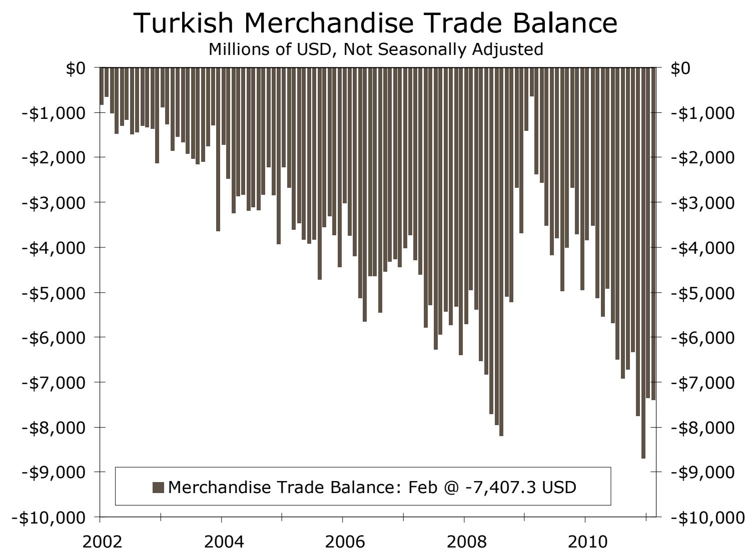
Turkey's economy expanded 9.2 percent year-over-year in the fourth quarter, up from 5.2 percent in the third quarter. This was second only to China's 9.8 percent in the fourth quarter among the Group of 20 major economies. For all of 2010, the economy expanded 8.9 percent. Driving fourth-quarter growth was a strong 9.0 percent year-over-year jump in household consumption, which accounted for about two-thirds of annual growth. Also providing support were a 42 percent surge in fixed investment and a 3.9 percent increase in government spending. However, trade remained a drag on growth as exports rose 4.3 percent, while imports soared by 25.4 percent.

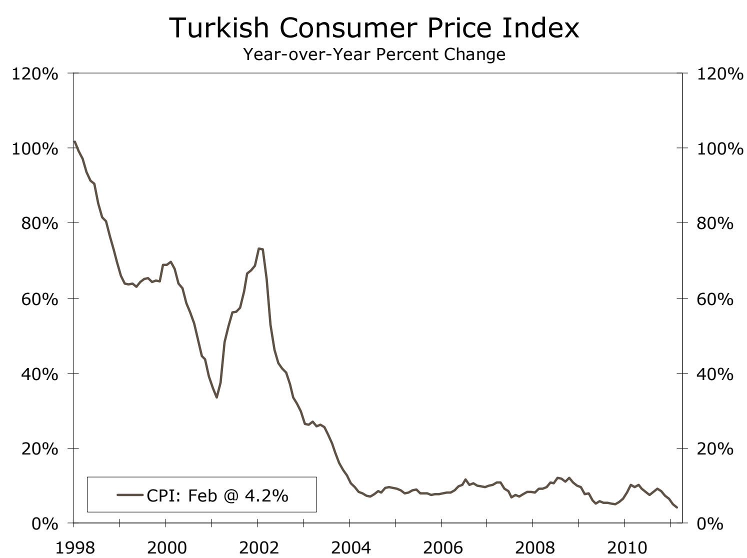
A big concern for the central bank has been the continued swift growth of credit, which is currently expanding at about a 30 percent to 40 percent year-over-year clip. The government would like to see this scaled back to about 25 percent. As such, the central bank hiked reserve requirements on March 23 by an average of 400 bps. While this is intended to slow credit growth, most banks are not planning to slow lending much. The central bank has raised reserve requirements rather than interest rates in an attempt to cool the economy without attracting more speculative capital inflows and pushing up the value of the lira. A strong lira would reduce the competitiveness of Turkey's exports. With the trade deficit already near unsustainable levels and the current account deficit continuing to widen as a result, tighter monetary policy is not the best option to steer the economy toward a soft landing. The best option would be tighter fiscal policy. However, with elections looming in June, it is likely that government spending will increase as Prime Minister Erdogan attempts to keep the masses complacent and win their support.

Strong domestic demand has fueled robust industrial production, which was up 18.9 percent in January from a year ago. Rising employment and wages, along with improving consumer confidence, have spurred strong household spending and kept the factories humming. Even so, inflation remains benign, coming in at just 4.2 percent year-over-year in February, a record low. Although oil and commodity prices have risen, prices for clothing, tobacco and some services have dropped, keeping inflation low. The high base of comparison due to tax increases at the beginning of 2010 is also contributing to the low inflation numbers.

Low inflation has allowed the central bank to refrain from raising interest rates. However, the central bank is expecting further increases in oil and commodity prices to push inflation higher in the coming months. This will put a wrench in the government's attempts to slow the economy without hurting exports. Sooner or later the central bank will likely be forced to raise interest rates, which could put upward pressure on the lira, restrain exports and lead to a further widening of the current account deficit, which could be exacerbated by high prices for oil imports. The wider the current account deficit, the more dependent the country is on capital inflows, and the more vulnerable the currency and the economy are to changes in investor sentiment. In these volatile times, instability is a greater concern than in prior election years.

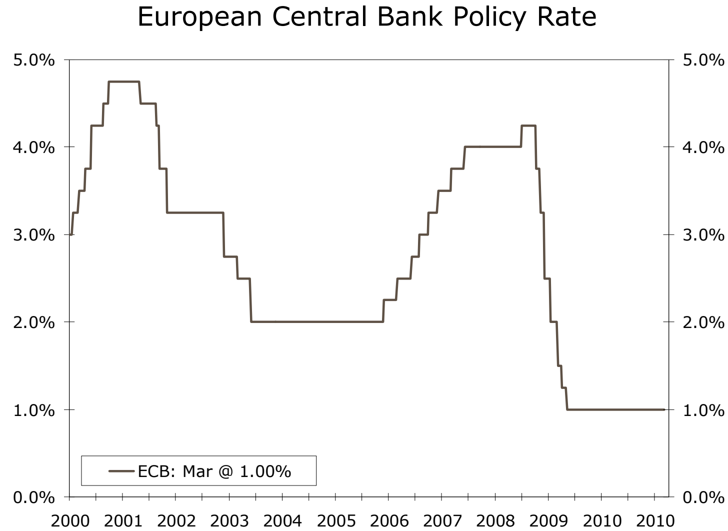






ECB Rate Decision • Thursday

At its most recent meeting, the European Central Bank (ECB) left rates unchanged, but ECB President Jean-Claude Trichet made clear the intention to begin raising rates, citing the need for “strong vigilance” with respect to containing inflation. Consumer prices rose 2.4 percent on a year-over-year basis in February. Given the rising price pressure in commodities, particularly crude oil, there is plenty of evidence of building inflationary pressure. Given the terms of the ECB’s mandate and our inflation outlook for the Eurozone, we believe the ECB will raise its policy rates by 25 bps at its meeting next week, its first rate hike in three years.

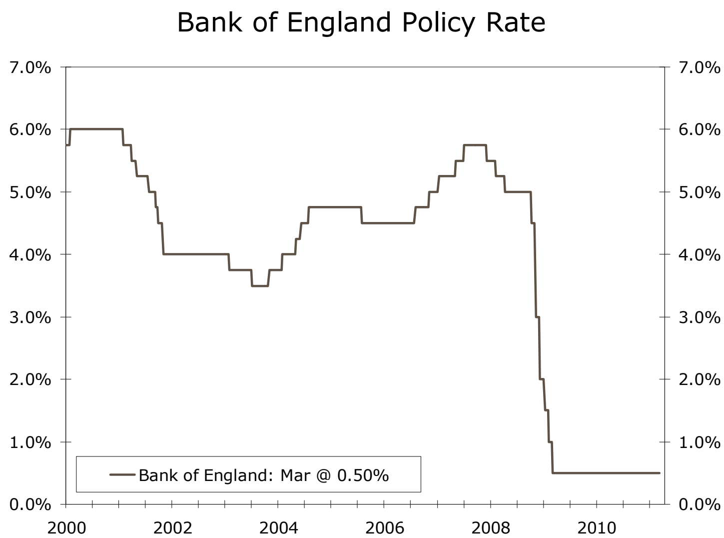


Previous: 1.00% **Wells Fargo: 1.25%**

Consensus: 1.25%

Bank of England Rate Decision • Thursday

British CPI inflation has been above three percent for more than a year. The Bank of England’s (BoE) sole monetary policy objective is to maintain price stability, though it is afforded some flexibility in uncertain economic times. Initially, the BoE expected sluggish economic growth to eventually bring inflation back within the target range. However, inflation has failed to recede as widely expected, and the recent run-up in food and commodity prices makes it appear increasingly likely that the overall rate of CPI inflation may not be retreating anytime soon. In our view, the BoE will choose to maintain credibility by raising rates to bring inflation back in line with its two percent target. But, the move may not come at the meeting next week. Real GDP growth slipped back into negative territory in the fourth quarter, and despite the sole mandate of price stability, we think the BoE will wait until the economy appears to be on firmer footing.



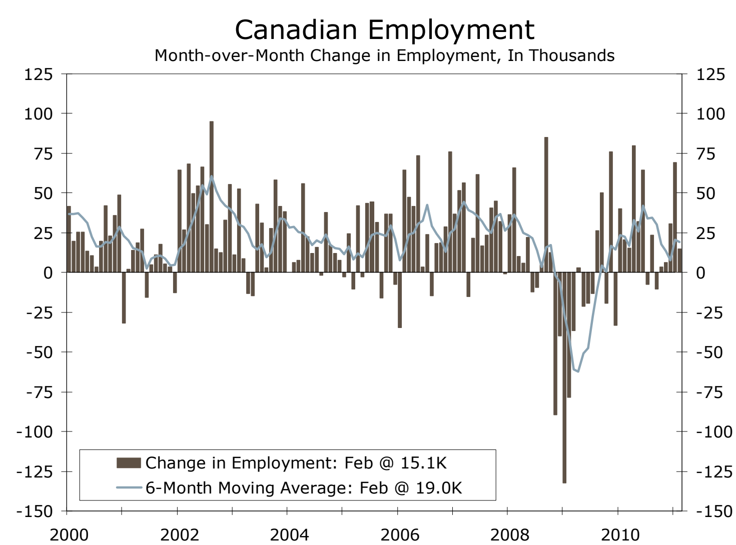
Previous: 0.50% **Wells Fargo: 0.50%**

Consensus: 0.50%

Canadian Employment Report • Friday

Canadian payrolls grew for the fifth straight month in February. The gain was less than the consensus had expected, and the details were somewhat disappointing. While the total number of people employed increased, the number of full-time jobs actually dropped 23,800 workers in the month. The growth in part-time jobs lifted the headline number to positive territory.

Subsequently, we learned that retail sales dropped off a bit in January. Taken together, these reports might raise some questions about the strength of consumer spending in Canada. That said, we are not too concerned. The drop in sales had a lot to do with a big decline in auto sales, and the jobs miss will only become a worry if it turns out to be the start of a new trend. Next Friday (April 8), we will get a more contemporary number on the Canadian job market when the jobs report for March prints at 8:30 a.m.



Previous: 15.1K

Consensus: 30.0K

Interest Rate Watch

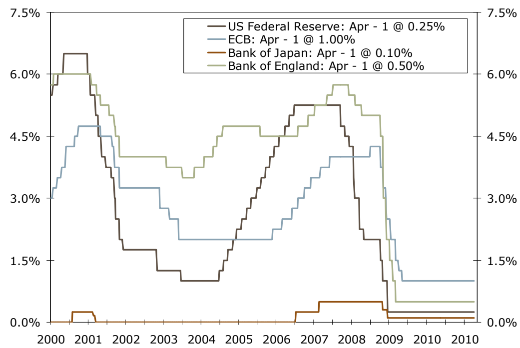
Payroll Report not a Game Changer

The immediate market reaction to the employment report today was for the yield curve to steepen. That is, yields in the two- to five-year part of the curve rose more than very short-term rates. The market reaction seems reasonable to us. The stronger-than-expected employment report, as welcome as the new is, was probably not robust enough to lead to near-term tightening by the Federal Reserve.

In our view, the Fed would need to see a number of months in which payroll gains exceed 300,000 or so to lead it to begin to hike rates. Indeed, at the commencement of the last tightening cycle in 2004, increases in nonfarm payrolls had averaged 300,000 for three months before the Fed felt comfortable enough to start tightening policy. Although we look for further employment gains in the months ahead, we do not expect increases of 300,000 per month on a sustained basis. Although the Fed may bring a premature end to its second round of quantitative easing, we still believe that the FOMC will not begin to hike rates until early next year. (For more details, see our *Monthly Economic Outlook* for April, which we expect to post on our website by midweek.)

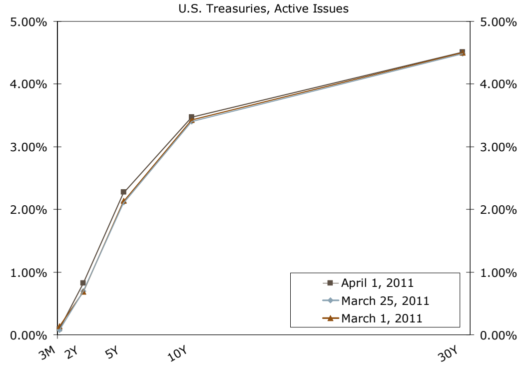
Meanwhile, a rate hike by the European Central Bank on April 7 seems like a virtual certainty (see the Topic of the Week on the next page). ECB President Trichet strongly hinted at that possibility following the policy meeting last month, and Jürgen Stark, an influential member of the Governing Council, essentially argued for higher rates in an op-ed piece in the *Financial Times* this week. The final nail in the coffin was the higher-than-expected CPI inflation data that were released this week. Preliminary data show the overall CPI inflation rate rising from 2.4 percent in February to 2.6 percent in March, the highest rate in more than two years. Although food and energy probably accounted for most of the increase—underlying details will not be released for a few more weeks—the higher-than-expected print undoubtedly has sent a chill down the spine of the inflation-phobic ECB.

Central Bank Policy Rates



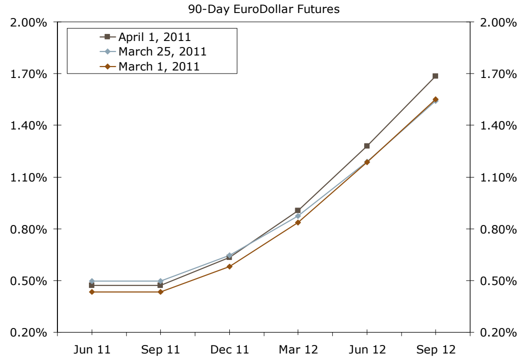
Yield Curve

U.S. Treasuries, Active Issues



Forward Rates

90-Day EuroDollar Futures



Credit Market Insights

Rise of the Machines

Loans outstanding at commercial banks are down for all loan categories on a year-ago basis. However, since bottoming in the third week of September, commercial and industrial (C&I) loans are up 2.7 percent, while all other categories have declined since that point. C&I loans are used to provide working capital or finance capital expenditures and correlate somewhat strongly with investment in equipment and software (E&S). Investment in E&S is up 22 percent since bottoming in the first quarter of 2009, a quarter after corporate profits bottomed. During the same period, employment has declined 2.0 percent as companies have focused on improving productivity rather than adding to payrolls to meet improving demand. The abrupt increase in capital intensity is even more striking when we look at the correlation between E&S investment and employment. From the first quarter of 1950 to the peak of E&S investment in the first quarter of 2008, the correlation was 91 percent. However, since that time (11 quarters), the correlation has plunged to just 36 percent. Comparing to prior cycles, the correlation was 73 percent 11 quarters after the 2000 peak and 98 percent 11 quarters after the 1981 peak. It was at 32 percent after the 1989 peak, so there is some precedent for a weak correlation at this stage of the cycle. This focus on investment in machines versus people is good for C&I loan demand, but it does not bode well for job seekers or consumer loan demand in the near term.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.86%	4.81%	4.87%	5.08%
15-Yr Fixed	4.09%	4.04%	4.15%	4.39%
5/1 ARM	3.70%	3.62%	3.72%	4.10%
1-Yr ARM	3.26%	3.21%	3.23%	4.05%
MBA Applications				
Composite	485.3	524.4	445.1	602.8
Purchase	188.5	191.7	172.8	243.0
Refinance	2,222.5	2,471.2	2,034.7	2,707.8

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

Topic of the Week

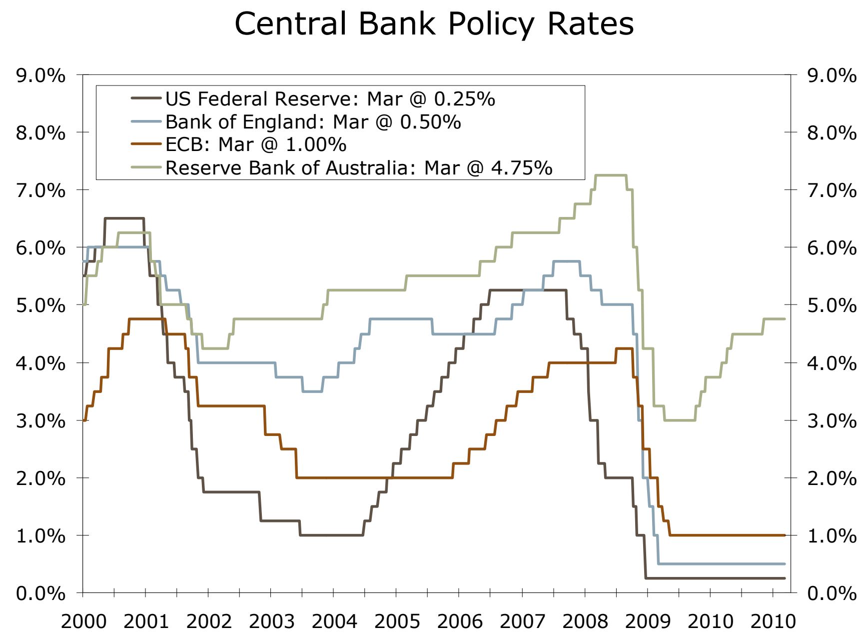
Two-Speed Recovery, Two-Speed Tightening

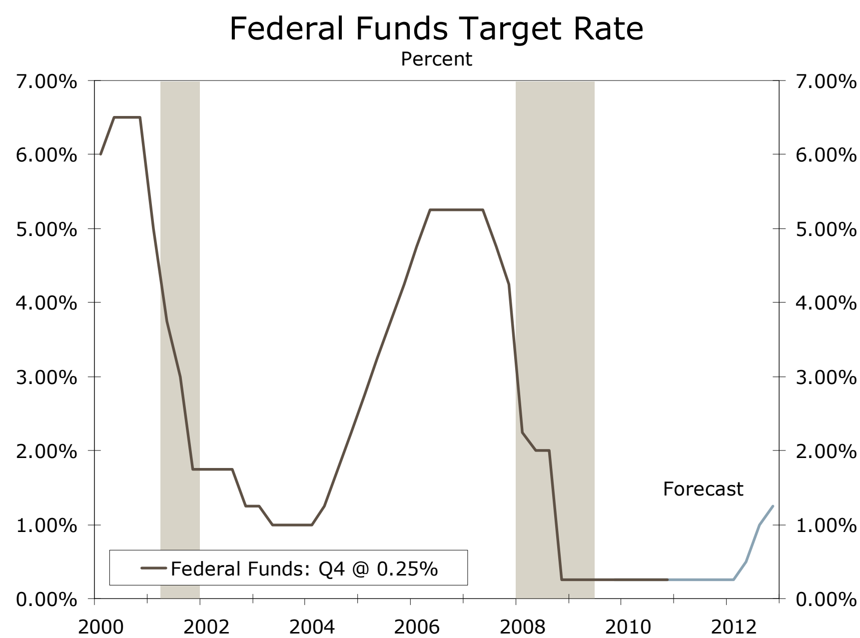
The developed economies are faring very differently in the wake of the global recession. The economies of Australia and Canada are firmly in expansion territory, while economies in the Eurozone and the United Kingdom are still striving to get output back to pre-recession levels. The U.S. economy is somewhere in between, having just recently surpassed its pre-recession peak in real GDP. The already-fragile recovery in Japan was dealt a serious blow by the recent earthquake and the still-unfolding developments related to that tragedy.

Canada and Australia have had very strong growth relative to the rest of the developed world, and their central banks have acted accordingly. Both central banks raised interest rates multiple times in 2010 and are likely to continue hiking this year.

Although the conversation about central bank activity in Australia and Canada is focused on when the current tightening cycle will resume, discussion about European monetary policy is a question of when rate hikes will begin. Both the European Central Bank (ECB) and the Bank of England (BoE) began cutting rates in October 2008 when the financial crisis rattled markets around the world and have kept rates on hold at these low levels since mid-2009. But, the ECB is particularly hawkish, and rising commodity and oil prices have fueled inflationary pressure. We believe the ECB will raise rates at its April 7 meeting, and the BOE may soon follow suit.

While the ECB's and the BOE's mandates are focused entirely on prices, the Fed's dual mandate takes into account the employment picture. Although employment growth is gaining momentum, we are still far from full employment or even the level of employment we enjoyed prior to the recession. In addition, the Fed's QE2 program is set to expire this summer; raising rates while purchasing Treasury securities is self-defeating and a very unlikely course of action. For further reading, see our recent special report, *The Outlook for Central Bank Policy Rates* on our website.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 4/1/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.07	0.08	0.15
3-Month LIBOR	0.30	0.31	0.29
1-Year Treasury	0.30	0.29	0.39
2-Year Treasury	0.81	0.73	1.06
5-Year Treasury	2.25	2.16	2.59
10-Year Treasury	3.46	3.44	3.87
30-Year Treasury	4.51	4.50	4.73
Bond Buyer Index	5.00	4.91	4.44

Foreign Exchange Rates

	Friday 4/1/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.421	1.409	1.359
British Pound ($/£)	1.613	1.604	1.529
British Pound (£/€)	0.881	0.878	0.889
Japanese Yen (¥/$)	84.110	81.340	93.820
Canadian Dollar (C$/$)	0.963	0.981	1.009
Swiss Franc (CHF/$)	0.925	0.920	1.054
Australian Dollar (US$/A$	1.039	1.026	0.921
Mexican Peso (MXN/$)	11.832	11.992	12.322
Chinese Yuan (CNY/$)	6.548	6.557	6.826
Indian Rupee (INR/$)	44.585	44.756	44.918
Brazilian Real (BRL/$)	1.617	1.662	1.765
U.S. Dollar Index	75.950	76.217	80.776

Foreign Interest Rates

	Friday 4/1/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.19	1.15	0.58
3-Month Sterling LIBOR	0.82	0.82	0.65
3-Month Canadian LIBOR	1.20	1.20	0.41
3-Month Yen LIBOR	0.20	0.20	0.24
2-Year German	1.82	1.73	0.95
2-Year U.K.	1.38	1.28	1.15
2-Year Canadian	1.84	1.73	1.73
2-Year Japanese	0.22	0.21	0.18
10-Year German	3.37	3.28	3.09
10-Year U.K.	3.72	3.61	3.92
10-Year Canadian	3.38	3.24	3.56
10-Year Japanese	1.29	1.23	1.36

Commodity Prices

	Friday 4/1/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	107.84	105.40	84.87
Gold ($/Ounce)	1426.95	1429.74	1126.80
Hot-Rolled Steel ($/S.Ton	880.00	875.00	700.00
Copper (¢/Pound)	425.15	440.85	357.70
Soybeans ($/Bushel)	13.93	13.34	9.26
Natural Gas ($/MMBTU)	4.34	4.40	4.09
Nickel ($/Metric Ton)	26,075	27,191	24,960
CRB Spot Inds.	627.38	626.56	503.61

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	4	5	6	7	8
U.S. Data		**ISM Non-Mfg** February 59.7 March 60.0 (W)		**Consumer Credit** January $5.014B February $4.50B (C)	**Wholesale Inventories** January 1.1% February 1.1% (C)
Global Data	**Germany** **Retail Sales (MoM)** Previous (Jan) 0.4%	**Japan** **IP (YoY)** Previous (Jan) 3.5%	**Australia** **Retail Sales (MoM)** Previous (Jan) 0.4% **Japan** **Retail Trade (MoM)** Previous (Jan) 4.1%	**Eurozone** **CPI (YoY)** Previous (Feb) 2.4% **Canada** **GDP (MoM)** Previous (Dec) 0.5%	**Japan** **Tankan Survey** Previous (Q4) 5 **U.K.** **PMI Mfg.** Previous (Feb) 61.5

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

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