April 15, 2011

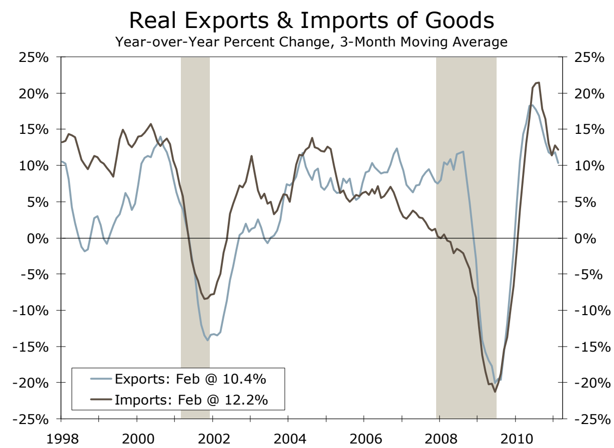
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

A Downside Surprise from Trade and Inventories

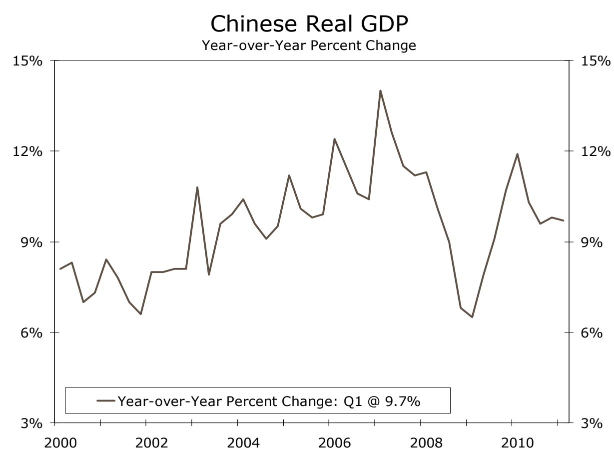
- The U.S. trade deficit remained well above consensus expectations in February as exports declined sharply. Imports declined in February as well, though the pace of decline was tempered somewhat by oil price increases. There was also an upward revision in January's trade deficit, prompting another round of downward revisions in Q1 GDP estimates from economists.
- Business inventories were also weaker than expected in February as retail auto inventories plunged 1.4 percent. Inventory increases for manufacturers and wholesalers remained weak, suggesting less of a boost for Q1 GDP.



Global Review

Chinese Economy Keeps Humming Along

- Real GDP in China grew 9.7 percent in the first quarter, which is only a miniscule slowdown relative to the 9.8 percent rate that was registered in the preceding quarter. Growth in domestic demand appears to have remained very robust in the first quarter.
- Inflationary pressures continue to rise. In response, Chinese authorities likely will continue to tighten policy. Not only do we expect policymakers to sanction further rate hikes, but we look for further appreciation of the Chinese renminbi in the months ahead.



Wells Fargo U.S. Economic Forecast

	Actual 2010 1Q	2Q	3Q	4Q	Forecast 2011 1Q	2Q	3Q	4Q	Actual 2008	2009	2010	Forecast 2011	2012
Real Gross Domestic Product [1]	3.7	1.7	2.6	3.1	1.8	2.0	2.9	2.9	0.0	-2.6	2.9	2.4	2.8
Personal Consumption	1.9	2.2	2.4	4.0	2.2	1.9	2.1	2.9	-0.3	-1.2	1.7	2.5	2.3
Inflation Indicators [2]													
"Core" PCE Deflator	1.8	1.5	1.2	0.8	0.9	1.0	1.3	1.7	2.3	1.5	1.3	1.2	1.8
Consumer Price Index	2.4	1.8	1.2	1.2	2.2	3.4	3.7	3.9	3.8	-0.3	1.6	3.3	3.3
Industrial Production [1]	8.1	7.1	6.7	3.2	6.0	4.4	4.1	3.9	-3.3	-11.1	5.3	5.0	4.0
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	70.6	71.0	72.0	73.0	74.3	77.7	75.6	71.6	75.5
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	1.19
Conventional Mortgage Rate	4.97	4.74	4.35	4.71	4.84	5.20	5.25	5.30	6.04	5.04	4.69	5.15	5.70
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	4.23

Forecast as of: April 15, 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

U.S. Review

U.S. Economic Indicators Turn Less Rosy

More economic data emerged this week showing that the recent spike in gasoline and oil prices is having negative effects on our economy and the prospects for future growth. According to the National Federation of Independent Business, small business optimism slipped to 91.9 in March from 94.5 in February. This was well below the six-month average of 93.0. Plans to hire slipped to 2.0 percent from 5.0 percent. Small businesses appear to be increasingly squeezed by higher prices and still weak demand. Of those surveyed, a net 32 percent reported weaker earnings in March, a deterioration from a net 27 percent in February and the worst reading since last December.

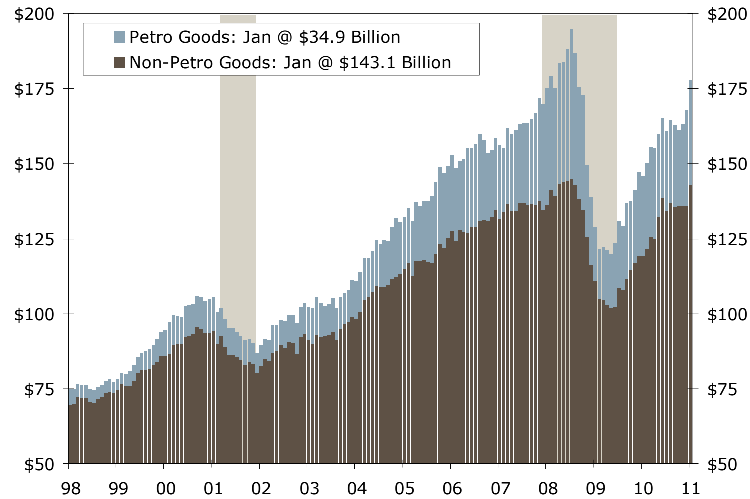
The U.S. trade deficits for January and February provided more fuel for those bearish on the economy's performance. Demand from abroad appears to be slowing down as inflation causes many faster growing emerging markets to tighten monetary policy and restrict loan growth. Exports took a surprising plunge in February, falling 1.4 percent, the largest decline since last fall. At the same time, rapid increases in oil prices have been pushing up oil imports in the United States even though import volumes for oil fell in February. Net exports are expected to be a sizable 1.5 percentage point net drag on GDP growth in the first quarter.

U.S. inflation measures for March increased on higher oil and gasoline prices. U.S. producer price inflation for March was somewhat below consensus expectations, though it still increased at a sizable 0.7 percent on the month with the year-on-year growth rate rising to 5.8 percent from 5.6 percent. Gasoline prices jumped 5.7 percent during the month, while energy prices rose 2.6 percent. Those price gains were tempered by price declines for residential gas, prescription drugs, computers and even a surprising decline in food prices. Core producer price inflation increased by a tenth to 1.9 percent from a year ago. We expect core inflation to rise gradually throughout the year as prices in other areas of the economy follow energy prices higher.

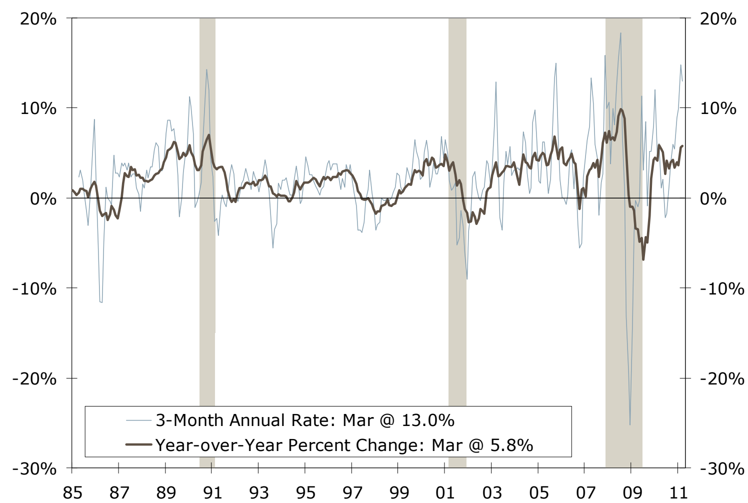
The spring home selling season does not appear to be starting off on a strong footing. Mortgage applications plunged 6.7 percent in the first week of April, with purchase applications declining 4.7 percent and mortgage refinancing dropping another 7.7 percent. Mortgage interest rates rose on the week, especially for FHA mortgage loans, which saw an 11 basis point increase to 5.36 percent. Housing demand remains exceptionally weak and higher mortgage rates will make it that much more difficult to attract buyers. Rising inflation and increased inflation expectations could also send mortgage rates even higher, putting a recovery in home sales off even further.

We also got some conflicting data on the U.S. jobs picture. The BLS reported that help wanted ads for February rose to 3.1 million in February, the best since September 2008. On the other hand, initial jobless claims increased by 27,000 last week to 412,000, and the four-week moving average of claims increased back up to 395,750 from 390,250 the previous week.

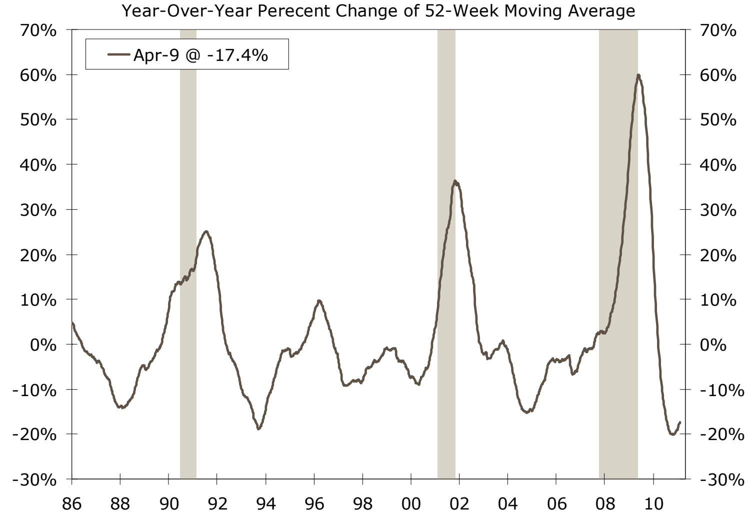
Imports of Petroleum and Non-Petroleum Goods
Billions of Dollars



Finished Goods Producer Price Index



Initial Claims for Unemployment
Year-Over-Year Perecent Change of 52-Week Moving Average

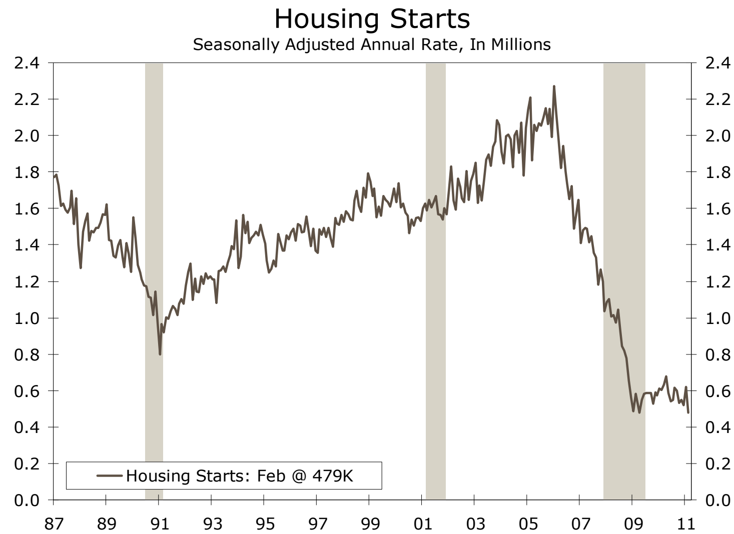


Housing Starts • Tuesday

Housing starts dropped sharply in February to a 479,000-unit pace, representing a 22.5 percent decline. The volatile multifamily component plunged 46.1 percent for the month, while single family starts declined 11.8 percent. Housing permits in February fell to the lowest level on record at a 517,000-unit pace, representing an 8.2 percent decline. The oversupply of existing homes along with the downward pressure on home prices due to foreclosures continues to hold back the construction of new homes. However, we expect that housing starts improved in March, increasing 17.1 percent for the month, coming off the low level observed last month due to weather effects. Housing starts will likely continue to be weak through the summer, but should gradually start to pick up in the second half of the year. The improvement in job and personal income growth along with improved affordability should result in an increase in new starts of 8.5 percent from last year's level.

Previous: 479K **Wells Fargo: 561K**

Consensus: 525K

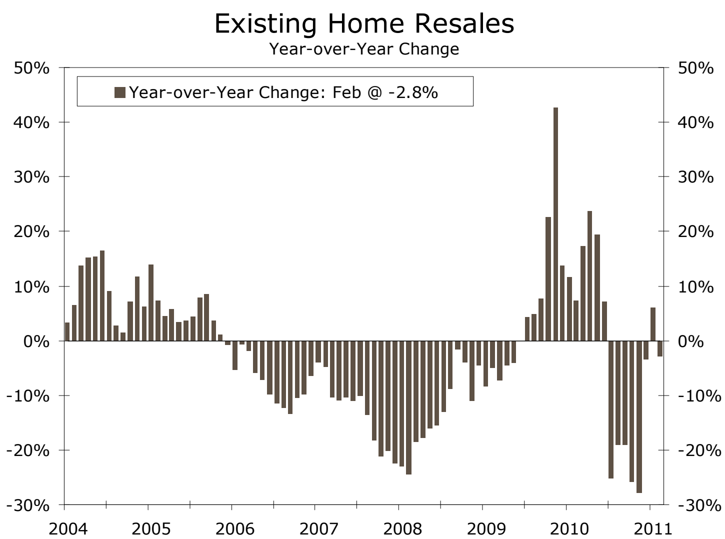


Existing Home Sales • Wednesday

Existing home sales in February fell 9.6 percent, with declines in every region of the country. The decline was likely due to the harsh winter weather in January that kept buyers away and limited closings for the month of February. Distressed transactions continued to play a role in pulling home prices lower, accounting for 39 percent of all transactions for the month. The median price of an existing single-family home fell 4.2 percent over the past year while the average home price fell 2.2 percent. The continual drop in prices appears to be leading to more conservative appraisals, which have slowed the pace of transaction closures. We anticipate that existing home sales improved in March to 4.98M units, a 2.0 percent increase. There will likely be continued weakness in existing home sales through the first half of the year with sales picking up in the second half of the year with continued improvement in the nation's employment situation.

Previous: 4.88M **Wells Fargo: 4.98M**

Consensus: 5.00M

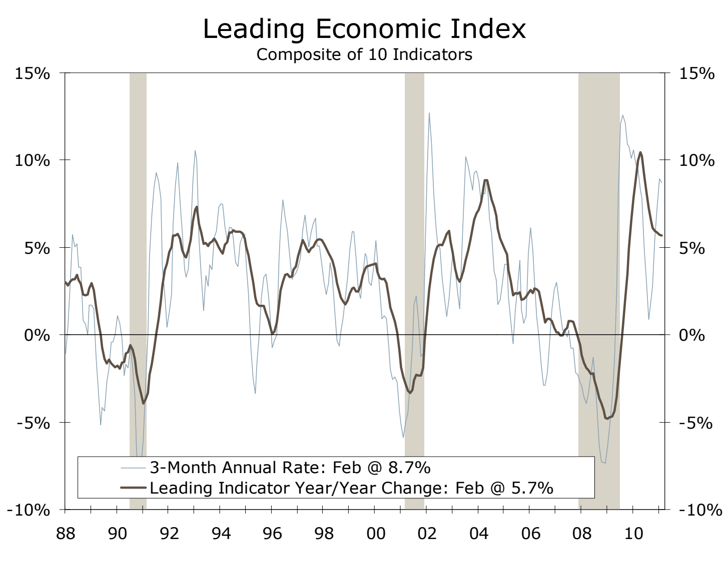


Leading Economic Index • Thursday

The Leading Economic Index, a measure that tracks changes in the business cycle, rose 0.8 percent in February. This marked the seventh consecutive month of improvement in the index. Nine of the 10 components of the indicator were in positive territory for the month. The only indicator that failed to show improvement was building permits which fell to the slowest pace in 50 years. Among the indicators that showed the most improvement were the interest rate spread and initial jobless claims. The indicator continues to support our view of a moderate pace of economic growth in the 2.5 to 3.0 percent range for 2011. We anticipate that the Leading Economic Index rose 0.1 percent for the month of March led by further improvements in interest rate spreads and an increase in supplier deliveries.

Previous: 0.8% **Wells Fargo: 0.1%**

Consensus: 0.3% (Month-over-Month)



Global Review

Chinese Economy Continues to Boom Along

Data released this week showed that economic growth in China remained very robust in the first quarter (see chart on front page). The 9.7 percent year-over-year growth rate that the economy achieved in the first quarter was stronger than most analysts had expected, and it represents only a miniscule slowdown from the 9.8 percent rate that was registered in the preceding quarter. A breakdown of the real GDP data into its underlying demand components is not available, but monthly indicators suggest that the source of strength in the first quarter came from domestic factors.

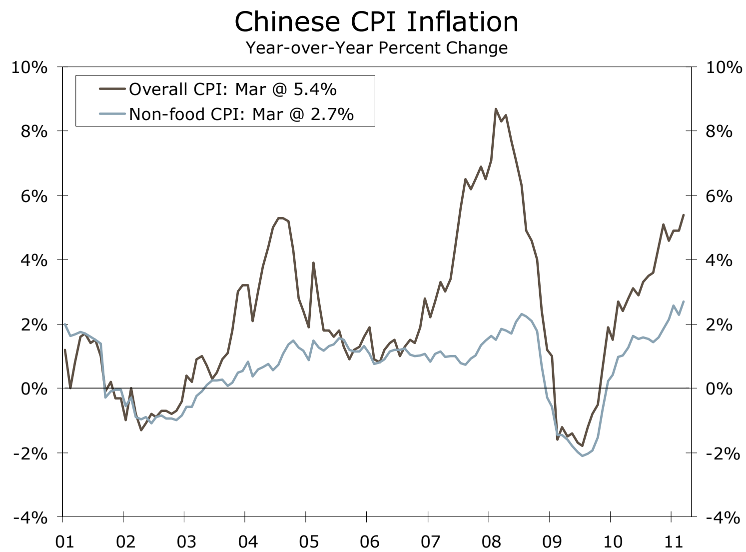
In that regard, China incurred a trade deficit of nearly $1 billion in the first quarter, the first red ink in the trade accounts on a quarterly basis in seven years. Although factory shutdowns associated with the Chinese New Year played a role in producing a trade deficit in the first quarter, export growth has slowed more than import growth over the past year or so. On the domestic side, retail sales rose 16 percent on a year-ago basis in the first quarter and fixed asset investment was up 25 percent. In other words, growth in domestic demand appears to have held up quite well in the first quarter.

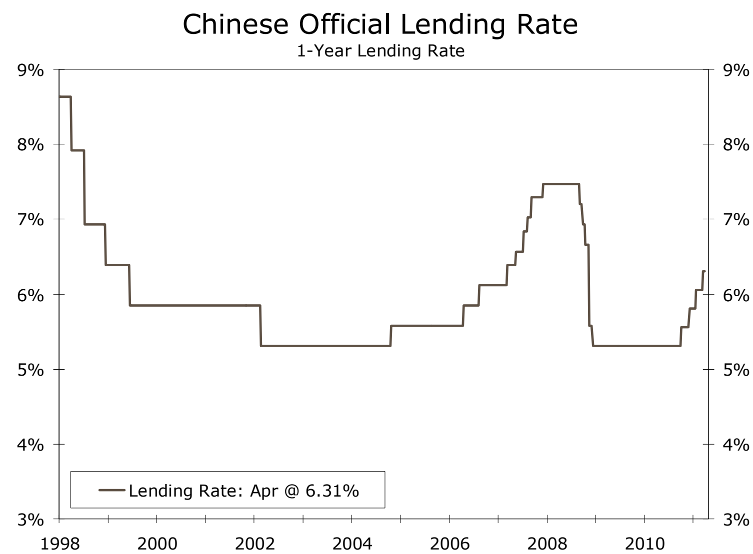
Inflation Is Rearing Its Ugly Head

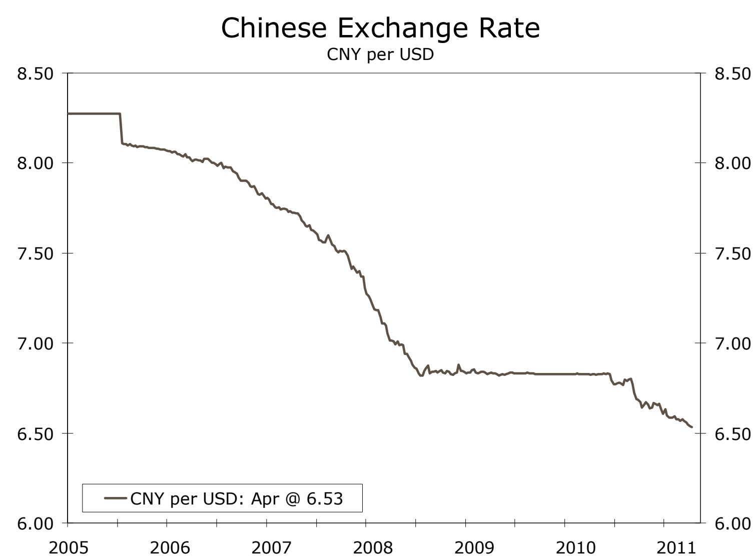
Continued strength in Chinese GDP growth is good news for the global economy in our opinion. The bad news for us is that inflationary pressures in China continue to build. The overall rate of CPI inflation, which rose to 5.4 percent in March, was pushed higher by the double digit increase in food prices (top chart). However, inflationary pressures are not confined to food. Although non-food price inflation is low in a relative sense, the 2.7 percent increase that was registered in March is the highest rate in at least ten years. Not only did the component measuring the price of residence rise 6.6 percent in March, but prices of all other major spending categories accelerated as well. (For further reading on Chinese inflation trends, see “Does China Have an Inflation Problem?”, which is posted on our website.)

Chinese authorities have tightened policy over the past few months in response to the building inflationary pressures. The central bank has raised its benchmark lending rate by 100 bps since last October, and further rate hikes seem likely (middle chart). Moreover, loan growth remains strong at 16 percent, so Chinese authorities could conceivably direct banks to tighten credit. Therefore, there is a risk that Chinese authorities could tighten policy too much, thereby leading to a significant slowdown in future quarters.

Because inflation has become the primary concern of Chinese policymakers, the government has allowed the Chinese renminbi to resume its path of appreciation (bottom chart). Since last June, the Chinese currency has strengthened about 5 percent against the U.S. dollar, and further gains in the months ahead seem likely. Indeed, Wells Fargo’s currency strategy team projects that the renminbi will appreciate another 5 percent vis-à-vis the greenback over the next 12 months.







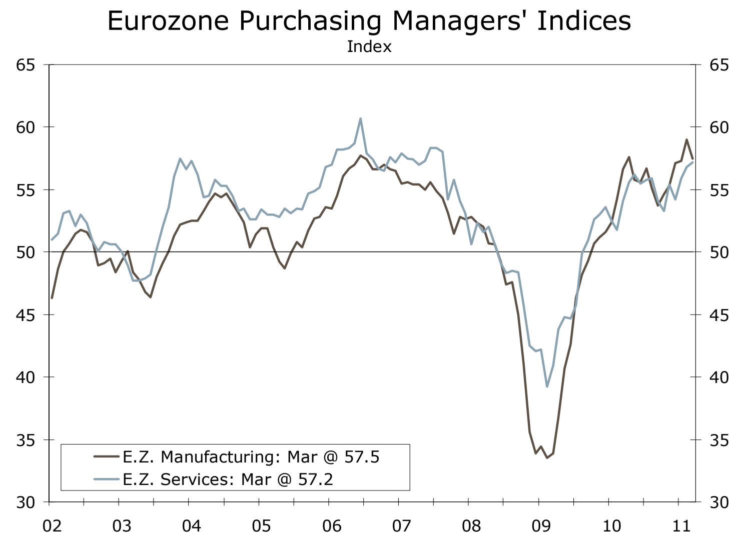
Eurozone PMIs • Tuesday

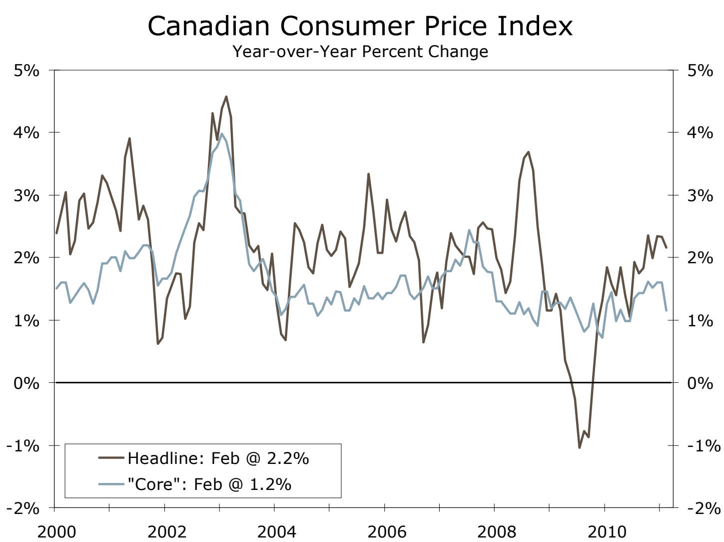
While the sovereign debt situation continues to rear its ugly head from time to time, the recovery in the Eurozone has continued to plod along. The European Central Bank (ECB) recently began to rein in easy monetary policy by tightening the bank rate to 1.25 percent, a 25 basis point increase.

There has been a fair amount of discussion that the rate hike comes at a bad time for an economy that has yet to return to pre-recession levels of total output. The ECB's mandate to maintain price stability forced the move. It will be a critical test in our opinion for the Eurozone economy to be able to weather the tightening monetary policy while still maintaining the recovery. We will get a clue as to how businesses sentiment is holding up when the April purchasing managers' indexes for manufacturing and services are published on Tuesday. Both measures were in expansion territory in March.

Previous: Manufacturing: 57.5, Services: 57.2

Consensus: Manufacturing: 57.0, Services: 56.9





Canadian CPI • Tuesday

Like the ECB, the Bank of Canada (BoC) also has a mandate to promote price stability. The difference is that the BoC is more focused on core inflation. Specifically the BoC targets a range of 1-3 percent for core price growth. While headline inflation has been trending higher in recent months, core prices have remained rather tame, even falling on a year-over-year basis in recent months. March CPI inflation data will hit the wire on Tuesday.

At its last meeting the BoC opted to keep rates unchanged and the monetary policy report was rather dovish, pointing to a number of obstacles that could slow Canadian growth in the quarters ahead including: slower U.S. growth, sovereign debt in Europe, and political instability in the Middle East and North Africa. Perhaps the biggest tangible take-away was the bank's estimate that the natural disasters in Japan might result in a 0.5 percent drag on Q2 GDP growth.

Previous: 0.3% **Wells Fargo: 0.3%**

Consensus: 0.6% (Month-over-Month)

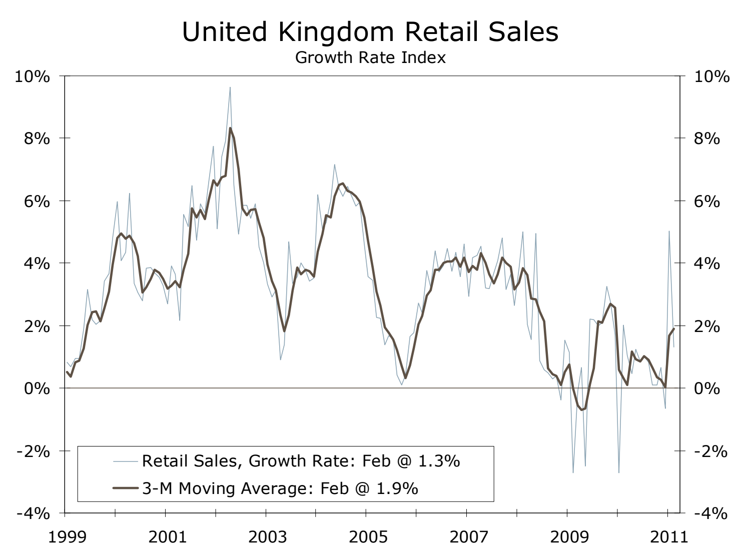
U.K. Retail Sales • Thursday

The fragile recovery underway in the United Kingdom is not getting much help from consumer spending. Retail sales data have been rather spotty, with stores reporting falling sales two out of the last three months. We will get some indication of how the first quarter finished when March retail sales data are reported next Thursday.

Also next week, the markets will get a look at the minutes from the most recent meeting of the Bank of England (BoE). The BoE opted to keep rates unchanged at its last meeting, despite the fact that consumer price growth remains more than 2 full percentage points above the mandated 2 percent target rate. The minutes should provide some context around the decision and perhaps offer some clues as to when the BoE will begin tightening monetary policy.

Previous: -0.8%

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



Interest Rate Watch

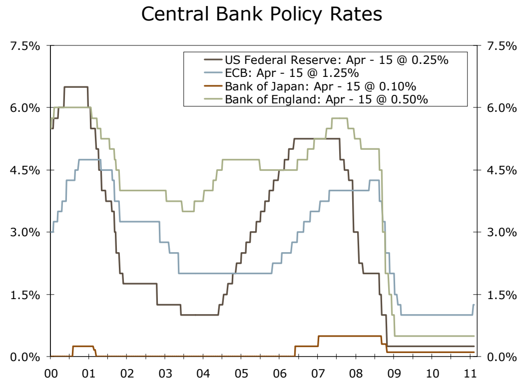
Fears Remain Contained, For Now

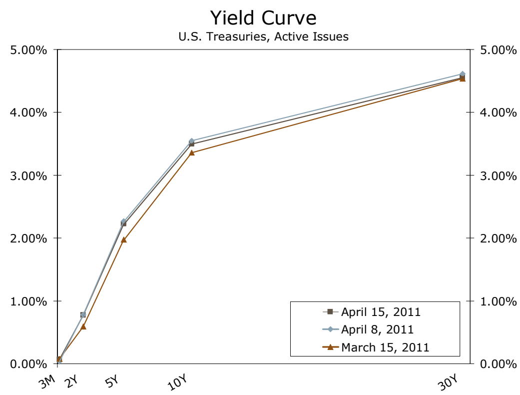
The Federal Reserve is fond of reminding us that long-term inflation expectations remain contained and that much of the increase in food and energy prices should prove transitory, or short-term in nature. The March CPI data generally support this notion but just barely. The overall Consumer Price Index rose 0.5 percent, as gasoline prices jumped 5.6 percent and food prices rose 0.8 percent. Gasoline prices have risen at an astonishing 71.2 percent annual rate over the past three months and food prices have risen at a 7.5 percent pace. It would be a national tragedy if those increases were to pass through to the core.

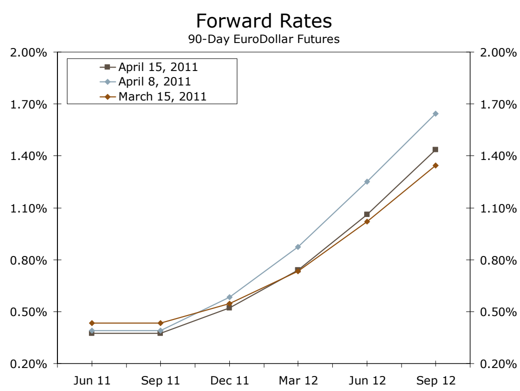
Fortunately, only a portion of the rise in food and energy prices has been passed on to other goods and services. The core CPI rose slightly less than expected, climbing 0.135 percent in March. But the core is still up at a 2.0 percent annual rate over the past three months and is now up 1.2 percent on a year-to-year basis. Price increases were held back in March by a smaller than expected rise in owners' equivalent rent and a decline in apparel prices. The slightly better-than-expected monthly reading on the core CPI does not reverse its recent acceleration.

We expect the core to rise 1.9 percent on a December-to-December basis this year, which is a little more than half a percentage point greater than the Fed's current expectations. Long-term yields should begin the reality of higher core inflation during the second half of this year, when the Fed will almost certainly have to adjust their expectations higher.

Another area where bond investors need to adjust their expectations is the federal budget deficit. Last week's budget deal will produce less savings than was hoped for. We have upped our estimates for budget deficits for 2011 and 2012 and look for a very contentious debate leading up to the deadline for boosting the debt ceiling. We are somewhat less concerned, at least for now, about the winding down of the Fed's Treasury purchase program, which is proceeding as has been widely expected.







Credit Market Insights

Housing Market Braces for Change

Although mortgage purchase applications fell 4.7 percent for the week ending April 8, they remain slightly above the lows hit in late February. Part of the reason could be a drop in the 30-year mortgage rate from 5.05 percent on February 11 to 4.76 percent on March 18, before they edged back up again more recently. Another reason may be that buyers are accelerating purchases to beat the 25 basis point increase in mortgage insurance premiums that takes effect April 18. According to the FHA, this will lead to a $30 increase in the monthly payment, on average. While that may not sound like a big increase, it's yet another headwind for first-time homebuyers who are already worried about further home price declines and high gas prices. Looking further ahead, more changes could be coming for FHA loans such as lower seller contribution allowances, higher required credit scores, higher down payments and lower conforming loan limits. In addition, the reduction or elimination of the mortgage interest deduction is being considered in Congress, which could affect all homeowners, not just first-time buyers. At this stage of the game, the housing market likely needs any good news it can get. Anything that makes buying a home more difficult or more expensive certainly does not appear to bode well for home sales and prices. The recent run-up in applications could portend a brief up-tick in home sales, but after that, sales will likely trend lower.

Mortgage Data

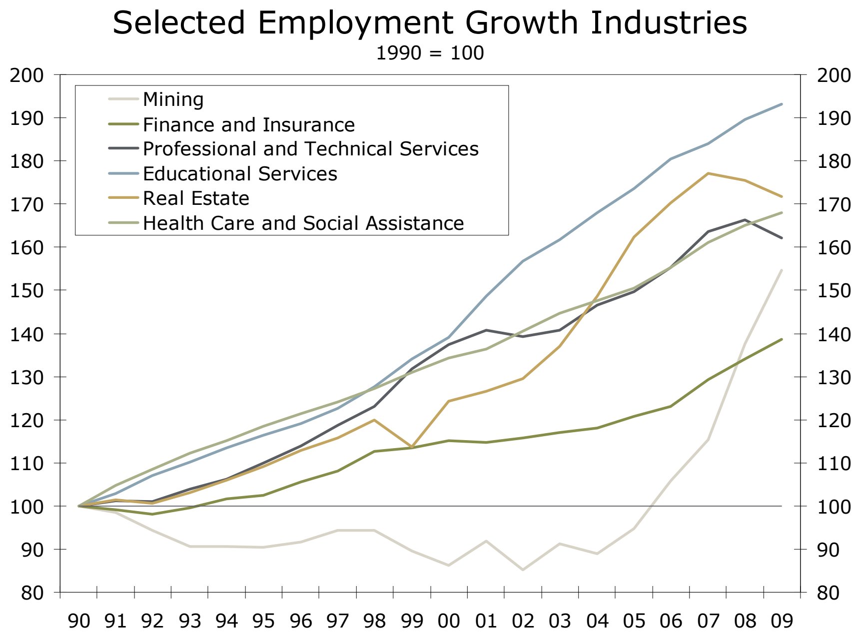
	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.86%	4.81%	4.87%	5.08%
15-Yr Fixed	4.09%	4.04%	4.15%	4.39%
5/1 ARM	3.70%	3.62%	3.72%	4.10%
1-Yr ARM	3.26%	3.21%	3.23%	4.05%
MBA Applications				
Composite	485.3	524.4	445.1	602.8
Purchase	188.5	191.7	172.8	243.0
Refinance	2,222.5	2,471.2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

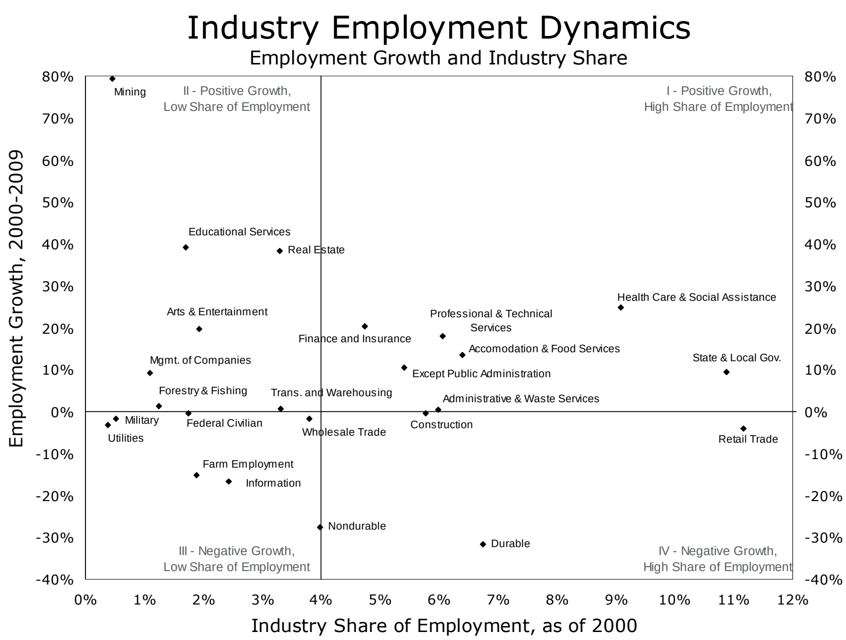
Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

Topic of the Week

Employment Dynamics & State Competitiveness

As state economies migrate from a recovery phase to an expansion phase, many individuals and policymakers have an interest in knowing which industries will lead employment growth for the foreseeable future and which states are best positioned to take advantage of this employment growth. Based on our analysis of employment dynamics across sectors, we identified several high-growth industries, which we expect to contribute to a large share of employment growth over the next several years. These high-growth industries have a high rate of employment growth and are above the average industry share of employment (quadrant I of the bottom graph) and include finance & insurance, professional & technical services, accommodation & food services, services other than public administration and healthcare & social assistance. We then looked at those states that have a regional competitive advantage in attracting employment in these industries by applying a regional shift-share analysis which aims to decompose the employment trends across a geographical area and identify employment growth that can be attributed to regional factors. We find that high-growth industries are located in many states due to the need to provide many services locally. These local industries emerge when the benefits of co-location are less than the transactions costs of local provision. This implies job growth over the near term should be widespread across these local industries. However, many of the positions within high-growth industries often require a higher level of education than a particular state's labor force may currently possess. Thus, the pace of skill set evolution will likely have an effect on job growth across different regions. States with a large number of high-growth industries that also have a large skilled workforce will be at a greater competitive advantage. This would tend to favor states such as Georgia, North Carolina, Arizona, Virginia and Texas, which not only have a large supply of skilled workers but have also been successful at attracting such workers from other parts of the nation.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 4/15/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.07	0.04	0.15
3-Month LIBOR	0.27	0.29	0.30
1-Year Treasury	0.22	0.25	0.41
2-Year Treasury	0.71	0.81	1.01
5-Year Treasury	2.14	2.31	2.54
10-Year Treasury	3.43	3.58	3.83
30-Year Treasury	4.50	4.64	4.71
Bond Buyer Index	5.06	5.04	4.43

Foreign Exchange Rates

	Friday 4/15/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.445	1.448	1.357
British Pound ($/£)	1.633	1.638	1.550
British Pound (£/€)	0.885	0.884	0.876
Japanese Yen (¥/$)	83.160	84.760	93.030
Canadian Dollar (C$/$)	0.962	0.955	1.002
Swiss Franc (CHF/$)	0.894	0.907	1.056
Australian Dollar (US$/A$)	1.056	1.056	0.935
Mexican Peso (MXN/$)	11.688	11.731	12.167
Chinese Yuan (CNY/$)	6.532	6.536	6.826
Indian Rupee (INR/$)	44.335	44.077	44.439
Brazilian Real (BRL/$)	1.574	1.569	1.749
U.S. Dollar Index	74.794	75.066	80.482

Foreign Interest Rates

	Friday 4/15/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.28	1.24	0.58
3-Month Sterling LIBOR	0.82	0.82	0.65
3-Month Canadian LIBOR	1.20	1.20	0.42
3-Month Yen LIBOR	0.20	0.20	0.24
2-Year German	1.84	1.91	0.94
2-Year U.K.	1.20	1.40	1.17
2-Year Canadian	1.77	1.90	1.94
2-Year Japanese	0.21	0.21	0.17
10-Year German	3.38	3.48	3.13
10-Year U.K.	3.60	3.81	4.04
10-Year Canadian	3.32	3.44	3.72
10-Year Japanese	1.29	1.33	1.37

Commodity Prices

	Friday 4/15/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	109.92	112.79	85.51
Gold ($/Ounce)	1485.10	1474.93	1159.25
Hot-Rolled Steel ($/S.Ton)	850.00	857.00	690.00
Copper (¢/Pound)	427.75	449.50	359.65
Soybeans ($/Bushel)	13.14	13.46	9.54
Natural Gas ($/MMBTU)	4.23	4.04	3.99
Nickel ($/Metric Ton)	25,799	26,799	26,338
CRB Spot Inds.	633.85	634.25	510.36

Next Week's Economic Calendar

	Monday 18	Tuesday 19	Wednesday 20	Thursday 21	Friday 22
U.S. Data		**Housing Starts** February 479K March 561K (W)	**Existing Home sales** February 4.88M March 4.98M (W)	**Leading Indicators** February 0.8% March 0.1% (W)	
Global Data	**Canada** **CPI (MoM)** Previous (Feb) 0.2%	**Eurozone** **PMI (Composite)** Previous (Mar) 57.6 **Canada** **CPI (YoY)** Previous (Feb) 2.2%		**U.K.** **Retail Sales (MoM)** Previous (Feb) -1.0% **Canada** **Retail Sales (MoM)** Previous (Jan) -0.3%	

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

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