April 27, 2012

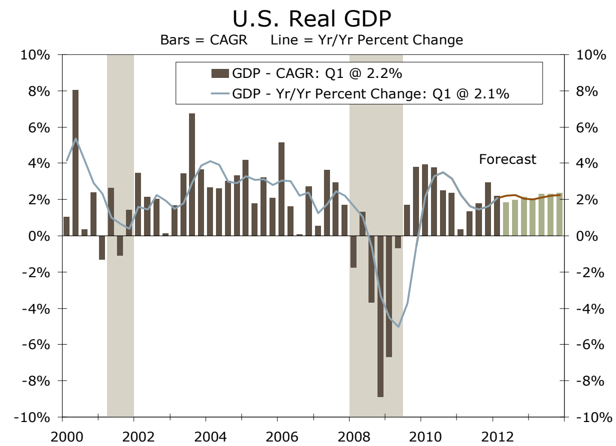
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

First-Quarter GDP Growth Slows

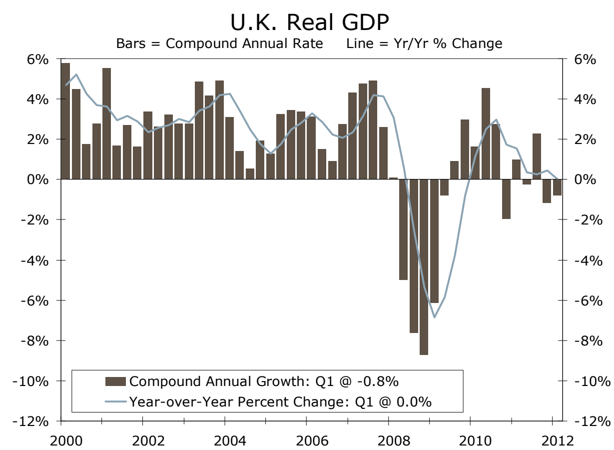
- The U.S. economy grew at a 2.2 percent annual rate in the first quarter, somewhat slower than the consensus had expected. Consumption remained the primary driver of growth as business spending slowed and the government sector continued to scale back spending.
- In our U.S. review section this week, we discuss the GDP report in the context of the big miss in durables and consider what it means for business spending going forward. We also look at a very small change in the Fed statement this week that reflects an improving view on the troubled housing sector.



Global Review

The United Kingdom Slides Back into Recession

- Real GDP in the United Kingdom contracted for the second consecutive quarter in Q1, indicating that, at least technically, the U.K. economy is back in recession.
- The sovereign debt crisis in Europe and the spillovers emanating from it may have played a role in depressing real GDP in Q1. However, weakness in the construction and service sectors, which are more insular than the industrial sector, suggest that there is inherent weakness in the British economy at present. Although we look for growth to turn positive again later this year, we continue to project a slow rate of U.K. economic growth.



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	3.0	2.2	1.8	2.0	2.1	-3.6	3.0	1.7	2.1	2.1
Personal Consumption	2.1	0.7	1.7	3.0	2.9	1.4	1.4	1.5	-2.0	2.0	2.2	1.9	1.3
Inflation Indicators [2]													
PCE Deflator	1.8	2.5	2.9	2.7	2.3	2.1	2.0	2.1	0.6	1.8	2.5	2.1	2.0
Consumer Price Index	2.1	3.3	3.8	3.3	2.8	2.5	2.3	2.5	-0.3	1.6	3.1	2.5	2.3
Industrial Production [1]	4.4	1.2	5.6	5.0	5.4	2.3	3.0	2.2	-11.3	5.4	4.1	4.0	2.2
Corporate Profits Before Taxes [2]	8.8	8.5	7.5	7.0	6.2	6.0	6.2	6.4	9.1	32.2	7.9	6.2	6.4
Trade Weighted Dollar Index [3]	70.6	69.4	72.8	73.3	72.7	73.0	73.5	74.0	77.7	75.6	70.9	73.3	76.0
Unemployment Rate	9.0	9.0	9.1	8.7	8.3	8.4	8.6	8.5	9.3	9.6	9.0	8.4	8.3
Housing Starts [4]	0.58	0.57	0.62	0.67	0.69	0.71	0.72	0.71	0.55	0.58	0.61	0.71	0.82
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	3.95	3.90	3.90	3.90	5.04	4.69	4.46	3.91	4.15
10 Year Note	3.47	3.18	1.92	1.89	2.23	2.00	2.00	2.10	3.26	3.22	2.78	2.08	2.35

Forecast as of: April 27, 2012
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units
[5] Annual Numbers Represent Averages

Inside

Together we'll go far

U.S. Review

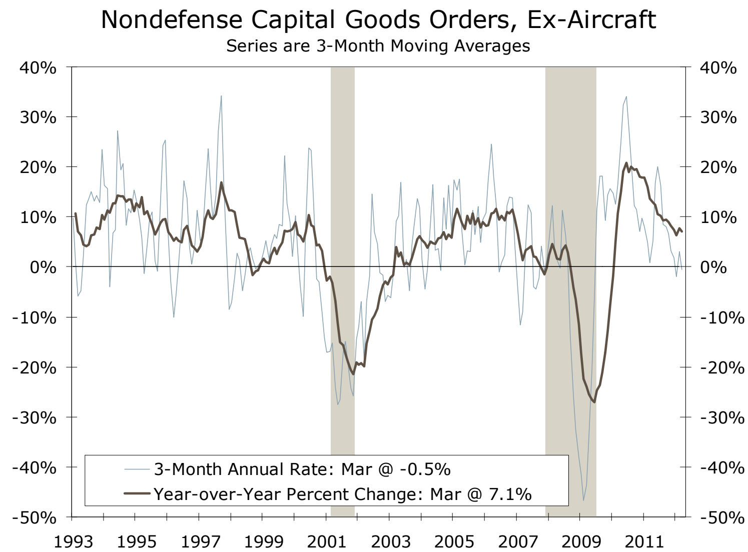
Business Spending Poised for a Slowdown?

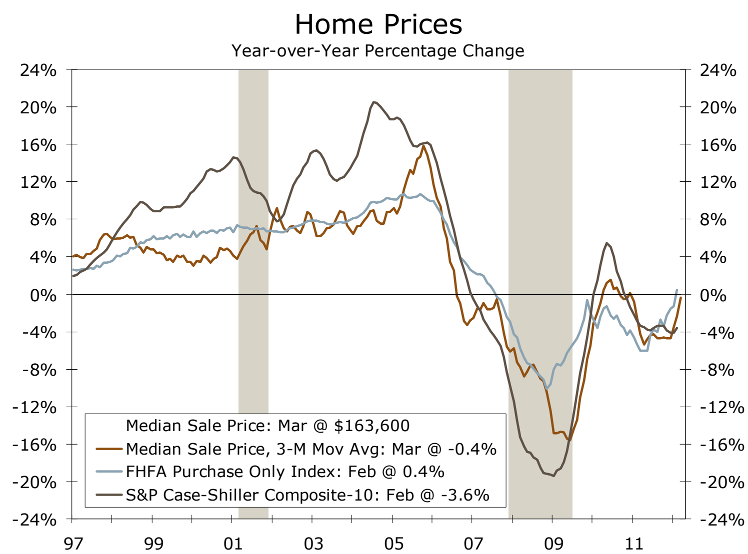
Durable goods orders for March were ugly. The 4.2 percent drop was the largest decline since the U.S. economy was in recession in 2009. While most of the decline was in the volatile aircraft sector, it raises questions about the ability of capital expenditures to continue to fuel economic growth. Business spending has been a steady locomotive for growth since the economy first began to emerge from recession nearly three years ago. That dynamic continued into 2012 as fixed investment spending grew at a 1.4 percent annualized pace in the first quarter. This modest increase in outlays offered a mere 0.2 percent positive contribution to first-quarter GDP growth. When calculating the role of business spending for GDP, the Bureau of Economic Analysis looks at shipments of nondefense capital goods orders, ex-aircraft, and those shipments increased only mildly during the first quarter. Another thing we learned from the durable goods report was that orders for this key series fell in March. A previous decline in January was blamed on the partial expiration of a tax credit in 2012, but this second decline in three months is somewhat disconcerting. That said, the orders component of the ISM index in March came in at 54.5, firmly in expansion territory. Most of the regional purchasing managers' indexes show orders still expanding as well. Given the relative strength in these surveys, we still look for business spending to support economic growth in the coming quarters, but we will keep a jaundiced eye focused on bookings for nondefense capital goods, ex-aircraft in the coming months for affirmation.

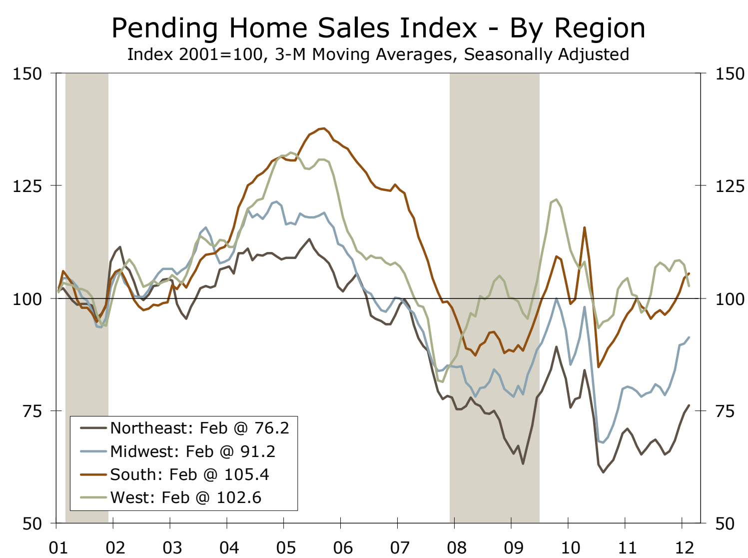
"Some Signs of Improvement" in Housing

For the better part of the past year and a half, we have identified early signs of stabilization in housing prices in some markets and we have noted an incipient recovery in homebuilding activity. We have struck a cautious tone repeatedly in recent publications of our housing chartbook, noting that the bottoming process will vary by market and the recovery in both prices and residential construction activity will take years to fully recover.

In its statement released this week, the FOMC added four words in the section dedicated to the housing sector—"some signs of improvement." Indicators this week affirmed that notion, though perhaps not with the sort of conviction that would signal a definite firming. The S&P Case-Shiller 20-city home price index posted a nearly imperceptible increase, up just 0.15 percent in February, while the broader FHFA home price index added a more substantial 0.3 percent. The pace of new home sales picked up slightly as well with 328,000 new homes sold in March. That is a far cry from the 1 million-plus numbers during the housing boom, but it was better than the consensus had been expecting. It also follows an upwardly revised print of 353,000 new homes for the prior month—a decidedly better outturn than the 313,000 that had first been reported for February. We also learned this week that the pipeline for future existing sales seems to be filling up as well, with March pending homes sales up 4.1 percent on the month—the largest sequential increase since November.





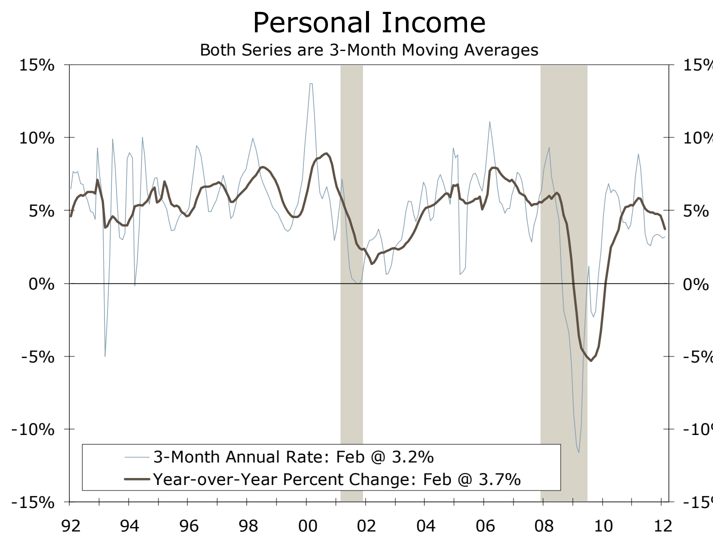


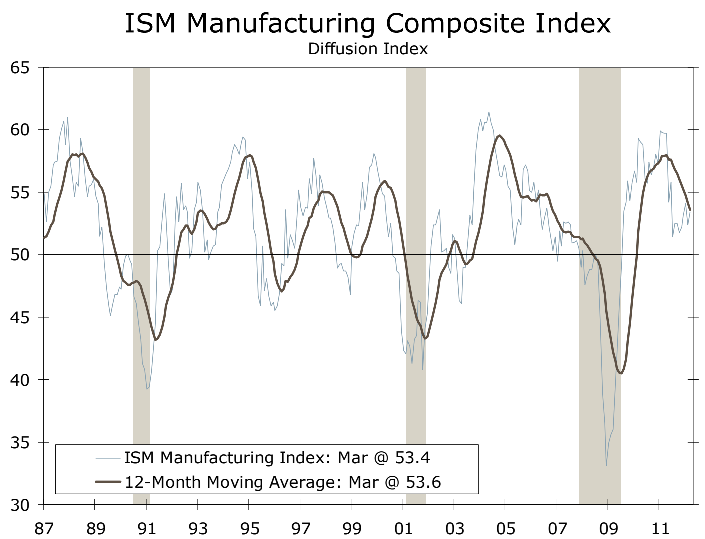
Personal Income • Monday

Personal income continued its tepid pace in February, rising only 0.2 percent. Reflecting the pickup in employment, wage and salary growth, however, has improved in recent months. Much like other seasonally adjusted data, the ramp-up was due in part to milder-than-usual weather conditions. In contrast to weak income growth, consumer spending has been surprisingly strong in the first quarter. Indeed, in the first quarter, real consumer spending growth rose at a 2.9 percent annual pace, which is well above modest income gains. That said, the pace of household outlays may be short lived. Much of the gains continue to be in durable goods, which increased at a 15.3 percent pace in the first quarter. We expect consumer spending to increase at around a 2.0 percent pace in 2012, but slow to a 1.3 percent rate in 2013.

Previous: 0.2% (Month-over-Month) **Wells Fargo: 0.3%**

Consensus: 0.3%





ISM Manufacturing • Tuesday

The pace of manufacturing edged a bit higher in March to 53.4 but has slowed considerably from its 59.9 high in January 2011. Of the five components that make up the composite index, supplier deliveries contracted for the second consecutive month and inventories barely scratched the surface of expansion. While the pace of growth in the factory sector has slowed in recent months, we continue to expect further gains. Indeed, the forward-looking new orders component remains in expansionary territory and comments from the panel remained positive with some citing increased sales and demand for the next few months. This feedback is consistent with recent gains in consumer spending but could prove to be fleeting as household spending has outpaced income. Regional manufacturing surveys suggest further gains in the coming month as well, but at a decelerating pace.

Previous: 53.4 **Wells Fargo: 52.7**

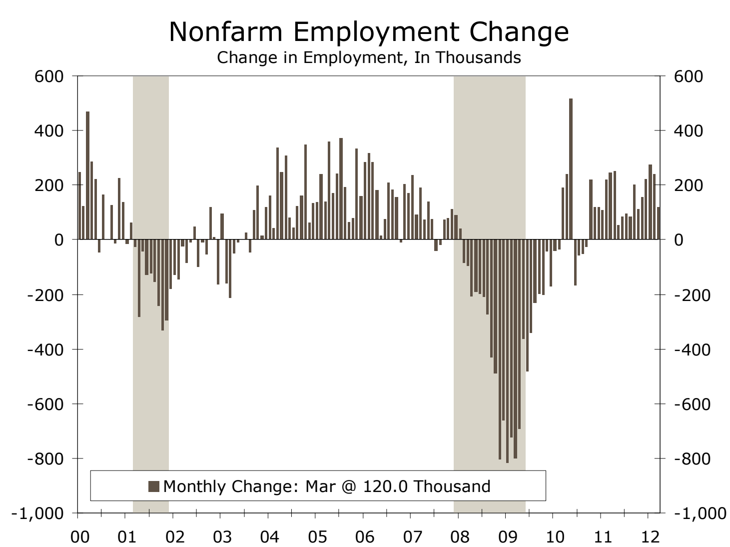
Consensus: 53.0

Employment • Friday

Following three straight months of robust job gains, nonfarm employment sorely disappointed in March, registering only 120,000 jobs. Construction employment pulled back for the second consecutive month, but we expect to see some payback as the decline was likely due to weather. The underlying trend in the labor market is still improving, however. The unemployment rate edged lower to 8.2 percent and is nearly two percentage points lower than its 10 percent peak in October 2009. While the recent decline was due to a pullback in the labor force, we expect the unemployment rate to increase only slightly higher by the end of the year to 8.4 percent as many discouraged workers return to the labor force. That said, initial jobless claims trended higher in April, but remain below the threshold of 400,000. We expect nonfarm employment to post 164,000 jobs in April and the unemployment rate to fall to 8.1 percent.

Previous: 120K **Wells Fargo: 164K**

Consensus: 165K



Global Review

The United Kingdom Slides Back into Recession

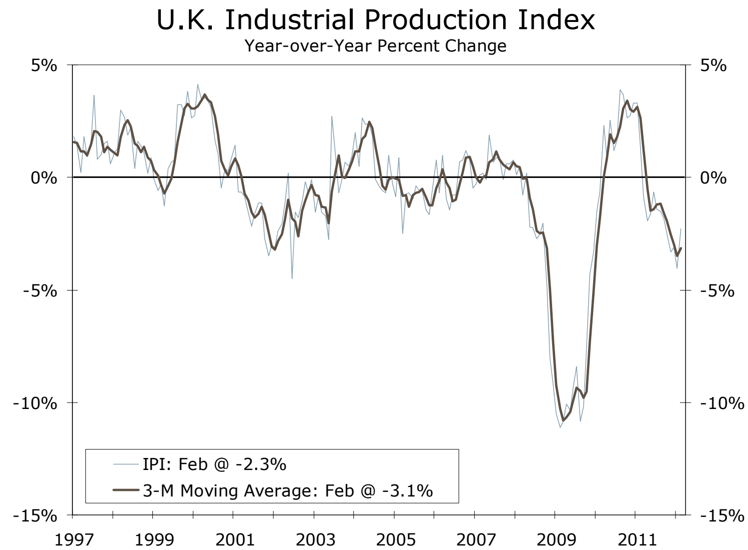
Data released this week showed that real GDP in the United Kingdom contracted at an annualized rate of 0.8 percent in the first quarter of 2012. If one defines recession as two consecutive quarters of negative GDP growth, then the economy slid back into recession only two years after exiting the deep downturn of 2008–2009. Moreover, output has been essentially flat on balance since mid-2010. Chancellor of the Exchequer Osborne laid some of the blame for the latest U.K. recession on the European sovereign debt crisis and the renewed economic downturn in the Eurozone.

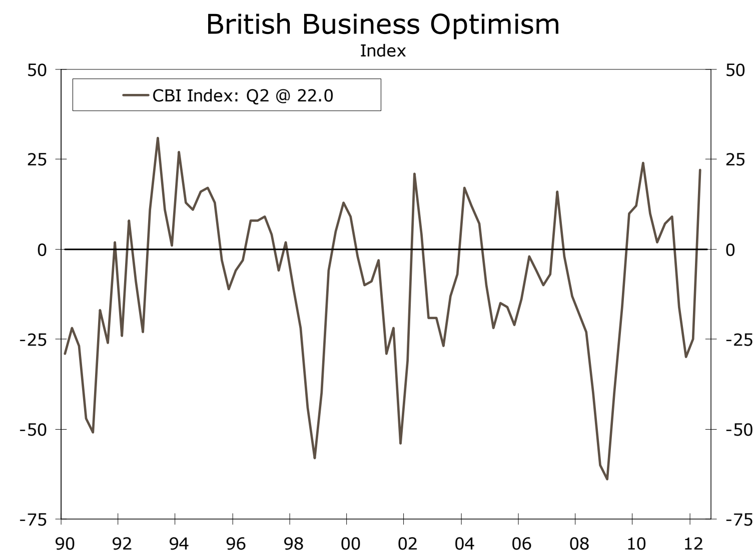
Weakness in the British economy may be attributable, at least in part, to the problems in Europe. The 0.4 percent (not annualized) decline in U.K. industrial production in Q1 may reflect weakness in exports to Europe. Although a breakdown of the GDP data into its underlying demand components is not yet available, monthly trade data show that real exports in the January–February period fell 1.5 percent relative to the fourth-quarter average.

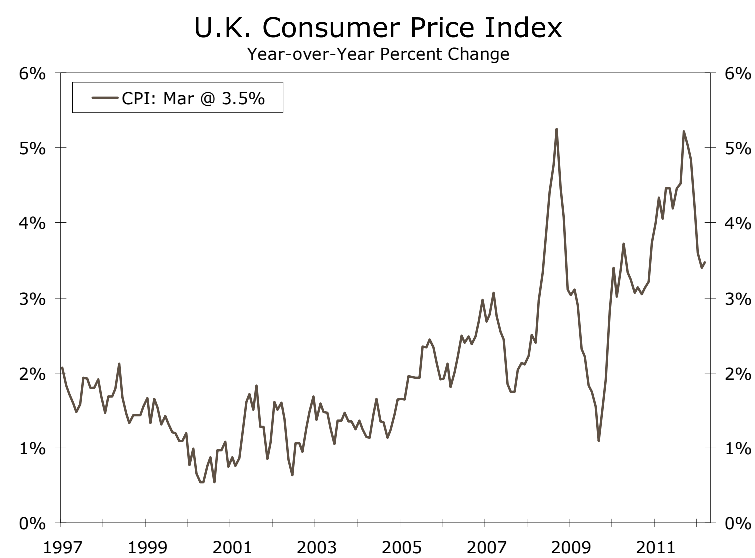
However, there is more to the story than simply the economic and financial problems in continental Europe. U.K. construction output plunged 3.0 percent (not annualized) in Q1, the sharpest drop since Q1 2009 when the economy was in freefall. It is difficult to see how the problems in Europe are related to the sharp decline in British construction, which is largely an insular sector. In addition, output in the service sector was up only 0.1 percent, an anemic outturn for a sector that is largely domestic in origin. As we discussed in a recent special report, the combination of fiscal consolidation and the unwillingness (or inability) of the private sector to pick up the spending slack may be contributing to the weakness in the British economy at present (see "Lessons from British Fiscal Consolidation," which is posted on our website). We will need to await the second release of GDP data, which is to occur on May 24, for a breakdown of spending into its demand components to glean more insights into the causes of the renewed recession.

If there was any good news this week, it showed up in widely followed series on British business sentiment. The index measuring business optimism jumped sharply in the second quarter (middle chart). The European sovereign debt crisis, which was raging late last year, may have played a role in depressing sentiment in the previous two quarters. Now that the crisis has died down (at least for now), perhaps British businesses are feeling more optimistic about the future. However, we will need to see stronger "hard" data before we will feel more comfortable regarding the outlook for the British economy.

The contraction in real GDP in Q1 may lead some members of the Monetary Policy Committee (MPC) at the Bank of England to contemplate more unconventional policy easing. However, the elevated rate of CPI inflation, which exceeds the MPC's medium-term target of 2 percent, will likely preclude further unconventional easing, at least in the near term. Although we look for growth to turn positive again later this year, we continue to project a slow rate of U.K. economic growth.





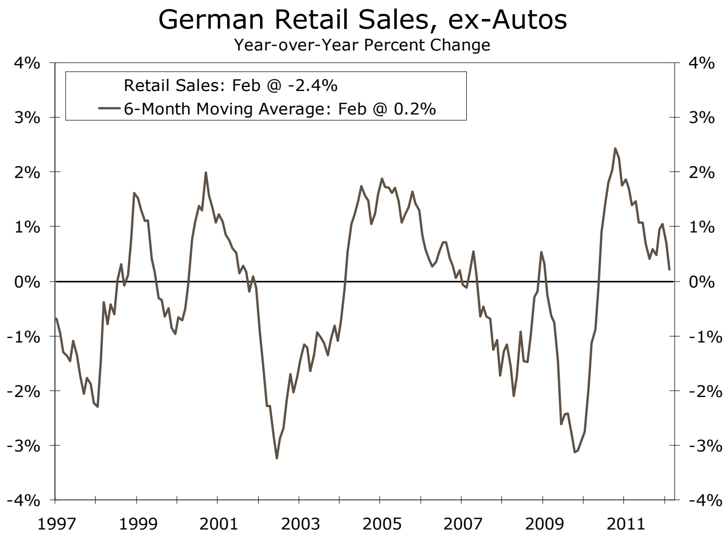


German Retail Sales • Monday

German real retail sales fell 1.1 percent in February from the previous month, the fourth decline in the past five months. Excluding autos, sales growth has been trending down for well over a year, aside from a brief rebound toward the end of last year. This has come despite a general improvement in confidence during the same period. But actions speak louder than words, and in the end, it matters not how consumers feel, but how much they spend. It appears that they may feel confident when taking surveys, but when staring at a product in the store and deciding whether to buy, they are balking. And who can blame them? Every time it appears that European leaders are making progress and resolving the debt crisis, things become unraveled. The recent backup in Italian and Spanish bond yields, the breakup of the Dutch government over disagreements on austerity and the better showing for an anti-euro candidate in France will likely keep German consumers cautious.

Previous: -1.1% (Month-over-Month)

Consensus: 1.1%



Chinese PMI • Monday

China's manufacturing purchasing managers index rose to 53.1 in March from 51.0 in February, indicating that manufacturing remained in expansion mode for a fourth straight month. Output, new orders and employment improved, while export orders expanded for a second consecutive month following four months of contraction. The rebound in Chinese manufacturing is good news amid other signs of slowing growth. Economic growth slowed to 8.1 percent year over year in the first quarter, and export growth has been slowing as Europe's debt crisis saps demand. Still, a bit of caution was in order over the March PMI release, as it tends to rise every March after the Lunar New Year. Therefore, the April PMI reading will be a better barometer of Chinese manufacturing. Unfortunately, the preliminary reading from HSBC on April 23 suggests a disappointing reading could be in the offing. If manufacturing weakens, reserve requirements may be reduced.

Previous: 53.1

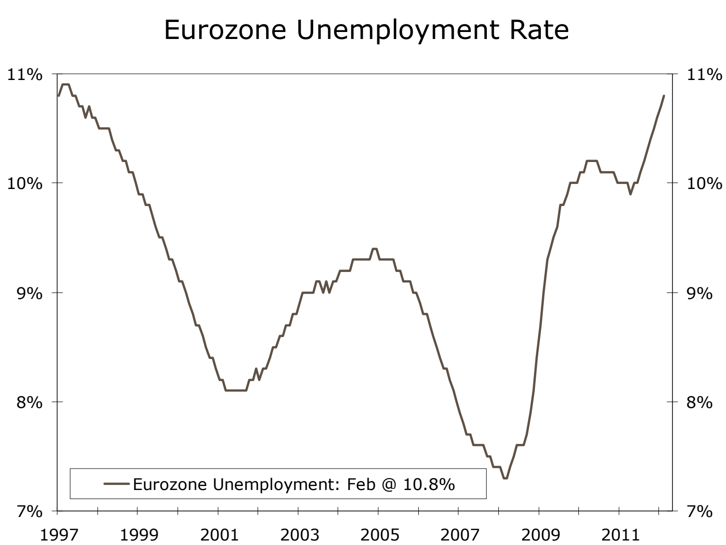
Consensus: 53.6

Eurozone Unemployment • Wednesday

The Eurozone unemployment rate rose to 10.8 percent in February, the highest since June 1997. Spain's unemployment rate reached an astonishing 23.6 percent, while Portugal weighed in at 15.0 percent and Italy held at 10.0 percent. The latest data available for Greece was 21.8 percent for January. We suspect unemployment rose again in March based on recent economic data. Production of consumer goods fell sharply in February, as did construction activity. In March, the manufacturing PMI for the Eurozone fell to 47.7 from 49.0, the eighth straight month of contraction. The leading economic indicators index also declined in March. In addition, the European Commission's Industry Survey showed weakening production and orders and worsening expectations for production and employment, while the Services Survey showed lagging expected demand. With European economies continuing to struggle, the appetite for austerity appears to be at a breaking point.

Previous: 10.8%

Consensus: 10.9%



Interest Rate Watch

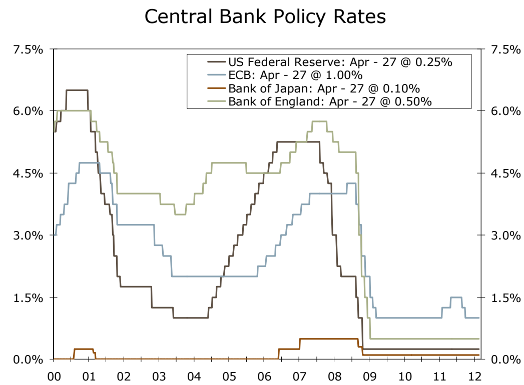
FOMC Statement Largely Unchanged

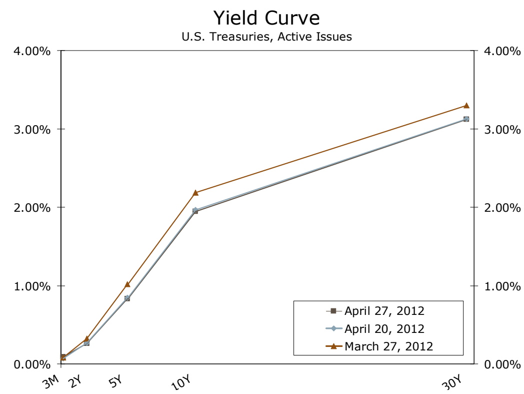
As expected, the FOMC maintained its policy stance at the conclusion of its two-day meeting on Wednesday. Moreover, it made only superficial changes to its statement that was released at the conclusion of the March 13 meeting. The FOMC still describes the pace of the economic expansion as “moderate,” and it still characterizes long-term inflation expectations as “stable.” It also anticipates that the unemployment rate will decline “gradually.”

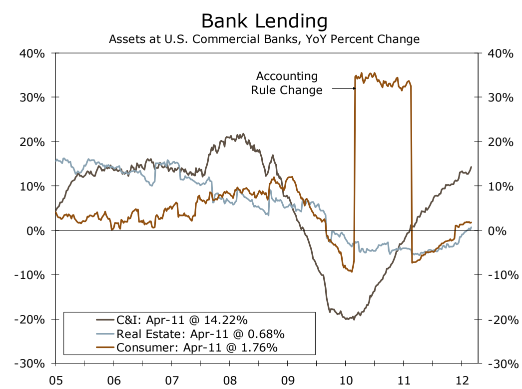
Given its rather subdued outlook, the FOMC still anticipates that it will keep the Federal Funds rate at “exceptionally low levels” through late 2014, although Richmond Fed President Jeffrey Lacker cast another dissenting vote against that view. In his post-meeting press conference, Fed Chairman Bernanke reemphasized that the FOMC’s guidance was “conditional.” That is, if the economy turns out to be stronger than expected and/or inflation ends up being higher than anticipated, then the FOMC will change its forward guidance regarding the outlook for interest rates. We continue to project an unchanged Fed Funds rate through the end of next year when our forecast currently ends.

Around the time of the previous FOMC meeting on March 13, long-term interest rates rose sharply. For example, the yield on the 10 year Treasury bond shot up about 40 bps. Not only were most economic data releases at the time stronger than most investors had expected, but some market participants were disappointed that the FOMC did not announce further easing measures at the March 13 meeting.

Over the past six weeks, rates have retreated again and are essentially unchanged on balance. Not only have the economic data been more mixed, but some renewed focus on the European sovereign debt crisis has contributed to the rally in the bond market. As we describe more fully in the Topic of the Week, we believe that European developments will warrant market attention in the coming weeks. Therefore, we look for long-term rates to remain well-contained for the foreseeable future.







Credit Market Insights

Potential Headwinds to Trade Finance

Along with the pickup in business lending over the past year, trade credit for U.S. nonfinancial corporations has also increased. Trade finance is a key factor for international trade, supporting as much as 90 percent by some estimates, by providing short-term working capital loans. In the United States, trade credit for the nonfinancial corporate sector declined 18 percent following the past recession as international trade dropped off amid weak demand for goods and tough credit conditions. However, credit for trade activities has steadily improved since 2009 and is now up 12.8 percent year over year.

While many banks have reported an increase in trade finance lending in the first quarter, companies may face headwinds to obtaining trade credit ahead. First, the U.S. Export-Import Bank, which provides direct loans, loan guarantees and insurance for U.S. exporters, is expected to reach its credit ceiling in May. The bank is seeking an increase in its lending limit to $140 billion from $100 billion, but political wrangling in Washington may delay the bank’s reauthorization. Second, under Basel III regulations, trade finance loans—which are typically around three months—will be treated as one-year loans. This will require more capital to be held against them, making trade finance less profitable for lenders and/or more expensive for borrowers once the Basel III standards are adopted.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.88%	3.90%	3.99%	4.78%
15-Yr Fixed	3.12%	3.13%	3.23%	3.97%
5/1 ARM	2.85%	2.78%	2.90%	3.51%
1-Yr ARM	2.74%	2.81%	2.78%	3.15%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$1,415.9	30.56%	27.60%	14.22%
Revolving Home Equity	$544.4	-3.86%	-4.48%	-4.37%
Residential Mortgages	$1,569.4	51.62%	-0.18%	5.72%
Commerical Real Estate	$1,424.0	-5.95%	0.06%	-2.48%
Consumer	$1,098.7	-1.70%	5.23%	1.76%

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

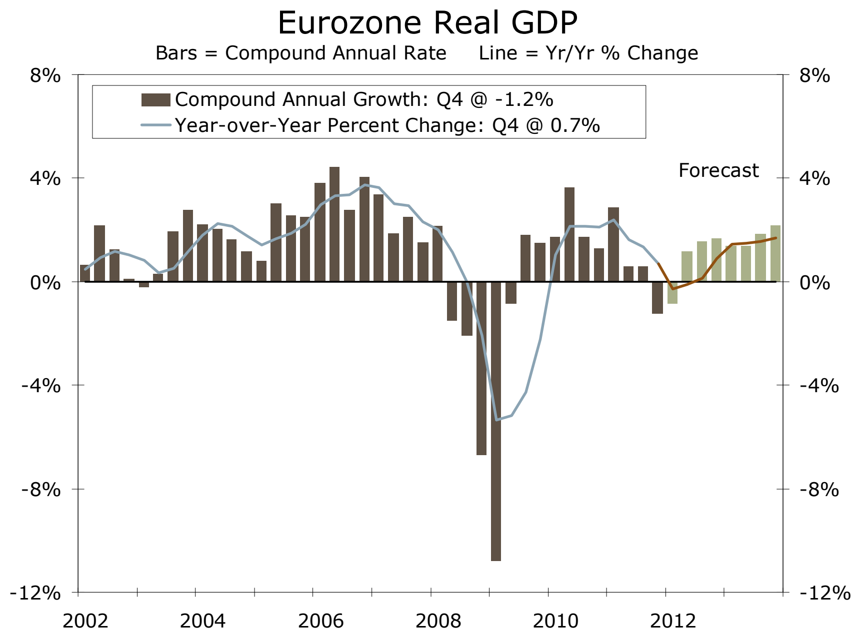
Topic of the Week

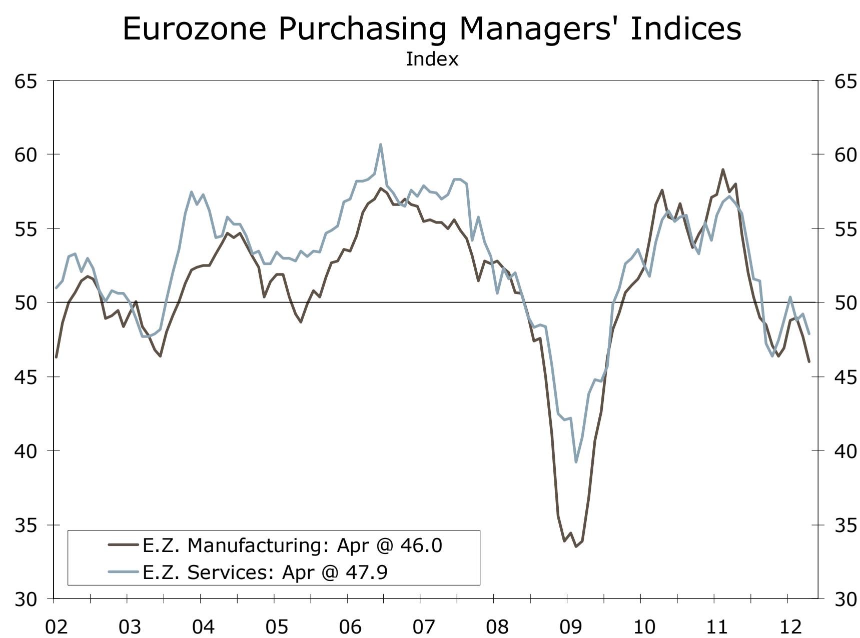
Thoughts on Recent European Developments

Recent economic and political developments in Europe raise some concern for the coming months. Real GDP for the overall Euro area fell at an annualized rate of 1.2 percent in Q4 2011, and recent indicators intimate that output contracted again in Q1. The Eurozone purchasing managers' indices for April came in significantly weaker than expected, as the manufacturing PMI fell to its lowest reading since the summer of 2009. The service sector PMI also remained in contraction territory. With the pace of economic activity very week, it appears that the overall euro area is in another technical recession.

In addition, while the ECB's liquidity-providing measures helped to stabilize financial markets earlier this year, rising Spanish and Italian bond yields suggest that the sovereign debt crisis may be migrating off of the back burner. If the sovereign debt crisis should return in full force, European policy makers would need to be united to effectively respond. However, recent political developments raise the possibility of policy disagreement among the major countries.

There is a significant probability that the French and Dutch governments, both of which are currently governed by the center-right and helped support the call for fiscal austerity, will soon be led by the center-left. France will hold the second round of its presidential election in May and polls currently favor Hollande. The Dutch government, which recently collapsed due, at least in part, to disagreements about a budget-cutting plan, will hold elections in September. Although the center-left recognizes the need for fiscal consolidation, they disagree with the pace at which it should be implemented, especially under constrained economic conditions. Policy disagreements among major countries will likely be viewed negatively by financial markets and thus investors should be prepared for a period of some financial market instability in the coming months. For more of our thoughts on recent developments in Europe, please see the full report on our website.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 4/27/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.09	0.07	0.05
3-Month LIBOR	0.47	0.47	0.27
1-Year Treasury	0.10	0.09	0.16
2-Year Treasury	0.26	0.26	0.64
5-Year Treasury	0.83	0.84	2.02
10-Year Treasury	1.95	1.96	3.36
30-Year Treasury	3.12	3.12	4.45
Bond Buyer Index	3.86	3.90	4.86

Foreign Exchange Rates

	Friday 4/27/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.325	1.322	1.479
British Pound ($/£)	1.625	1.612	1.663
British Pound (£/€)	0.815	0.820	0.889
Japanese Yen (¥/$)	80.440	81.520	82.160
Canadian Dollar (C$/$)	0.981	0.992	0.950
Swiss Franc (CHF/$)	0.907	0.909	0.875
Australian Dollar (US$/A$)	1.044	1.038	1.087
Mexican Peso (MXN/$)	13.106	13.101	11.524
Chinese Yuan (CNY/$)	6.310	6.309	6.512
Indian Rupee (INR/$)	52.543	52.085	44.435
Brazilian Real (BRL/$)	1.887	1.872	1.567
U.S. Dollar Index	78.766	79.194	73.519

Foreign Interest Rates

	Friday 4/27/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.64	0.65	1.33
3-Month Sterling LIBOR	1.01	1.01	0.82
3-Month Canadian LIBOR	1.35	1.35	1.20
3-Month Yen LIBOR	0.20	0.20	0.20
2-Year German	0.10	0.14	1.81
2-Year U.K.	0.43	0.48	1.19
2-Year Canadian	1.41	1.35	1.78
2-Year Japanese	0.11	0.11	0.21
10-Year German	1.70	1.71	3.29
10-Year U.K.	2.13	2.18	3.57
10-Year Canadian	2.07	2.06	3.27
10-Year Japanese	0.90	0.94	1.22

Commodity Prices

	Friday 4/27/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	104.41	103.05	112.76
Gold ($/Ounce)	1665.73	1642.93	1527.35
Hot-Rolled Steel ($/S.Ton)	670.00	687.00	858.00
Copper (¢/Pound)	380.60	369.80	422.80
Soybeans ($/Bushel)	14.78	14.12	13.75
Natural Gas ($/MMBTU)	2.16	1.93	4.38
Nickel ($/Metric Ton)	18,122	17,526	26,628
CRB Spot Inds.	542.38	535.35	624.56

Next Week's Economic Calendar

	Monday 30	Tuesday 1	Wednesday 2	Thursday 3	Friday 4
U.S. Data	**Personal Income** February 0.2% March 0.3% (W)	**ISM Manufacturing** March 53.4 April 52.7 (W)	**Factory Orders** February 1.3% March -1.8% (W)	**Nonfarm Productivity** 4Q 0.9% 1Q-A -0.1% (W)	**Nonfarm Payrolls** March 120K April 164K (W)
	Personal Spending February 0.8% March 0.5% (W)	**Construction Spending** February -1.1% March 0.3% (W)		**Unit Labor Costs** 4Q 2.8% 1Q-A 2.5% (W)	**Unemployment Rate** March 8.2% April 8.1% (W)
	PCE Deflator (YoY) February 2.3% March 2.2% (W)	**Total Vehicle Sales** March 14.32M April 14.13M (W)		**ISM Non-Manf.** March 56.0 April 56 (W)	
Global Data	**China** **PMI Manufacturing** Previous (Mar) 53.1	**U.K.** **PMI Manufacturing** Previous (Mar) 52.1	**U.K.** **PMI Construction** Previous (Mar) 56.7	**U.K.** **PMI Services** Previous (Mar) 55.3	**Eurozone** **Retail Sales (MoM)** Previous (Feb) -0.1%
	Germany **Retail Sales (MoM)** Previous (Feb) -1.1%	**Australia** **RBA Cash Target** Previous 4.25%	**Eurozone** **Unemployment Rate** Previous (Feb) 10.8		**Canada** **Ivey PMI** Previous (Mar) 63.5

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

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