May 13, 2011

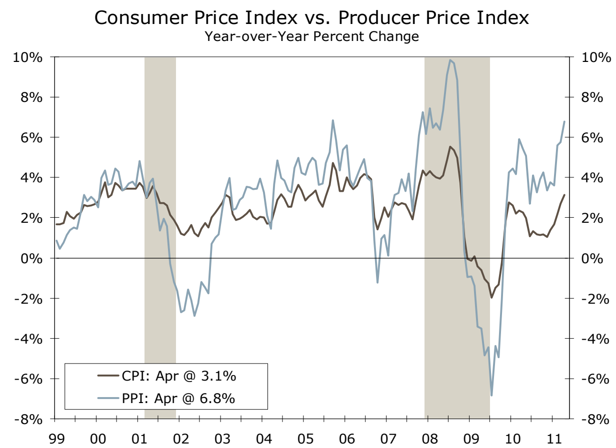
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

After a Momentous Week Comes a Discerning Week

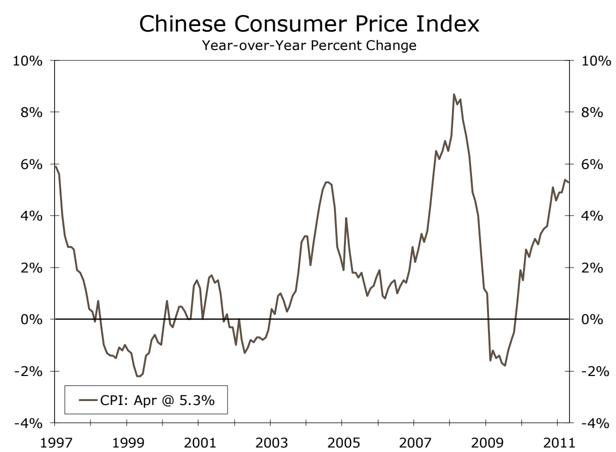
- U.S. inflation reports came mostly above expectations during the week with import prices increasing 2.2 percent, producer prices up 0.8 percent and consumer prices up 0.4 percent month-over-month. Meanwhile, core consumer prices were up 0.2 percent.
- The good news for the U.S. economy is that oil and overall commodity prices continued to drop during this week and this will help the U.S. consumer as gasoline and food prices come back down. However, the drop in commodity prices will need to be sustainable, something not guaranteed.



Global Review

More Inflation and China Tightens Again

- Chinese consumer and producer price inflation for April came in somewhat hotter than the consensus expected, prompting the Chinese central bank to boost the banks' reserve requirements for the fifth time this year to help cool inflationary pressures.
- In another sign that global growth may be nicked by rising energy prices, Eurozone industrial production unexpectedly slipped 0.2 percent in March. Analysts had been looking for a 0.3 percent increase. Partially softening the blow, February's Eurozone industrial production was revised up 0.2 percentage points.



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	1.8	2.0	2.9	3.0	0.0	-2.6	2.9	2.4	2.7
Personal Consumption	1.9	2.2	2.4	4.0	2.7	2.4	2.2	3.0	-0.3	-1.2	1.7	2.7	2.3
Inflation Indicators [2]													
"Core" PCE Deflator	1.8	1.5	1.2	0.8	0.9	1.1	1.4	1.8	2.3	1.5	1.3	1.3	2.0
Consumer Price Index	2.4	1.8	1.2	1.2	2.2	3.5	3.8	4.0	3.8	-0.3	1.6	3.4	3.4
Industrial Production [1]	8.1	7.1	6.7	3.2	6.0	4.0	4.6	4.0	-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	8.8	8.5	8.2	5.8	9.3	9.6	8.6	7.8
Housing Starts [4]	0.62	0.60	0.59	0.53	0.56	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	4.80	5.00	5.10	6.04	5.04	4.69	4.94	5.53
10 Year Note	3.84	2.97	2.53	3.30	3.47	3.40	3.60	3.70	3.66	3.26	3.22	3.54	4.05

Forecast as of: May 13, 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

After a Momentous Week Comes a Discerning Week

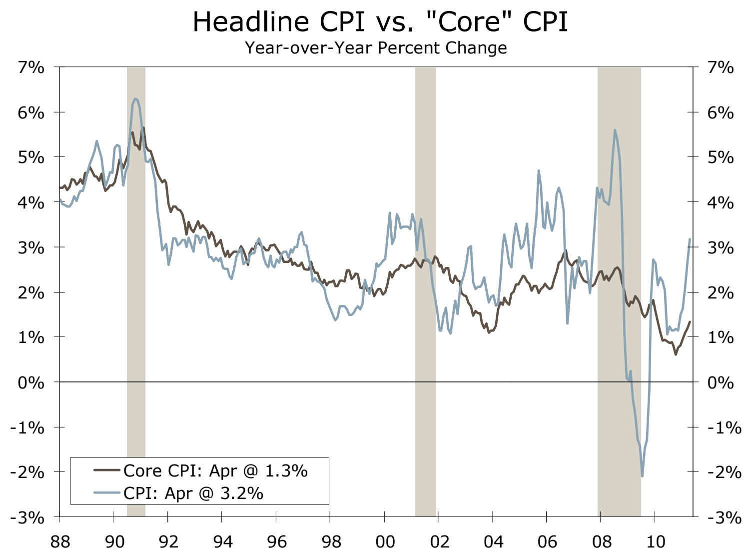
In this week's economic releases there was something for everybody to discern so as to make sense of what is happening in the U.S. economy. For those that are concerned with inflation, we got very strong numbers from import prices, up 2.2 percent, export prices, up 1.1 percent, producer prices, up 0.8 percent and consumer prices up 0.4 percent while the core rate was up 0.2 percent month-over-month. Thus, inflation hawks could not have been better served by these releases. However, if commodity prices continue to fall then the Federal Reserve's position that this increase in prices is of a "transitory" nature will come to fruition. So, inflation hawks should take what they were dealt this week and run with it, because it probably won't stick if the Federal Reserve is correct.

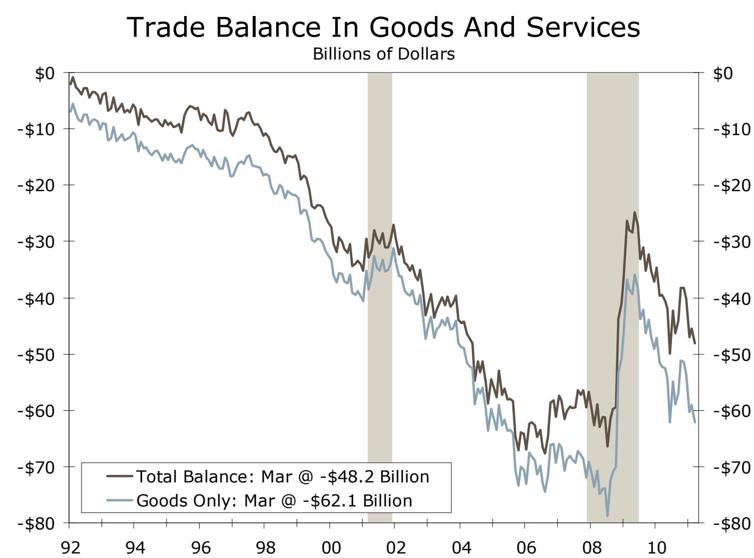
For those concerned with the current account deficit, the U.S. trade balance was higher than expected at $48.2 billion in March from a revised reading of $45.4 billion in February. This higher-than-expected trade deficit will put more pressure on the U.S. dollar. However, we were surprised that most of the increase in the deficit was due to a 20.9 percent increase in the volume of petroleum imported after a drop of 18.1 percent in that measure in February. Thus, while higher oil prices contributed to the higher deficit, the largest contributor was an increase in volume rather than price. The increase in the price per barrel was $6.59 during the month. On the positive side, U.S. exports increased 4.6 percent compared to February and 14.9 percent compared to March a year earlier. This increase in the deficit will not have that much of a drawback for first-quarter GDP because the BEA was very close to the estimate of net exports during the first quarter of the year. The only surprise could come if the BEA revises exports and imports considerably during the next several weeks and the net exports estimate changes.

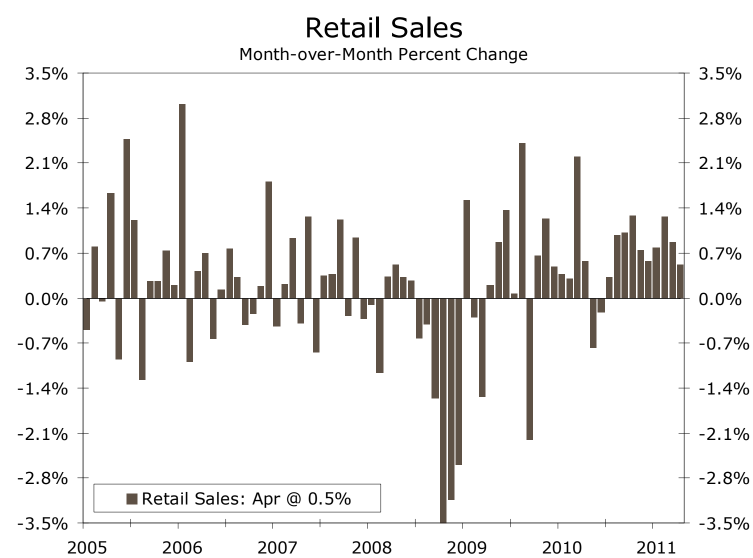
For those concerned with economic growth, initial jobless claims remained above 400,000 for the fifth consecutive week. The number came down to 434,000 from the previous week's revised number of 478,000, but is putting doubt over the ability of the economy to grow employment above 200,000 per months as we have seen during the last several months.

Then, for those concerned with the stance of the U.S. consumer, the news on April's retail sector was mixed, with bad news for housing-market-related purchases such as furniture and home appliances that were down 1.1 percent, a very large increase in gasoline sales due to the surge in gasoline prices, up 2.7 percent, and a relatively strong 1.2 percent month-over-month increase in food and beverage sales.

The good news for the U.S. consumer and the U.S. economy is that oil and overall commodity prices continued to drop during this week and will help the U.S. consumer as gasoline and food prices come back down. Of course, for this to happen the drop in commodity prices will need to be sustainable, something that cannot be guaranteed due to rising global demand.





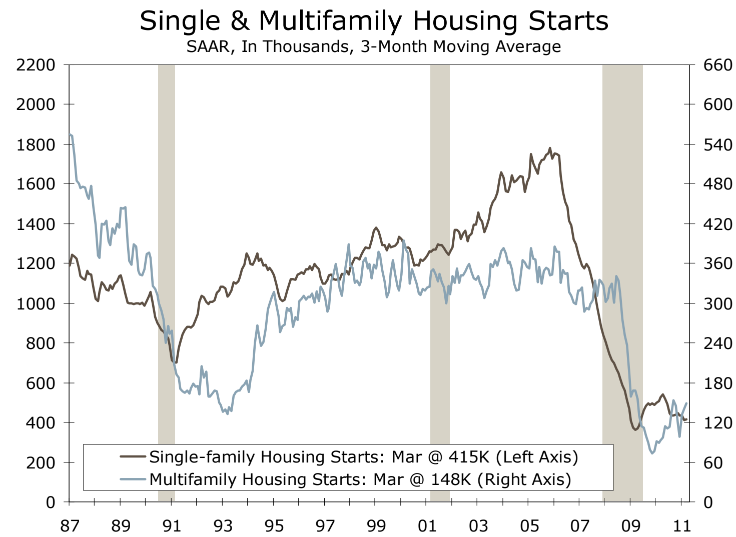


Housing Starts • Tuesday

Housing starts came in stronger than expected in March, rising 7.2 percent to a 549,000 unit pace. Both single- and multifamily starts increased for the month due to a payback from the lower level of starts observed in February tied to harsh weather conditions. While single-family starts showed a moderate improvement, new starts remained at very depressed levels. A recovery in the single-family market will take some time as existing home inventories and foreclosures weigh on prices and hold back new construction. One piece of good news can be found in the trend for multifamily housing starts, which rose 5.8 percent in March. We continue to expect modest improvement in multifamily starts as the demand for apartments increases. We expect that new housing starts rose 6.6 percent for April to a 585,000 unit pace. The pace of new starts should gradually start to pick up as the year progresses and job growth continues to show gains.

Previous: 549,000 **Wells Fargo: 585,000**

Consensus: 570,000

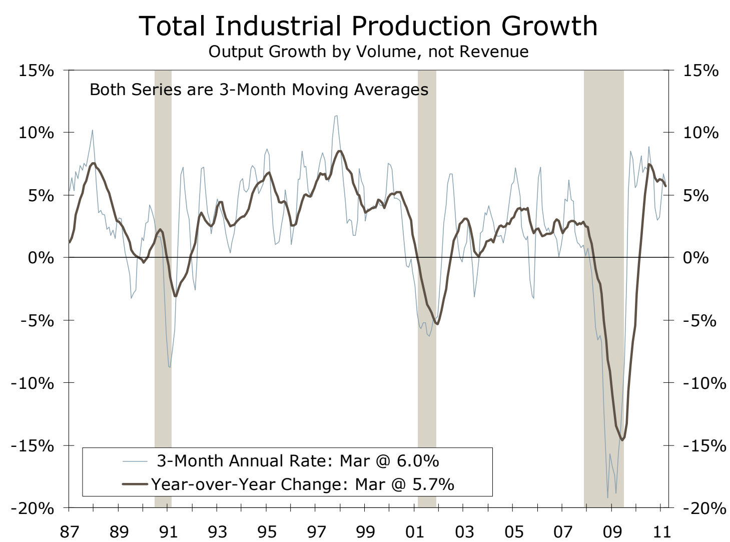


Industrial Production • Tuesday

March industrial production rose 0.8 percent with production output increasing in every major industry sector. Motor vehicle and parts led the gains in output with a 3.0 percent increase for the month. Production of consumer goods improved 0.9 percent with strong gains from automotive products. Business equipment production increased 0.4 percent, up 13.4 percent over last year. The consistent improvement in business equipment production supports our forecast view for double-digit growth in equipment and software spending for this year. While the month's production improvements were strongly positive, we expect some slowdown in the pace of April's industrial production as the full impact of the Japanese disasters and subsequent supply chain disruption affect output primarily in the automotive and technology sectors. Our forecast now reflects this slowdown in output in the second quarter. We think April's industrial production improved 0.3 percent.

Previous: 0.8% **Wells Fargo: 0.3%**

Consensus: 0.4% (Month-over-Month)

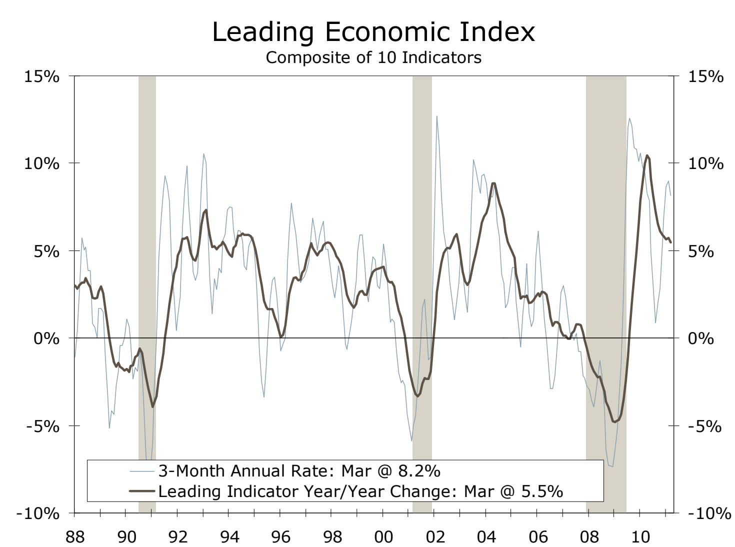


Leading Economic Indicator • Thursday

The Leading Economic Index rose 0.4 percent in March following an upwardly revised 1.0 percent increase in February. The continued positive reading in the LEI signals a positive pace of economic growth going forward. The index was led higher by improvements in housing permits, supplier deliveries and the interest rate spread. Gas prices began to have an effect on consumer sentiment in March as the sentiment component held back the headline LEI. The good news came from new housing permits that jumped 11.2 percent for the month. The moderate pace of economic growth signaled by the LEI over the past few months supports our forecast for a moderate pace of economic growth for this year. We expect the index to show some signs of softening in April with a flat reading. The recent increases in initial jobless claims and decreases in supplier deliveries and average hours worked will hold the index back from posting a positive print.

Previous: 0.4% **Wells Fargo: 0.0%**

Consensus: 0.1%



Global Review

China Not Satisfied With Progress on Inflation

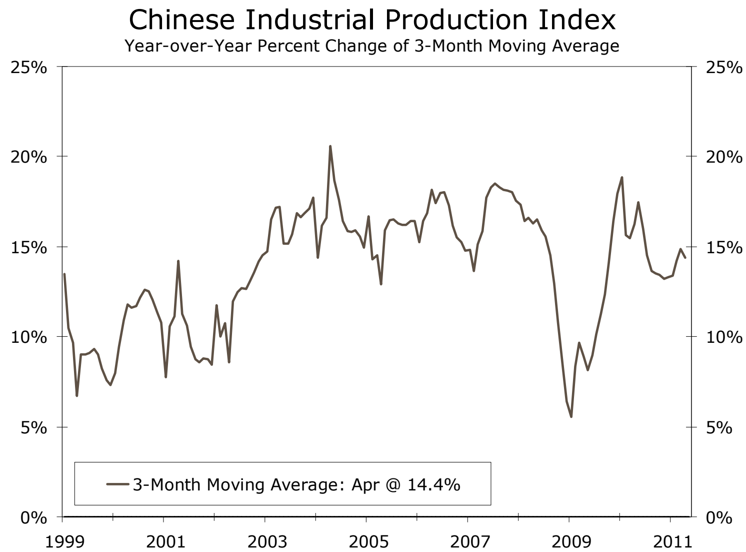
Consumer and producer price inflation in China eased a touch in April, but not enough to satisfy the Chinese central bank. China's consumer price inflation slowed to 5.3 percent in April from 5.4 percent in March, which marked the highest inflation rate since July 2008 (see bottom chart on page 1). This improvement was somewhat less than what the markets had anticipated with the consensus looking for a 5.2 percent rate year over year in April. Declining food inflation helped bring down the headline rate in April as food inflation slowed to 11.5 percent in April from 11.7 percent in March.

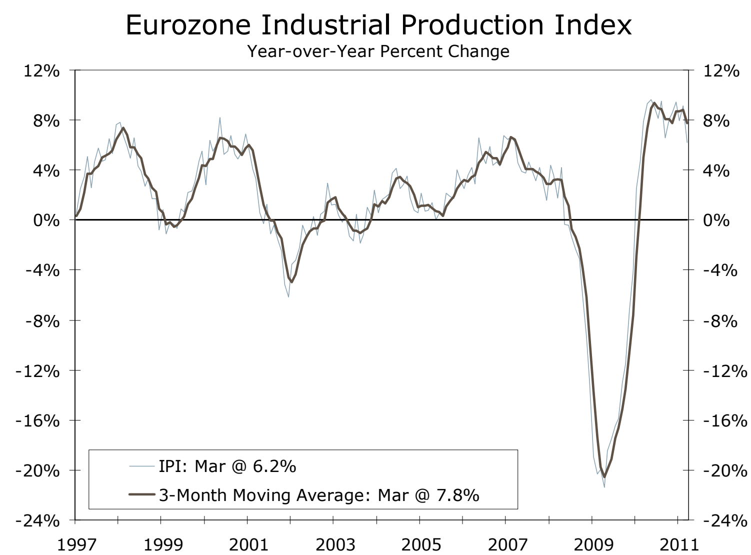
Yet, what concerns authorities was the resilience in non-food inflation, which held steady at 2.7 percent year over year, the highest rate for this component since 1997. The Chinese have set an inflation target of 4.0 percent for 2011, so it appears the government still has much work to do if it plans to get anywhere near that target by year-end. The central bank did not waste much time getting to work on the problem, deciding on Thursday to raise the bank's reserve requirements for the fifth time this year. The reserve ratios will increase 0.5 percent on May 18, pushing the ratio for the nation's largest banks to a record 21 percent.

China is using a combination of approaches to attack its inflation problem, raising interest rates and reserve requirements, setting limits on loan growth and even accelerating the appreciation of the Yuan. More aggressive monetary tightening in China has also helped push commodity prices lower this week as markets begin to anticipate a slower growth outlook for China as authorities try and stomp out inflation pressures. Playing right into the fears were weaker readings on Chinese industrial production (top chart), retail sales (middle chart) and loan growth for April.

Weaker Manufacturing Growth Comes to Europe

Economic releases out of Europe have not been any brighter on the global economic front. Disappointing March industrial production growth was released for the Eurozone (bottom chart). Production in the 17-country region fell 0.2 percent in March, following an upwardly revised 0.6 percent increase in February. Declines were seen in capital goods, non-durable consumer goods and energy. From a year ago, Eurozone growth slipped to 5.3 percent from 7.7 percent in February. Germany, which has led the Eurozone region in its manufacturing and export performance, saw production growth slow to 0.4 percent on the month from a strong 1.6 percent pace in February. Production fell 0.9 percent in France, and also fell in Ireland, Greece, Spain and Finland. Weak demand from non-European developed countries and slowing growth in emerging markets is expected to hurt Europe's export and manufacturing performance at a time when fiscal austerity measures in many European countries are limiting domestic demand. The Bank of England inflation report added to the souring economic news this week. The bank raised the U.K.'s inflation forecasts, noting that consumer inflation could hit 5.0 percent by year-end, but it also revised down the growth outlook, highlighting risks of weaker growth and higher inflation.





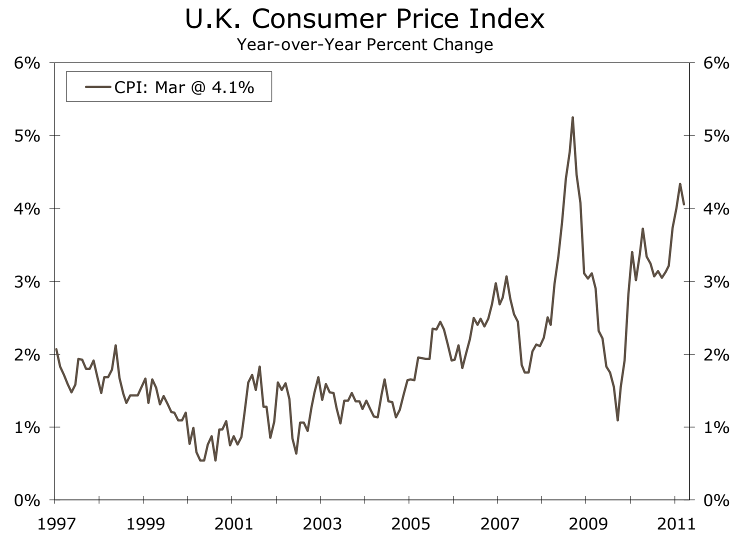
British CPI Inflation • Tuesday

The overall rate of CPI inflation in the United Kingdom fell from 4.4 percent in February to 4.0 percent in March, which was lower than most analysts had expected at the time. That said, the overall rate of inflation is still significantly above the two percent target that the Bank of England is mandated to achieve in the "medium term." Although most members of the Monetary Policy Committee (MPC) believe the sluggish rate of economic growth will lead to lower CPI inflation in the future, there are some members who would prefer to raise rates now before inflation expectations get out of control. The April CPI data will have important implications for British monetary policy in the near term.

Other soundings on the present state of the U.K. economy will be provided by April data on retail spending and the labor market. Stronger-than-expected outturns would bolster the case of those MPC members who want to tighten monetary policy.

Previous: 4.0% **Wells Fargo: 4.0%**

Consensus: 4.1% (Year-over-Year)



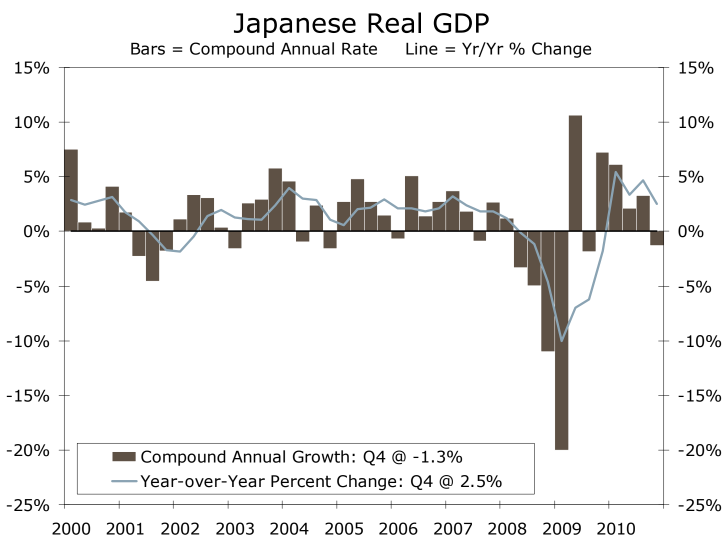
Japanese GDP • Thursday

The Japanese economy contracted slightly in the fourth quarter of last year, and many analysts look for another negative number in the first quarter. Although industrial production grew 1.8 percent in February, it tanked in March in the aftermath of the earthquake and tsunami that struck northern Japan. Not only did industrial production take a hit in the wake of the natural disasters, but retail spending also tumbled in March. Next week's figures on real GDP in the first quarter will give a deeper indication of the economic fallout from the disasters.

It is apparent that economic weakness has lingered into the second quarter. Japan's power supply has been negatively affected by the ongoing problems at the crippled nuclear power plant. Although we look for the Japanese economy to eventually bounce back, the disasters have dealt a serious economic blow to Japan.

Previous: -1.3% **Wells Fargo: 0.6%**

Consensus: -2.0% (Annualized Rate)



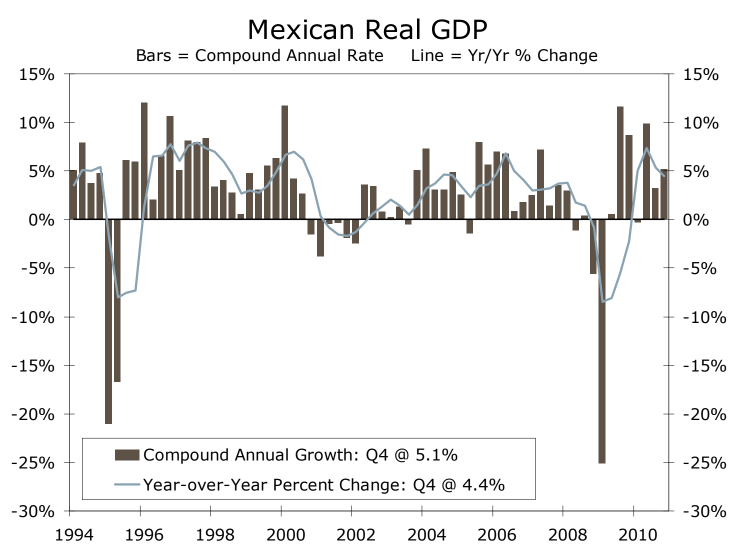
Mexican GDP • Thursday

An economic upturn has been in place in Mexico for nearly two years, and we expect the data to be released on Thursday will show that the year-over-year rate of real GDP growth remained solid in the first quarter. Not only has the global recovery helped to bolster Mexican exports, but domestic demand south of the border has also strengthened. Indeed, real personal consumption expenditures were up 4.6 percent on a year-ago basis in the fourth quarter of 2010, and growth in business fixed investment spending exceeded 6 percent during the same period. Real GDP data will give analysts a more complete insight into how the Mexican economy fared in the first quarter.

We look for some slowing in the rate of real GDP growth in Mexico over the course of the year as economic growth in most of Mexico's trade partners slows. That said, we still expect the Mexican economy to grow in excess of four percent in 2011.

Previous: 4.6% **Wells Fargo: 4.5%**

Consensus: 4.9% (Year-over-Year)



Interest Rate Watch

Modest Uptrend in Rates

Multiple one-off forces will generate a volatile period for interest rates, but our outlook is that the trend will be a modest rise in rates over the rest of this year.

We expect the Federal Reserve to complete QE2 in the next month and not pursue a QE3 policy. Meanwhile, the Treasury debt ceiling issue will likely be resolved in August. These events will create volatility in the marketplace, but the trend in rates should be driven more by the fundamentals of expectations for growth, inflation and the funds rate benchmark.

Growth should average 2.5 percent for the next three quarters with gains in consumer and business investment spending while the federal government will be cutting spending as budget restraint begins to take hold. Our outlook remains below the Blue Chip consensus for 2011.

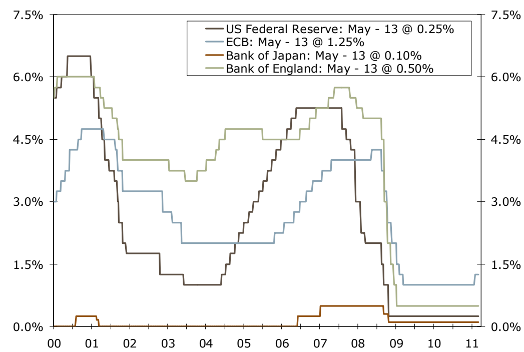
Inflation, as measured by the core PCE deflator, is expected to rise modestly over the next three quarters at a pace around 1.3 percent. Putting both our outlook and the FOMC on a consistent fourth-quarter over fourth-quarter basis, our core PCE deflator outlook is at 1.8 percent compared to 1.3–1.6 percent for the FOMC. For the overall consumer price index we expect a pace of 3.5 percent-plus over the same period. Our outlook is a bit above the Blue Chip consensus on inflation.

With these growth and inflation fundamentals, the Federal Reserve is unlikely to move the funds rate needle given the bias to ease among the Chairman Bernanke, Vice Chairman Yellen and New York Fed President Dudley.

Our two-year Treasury note outlook is for a move in the rate from 0.65 percent in the current quarter to 1.1 percent in the fourth quarter of this year. Our outlook for the 10-year rate is for 3.4 percent this quarter to 3.7 percent in the fourth quarter of this year.

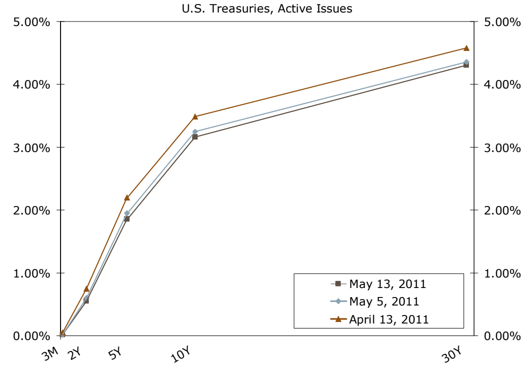
While our short-run outlook is for modest change, our long-run view, as represented in our *Annual Outlook*, is that the low interest rates are unsustainable given our budget and current account imbalances. The risks remain on the upside.

Central Bank Policy Rates



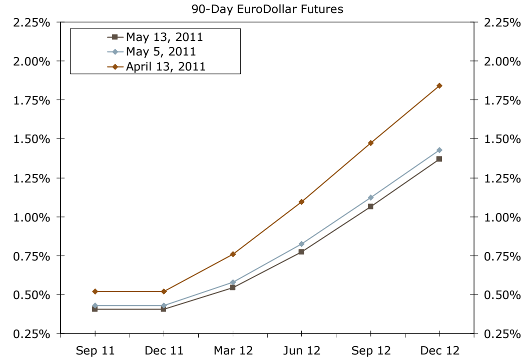
Yield Curve

U.S. Treasuries, Active Issues



Forward Rates

90-Day EuroDollar Futures



Credit Market Insights

No News is Good News

With the financial system in much better shape now than it has been in for the past few years, credit spreads have come down significantly—so much so that there is hardly anything to even say at this point. Still, we thought we would take a look at where things currently stand.

The spread on Baa corporate bonds over the 10-year Treasury dropped from a peak of 612 bps on Dec. 5, 2008, to 238 bps on April 30, 2010. It moved back up to 327 bps by Nov. 12, 2010, as the 10-year yield fell due to quantitative easing, but it has since narrowed again as the 10-year yield has rebounded while the Baa corporate yield has dropped further. Still, at 258 bps as of May 6, the spread over Treasuries remains about 60 bps above the historical average, which has helped to keep demand for corporate bonds elevated. Meanwhile, low nominal yields have provided issuers with very cheap financing, which has helped to improve corporate balance sheets and drive business investment.

Spreads have also returned to more normal levels for residential mortgages, currently hovering around 150 bps compared to almost 300 bps at the peak. This has helped to keep mortgage rates low for quite some time. However, unlike corporations, many homebuyers have not been able to take advantage of these ultra-low rates as lending standards remain tight, the unemployment rate remains high and negative home equity persists.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.63%	4.71%	4.91%	4.93%
15-Yr Fixed	3.82%	3.89%	4.13%	4.30%
5/1 ARM	3.41%	3.47%	3.78%	3.95%
1-Yr ARM	3.11%	3.14%	3.25%	4.02%
MBA Applications				
Composite	496.3	458.7	444.0	578.1
Purchase	194.9	182.7	191.7	263.6
Refinance	2,269.1	2,081.6	1,923.9	2,430.8

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

Topic of the Week

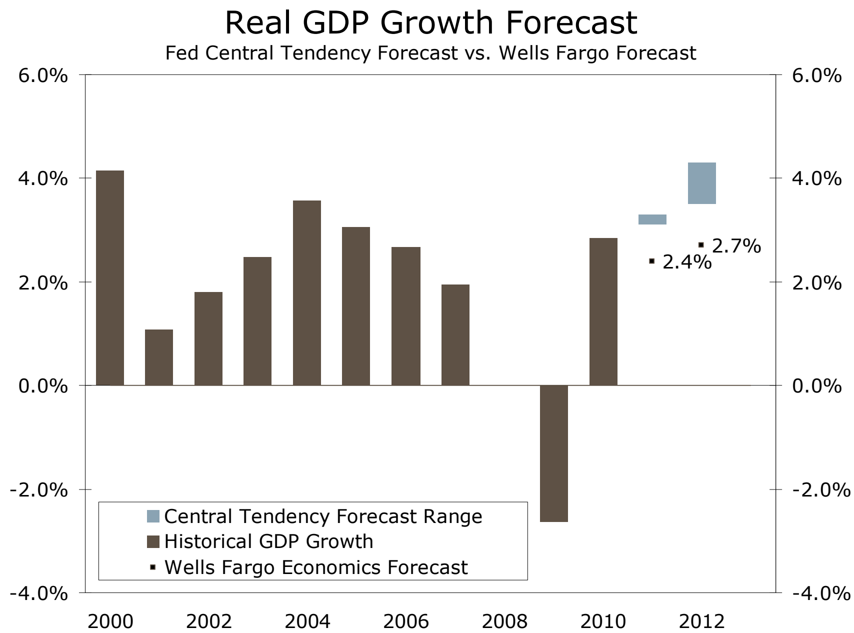
Forecast Comparison: Federal Reserve Board

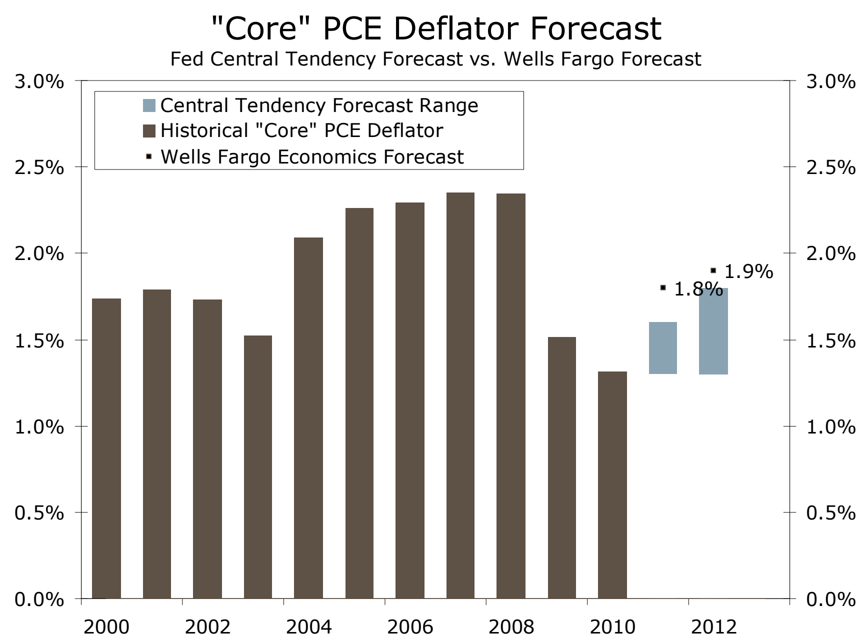
On April 27, the Federal Reserve released its latest economic projections for four key indicators: real GDP growth, the unemployment rate, headline PCE and core PCE inflation. Our forecasts differ considerably with the Fed's outlook for core PCE inflation and real GDP growth. We see inflation being slightly less contained than the Fed does, with the core PCE deflator rising slightly faster than the upper end of the Fed's forecast range in 2011 and 2012.

As the economy improves, we believe some of the excess slack will be removed from the economy, allowing producers to begin passing on price increases. We also believe a significant portion of the "slack" in the economy is also structural in nature and will not provide much restraint to higher inflation. Price increases will weigh on real personal consumption as more and more income is required to maintain the same level of purchases. Furthermore, consumer balance sheets remain highly leveraged by historical standards, which suggest that the economy should continue to see consumers deleverage over the next two years.

The housing market was one of the central drivers of economic growth in the prior economic expansion, both in terms of spending and employment, but we expect the housing sector to remain on the sidelines for the foreseeable future during this expansion. In addition to the weak housing market and the cautious consumer, there are large downside risks from impending government cutbacks, both at the national and the state and local levels. For instance, government transfer payments have accounted for an outsized portion of personal income growth since the recession.

Generally, we view higher inflation as a threat to growth rather than a byproduct of stronger growth. With a weak consumer, a limping housing market and government cutbacks, economic growth will be more sensitive to higher inflation than in past expansions. For a more in-depth analysis of our economic forecast, see the May edition of our *Monthly Economic Outlook*.





Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 5/13/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.02	0.01	0.16
3-Month LIBOR	0.26	0.27	0.44
1-Year Treasury	0.14	0.13	0.27
2-Year Treasury	0.53	0.55	0.82
5-Year Treasury	1.81	1.86	2.24
10-Year Treasury	3.15	3.15	3.53
30-Year Treasury	4.30	4.29	4.43
Bond Buyer Index	4.61	4.69	4.32

Foreign Exchange Rates

	Friday 5/13/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.417	1.432	1.254
British Pound ($/£)	1.619	1.637	1.461
British Pound (£/€)	0.875	0.875	0.858
Japanese Yen (¥/$)	80.680	80.630	92.750
Canadian Dollar (C$/$)	0.971	0.967	1.020
Swiss Franc (CHF/$)	0.889	0.879	1.118
Australian Dollar (US$/A$	1.058	1.070	0.896
Mexican Peso (MXN/$)	11.747	11.637	12.431
Chinese Yuan (CNY/$)	6.498	6.493	6.828
Indian Rupee (INR/$)	44.865	44.795	45.078
Brazilian Real (BRL/$)	1.639	1.615	1.776
U.S. Dollar Index	75.483	74.841	85.207

Foreign Interest Rates

	Friday 5/13/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.37	1.37	0.62
3-Month Sterling LIBOR	0.82	0.82	0.70
3-Month Canadian LIBOR	1.20	1.20	0.53
3-Month Yen LIBOR	0.20	0.20	0.25
2-Year German	1.78	1.76	0.60
2-Year U.K.	0.99	1.01	0.99
2-Year Canadian	1.69	1.66	1.95
2-Year Japanese	0.19	0.19	0.17
10-Year German	3.08	3.17	2.94
10-Year U.K.	3.37	3.38	3.84
10-Year Canadian	3.19	3.19	3.52
10-Year Japanese	1.13	1.15	1.32

Commodity Prices

	Friday 5/13/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	98.19	97.18	74.40
Gold ($/Ounce)	1498.53	1495.60	1232.70
Hot-Rolled Steel ($/S.Ton	800.00	800.00	695.00
Copper (¢/Pound)	399.20	396.35	321.95
Soybeans ($/Bushel)	13.40	13.18	9.48
Natural Gas ($/MMBTU)	4.17	4.24	4.34
Nickel ($/Metric Ton)	24,549	24,510	22,479
CRB Spot Inds.	600.76	606.07	491.60

Next Week's Economic Calendar

	Monday 16	Tuesday 17	Wednesday 18	Thursday 19	Friday 20
U.S. Data		**Housing Starts** March 549K April 585K (W) **Indus. Production** March 0.8% April 0.3% (W) **Capacity Utilization** March 77.4% April 77.4% (W)		**Existing Home Sales** March 5.10M April 5.19M (W) **Leading Indicators** March 0.4% April 0.0% (W)	
Global Data	**Eurozone** **CPI (YoY)** Previous (Mar) 2.8% **Japan** **Machine Orders (YoY)** Previous (Feb) 7.6%	**U.K.** **CPI (YoY)** Previous (Mar) 4.0% **Germany** **Zew Current Situation** Previous (Apr) 87.1		**Japan** **GDP (CAGR)** Previous (Q4) -1.3% **Mexico** **GDP (YoY)** Previous (Q4) 4.6%	**Canada** **CPI (YoY)** Previous (Mar) 3.3% **Canada** **Retail Sales (MoM)** Previous (Feb) 0.7%

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

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