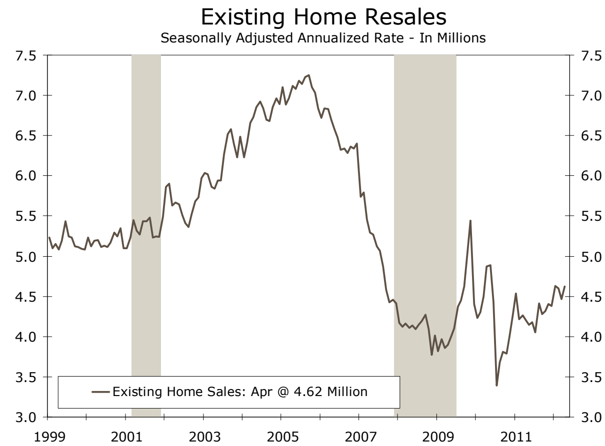
May 25, 2012

Economics Group

Weekly Economic & Financial Commentary

U.S. Review

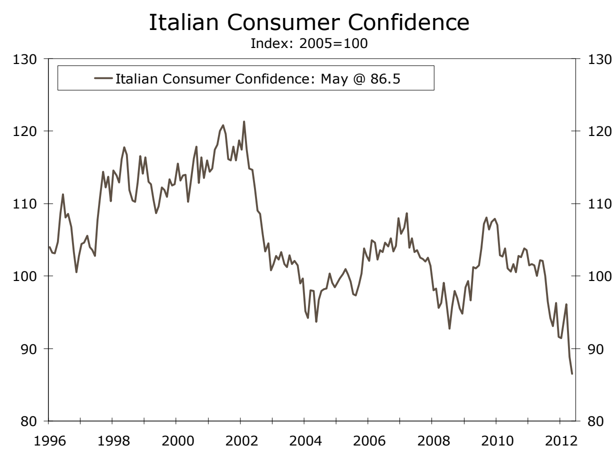
Housing Recovery on Track, but Manufacturing Slows



- April housing data on new and existing home sales came in a bit better than expected, and home prices showed more signs of stabilizing, both welcome indications that the U.S. housing recovery remained on track to start the second quarter. On a less positive note, mortgage purchase applications from the Mortgage Bankers Association have dropped for two consecutive weeks in May.
- The new Markit PMI for the United States showed moderating manufacturing growth for May. April durable goods orders showed more signs of weakness.

Global Review

Europe and Asia Vie for Title of Worst News of the Week



- Eurozone manufacturing and services contracted more than expected in May. In addition, consumer confidence in Italy fell to the lowest on record and German business confidence fell for the first time in seven months. In the United Kingdom, retail sales fell and first quarter GDP contraction turned out to be worse than estimated.
- Japan's credit rating was downgraded this week as the debt-to-GDP ratio was forecast to rise further. Japan also reported weaker-than-expected export growth. Meanwhile, Chinese manufacturing may be losing steam and the World Bank cut its forecast for Chinese growth.

Wells Fargo U.S. Economic Forecast

	Actual				Forecast				Actual			Forecast	
	2011				2012				2009	2010	2011	2012	2013
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	0.4	1.3	1.8	3.0	2.2	2.1	1.6	1.9	-3.6	3.0	1.7	2.1	1.8
Personal Consumption	2.1	0.7	1.7	3.0	2.9	2.5	1.5	1.5	-2.0	2.0	2.2	2.1	1.5
Inflation Indicators [2]													
PCE Deflator	1.8	2.5	2.9	2.7	2.3	2.1	2.1	2.3	0.6	1.8	2.5	2.2	2.1
Consumer Price Index	2.1	3.3	3.8	3.3	2.8	2.1	1.6	1.7	-0.3	1.6	3.1	2.1	1.9
Industrial Production [1]	4.4	1.2	5.6	5.0	5.4	4.7	3.0	2.2	-11.3	5.4	4.1	4.4	2.6
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	73.5	74.0	74.5	77.7	75.6	70.9	73.7	76.1
Unemployment Rate	9.0	9.0	9.1	8.7	8.3	8.1	8.2	8.1	9.3	9.6	9.0	8.2	7.9
Housing Starts [4]	0.58	0.57	0.61	0.68	0.71	0.74	0.76	0.75	0.55	0.59	0.61	0.74	0.85
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	1.80	1.85	1.90	3.26	3.22	2.78	1.95	2.15

Forecast as of: May 25, 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

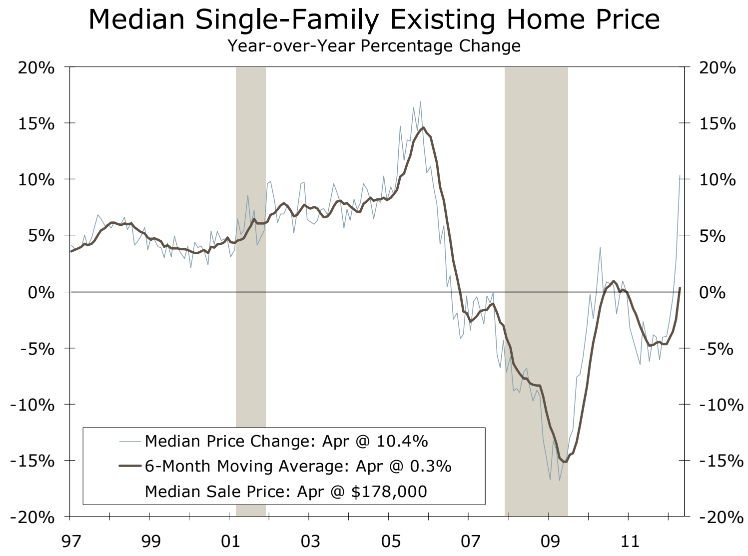
U.S. Review

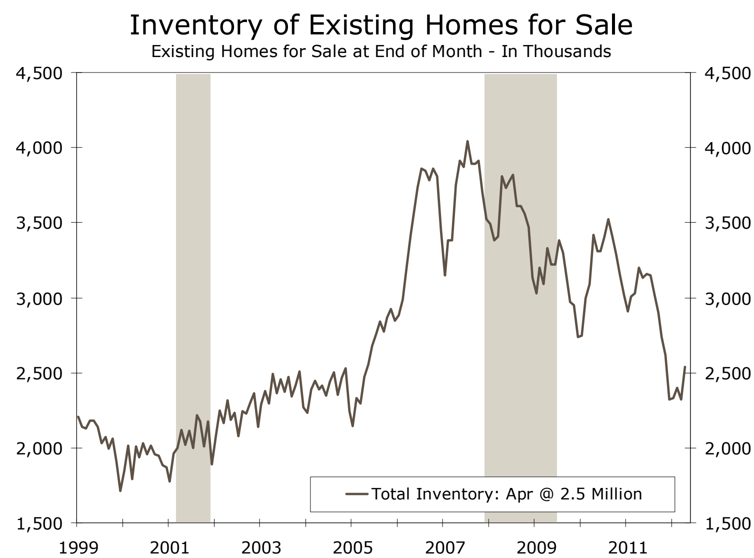
Housing Rebound Continues in April

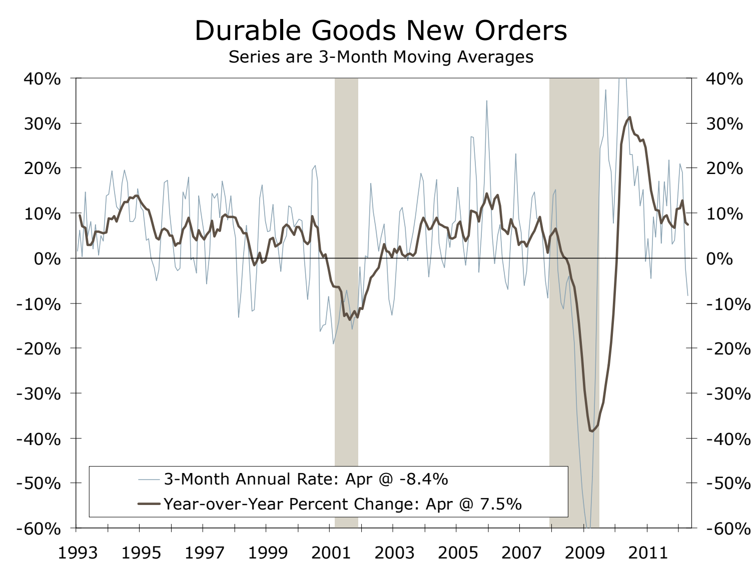
It's a relief to finally be getting some positive economic news from the U.S. housing market. And on that front, the April housing data did not disappoint. Existing home sales for April increased to a 4.62 million annual rate, a 3.4 percent increase over March. Condo and co-op sales advanced at a 6.0 percent pace on the month, while single-family sales increased 3.0 percent. Improvements in the labor market and record low mortgage rates are helping stabilize housing demand. Even so, months' supply increased to 6.6 months from 6.2 in March as more sellers put their houses on the market. The number of existing homes on the market increased 9.5 percent in April. The median existing single-family sales price was 10.4 percent above year-ago levels in April, rising to $178,000. However, this was due more to a change in the mix of sales—fewer distressed sales and more traditional sales—rather than home buyers deciding to pay up for properties. New home sales also increased a better-than-expected 3.3 percent in April, with solid seller gains in the Midwest and West, pushing the national months' supply of new homes down to 5.1 months of inventory. The March home price data from FHFA confirmed the trends seen in other home price metrics, increasing 1.8 percent from February with solid home price gains in the Pacific and Northeast regions of the country. However, it remains a challenging economic environment for housing. The Mortgage Bankers Association's purchase application index has slipped over the past two weeks and is now trending 4.2 percent lower than a year ago, so the road to recovery will likely be a winding one rather than a straight shot to new cyclical highs.

U.S. Manufacturing Shows More Signs of a Slowdown

While the U.S. manufacturing expansion does not look to be in any near-term danger of reversing, there was more data this week to support the view that U.S. manufacturing momentum is decelerating. An economic recession in much of Europe and slower growth in many emerging market economies such as China, India and Brazil is starting to take a toll on the U.S. manufacturing expansion as well. The week started on a sour note with the release of the Richmond Fed manufacturing PMI for May, which came in weaker than expected at 4, down from a 14 reading in April. This view of a slower manufacturing expansion was corroborated by the first release of the Markit manufacturing PMI for the United States, which also fell to 53.9 from 56.0 in April. This index is the first national read on U.S. manufacturing for May, and according to Markit, is based on about 85 percent of the usual monthly replies to the ISM PMI released later in the month. While we do not yet have a lot of history to go on with this manufacturing index, it may become a closely watched first take on manufacturing activity in the months ahead. The PMI was pulled down by deterioration in output, new orders, employment, and slower inventory growth. The April durable goods orders also showed broad-based weakness in machinery, fabricated metals, and computer orders that suggests less durable goods manufacturing and business equipment spending in the months ahead.





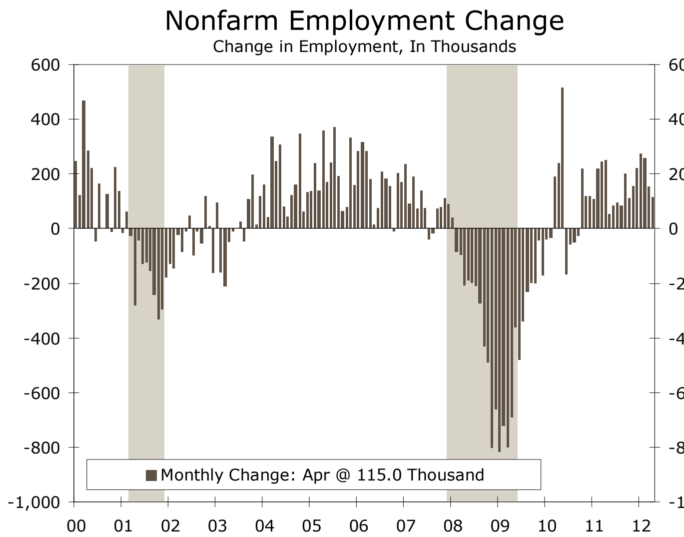


Employment • Friday

Over the past two months nonfarm payrolls sorely disappointed adding an average of only 134,000 jobs per month. Moreover, the drop in the unemployment rate to 8.1 percent in April due to a decline in the labor force participation rate presented more questions than answers. In fact, the report appears to be an even greater paradox as other employment indicators such as the NFIB Small Business Optimism Survey and the Job Openings Labor Turnover Survey showed improvement on the month. The April NFIB Small Business Optimism Survey showed the percentage of owners reporting at least one hard-to-fill job opening rose and JOLTS showed the number of job openings in March rose to the highest level since July 2008. We suspect the lackluster results were partly due to some payback from the early Easter and milder-than-usual winter and payrolls could add 150,000 jobs in May, with the unemployment rate edging down to 8.0 percent.

Previous: 115,000 **Wells Fargo: 150,000**

Consensus: 150,000

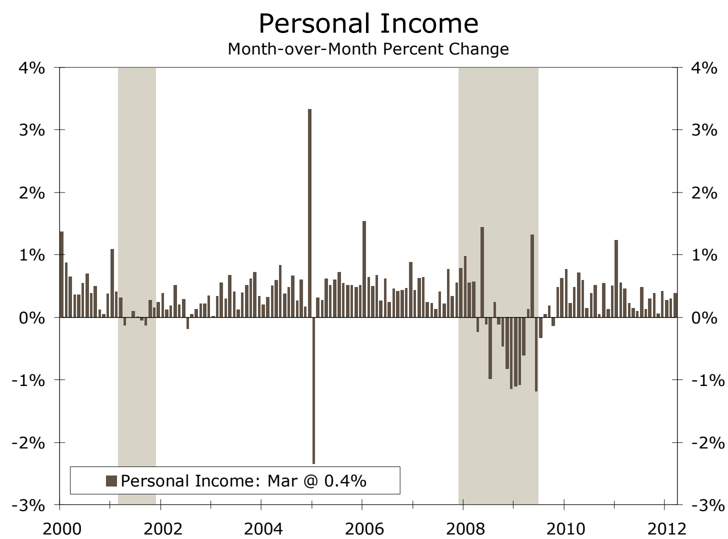


Personal Income • Friday

Personal income rose a solid 0.4 percent in March, while spending rose 0.3 percent, which allowed the saving rate to rise to 3.8 percent. Wages and salaries, the largest component of income, rose in all major sectors, suggesting broad-based improvement. Overall, income growth still remains exceptionally modest, however, particularly after adjusting for inflation and taxes. Real after-tax disposable income rose 0.2 percent in March, following declines of 0.1 percent in January and February. On a per-person basis, real after-tax income has shown essentially no growth for the past two years. Modest gains in income will likely continue to constrain consumer spending. That said, the relatively healthy 2.9 percent growth in real personal consumption during the first quarter looks unsustainable, as outlays continue to be largely driven by durable goods purchases. We expect consumer spending to increase at around a 2.0 percent pace in 2012.

Previous: 0.4% (Month-over-Month) **Wells Fargo: 0.3%**

Consensus: 0.3%

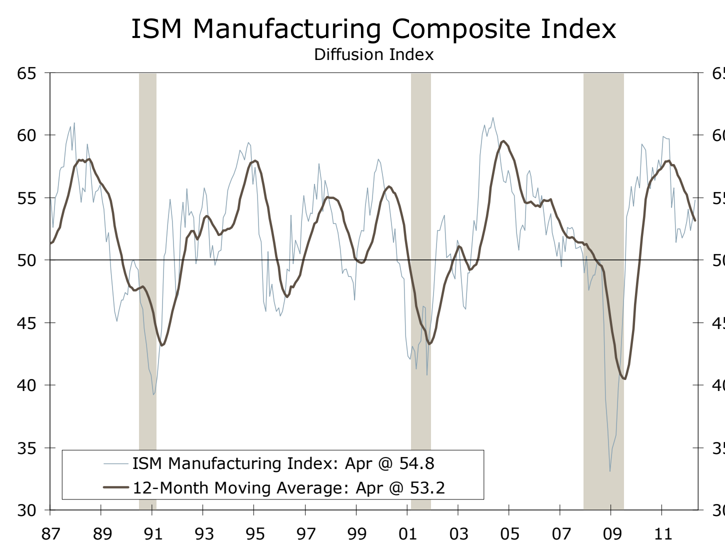


ISM Manufacturing • Friday

The pace of manufacturing edged a bit higher in April to 54.8, but has slowed considerably from its 59.9 high in January 2011. In fact, weaker-than-expected regional purchasing manager surveys suggest the factory sector could see a modest pullback in May. Comments from the April survey are telling and indicate manufacturers are seeing stable to strong demand, but still have some concerns about Europe. That said, uncertainty will likely continue to affect manufacturing activity in the coming months, as issues regarding the European sovereign debt crisis continue to remain in the forefront. While growth will likely be modest, we expect manufacturing activity to remain expansionary. We expect the ISM manufacturing index to pull back slightly in May to 53.9.

Previous: 54.8 **Wells Fargo: 53.9**

Consensus: 54.0



Global Review

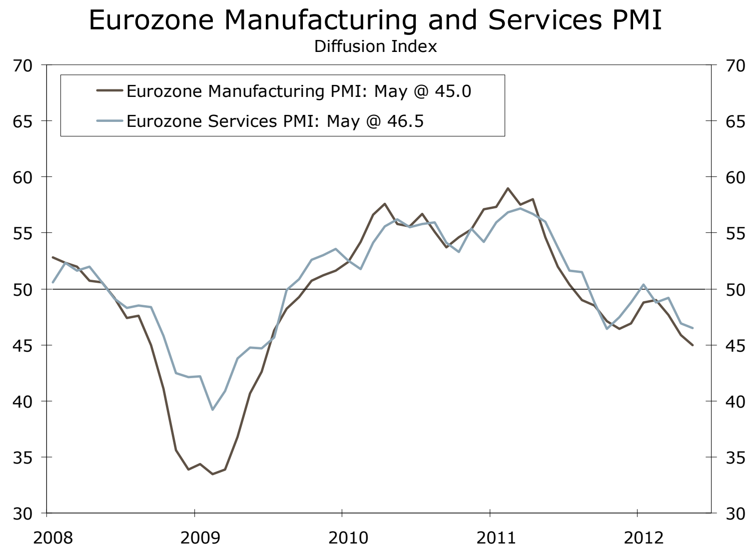
More Signs of Weakness in Europe

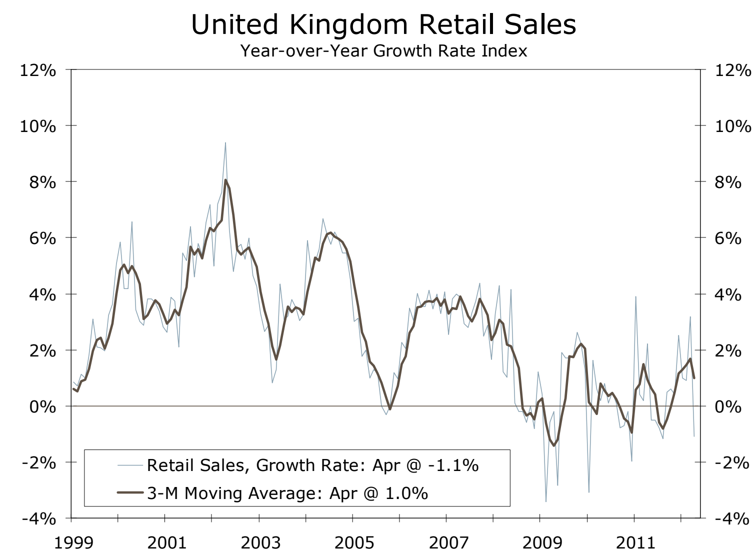
According to the latest Purchasing Managers Indices (PMIs), the situation in the Eurozone is worsening. The composite PMI for the Eurozone fell in May to 45.9. The services PMI fell to 46.5, the lowest in seven months, while the manufacturing PMI dropped to 45.0, the weakest in nearly three years. All three measures were below expectations. Confidence in the region is also tumbling. Italian consumer confidence plunged in May to the lowest since records began in 1996 as the country endures severe austerity amid its fourth recession in a decade. This certainly does not bode well for the outlook for consumer spending and economic growth, or for the country's prospects of paying down its crippling debt. In addition, Germany, the largest European economy, saw in May the first decline in business confidence in seven months.

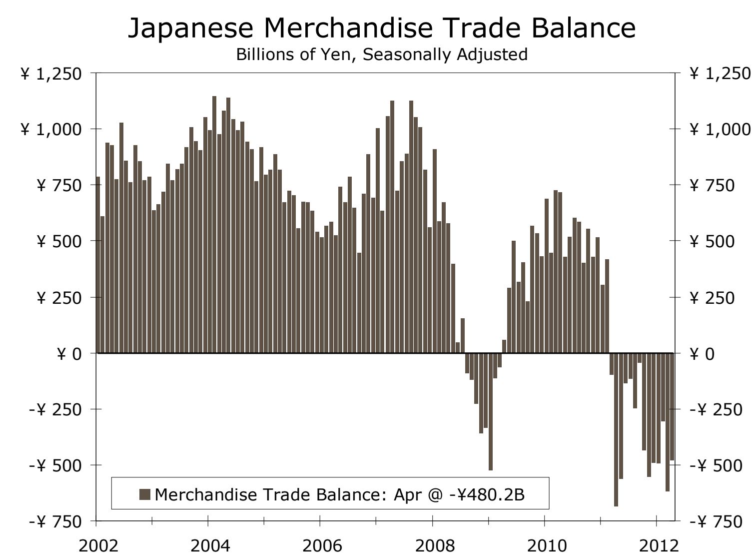
Outside the currency union, things are not looking any better. Retail sales in the United Kingdom plunged 2.3 percent in April from the prior month, the biggest decline since January 2010. However, this follows a 2.0 percent surge in March that was driven by warm weather. In April, the weather turned unfavorable as the United Kingdom experienced the most rainfall for April in over a century, weighing on purchases of clothing and gardening products. Sales were also hampered by a big decline in fuel sales, but this also followed a surge in March as consumers rushed to buy fuel in anticipation of a fuel trucker strike. Yet, absent the effects of weather and subtracting fuel, sales still declined on the month. With all of these factors in the mix, a clearer picture of underlying consumer spending trends should emerge when May data are released. With unemployment near a 16-year high, spending will likely remain subdued in the near term. The kingdom's manufacturing industry is also reeling, as the Confederation of British Industry reported that a measure of manufacturing orders fell to the weakest this year in May, while the outlook deteriorated sharply. Minutes of the May 10 meeting show that the Bank of England stands after ready should another round of stimulus be needed, which may be necessary considering the first quarter contraction was worse than originally estimated.

Japan Exports Disappoint, China Growth Forecast Cut

There was disappointing news from Asia this week as well. Japan's credit rating was downgraded by Fitch, as gross public debt was forecast to reach 223 percent of GDP by next year. This has led to calls for Japan to boost the consumption tax, putting Japan in the same predicament as Greece of needing to tighten fiscal policy while the economy is still fragile. The next day, Japan reported export growth of 7.9 percent year over year, far less than the 11.8 percent increase that was expected due to the plunge in exports last April in the wake of the earthquake and tsunami. Finally, the HSBC flash estimate for manufacturing in China showed that Chinese manufacturing may be losing steam. This came just a couple days after the World Bank reduced its forecast for growth in China this year citing weak U.S. and European demand and the softening property market. News that China's banks may fall short of loan growth targets this year added to the gloom, but markets cheered China's plans to support growth.







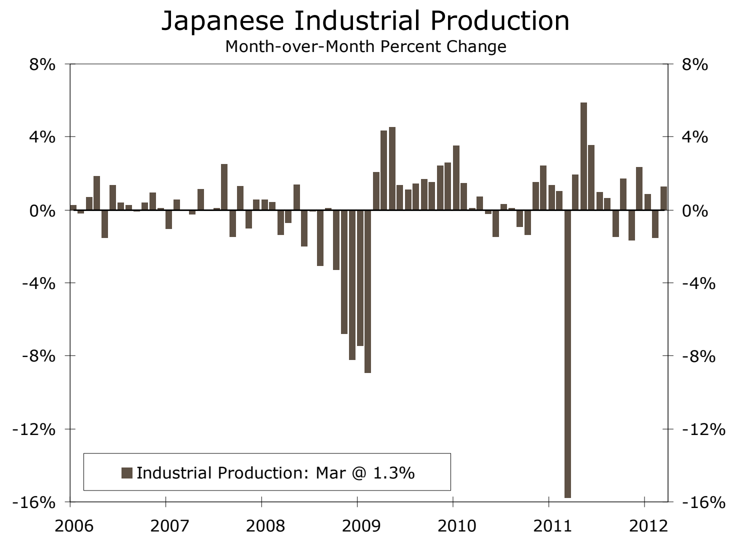
Japan Industrial Production • Thursday

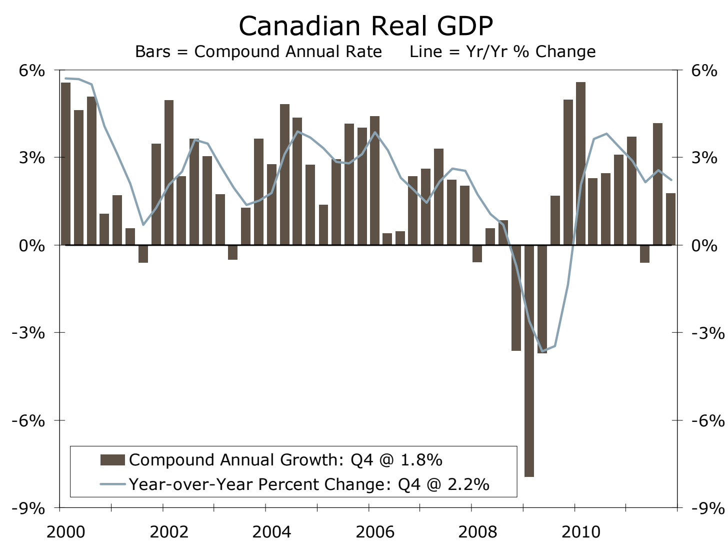
Real GDP in Japan grew at an annualized rate of 4.1 percent in the first quarter, which was stronger than most analysts had expected. Next week's data barrage will show whether the momentum has continued in the second quarter. In that regard, the industrial production (IP) data for April, which will print on Thursday, will be one of the most closely watched indicators. IP rose 1.3 percent in March relative to the previous month, and the consensus forecast looks for another 0.8 percent increase in April, which would get Q2 off to a good start if realized. However, giving the disappointing export figures, the risks are still on the downside.

Although IP probably will receive the attention, there are some other important indicators for April on the docket as well. Analysts expect that retail sales will remain about flat in April following their 1.2 percent decline in March. Data on the labor market and housing starts also will be released next week.

Previous: 1.3% (Month-over-Month)

Consensus: 0.8%





Canada GDP • Friday

Real GDP growth in Canada has cooled somewhat over the past year or so, and we expect that the quarterly data that are slated for release on Friday will show that the pace of growth remained lackluster in the first quarter. We base our forecast in part on previously released monthly GDP data that show a 0.2 percent contraction in February following an uninspiring 0.1 percent increase in January. The slowdown has been broad based. Not only have exports decelerated, but growth in most components of domestic demand has slowed as well.

Due to the slowdown in the global economy and the strength of the Canadian dollar, Canada's current account has swung into a modest deficit over the past few years. Analysts expect another small deficit when Q1 current account data print on Friday. Data on Canadian house prices in March are on the docket on Wednesday.

Previous: 1.8% (Qtr-over-Qtr) Wells Fargo: 1.7%

Consensus: 2.0%

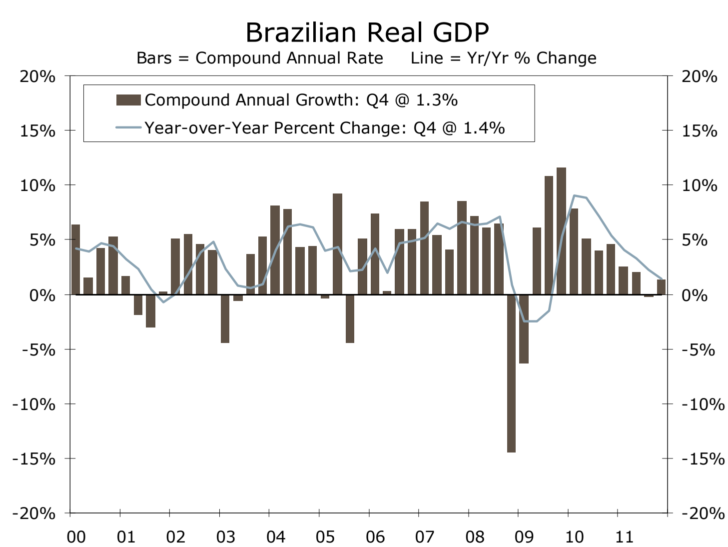
Brazil GDP • Friday

Real GDP growth in Brazil has slowed sharply over the past two years. The 1.4 percent GDP growth rate that was registered in Q4-2011 was the slowest year-over-year rate of growth since the country pulled out of the global economic downturn in 2009. The recent slowdown in Brazil reflects, at least in part, weaker export growth to important trading partners such as China and the Eurozone. We expect the GDP data will show that growth in Brazil remained sluggish in the first quarter.

Prior to the GDP release, the Central Bank of Brazil will hold a policy meeting on Wednesday. The central bank has sliced its main policy rate 350 bps since early September as economic growth has cooled and inflation has receded. Most analysts expect the central bank will announce on Wednesday another 50 bps cut in its policy rate. If these expectations are realized, the policy rate would fall to its lowest level in at least 13 years.

Previous: 1.4% (Year-over-Year) Wells Fargo: 1.5%

Consensus: 1.3%



Interest Rate Watch

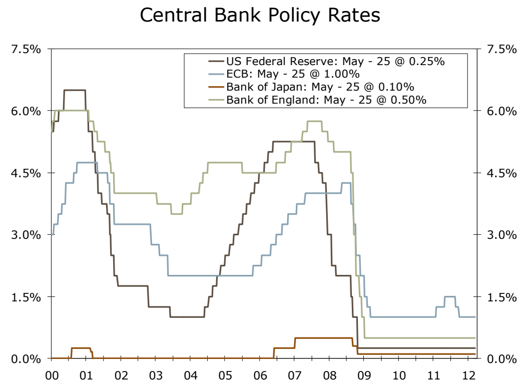
Slower Growth Cuts Yields Further

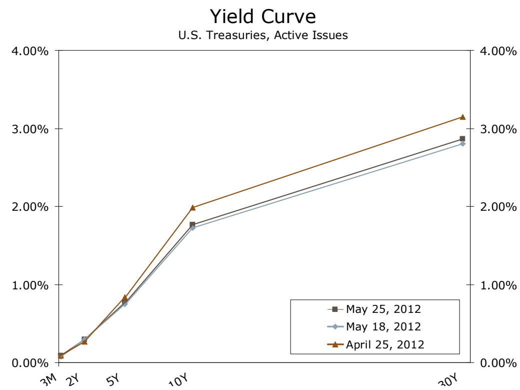
The wall of worry related to the European financial crisis, combined with reports of slower economic growth in China, has pulled interest rates lower and reduced interest expectations going forward. The 10-year Treasury yield is ending the month just below 1.75 percent and the two-year Treasury remains below 0.3 percent. The federal funds rate has actually traded a bit firmer in recent weeks, possibly reflecting the effect of modestly stronger loan growth. Despite being a couple of basis points higher, expectations for the timing of a firming in monetary policy remain unchanged, with the majority of Open Market Committee members and market participants expecting the first tightening move no sooner than the middle of 2014.

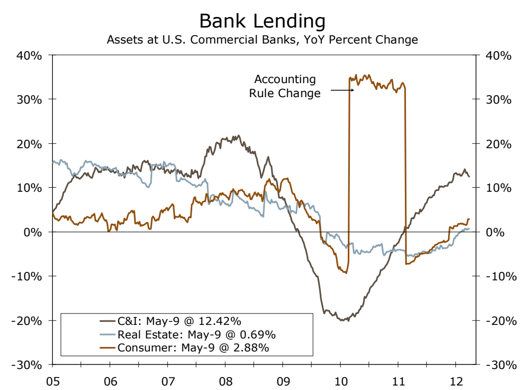
Our forecast now calls for weaker economic growth during the second half of 2012 and first half of 2013, which is when we believe the bulk of the drag from Europe's weakening economy will be felt in the United States. That period is also likely to see a great deal of uncertainty concerning U.S. fiscal policy, with a likely debate surround raising the federal debt ceiling and debates about the currently scheduled sequester and expiration of the Bush-era tax cuts all coming to a head.

Europe's financial woes and the still intractable fiscal situation in the United States continue to hang a low ceiling over the probable and possible trend of growth, both for the next few years and, in all likelihood, decades. Slower potential growth rates for the United States and other developed economies mean Treasury yields will likely remain significantly lower than they have been in the past.

Economists and policymakers need to consider the implications of slower growth, which will make it much more difficult to deal with the nation's budget issues, and lower interest rates, which will make it much more difficult to adequately fund retirement plans. One likely outcome will be increased demand for long-dated issues and some further compression in the spread between the 30-year and 10-year Treasury.







Credit Market Insights

Home Mortgage Market in Repair

Data from the Mortgage Bankers Association continues to point toward a slightly healthier home mortgage market. The mortgage delinquency rate continued to fall in the first quarter to 7.4 percent from 7.6 percent in the fourth quarter. Even more impressive is the pace of progress since this time last year when the delinquency rate was 8.3 percent. While still elevated, the continued signs of improvement are promising. The number of mortgages that fell into the 90-day delinquent category, which typically is a leading indicator of future foreclosures, also fell slightly to 9.1 percent from 9.3 percent in the fourth quarter. The decline in delinquencies points toward a slowing pipeline of potential foreclosures.

The level of foreclosure activity edged slightly higher in the first quarter as some of the backlog of foreclosures from last year's moratorium began to be processed. The slight uptick in foreclosures was driven by a slight rise in prime mortgage foreclosures; however subprime foreclosures remained the largest category of defaults.

Given the lower delinquency rates along with the ongoing clearing of foreclosures the home mortgage market continues to repair itself. While there remain many headwinds to a full recovery in the mortgage market, there are some signs that overall loan portfolios are beginning to improve, providing more stability for future credit conditions.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.78%	3.79%	3.88%	4.60%
15-Yr Fixed	3.04%	3.04%	3.12%	3.78%
5/1 ARM	2.83%	2.83%	2.85%	3.41%
1-Yr ARM	2.75%	2.78%	2.74%	3.11%

Bank Lending	Current Assets (Billions)	1-Week Change (SAAR)	4-Week Change (SAAR)	Year-Ago Change
Commercial & Industrial	$1,412.5	-0.88%	-2.15%	12.42%
Revolving Home Equity	$541.6	-5.88%	-6.37%	-4.46%
Residential Mortgages	$1,573.0	-1.56%	3.27%	5.79%
Commerical Real Estate	$1,419.6	2.80%	-3.09%	-2.52%
Consumer	$1,109.8	-3.26%	14.62%	2.88%

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

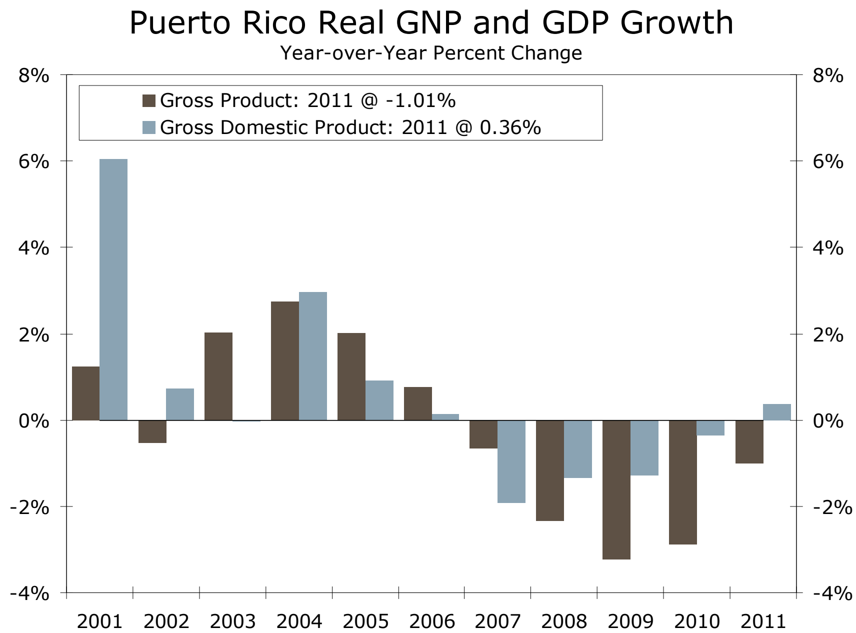
Topic of the Week

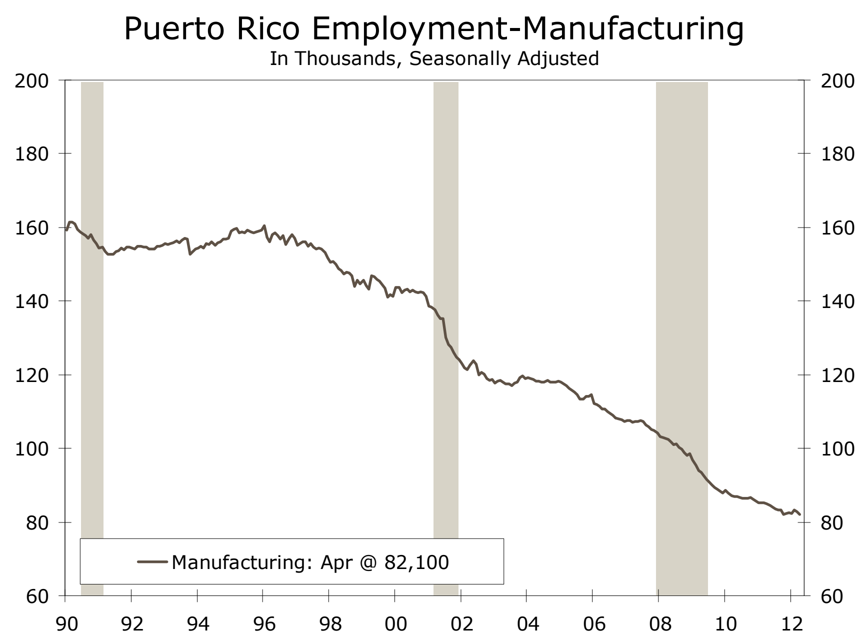
Puerto Rico: Failure of the State

The Puerto Rican economy has come a long way since it started to industrialize and modernize in the mid-1900s through what was called "Operation Bootstrap" in English, or "Operación Manos a la Obra" in Spanish. The process of industrialization was, by many measures, a success, even though some economic indicators have continued to point to many economic disequilibria that have persisted over time, such as a persistently high rate of unemployment as well as a high rate of inflation compared to the U.S. mainland, even though Puerto Rico uses the U.S. dollar as its currency and monetary policy is conducted by the U.S. Federal Reserve.

The Puerto Rican economy today is at a difficult junction. The development model used to industrialize the island, which was extremely successful in the beginning has mutated into a system that has the state, the Puerto Rican government, as the lifeline for almost everything that goes on in the economy. This increased intervention in the economy is strangling the Puerto Rican economy and jeopardizing future growth.

Many of the institutional settings in the Puerto Rican economy discourage investments in the island compared to other countries in the region that have free access to the U.S. market. This is the reason why we say that the elimination of the 936 laws and the closing of the government for two weeks in 2006, probably helped push the Puerto Rican economy off the cliff, but Puerto Rico had been walking that cliff for a long time. When the IRS 936 subsidies ended then the only advantage Puerto Rico had was its access to the U.S. market. However, that access became a common currency with the implementation of the NAFTA agreement and with other free trade agreements signed with many of the South American, Central American and Caribbean countries. Thus, Puerto Rico's benefits disappeared fast and furiously. Puerto Rico needs to find a government that is willing to put its priorities in order and invest in the future of the island. For more commentary, see our report, *Puerto Rico: Failure of the State*, on our website.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 5/25/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.09	0.08	0.05
3-Month LIBOR	0.47	0.47	0.25
1-Year Treasury	0.11	0.11	0.15
2-Year Treasury	0.29	0.29	0.54
5-Year Treasury	0.77	0.75	1.76
10-Year Treasury	1.77	1.72	3.13
30-Year Treasury	2.86	2.81	4.28
Bond Buyer Index	3.81	3.75	4.52

Foreign Exchange Rates

	Friday 5/25/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.257	1.278	1.409
British Pound ($/£)	1.568	1.582	1.627
British Pound (£/€)	0.802	0.808	0.866
Japanese Yen (¥/$)	79.540	79.020	81.970
Canadian Dollar (C$/$)	1.027	1.022	0.977
Swiss Franc (CHF/$)	0.956	0.940	0.873
Australian Dollar (US$/A$	0.979	0.984	1.053
Mexican Peso (MXN/$)	13.980	13.816	11.670
Chinese Yuan (CNY/$)	6.344	6.328	6.494
Indian Rupee (INR/$)	55.375	54.425	45.333
Brazilian Real (BRL/$)	2.029	2.009	1.624
U.S. Dollar Index	82.094	81.292	75.932

Foreign Interest Rates

	Friday 5/25/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.60	0.61	1.38
3-Month Sterling LIBOR	1.00	1.01	0.83
3-Month Canadian LIBOR	1.33	1.35	1.20
3-Month Yen LIBOR	0.20	0.20	0.20
2-Year German	0.06	0.05	1.66
2-Year U.K.	0.25	0.31	0.93
2-Year Canadian	1.12	1.21	1.59
2-Year Japanese	0.11	0.10	0.18
10-Year German	1.40	1.43	3.05
10-Year U.K.	1.78	1.83	3.33
10-Year Canadian	1.84	1.89	3.08
10-Year Japanese	0.89	0.83	1.13

Commodity Prices

	Friday 5/25/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	91.07	91.48	101.32
Gold ($/Ounce)	1562.28	1592.99	1525.32
Hot-Rolled Steel ($/S.Ton)	662.00	662.00	795.00
Copper (¢/Pound)	345.25	346.95	410.20
Soybeans ($/Bushel)	13.69	14.31	13.75
Natural Gas ($/MMBTU)	2.61	2.74	4.38
Nickel ($/Metric Ton)	17,032	17,130	22,883
CRB Spot Inds.	516.15	523.98	602.67

Next Week's Economic Calendar

	Monday 28	Tuesday 29	Wednesday 30	Thursday 31	Friday 1
U.S. Data		**Consumer Confidence** April 69.2 May 68.4 (W)	**Pending Home Sales** March 4.1% April -0.1% (C)	**GDP (Q/Q Annualized)** 1Q-A 2.2% 1Q-S 2.0% (W) **Personal Consumption** 1Q-A 2.9% 1Q-S 2.9% (C) **Core PCE (QoQ)** 1Q-A 2.1% 1Q-S 2.1% (C)	**Nonfarm Payrolls** April 115K May 150K (W) **Personal Income** March 0.4% April 0.3% (W) **ISM Manufacturing** April 54.8 May 53.9 (W)
Global Data	**Japan** **Retail Trade (YoY)** Previous (Mar) 10.3%	**Germany** **CPI (YoY)** Previous (Apr) 2.1%		**Eurozone** **CPI Estimate (YoY)** Previous (Apr) 2.6% **Japan** **IP (MoM)** Previous (Mar) 1.3%	**Canada** **GDP (Q/Q Annualized)** Previous (4Q) 1.8% **Brazil** **GDP (YoY)** Previous (4Q) 1.4%

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

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