June 01, 2012

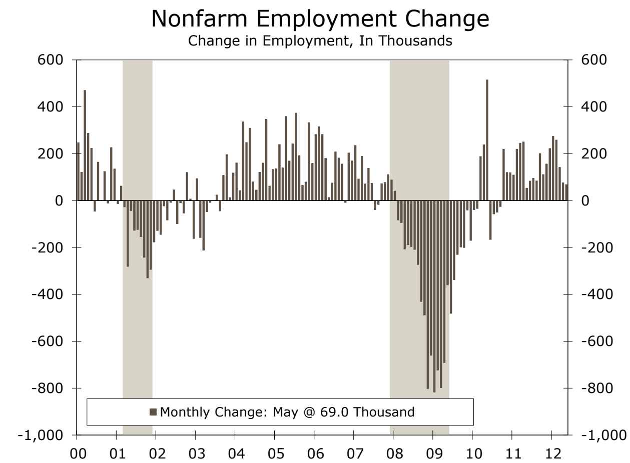
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Contrary to Popular Belief, the Recovery is not Stalling

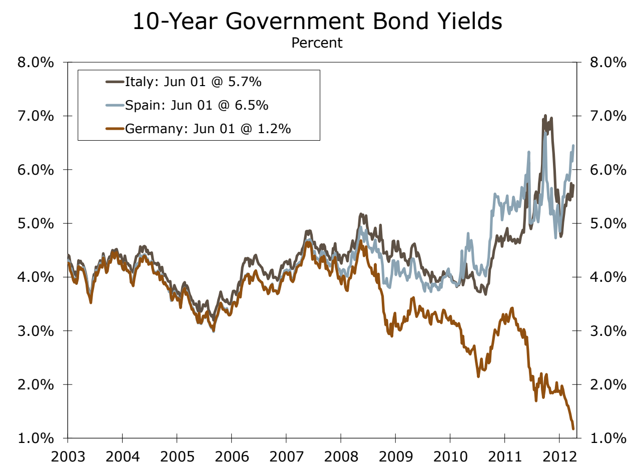
- Nonfarm employment came in well below expectations in May, adding only 69K jobs with the unemployment rate drifting a notch higher to 8.2 percent. The details of the nonfarm payroll report suggest that weather could have been a driver for the weaker-than-expected outturn.
- The ISM manufacturing survey weakened a bit, sliding 1.3 points to 53.5; however, the forward-looking new orders component jumped to 60.1, the highest level in 13 months, showing the continued resilience of the manufacturing sector.



Global Review

European Worry Spreads to Spain

- Spanish bond yields shot up this week on concerns that some of the country's major banks would need to be recapitalized, which would compound the financial woes faced by the Spanish government. The country's economy has slipped back into recession, and the government is finding it increasingly difficult to meet its deficit targets.
- Greek voters return to the polls on June 17 for another round of parliamentary elections. After the Greek elections, the next marker will be the EU summit on June 29-30 where bank recapitalization proposals may be discussed.



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	1.9	2.1	1.9	1.9	-3.6	3.0	1.7	2.1	1.9
Personal Consumption	2.1	0.7	1.7	3.0	2.7	2.4	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	1.9	1.9	2.1	0.6	1.8	2.5	2.1	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	6.5	6.0	6.2	6.4	9.1	32.2	7.9	6.3	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	3.70	3.70	3.80	5.04	4.69	4.46	3.79	4.05
10 Year Note	3.47	3.18	1.92	1.89	2.23	1.70	1.70	1.90	3.26	3.22	2.78	1.88	2.15

Forecast as of: June 1, 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

"There Is Nothing to Fear, but Fear Itself"

Nonfarm employment came in well below expectations in May, adding only 69K jobs, with the unemployment rate drifting a notch higher to 8.2 percent. Moreover, downward revisions to the previous months' data show the labor market was weaker than first reported. With the disappointing jobs print, Treasuries rallied, pulling the 10-year Treasury yield down to an all-time low of 1.45 percent, and crude oil prices fell below $85 a barrel. The increase in Treasury prices and the decline in crude oil prices likely reflect the market's ever-growing pessimistic view that the U.S. economic recovery is stalling along with Eurozone weakness. While weaker-than-expected economic data may give merit to this argument, we contend there is likely a bit of noise in the data and continue to expect moderate economic growth.

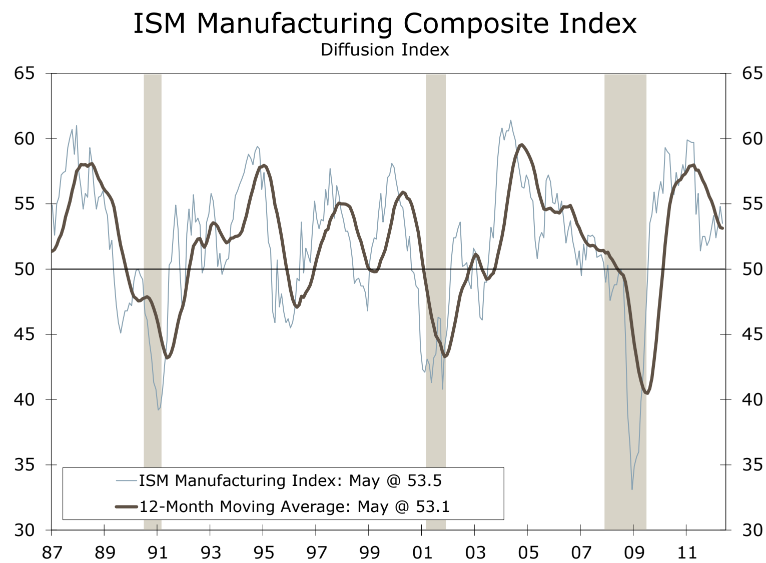
The details of the nonfarm payroll report suggest weather could have been a driver for the weaker-than-expected outturn. Indeed, the construction sector shed 28K jobs and leisure and hospitality cut 9k jobs. Another glimmer of hope in the report was that household employment increased by 422K, rebounding from a drop of 166K in April, which suggests some labor market sustainability. We admit the glass-half-full view may appear Pollyanna-ish, but the market's reaction to the report seems overblown and does not reflect the actual positive momentum.

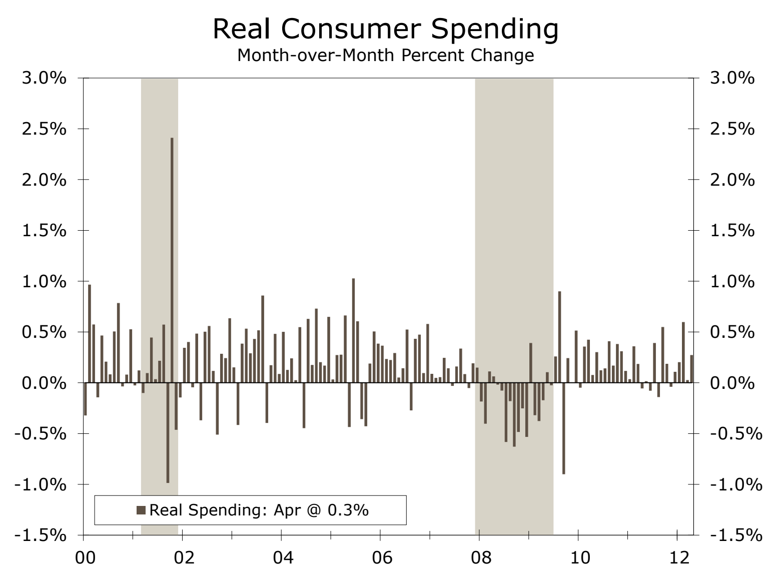
One clear sign the economy continues to grow is the continued resiliency of the manufacturing sector. While the ISM manufacturing survey weakened a bit, sliding 1.3 points to 53.5, the forward-looking new orders component jumped to 60.1, the highest level in 13 months. The modest pullback in the headline was due to a 5.4 point decline in production. Moreover, it is important to remember the survey is a diffusion index, which tells us more about the breadth of strength in the economy than the magnitude of that strength.

Another important economic release this week was the personal income and spending report. Personal income rose a paltry 0.2 percent in April, with wages and salaries, which account for a little more than half of overall personal income, also increasing just 0.2 percent. While much of the increase in wages and salaries continues to come from the service sector, manufacturing also posted a gain and government earnings remained unchanged.

There was a bit of good news in the report. Real consumer spending increased 0.3 percent in April and is now up at a 3.6 percent pace over the last three months. Much of the spending, however, is being fueled by consumers reaching into savings. The saving rate fell to 3.4 percent. The lack of income growth and the decline in the saving rate are why we continue to expect tepid consumer spending over the course of the year.

On the inflation front, the PCE deflator, which is the Fed's preferred price measure, fell to 1.8 percent on a year-ago basis, which is well within the Fed's explicit inflation target. That said, the Fed continues to have the green light for additional monetary accommodation, and if economic and labor conditions continue to deteriorate, QE3 becomes a big possibility.



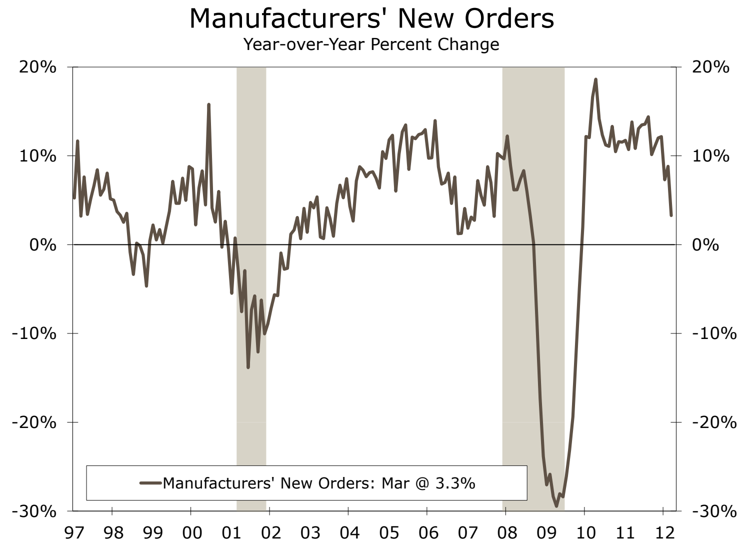


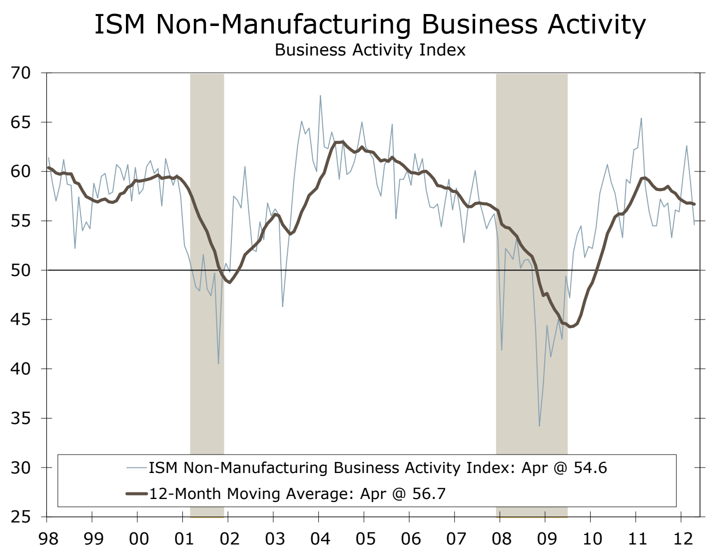
Factory Orders • Monday

Factory orders posted a disappointing reading in March, declining 1.5 percent for the month. The headline orders number was pulled down by a large drop in aircraft orders. Even more disappointing was the 0.1 percent decline in nondefense capital goods excluding aircraft, leaving the three-month annualized rate for orders of these capital goods at 0.4 percent. The pullback in capital goods orders was also reflected in the first-quarter GDP numbers with a much slower pace of growth in equipment and software spending. We expect April factory orders to bounce back slightly, rising 0.2 percent; however, the slow pace of new capital goods orders will likely persist. We continue to expect business investment in equipment and software to moderate through year end, rising a more modest 5.0 percent for the year as opposed to the double-digit gains of the past two years.

Previous: -1.5% (Month-over-Month) **Wells Fargo: 0.2%**

Consensus: 0.3%





ISM Non-Manufacturing • Tuesday

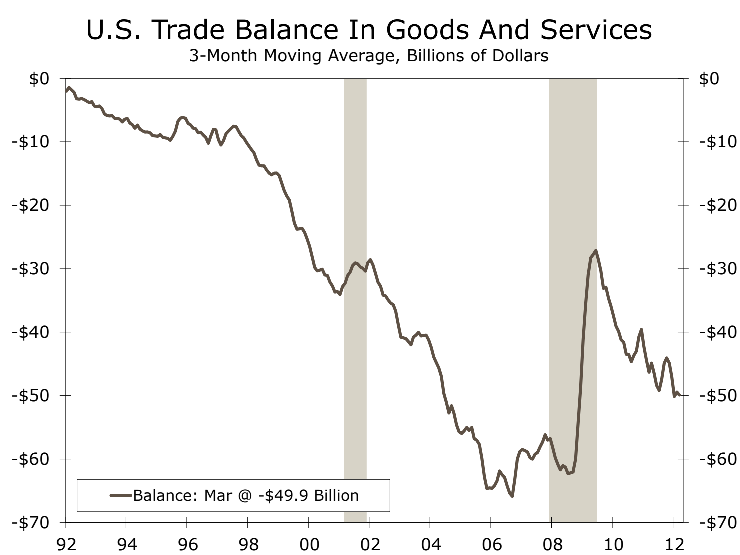
April's ISM Non-Manufacturing Index fell to 53.5 from 56.0 signaling slower growth in the service sector for the month. Business activity rose for 14 sectors including retail, construction, finance and transportation. Prices paid, a measure of input costs, continued to moderate. The disappointing aspect of the report was the pullback in both the new orders and employment components of the index, which suggested that the slower growth environment within the service sector likely will persist. We expect the index to remain unchanged at 53.5 in May. Thus, the index should remain in positive territory; however, we do not expect acceleration in the pace of growth for the sector anytime soon. Given the importance of the service sector in generating job gains, a continued slow pace of growth in this sector will continue to translate into only modest job growth as evidenced from this week's employment report.

Previous: 53.5 **Wells Fargo: 53.5**

Consensus: 53.5

International Trade • Friday

Trade figures for the month of March indicated a widening of the trade deficit to $51.8 billion from February's $45.4 billion. Export growth remained strong for the month, rising $5.3 billion, even in light of a weakening global economic growth environment. March was the fourth consecutive month for export growth. Imports rose $11.3 billion for the month with some of the increase derived from higher petroleum prices. The bulk of the rise in imports was due to non-oil imports, which rose $1.7 billion on the heels of a sizable decline in February. We expect the trade deficit to narrow further in April to -$50.7 billion as exports begin to slow, reflecting the weakening global demand. Going forward, we believe trade will continue to subtract from GDP growth for the remainder of the year as the trade deficit continues to gradually widen.



Previous: -$51.8B **Wells Fargo: -$50.7B**

Consensus: -$49.5B

Global Review

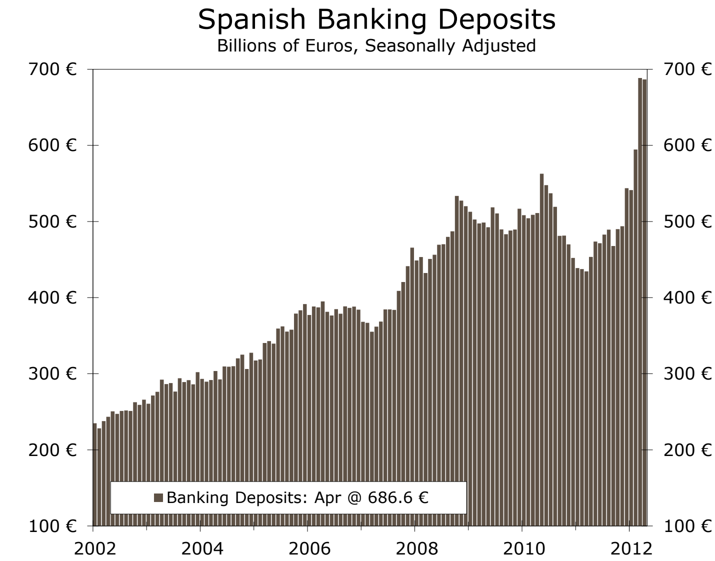
European Worry Spreads to Spain

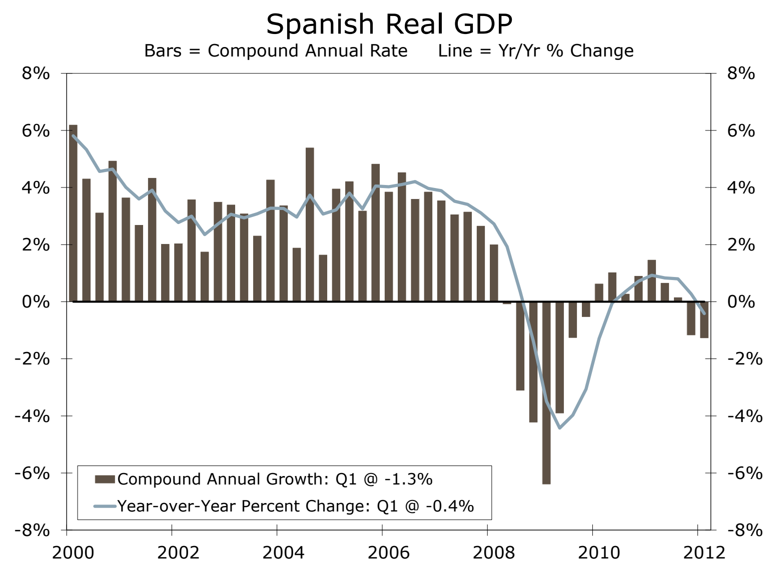
Although it is beginning to sound like a broken record, Europe again stole most of this week's headlines. Yields on Spanish government bonds approached the highs that were reached last autumn when the European sovereign debt crisis last reared its ugly head, whereas the yields on safe-haven German government bonds plunged to all-time lows (chart on front page). The catalyst for the recent rout in the peripheral European bond market was worries about Spain. Bankia, a banking conglomerate that is one of Spain's largest banks, disclosed that it would need an additional capital injection worth €19 billion. In addition, the comments by a senior official that the European Union could possibly extend Spain's deadline to hit a 3 percent of GDP deficit target from 2013 to 2014 underlined the precarious state of country's finances.

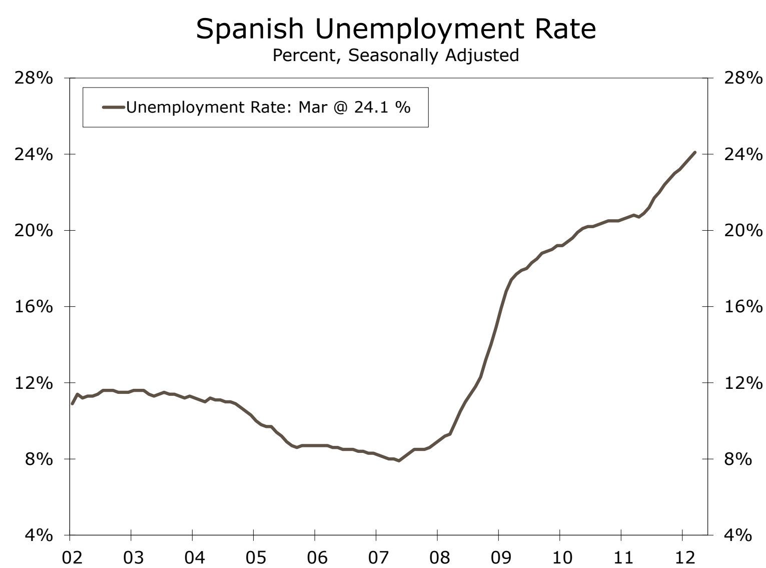
The Spanish banking system has been laid low by the country's burst housing bubble. Unlike Greece, where bank deposits have dropped about 30 percent over the past 3 years, a "classic" bank run in Spain has not yet materialized (see top chart and chart on page 7). That said, investors worry that Bankia is not the only bank in Spain that will need to be recapitalized. Not only would recapitalization by the Spanish government further raise the amount of outstanding government debt—the government debt-to-GDP ratio has shot up from less than 40 percent of GDP in 2007 to about 80 percent today—but an ill-capitalized banking system is hardly conducive for strong economic growth.

In that regard, the Spanish economy is very weak at present. Not only has Spain slipped into recession again, but the level of real GDP remains more than 4 percent below its Q1-2008 peak (middle chart). The unemployment rate has shot up to 24 percent, the highest rate in at least three decades (bottom chart). House prices have dropped about 30 percent since their peak in 2007, and the downward trend remains firmly intact. The combination of a contracting economy and falling house prices will further stress household and bank balance sheets.

We expect tension in the European financial markets to remain high, at least for the next few weeks. Greek voters return to the polls on June 17 as the May 6 parliamentary elections were unable to produce a coalition government. If the left parties that want to jettison the EU/IMF agreement come to power, there would be increasing speculation of a Greek exit from the Eurozone. (For further reading, see our report "*Implications of a Euro Exit to Greece*," which is posted on our website.) In that event, financial market tensions would increase even further. After the elections the next marker will be the EU summit on June 29-30. Some European leaders would like to allow the European Stability Mechanism (ESM), which is the fund that has been established to bail out governments, to recapitalize banks. To date, Germany has opposed this suggestion. If a compromise can be reached about using the ESM funds for banks, tensions may subside for a bit. However, Europe is not fully "fixed," and we believe the crisis will continue to wax and wane for some time.





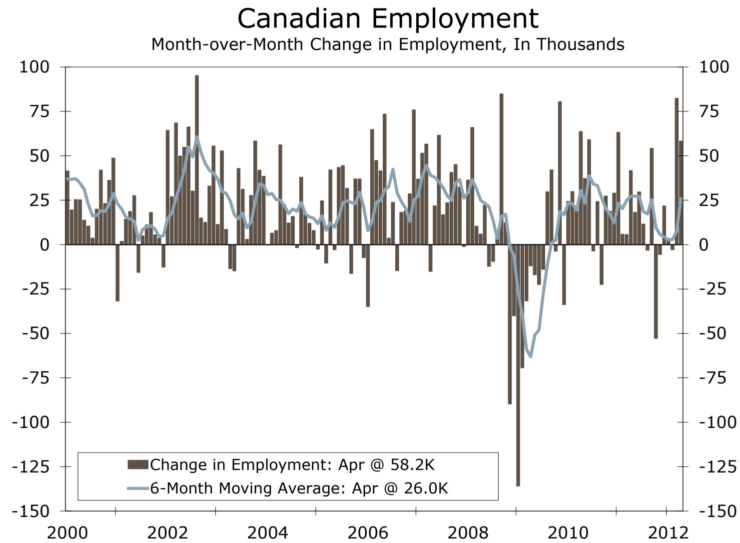


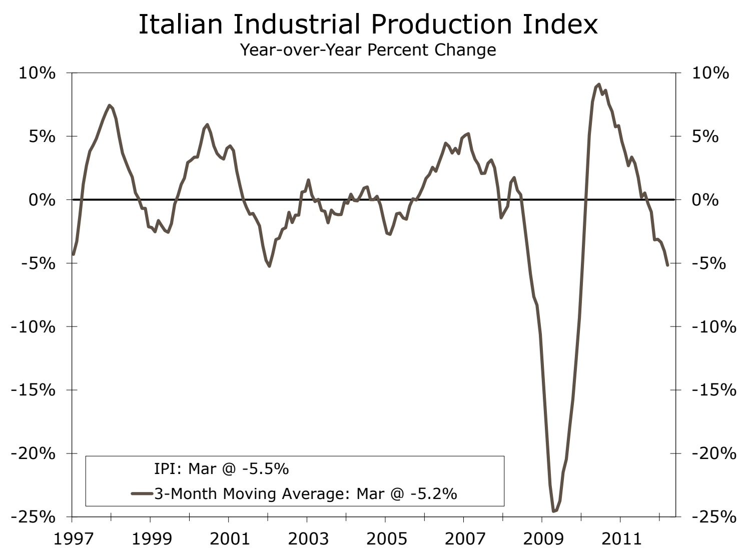
Canada Employment • Friday

Canada's economy added 58.2K jobs in April, nearly six times the 10,000 expected gain. Coupled with the 82.3K jump in March, the recent two-month gain of 140.5K was the strongest since January and February in 1981. Private companies added 85.8K workers in April, while public employment dropped 19.2K. The construction industry added the most workers, at 24.6K, while natural resources saw the biggest year-over-year increase of 12.5 percent. However, the unemployment rate ticked up to 7.3 percent as the labor force rose by 72.5K, outpacing the gain in jobs. The strong job gains had investors raising the possibility of higher interest rates. But slowing inflation, the intensification of the Eurozone debt crisis, a slowdown in China and slower U.S. job growth will likely negate any interest rate increases for a while. Low interest rates may continue to underpin construction employment, but a global slowdown could threaten the manufacturing industry.

Previous: 58.2K

Consensus: 7.2K





Italy Industrial Production • Friday

Industrial production in Italy rose 0.5 percent in March from the prior month, better than the 0.1 percent expected increase. From a year ago, production was down 5.8 percent, while the three-month trend fell to -5.2 percent. A 1.4 percent increase in consumer non-durable goods drove the improvement in production, but this did not make up for the big losses in the previous two months. Meanwhile, production of consumer durables fell for the third straight month. Intermediate goods production rose for the first time since August. The economy continues to crumble under the weight of severe austerity measures, which has forced the government to push back its goal to balance the budget by another year to 2014. While this might bring small relief to the domestic economy, producers and exporters are still at the mercy of the situation in other Eurozone countries. Also, the recent earthquakes could slow production of autos and machinery.

Previous: 0.5% (Month-over-Month)

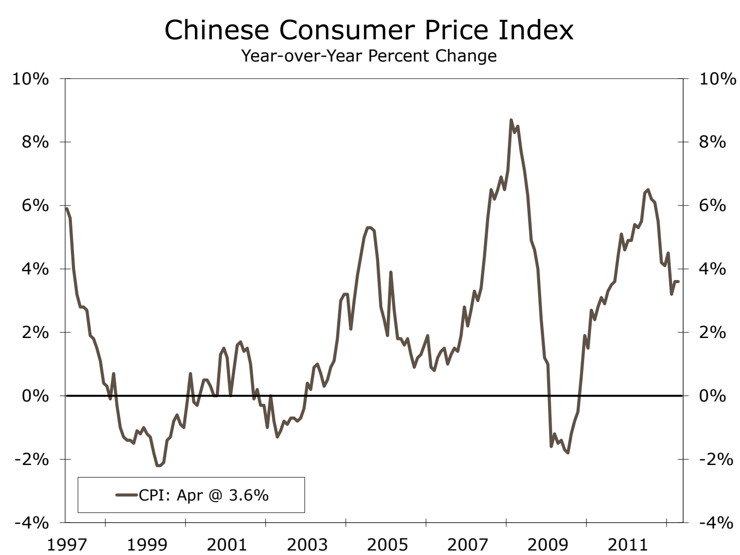
Consensus: -0.5%

China CPI • Friday

Chinese consumer price inflation slowed in April to 3.4 percent year over year. Price growth eased for food, tobacco and alcohol, clothing and housing. Inflation for household items, medicines and transport and communications was the same as the prior month, while recreation and education prices rose a bit faster. With inflation below the government's 4.0 percent annual goal, the government has more flexibility to support the economy. With global trade slowing, loan growth cooling and industrial production growth the weakest since 2009, the government is shifting its focus away from fighting inflation and toward boosting growth. Thus, the central bank lowered the required reserve ratio for banks to 20.0 percent in May, the third reduction in six months. The Eurozone debt crisis, as well as China's own softening, has led to a big drop in commodity prices recently. This will help to keep inflation at bay and allow further policy easing.

Previous: 3.4% (Year-over-Year)

Consensus: 3.2%



Interest Rate Watch

Fear Triumphs—in the Short-Run

Fears of the downside in the European economic and financial future have altered the outlook for U.S. and global interest rates in ways outside the domestic fundamentals in each country.

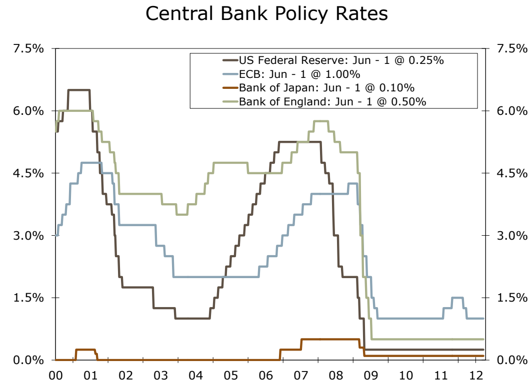
Weaker European growth implies weaker U.S. exports and, by implication, weakness in employment and capital spending since less labor and less capital will be required to produce the lower expected pace of U.S. growth. Weaker growth expectations have also lowered inflation expectations and thereby the pricing power of firms selling to consumers and other businesses; therefore, inflation measures have also show some weakness in recent months.

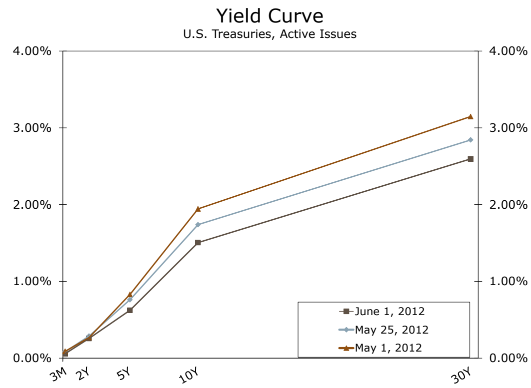
Meanwhile, financial concerns have prompted significant capital outflows from Europe into financial assets in Switzerland, Germany and the U.S. with significant downward pressure on the benchmark U.S. 10-year Treasury rate and interest rates in Switzerland and Germany as well.

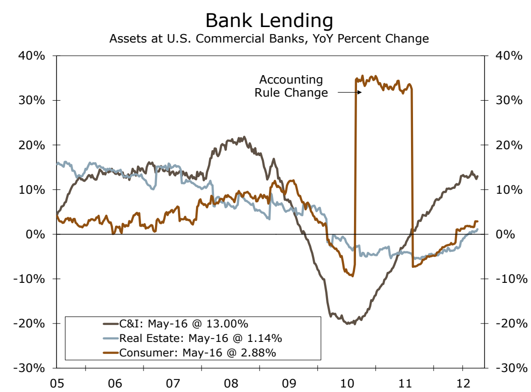
These concerns have produced a flatter yield curve in the United States as global investors search for liquidity and the preservation of capital. The flatter yield curve for Treasury notes has led to lower interest rates for the mortgage and private corporate credit markets. Shifts in global capital flows have also improved the attractiveness of the U.S. dollar, the yen and the Swiss franc relative to the euro.

Globalization of Capital Markets

Follow-on developments coming from the European experience reinforce the paramount importance of recognizing the global character of the capital markets and that, at times, these forces can overwhelm the domestic fundamentals of expectations of growth, inflation and domestic monetary/fiscal policy. The framework for decision making continues to evolve, and recent developments suggest that the relative importance of global developments will continue to take the lead for the near-term. Our outlook for interest rates has emphasized caution on the economic front and the implications of Europe. The probability of further Fed policy action has increased.







Credit Market Insights

Personal Bankruptcy Filings

Data on personal bankruptcies over the past year have shown that consumer finances are improving. The number of households filing for bankruptcy has fallen 11.8 percent over the past year and 18 percent from their peak in the second quarter of 2010. However, personal bankruptcies ticked up in first quarter, rising 1 percent from the previous period. The rise is likely due to higher foreclosure activity over the past quarter. The recent end of the foreclosure moratorium helped to drive the number of completed foreclosures up 7 percent, which likely pushed more households into bankruptcy.

While personal bankruptcy filings may move higher over the next few quarters due to the backlog of foreclosures, consumer finances are generally improving, which will keep any increase modest. Consumer loan delinquencies at commercial banks have fallen for eight consecutive quarters to the lowest rate since 2006, suggesting improved credit quality among households. Households are still deleveraging, with mortgage and consumer debt as a percentage of income having fallen 18 percentage points to 105 percent since peaking in the second quarter of 2007. In addition, continued job gains, while modest, should boost household incomes. Therefore, the recent uptick in personal bankruptcies should not be too concerning, as many more forward-looking indicators of consumer finances are showing some signs of improvement.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.75%	3.78%	3.84%	4.55%
15-Yr Fixed	2.97%	3.04%	3.07%	3.74%
5/1 ARM	2.84%	2.83%	2.85%	3.41%
1-Yr ARM	2.75%	2.75%	2.70%	3.13%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,415.8	15.09%	3.69%	13.00%
Revolving Home Equity	$540.7	-7.97%	-6.59%	-4.51%
Residential Mortgages	$1,582.4	37.06%	6.37%	7.12%
Commerical Real Estate	$1,415.8	-11.15%	-6.36%	-2.73%
Consumer	$1,110.0	0.81%	16.85%	2.88%

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

Topic of the Week

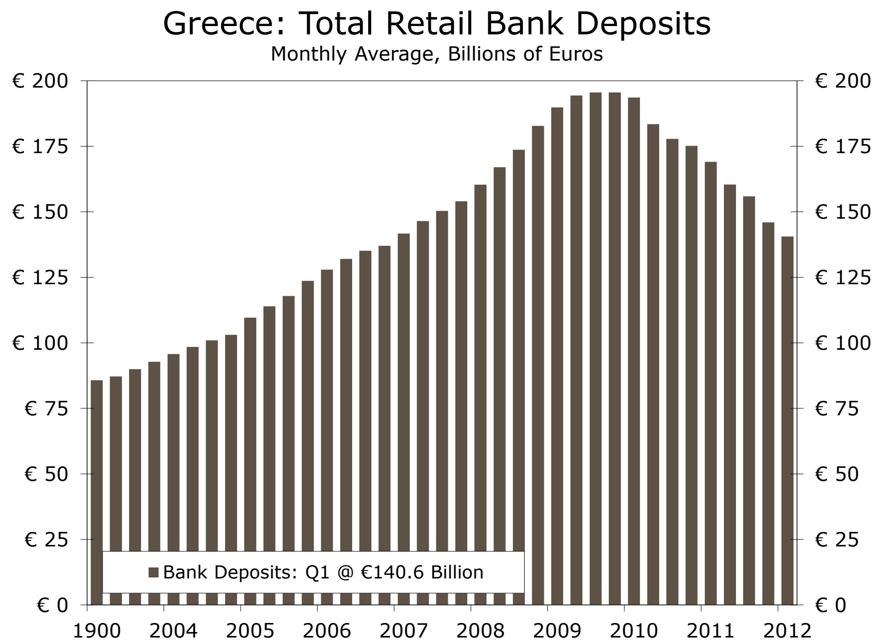
Implications of a Euro Exit to Greece

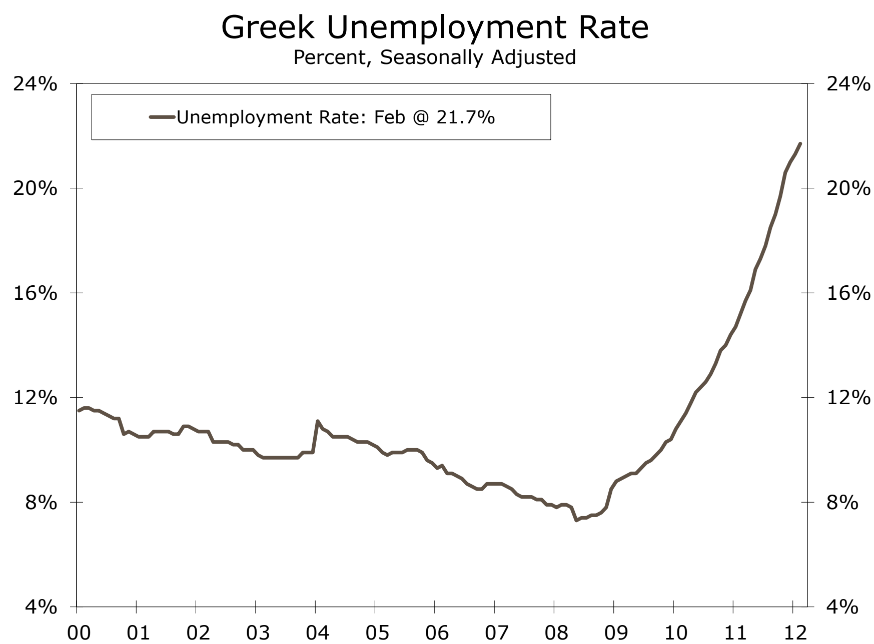
There is mounting speculation that Greece will eventually abandon the euro and depart the Eurozone. What would be the implications to different sectors within the Greek economy of euro abandonment? For starters, a Eurozone exit would go hand-in-hand with government default that could lead to the collapse of the banking system. (Greek banks own significant amounts of Greek government bonds.) Greek residents have been pulling deposits out of banks due, at least in part, to fears of a banking collapse. A full-blown bank run would just hasten the collapse of the banking system.

A new currency would be introduced—call it the drachma—and any remaining deposits in the banking system would likely be redenominated in depreciated drachma. With liabilities denominated in euros—every homeowner in Greece has a euro-denominated mortgage—and assets in drachma, many Greek households would become insolvent. Real income would take a hit as the price of imports would soar. Consequently, spending would plummet, leading to the failure of many Greek businesses. Exporters would fare relatively better because the depreciation of the drachma would significantly improve the price competitiveness of their products.

Although the rebound in exports could lead to stabilization and an eventual economic rebound, the Greek economy, which has already contracted 15 percent since 2007, would slide even further into depression in the immediate aftermath of Eurozone exit. Unemployment would shoot even higher than the 22 percent rate at which it already stands. In short, there would be few sectors that would escape the pain of a near-term economic collapse.

For further reading, see our special report, "*Implications of a Euro Exit to Greece*," which is posted on our website. We will analyze the implications of a broader Eurozone exit in a subsequent special report.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 6/1/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.06	0.08	0.04
3-Month LIBOR	0.47	0.47	0.25
1-Year Treasury	0.08	0.11	0.14
2-Year Treasury	0.25	0.29	0.43
5-Year Treasury	0.62	0.76	1.59
10-Year Treasury	1.50	1.74	2.94
30-Year Treasury	2.59	2.84	4.14
Bond Buyer Index	3.77	3.81	4.51

Foreign Exchange Rates

	Friday 6/1/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.243	1.252	1.433
British Pound ($/£)	1.542	1.567	1.633
British Pound (£/€)	0.806	0.799	0.877
Japanese Yen (¥/$)	78.260	79.680	80.950
Canadian Dollar (C$/$)	1.036	1.029	0.977
Swiss Franc (CHF/$)	0.966	0.960	0.842
Australian Dollar (US$/A$	0.971	0.976	1.061
Mexican Peso (MXN/$)	14.326	14.029	11.709
Chinese Yuan (CNY/$)	6.370	6.344	6.478
Indian Rupee (INR/$)	55.585	55.375	44.843
Brazilian Real (BRL/$)	2.027	1.987	1.594
U.S. Dollar Index	83.051	82.402	74.677

Foreign Interest Rates

	Friday 6/1/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.59	0.60	1.38
3-Month Sterling LIBOR	0.99	1.00	0.83
3-Month Canadian LIBOR	1.31	1.33	1.20
3-Month Yen LIBOR	0.20	0.20	0.20
2-Year German	0.02	0.05	1.61
2-Year U.K.	0.26	0.23	0.88
2-Year Canadian	0.95	1.09	1.45
2-Year Japanese	0.09	0.11	0.18
10-Year German	1.19	1.37	2.99
10-Year U.K.	1.53	1.75	3.25
10-Year Canadian	1.67	1.81	2.99
10-Year Japanese	0.82	0.89	1.16

Commodity Prices

	Friday 6/1/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	83.69	90.66	100.29
Gold ($/Ounce)	1600.12	1573.03	1539.80
Hot-Rolled Steel ($/S.Ton)	640.00	663.00	760.00
Copper (¢/Pound)	333.15	342.90	410.65
Soybeans ($/Bushel)	13.33	13.69	13.79
Natural Gas ($/MMBTU)	2.36	2.65	4.63
Nickel ($/Metric Ton)	16,159	17,032	23,587
CRB Spot Inds.	513.17	515.11	611.97

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	4	5	6	7	8
U.S. Data	**Factory Orders** March -1.9% April 0.2% (W)	**ISM Non-Mfg.** April 53.5 May 53.5 (W)	**Nonfarm Productivity** 1Q-P -0.5% 1Q-F -0.5% (W) **Unit Labor Costs** 1Q-P 2.0% 1Q-F 2.3% (W)	**Consumer Credit** March $21.355B April $10.000B (C)	**Trade Balance** March -$51.8B April -$50.7B **Wholesale Inventories** March 0.3% April 0.3% (C)
Global Data	**Mexico** **Consumer Confidence** Previous (Apr) 97.2		**Germany** **Industrial prod. (MoM)** Previous (Mar) 2.8%	**Japan** **GDP (QoQ)** Previous (1Q) 1.0%	**Canada** **Employment** Previous (Apr) 58.2K **China** **CPI (YoY)** Previous (Apr) 3.4%

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

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