June 3, 2011

Economics Group

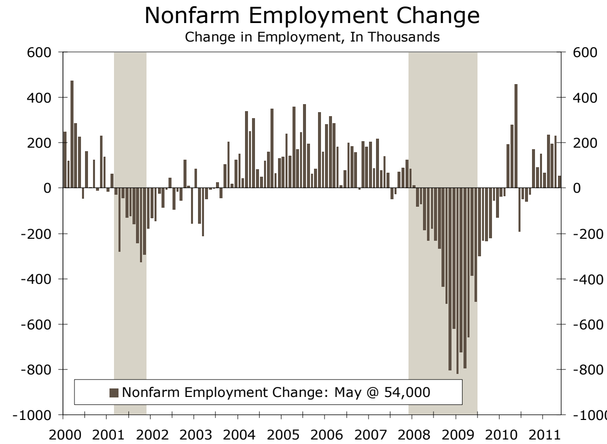
WELLS FARGO SECURITIES

Weekly Economic & Financial Commentary

U.S. Review

Have We Hit a Soft Patch or Something a Bit Worse?

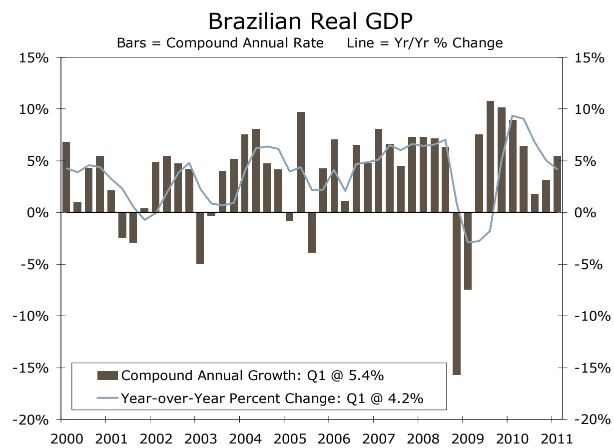
- Most of this week's economic reports came in on the soft side, including Friday's employment report, which showed payrolls rising just 54,000 in May and the unemployment rate rising to 9.1 percent.
- The ISM manufacturing survey also weakened much more than expected. The headline index fell 6.9 points to 53.5, with new orders plunging 10.7 points.
- Consumer confidence fell in May as consumers expressed more concern about both current and future economic conditions.



Global Review

Don't Count the Brazilian Economy Out, Yet

- The release for first-quarter GDP for Brazil came in just at the market expectation of a 4.2 percent year-over-year increase and down from 5.0 percent during the last quarter of 2010. However, the economy accelerated compared to the last quarter of 2010 with a seasonally-adjusted growth rate of 1.3 percent.
- Growth in the Brazilian economy has slowed, but is not recessionary. We still expect the Brazilian economy to post a healthy 4.5 percent rate of growth during this year, down from a 7.5 percent performance in 2010.



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	1.8	2.7	2.5	0.0	-2.6	2.9	2.3	2.4
Personal Consumption	1.9	2.2	2.4	4.0	2.2	2.2	1.9	2.5	-0.3	-1.2	1.7	2.5	2.1
Inflation Indicators [2]													
"Core" PCE Deflator	1.8	1.5	1.2	0.8	0.9	1.1	1.5	1.9	2.3	1.5	1.3	1.3	2.1
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	3.2
Industrial Production [1]	8.1	7.1	6.7	3.1	4.6	2.5	4.6	3.8	-3.3	-11.1	5.3	4.3	3.7
Corporate Profits Before Taxes [2]	37.6	37.0	26.4	18.3	8.5	6.2	6.2	6.7	-16.4	-0.4	29.2	6.9	7.3
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	9.1	8.9	8.8	5.8	9.3	9.6	8.9	8.5
Housing Starts [4]	0.61	0.60	0.58	0.54	0.58	0.55	0.61	0.66	0.90	0.55	0.58	0.60	0.76
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	0.69
Conventional Mortgage Rate	4.97	4.74	4.35	4.71	4.84	4.50	4.80	5.00	6.04	5.04	4.69	4.79	5.43
10 Year Note	3.84	2.97	2.53	3.30	3.47	2.90	3.20	3.40	3.66	3.26	3.22	3.24	3.83

Forecast as of: June 3, 2011
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units
[5] Annual Numbers Represent Averages

Inside

U.S. Review

Just a Temporary Glitch or Wishful Thinking?

It has been nearly two years since the economic recovery began. But rather than celebrate, this milestone has been marked by renewed doubts about the sustainability of the recovery. Virtually all the early data for May have been disappointing. Nonfarm employment increased by just 54,000, and previous gains in March and April were revised lower. The unemployment rate also rose 0.1 percentage point to 9.1 percent, as labor force growth exceeded the rebound in household employment. Private-sector payrolls were up a bit more, posting a gain of 83,000 jobs in May.

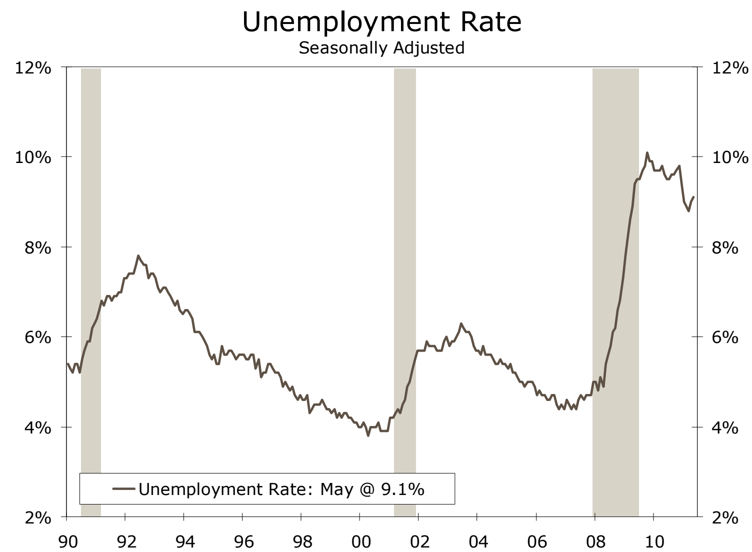
Some pullback had been expected. The Japanese earthquake led to supply shortages at a number of vehicle assembly plants and may have also reduced output in parts of the technology sector. The string of tornados that hit the country in April and May also likely cut into job growth as did the sharp run-up in energy prices. On the flip side, McDonald's, Home Depot and Lowes all announced major hiring programs. None of this hiring made it through to the final data. Both the retailing and the hospitality sectors lost jobs in May, indicating less hiring than usual.

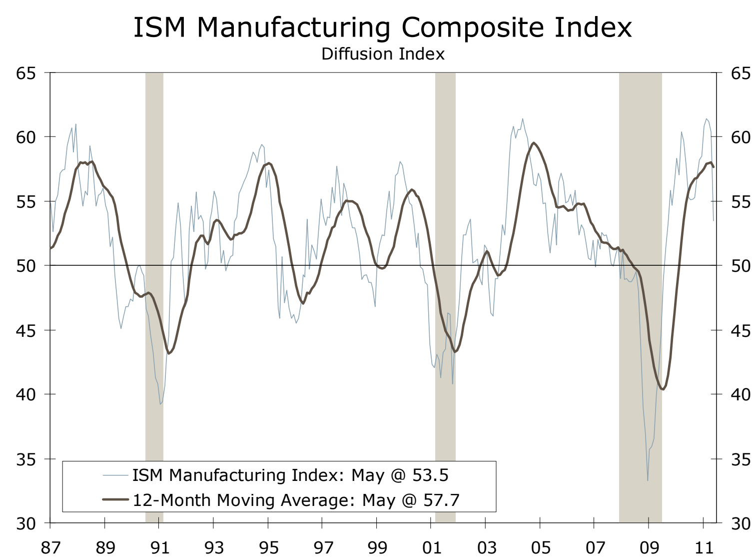
Not only was overall job growth weaker in May, but fewer industries are adding jobs. The diffusion index, which measures the breadth of hiring, fell to its lowest level since September. Employment at temporary staffing firms, which is a fairly reliable leading indicator of job growth, fell for the second straight month. On the plus side, construction employment may have bottomed, with builders and contractors slightly boosting employment for the fourth straight month. Aggregate hours worked also increased 0.1 percent and average hourly earnings rose 0.3 percent, suggesting wages and salaries rose modestly.

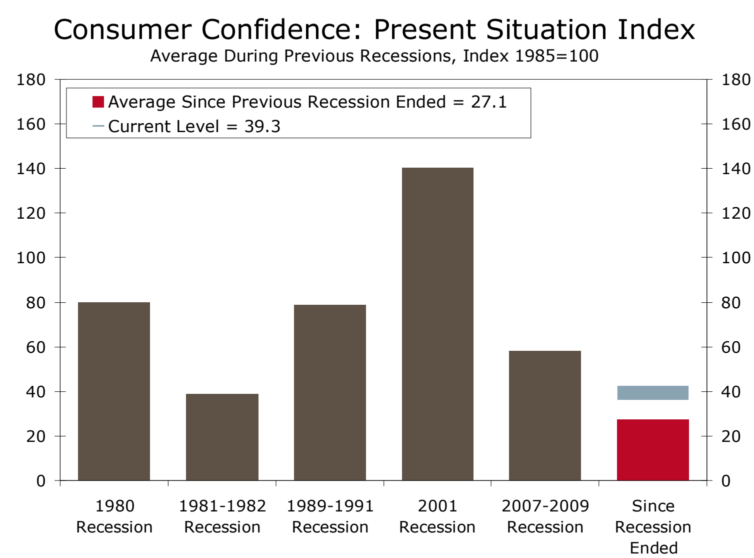
The ISM manufacturing survey fell sharply in May, declining 6.9 points to 53.5. The drop was worse than expected and reflects deeper cuts at motor vehicle assembly plants and parts suppliers. Production is slated to ramp back up in the summer, when manufacturers plan to have less downtime for model-year changeovers. The lack of auto inventory also means year-end price discounts will be much less than usual.

Of course, any pickup in motor vehicle production is premised on sales rising above their recent pace. Motor vehicle sales slid to just an 11.8 million unit-pace in May as dealers offered fewer deals on cars in short supply and buyers shied away from larger cars and SUVs. Higher gasoline prices appear to be spurring demand for smaller and less expensive cars.

Consumers are clearly not buying into the recovery story. The consumer confidence index fell 5.2 points in May. The drop likely reflects renewed concerns about the labor market, borne out by the rising unemployment rate, as well as the continued slide in home prices. Consumers' assessment of current conditions is downright chilling. The present situation index is just barely above the lows hit near the worst of the recession. Since the recovery began, the series has actually averaged a pace well below what was seen during the past five recessions, indicating, that as far as consumers are concerned, it still fells like a recession.





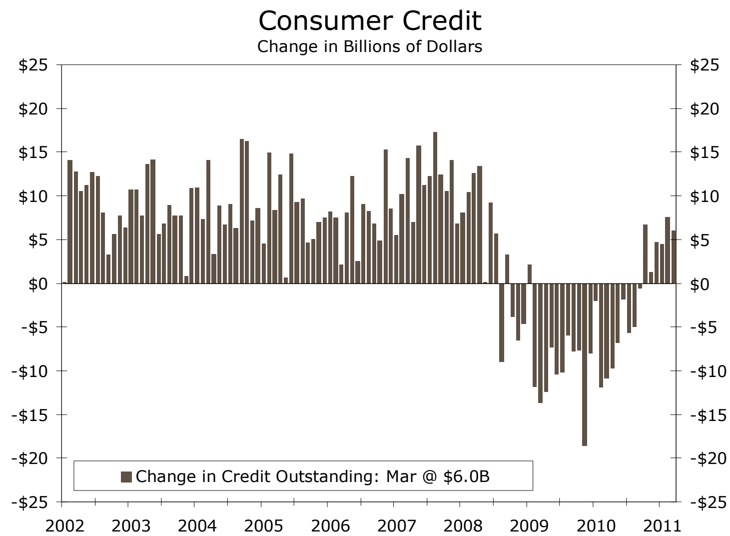


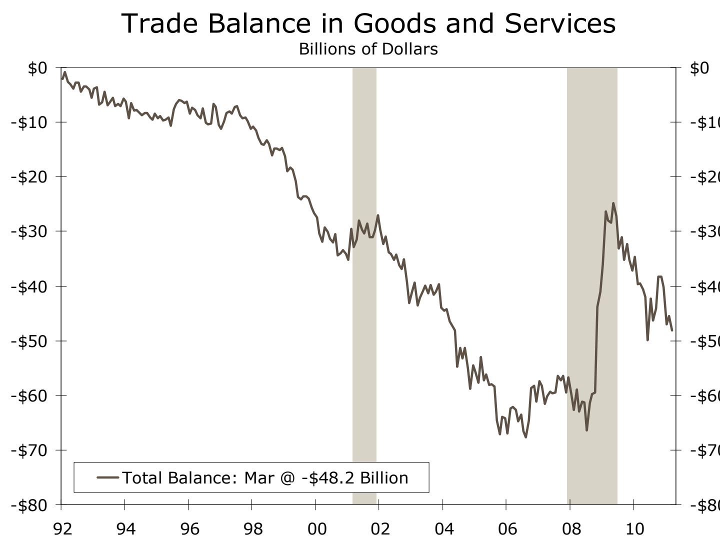
Consumer Credit • Tuesday

Consumer credit outstanding rose $6.0 billion in March, the sixth straight increase. Revolving credit, mainly credit cards, rose $1.9 billion, the second increase in the past four months. Strong payroll gains in March, along with rising incomes that have been bolstered by the Social Security tax cut, were likely factors in the increase in revolving debt. Meanwhile, nonrevolving debt rose $4.1 billion, driven by further increases in student loan debt. Still, on a nonseasonally adjusted basis, consumer credit declined as only federal student loans saw any significant increase. What appears to be a turnaround in the credit cycle is mostly an increase in student loan debt as people go back to school to improve skills amid high unemployment and as state budget cuts push up tuitions. Credit outstanding likely expanded further in April as the Easter holiday bolstered demand, while student loans likely rose further.

Previous: $6.0 Billion

Consensus: $5.0 Billion





Trade Balance • Thursday

The trade deficit widened in March to $48.2 billion as a 4.9 percent rise in imports outweighed the 4.6 percent rise in exports. Crude oil, petroleum products and fuel oil accounted for more than half of the increase in goods imports as both prices and volumes jumped. Imports of capital goods and autos also saw strong increases. However, the slowdown in March consumer spending was reflected in a plunge in consumer goods imports. Exports rose on strength in industrial supplies, machines and autos. We suspect oil imports remained robust in April as prices continued to rise through month-end, but it depends on whether import volumes weakened in response to higher prices at the pump. We are likely to see weaker numbers for both imports and exports of autos as the effect of the Japanese earthquake and tsunami were more fully felt in April. Consumer goods imports may also see more weakness as higher gas prices likely weighed on demand for other goods.

Previous: -$48.2 Billion **Wells Fargo: -$50.9 Billion**

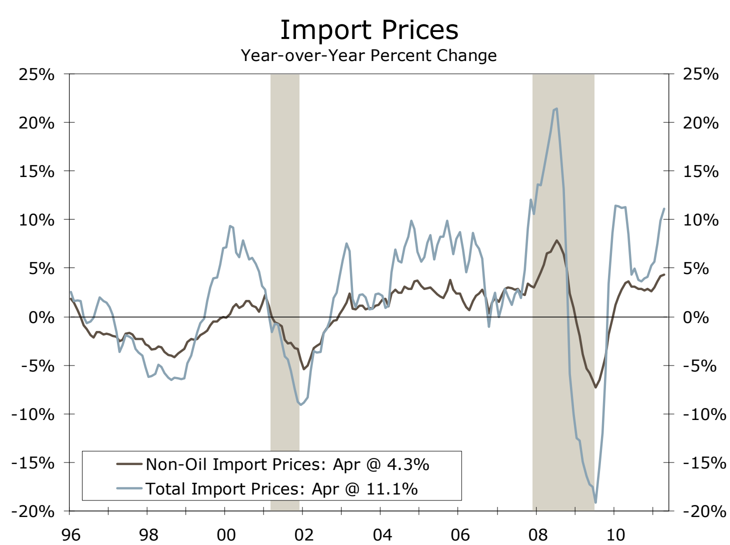
Consensus: -$48.8 Billion

Import Prices • Friday

Import prices rose 2.2 percent in April as petroleum prices soared 7.2 percent. A weaker dollar and unrest in the Middle East helped to push oil prices over $110/barrel during the month. Food prices also saw a strong 1.8 percent increase as higher corn prices pushed up prices for beef and dairy products. Auto prices rose as demand remained strong, while supplies were restrained due to the Japanese earthquake and tsunami. The dollar strengthened in May, helping to push oil prices down to around $100/barrel. Corn prices have stabilized as well. Thus, we should see some relief in oil and food import prices in the May report. However, we may see further increases in auto prices as supplies remained tight. While both overall and core import prices have risen recently, low core PCE inflation and high unemployment have kept the Fed from raising rates. The Fed's view that recent price increases are only transitory may turn out to be correct.

Previous: 2.2% **Wells Fargo: -0.7%**

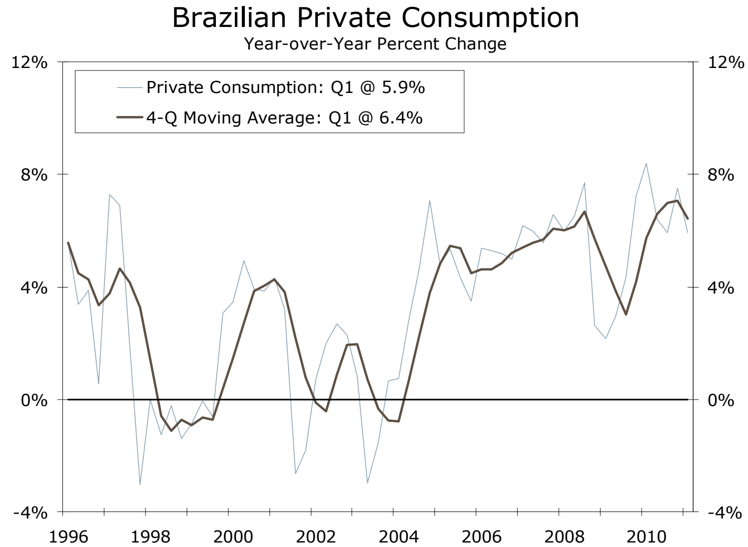
Consensus: -0.7% (Month-over-Month)



Global Review

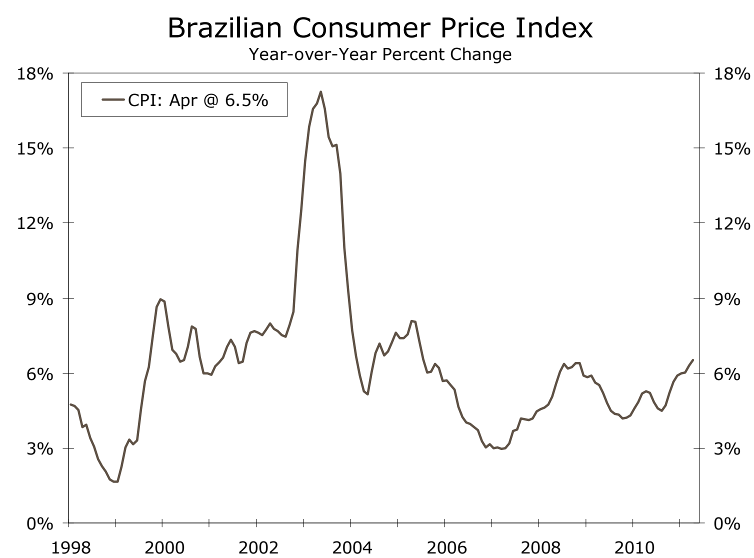
Don't Count the Brazilian Economy Out, Yet

The release for the first-quarter GDP for Brazil came in just at the market expectation of a 4.2 percent year-over-year increase and down from 5.0 percent during the last quarter of 2010. However, the economy accelerated compared to the last quarter of 2010 with a seasonally adjusted growth rate of 1.3 percent. As expected, domestic consumption slowed down considerably due to the Brazilian central bank's monetary tightening campaign during the past several quarters. Personal consumption expenditures remained relatively strong, however, growing at a 5.9 percent rate on a year-earlier basis but down from a 7.5 percent growth rate during the last quarter of 2010. Thus, the central bank's effort in slowing down domestic consumption has been effective and should continue to limit inflationary pressures that have been building during the past year or so. This slowdown was more evident when looking at the seasonally adjusted personal consumption number, which grew at only 0.6 percent from a 2.3 percent growth rate during the last quarter of last year.



Exports of goods and services grew by only 4.3 percent year-over-year after posting a 13.5 percent growth rate during Q4 2010. However, on a seasonally adjusted basis, exports of goods and services dropped 3.2 percent compared to Q4 2010 after posting a 3.9 percent growth rate during the last quarter of 2010. This was the largest single contributing sector to the slowdown in economic activity during the quarter as it went from a positive contribution during the last quarter of last year to a negative contribution during the first quarter. The export slowdown may also be a harbinger for slower emerging market economic growth. On the positive side, imports of goods and services, for which growth contributes negatively to GDP growth, posted a 1.6 percent drop, which means that it helped the economy during the first quarter of the year.

The Brazilian industrial sector also slowed down compared to Q4 2010. The industrial sector grew by 3.4 percent in the first quarter from a previous 4.3 percent growth rate. However, manufacturing production was actually slightly better during the first quarter, growing by 2.45 percent versus a 2.39 percent growth rate during Q4 2010 (all growth rates are on a year-earlier basis). However, the positive news is that industrial production was up by 2.2 percent on a seasonally adjusted basis, helped by a 2.8 percent increase in manufacturing production and a 2.0 percent increase in construction activity, both sectors improving their performance compared to the previous quarters.



Thus, we can say that growth in the Brazilian economy has slowed, but it is not recession bound. It has slowed during the past several quarters, but it is sill growing at a healthy clip. Meanwhile, inflationary pressures are going to continue to slow down and that means that the central bank will not have to increase interest rates too much from current levels, which will keep the economy from slowing down further. Thus, we are still expecting the Brazilian economy to post a healthy 4.5 percent rate of growth during this year, down from a 7.5 percent performance last year.

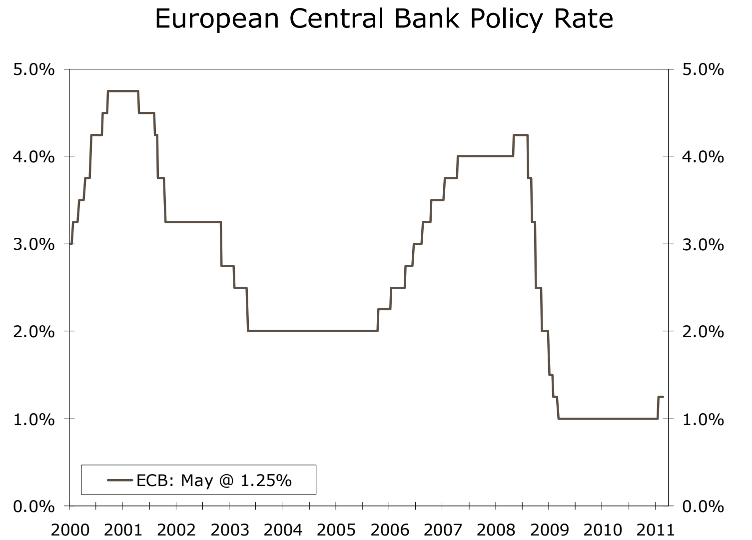
ECB Meeting • Thursday

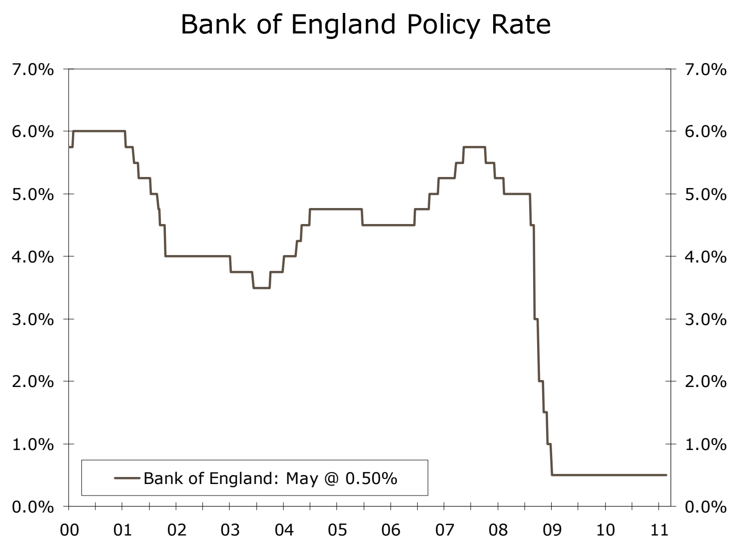
The European Central Bank holds its regular monthly policy meeting on Thursday, and most analysts, including us, expect the Governing Council to keep policy rates unchanged. Perhaps of more interest will be President Trichet's press conference that should give investors more insights into the ECB's current thinking. If Trichet says that "strong vigilance" is required regarding price pressures, it will indicate that the ECB is prepared to hike rates again at its next policy meeting in July.

On Wednesday, the second estimate of Eurozone GDP growth in the first quarter is to be released. The data will be watched because they will contain the first look at the breakdown into the demand-side components. Also of interest will be the German industrial production data for April that will print on Wednesday.

Previous: 1.25% **Wells Fargo: 1.25%**

Consensus: 1.25%





Bank of England Meeting • Thursday

The Bank of England has maintained its main policy rate at 0.50 percent since March 2009, and few analysts, we included, expect the Monetary Policy Committee (MPC) to change that rate at its policy meeting on Thursday. Although inflation is well above the Bank's target of 2 percent at present—it was 4.5 percent in April—most members of the MPC expect inflation to return to target due to sluggish growth in the economy. If, as we expect, the MPC does not change policy next week, then analysts will need to wait until the release of the meeting's minutes on June 22 for more insights into the MPC's current thinking.

Speaking of growth, industrial production (IP) data for April will be released on Friday. The market consensus forecast anticipates that IP was flat in April following its 0.3 percent rise in March.

Previous: 0.50% **Wells Fargo: 0.50%**

Consensus: 0.50%

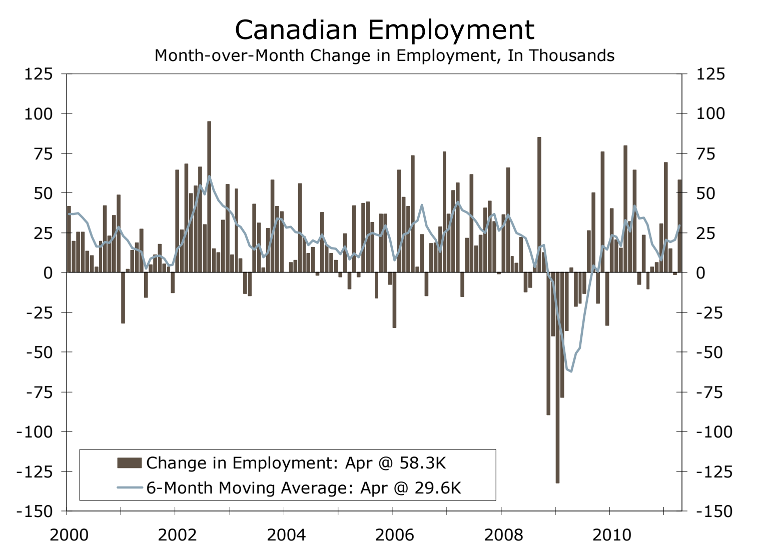
Canadian Employment • Friday

Unlike the United States, where employment remains 5 percent below its prerecession peak, payrolls in Canada rose to a record high earlier this year. Moreover, most analysts look for further job gains when the May data print on Friday. If the consensus forecast of a 25,000 rise in nonfarm payrolls in May is correct, then employment today would be nearly one percent higher than it was at the previous peak. The unemployment rate has trended down from its high of 8.7 percent in August 2009 to 7.6 percent in April, and the consensus forecast anticipates that the rate remained unchanged in May.

Also on the Canadian docket next week is the Ivey purchasing managers' index, which is slated for release on Monday, and data on housing starts in May, which will print on Wednesday.

Previous: 58,300

Consensus: 25,000



Interest Rate Watch

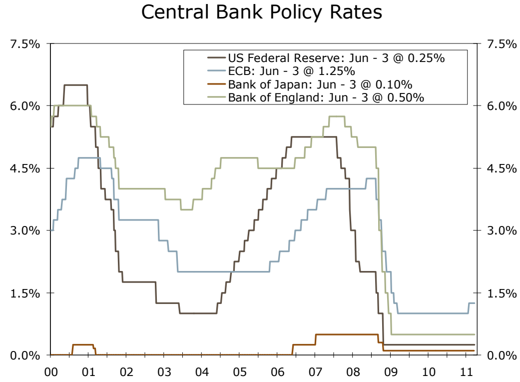
Fundamentals Drive Rates Lower

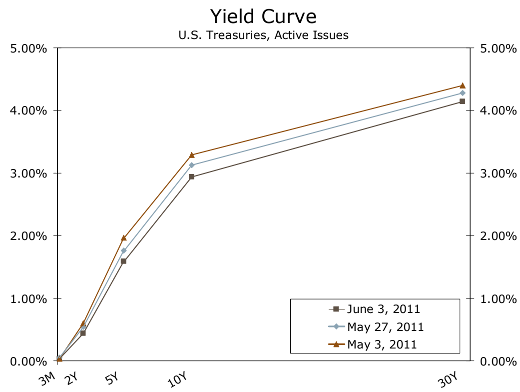
Expectations for slower economic growth drove rates lower this week. In addition, lower gas prices took a little bit of the inflation premium out of the market. Finally, some progress, even if just in words, appears on the debt ceiling/ spending cuts debate. Our outlook is for no change in the Fed Funds rate this year at the short end and only a modest rise in the benchmark 10-year rate. Fundamentals matter—especially in an era where "stories" appear more important to some investors than the facts.

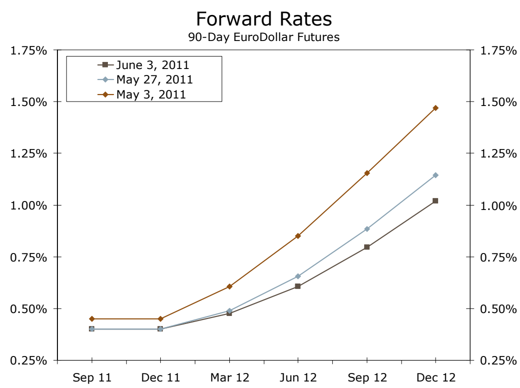
Economic growth expectations took a hit this week. The primary new information was the ISM manufacturing release, which suggested a greater slowdown in the economy than what was expected due to the Japanese tsunami, floods, tornadoes and higher gas prices. After the weaker real personal income growth numbers reported the prior week, expectations of growth must be adjusted downward. In the May Blue Chip Survey, the consensus growth rate was 2.7 percent, while our expectation was 2.3 percent. We expect the consensus will continue to move toward our estimate—as the consensus has been doing all year.

The inflation premium appears to have moderated as evidenced by the dip in the TIPS spread that we regularly monitor. In one way, lower oil and gas prices help explain the drop in market expectations for inflation. In addition, we have witnessed a broader peak in commodity prices thereby reinforcing the view that inflation, while still rising year over year, is not accelerating at the pace it was in the prior three months.

Finally, progress on the debt ceiling appears to be significant enough such that a deal is likely to be done. The real story will be, however, the details on spending restraint. Any progress on the recommendations made on the Simpson-Bowles commission would be a welcomed addition from our viewpoint. We do not believe that the magnitude of any cuts would affect economic growth over the next year. Over the long run, the impact would be to reduce the role of government.







Credit Market Insights

Charge-offs Show Improvement in Q1

The most recent Federal Reserve data on commercial bank charge-offs and delinquencies indicated that charge-offs for all loans and leases continued to decline in the first quarter of this year. In addition, delinquencies fell again in the first quarter as every category of loans and leases posted declines with the exception of residential and farmland real estate loans. While delinquency rates are improving, the pace of improvement has been sluggish since peaking in the second quarter of last year. The rebound of residential loan delinquency rates in the first quarter likely reflects further pressure on the housing market going forward. The modest decline in residential real estate loan charge-offs is driven by the ongoing moratorium on home foreclosures. Consumer loans showed further improvement with both lower delinquency and charge-off rates for consumer credit cards. On the commercial and industrial loan front, improvement was also observed as charge-off rates declined. Commercial real estate loan delinquency rates, while still elevated, continued to trend downward.

In general, the report for the first quarter was welcomed news. There appears to be increased stability in C&I loan, commercial real estate and consumer credit card charge-offs. However, we have not likely seen the end of residential real estate charge-offs. As the foreclosure process resumes later this year, the charge-off rates will begin to rise again.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.55%	4.60%	4.71%	5.08%
15-Yr Fixed	3.74%	3.78%	3.89%	4.39%
5/1 ARM	3.41%	3.41%	3.47%	4.10%
1-Yr ARM	3.13%	3.11%	3.14%	4.05%
MBA Applications				
Composite	519.4	540.8	458.7	639.0
Purchase	191.4	191.4	182.7	178.0
Refinance	2,442.9	2,591.7	2,081.6	3,336.9

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

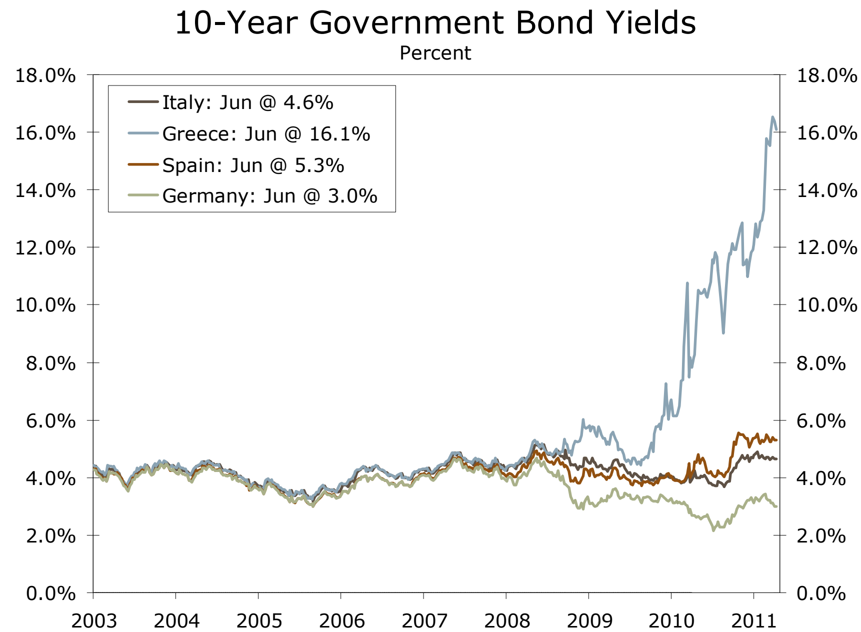
Topic of the Week

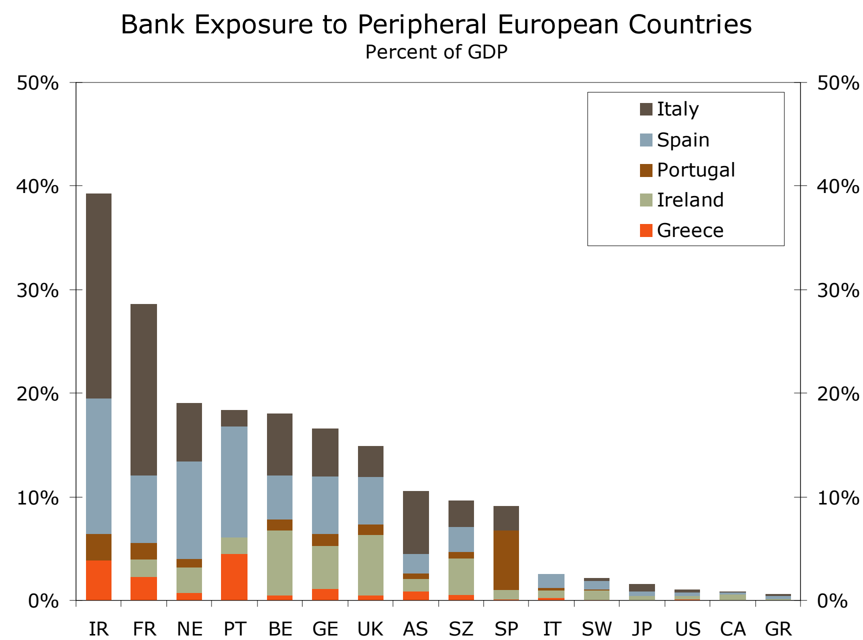
The Ongoing Saga in Europe

The European sovereign debt crisis, which has been under way for more than a year, continues to smolder with no obvious end in sight. This week, ECB President Trichet broached an idea that probably will get little traction, at least not in the near term. Trichet proposed a plan that would give E.U. officials veto power over spending and tax decisions in countries that have already received financial aid. He even went so far as to propose that a supra-national finance ministry should eventually be established. In our view, Trichet's ideas have little prospect of being approved, not least because many E.U. countries, even financially sound ones, would balk at giving up another vestige of national sovereignty.

Meanwhile, the bond market remains effectively closed to Greece—yields on government debt remain extremely elevated (top chart)—so the Greek government continues to negotiate with representatives of the E.U., the IMF and the ECB over details of a second bailout package. Negotiators are haggling over the amount of further budget cuts and privatizations that Greece needs to undertake to receive a second tranche of funds. As we wrote recently in our European trip notes, which are posted on our website, few European leaders have the stomach to restructure Greek debt at this point. Therefore, we believe that some accord with Greece will be found, essentially kicking the can down the road.

The ECB remains adamantly opposed to any restructuring or "reprofiling" of Greek debt. The worry among ECB policymakers seems to be contagion. If Greece is allowed to restructure its debt, won't Ireland and Portugal soon follow suit? And what about Spain and Italy? With European bank exposure to these five countries totaling almost €2 trillion, restructuring could entail hundreds of billions of euro worth of writedowns (bottom chart). The ECB can be justifiably excused for not wanting to entertain the topic of restructuring. However, the problem will probably not go away. We likely will be writing about the European debt crisis for sometime to come.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 6/3/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.04	0.04	0.13
3-Month LIBOR	0.25	0.25	0.54
1-Year Treasury	0.16	0.13	0.24
2-Year Treasury	0.43	0.48	0.81
5-Year Treasury	1.60	1.72	2.15
10-Year Treasury	2.99	3.07	3.36
30-Year Treasury	4.23	4.24	4.27
Bond Buyer Index	4.51	4.52	4.28

Foreign Exchange Rates	Friday 6/3/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.459	1.432	1.216
British Pound ($/£)	1.639	1.651	1.461
British Pound (£/€)	0.890	0.867	0.832
Japanese Yen (¥/$)	80.360	80.800	92.710
Canadian Dollar (C$/$)	0.978	0.976	1.040
Swiss Franc (CHF/$)	0.835	0.849	1.157
Australian Dollar (US$/A$	1.070	1.071	0.845
Mexican Peso (MXN/$)	11.671	11.604	12.782
Chinese Yuan (CNY/$)	6.480	6.492	6.828
Indian Rupee (INR/$)	44.819	45.168	46.695
Brazilian Real (BRL/$)	1.574	1.595	1.818
U.S. Dollar Index	73.947	74.954	87.136

Foreign Interest Rates	Friday 6/3/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.38	1.38	0.64
3-Month Sterling LIBOR	0.83	0.83	0.72
3-Month Canadian LIBOR	1.20	1.20	0.74
3-Month Yen LIBOR	0.20	0.20	0.24
2-Year German	1.68	1.56	0.50
2-Year U.K.	0.90	0.93	0.90
2-Year Canadian	1.45	1.51	1.77
2-Year Japanese	0.16	0.18	0.16
10-Year German	3.05	2.99	2.68
10-Year U.K.	3.28	3.32	3.58
10-Year Canadian	2.99	3.06	3.39
10-Year Japanese	1.14	1.13	1.29

Commodity Prices	Friday 6/3/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	99.30	100.23	74.61
Gold ($/Ounce)	1542.10	1536.40	1206.65
Hot-Rolled Steel ($/S.Ton	760.00	762.50	665.00
Copper (¢/Pound)	409.95	410.70	293.85
Soybeans ($/Bushel)	14.10	13.80	9.25
Natural Gas ($/MMBTU)	4.75	4.33	4.69
Nickel ($/Metric Ton)	22,563	23,399	19,574
CRB Spot Inds.	611.88	601.80	476.76

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	6	7	8	9	10
U.S. Data		**Consumer Credit** March $6.016B April $5.00B (C)		**Trade Balance** March -$48.2B April -$50.9B (W) **Wholesale Inven.** March 1.1% April 1.0% (C)	**Import Price** April 2.6% May -0.7% (W)
Global Data		**Germany** **Factory Orders** Previous (Mar) -4.0%	**Germany** **IP (MoM)** Previous (Mar) 0.7%	**E.U.** **ECB Meeting** Previous (May) 1.25% **U.K.** **BOE Meeting** Previous (May) 0.50%	**U.K.** **IP (MoM)** Previous (Mar) 0.3% **Canada** **Employment Change** Previous (Apr) 58.3K

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

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