June 17, 2011

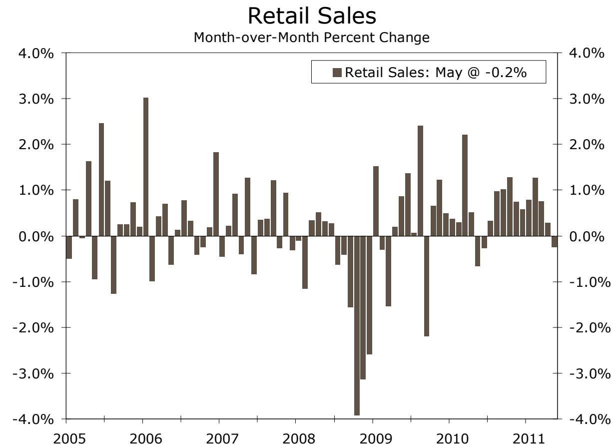
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Soft Patch Is Here

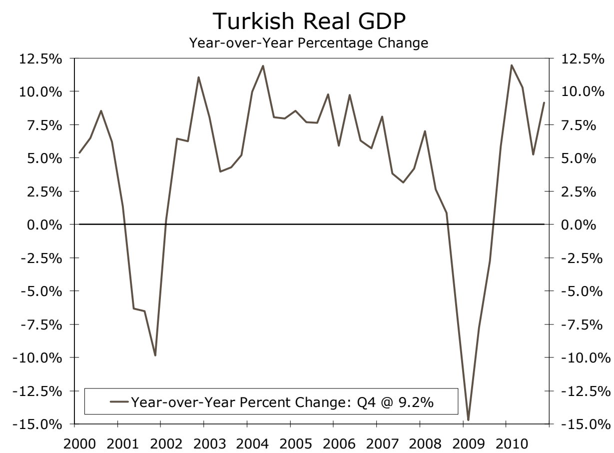
- The U.S. economy got off to a rough start in the second quarter, but just how rough is only now emerging from the economic data. Not only were May employment gains disappointing, but retail sales actually contracted in May for the first time since last summer.
- At the same time, the manufacturing slowdown that began to emerge in the May data appears to have intensified in June as the Empire State and Philly Fed surveys indicate contracting manufacturing activity in their regions for the first time since last fall.



Global Review

Turkey's Election Results Good for Growth, Stability

- The ruling Justice and Development Party won nearly half of the votes in the June 12 parliamentary election, ensuring that Prime Minister Erdogan will be in power for a third term, which will make him the longest-serving Turkish leader since 1923. This brings much needed stability in a very volatile region.
- Economic growth has been solid recently, and might possibly be overheating. While tighter monetary policy will slow down the domestic economy, it could also stoke speculative capital inflows. Thus, fiscal policy reforms are needed but will require concessions from the AKP.



Wells Fargo U.S. Economic Forecast

	Actual 2010				Forecast 2011				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2008	2009	2010	2011	2012
Real Gross Domestic Product [1]	3.7	1.7	2.6	3.1	1.8	1.9	2.6	2.7	0.0	-2.6	2.9	2.3	2.5
Personal Consumption	1.9	2.2	2.4	4.0	2.2	2.1	1.9	2.7	-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	1.6	2.1	2.3	1.5	1.3	1.4	2.2
Consumer Price Index	2.4	1.8	1.2	1.2	2.2	3.5	3.7	4.0	3.8	-0.3	1.6	3.3	3.0
Industrial Production [1]	8.1	7.1	6.7	3.1	4.2	1.8	6.8	3.0	-3.3	-11.1	5.3	4.3	3.8
Corporate Profits Before Taxes [2]	37.6	37.0	26.4	18.3	8.5	6.2	6.0	6.2	-16.4	-0.4	29.2	6.7	7.0
Trade Weighted Dollar Index[3]	76.1	78.8	73.6	73.2	70.6	69.0	69.5	71.0	74.3	77.7	75.6	70.0	75.3
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	0.56	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 17, 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

How Strong Is the Bounce Back?

The string of disappointing economic data continued this week, but there were a few signs of resilience, which suggest growth could rebound a bit over the next few months rather than continue to plunge headlong into another recession. The drag from rising gasoline prices and inflation remained highly visible in the retail sales data for May. Retail sales dropped 0.2 percent, the first decline since last summer's soft patch emerged. Monthly sales declines were seen in autos, furniture, electronics, food and beverages, sporting goods and department stores. From a year- ago basis, retail sales look more robust and have generally been growing well above incomes for much of the past year. There is little doubt, however, that rising consumer inflation has been eating into real personal income growth and forcing more consumers to dip into their savings to bolster spending.

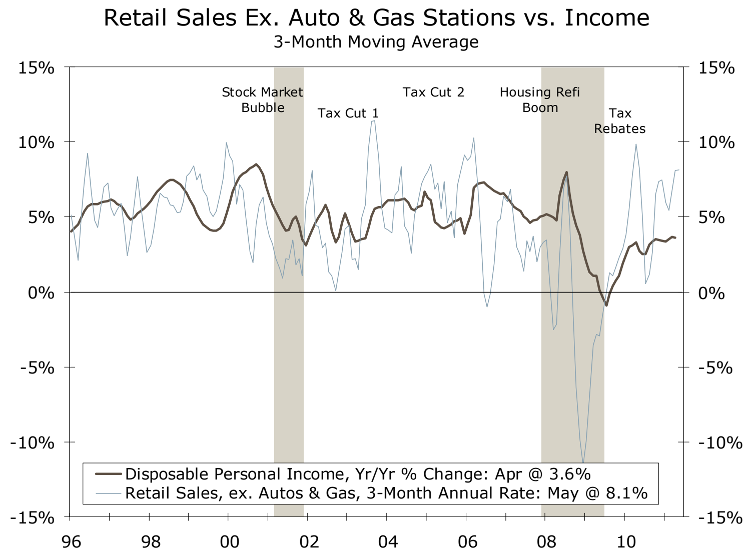
On the other hand, the announcement effect of this economic weakness has also helped bring down oil and gasoline prices. WTI crude oil is currently trading at around $93.00 a barrel, down from $114.00 at the beginning of May, over an 18.0 percent decline. According to the Department of Energy, average retail gasoline prices in the United States were $3.77 a gallon on June 13, down $0.25 a gallon from a high of $4.02 during the week of May 9. This is a smaller drop than oil, although still a measurable 6.2 percent drop in gas prices from the May peak. Further declines in retail gasoline can be expected in the weeks ahead, which will help ease some of the financial pressures that hamstrung stronger real consumer spending growth in the first half of the year.

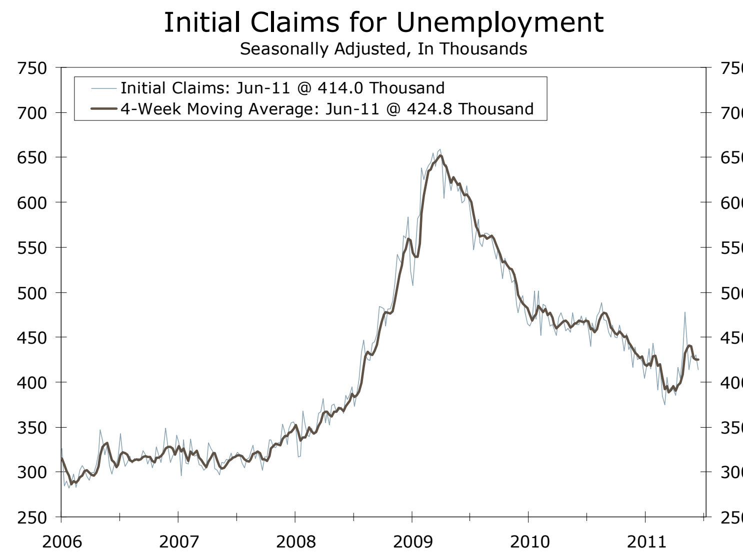
Better Job Numbers in June?

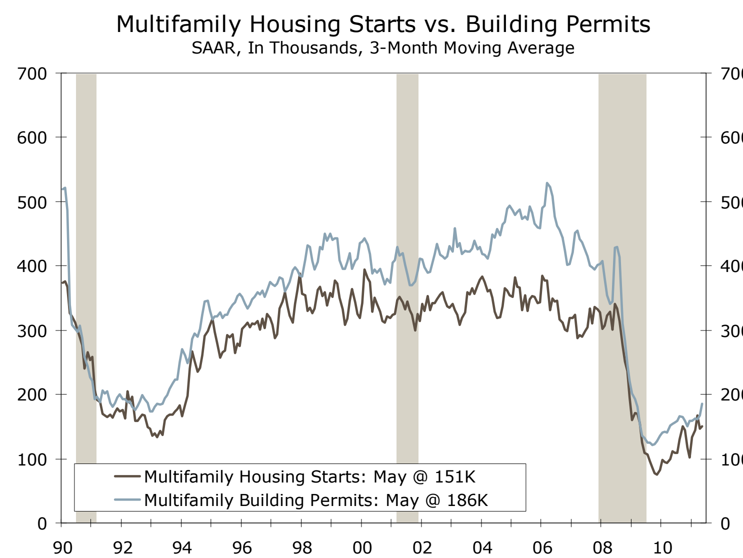
There is also some tentative evidence that the U.S. labor market is not getting any worse in June and may actually be gaining some momentum over May's lackluster pace of job creation. Initial jobless claims dropped back again last week, falling to 414,000 from 430,000 the week before. The four-week moving average of jobless claims has remained stable over the past two weeks at 424,750, below the pace at the end of May when claims averaged 426,750. Housing starts and permits also surprised on the upside this week, rising 3.5 percent and 8.7 percent, respectively, in May with solid gains in single-family and multi-family starts.

Soft Manufacturing Lingers Into June

On the downside, the June regional manufacturing surveys released so far point to further contraction in U.S. manufacturing activity. The Empire State and Philly Fed manufacturing surveys came in with negative prints, revealing contraction in manufacturing activity in those regions during June. New orders components declined, and the employment components showed less intense expansions in manufacturing employment. So far, the negative readings from these manufacturing surveys are in line with those seen during last summer's economic soft-patch and do not in themselves signal a general contraction in U.S. industrial production growth or gross domestic product. Stay-tuned for the June Chicago Fed National Activity Index to be released next Thursday.





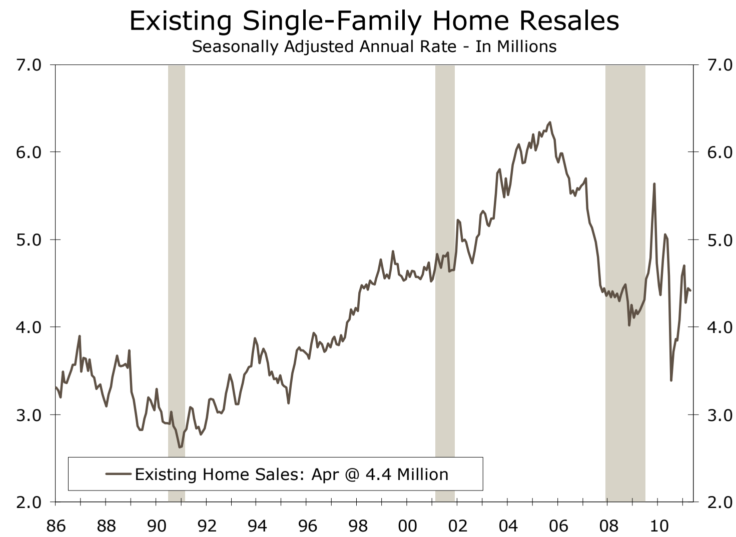


Existing Home Sales • Tuesday

The number for existing home sales for May will be released on Tuesday and markets are expecting that number to be lower than the 5.05 million reported in April. The market's expectation for May is for existing home sales to come at 4.80 million, while our own forecast is for them to come even at a lower annualized rate of 4.76 million. However, last week's better-than-expected housing starts number and the broadness of the improvement may set the stage for a more upbeat sentiment to come next week, especially if the housing starts number is supported by a higher number on new home sales for May, a number that is scheduled to be released on Thursday. If new home sales come in as low as we are expecting, however, the housing starts increase in May will probably not be sustainable. Market expectations for new home sales for May are at only 310,000 compared to the 323,000 reported in April, while we have estimated them to be at 311,000.

Previous: 5.05 Million **Wells Fargo: 4.76 Million**

Consensus: 4.80 Million



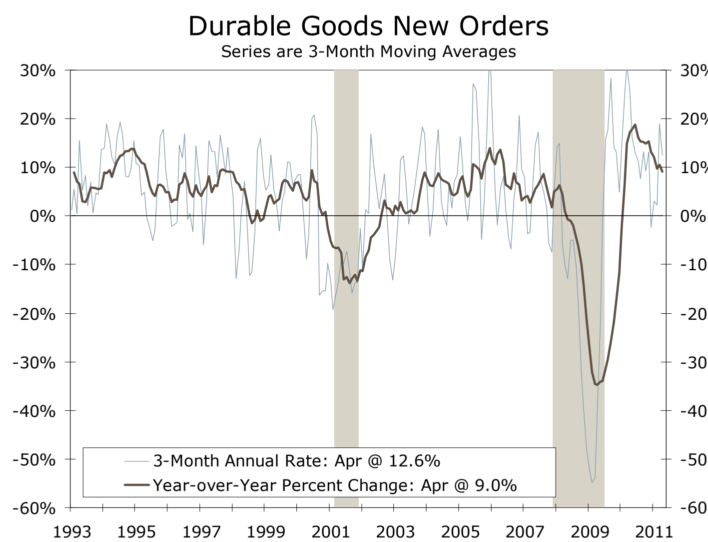
Durable Goods Orders • Friday

A positive number for May's durable goods orders on Friday will probably be nothing more than a bounce back from the previous month's 3.6 percent drop for the overall number and the 1.5 percent drop when excluding transportation goods. The market is expecting durable goods orders to bounce back by 1.6 percent in May and excluding transportation to be higher by 1.0 percent, while we expect this number to be higher by 1.3 percent.

However, we know that the Japanese earthquake, tsunami and ensuing nuclear crisis has introduced a lot of noise on all production numbers and it will not be strange that last month's durable goods numbers include some of this noise. Furthermore, durable goods numbers have always been highly volatile so do not be surprised if Friday's release brings an upside twist attached to it. Any good news will be welcome by the markets.

Previous: -3.6% **Wells Fargo: 1.6%**

Consensus: 1.6% (Month-over-Month)



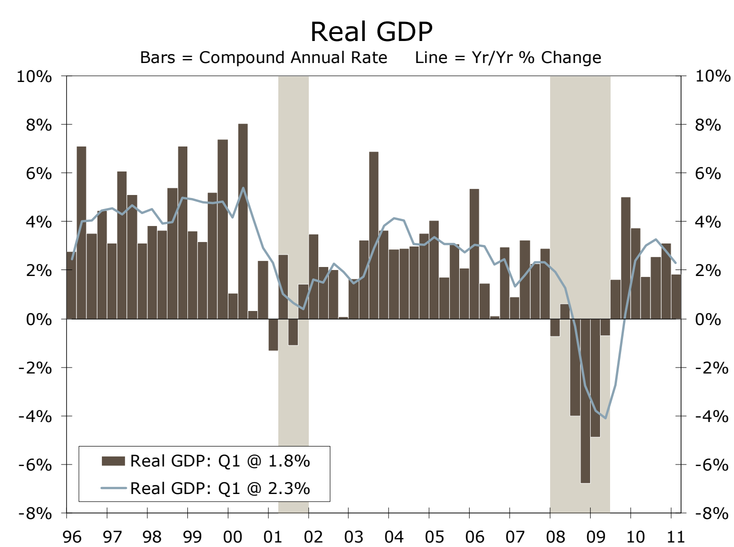
GDP • Friday

Friday's release of the revised first quarter GDP number is not expected to contribute too much to the analysis of the state of the U.S. economy, with markets expecting GDP to have increased by 1.9 percent compared to an earlier estimate of 1.8 percent. The 0.1 percent change in GDP growth expected by markets seems to be related to a revision in the size of inventories, as they came in higher in March than what markets were expecting. We still expect GDP to remain unchanged at 1.8 percent but recognize the potential for it to be a bit higher.

The rest of the numbers are expected to come without any surprise, with personal consumption expenditures at 2.2 percent, the GDP deflator coming in unchanged at 1.9 percent, while the core PCE coming also at an unchanged 1.4 percent. Thus, the housing market and durable goods orders are going to be doing all the talking for the U.S. economy next week.

Previous: 1.8% **Wells Fargo: 1.8%**

Consensus: 1.9% (CAGR)



Global Review

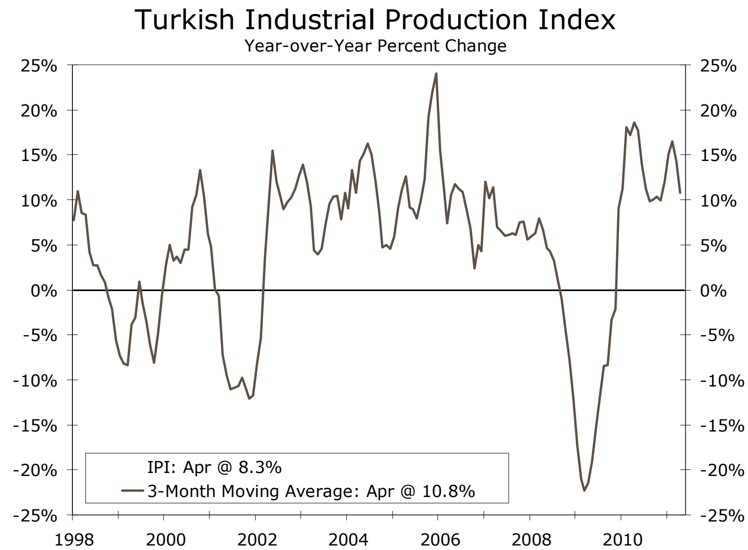
Turkey's Election Results Good for Growth, Stability

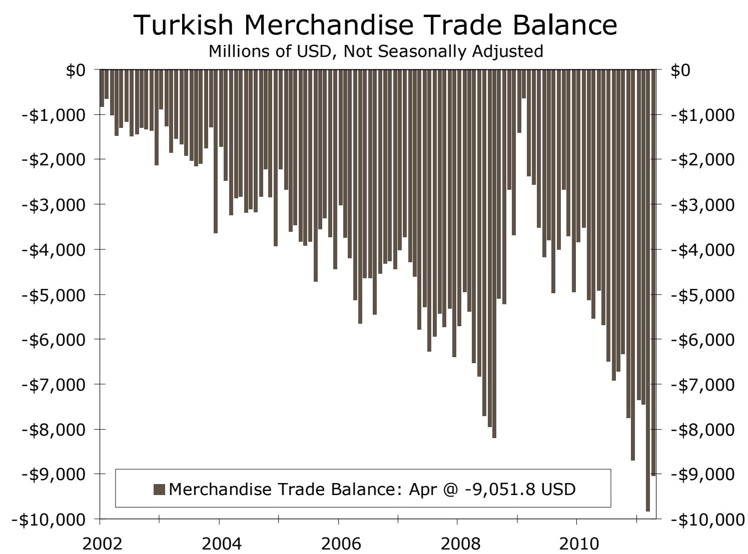
Turkey's ruling Justice and Development Party (AKP) won 49.9 percent of the votes in the June 12 parliamentary election and will have 326 seats in the 550 seat parliament. While the AKP's victory was of little surprise, the party fell four votes shy of the 330 votes needed to be able to put constitutional changes up for referendum. Thus, Prime Minister Erdogan and the AKP party will need to, and have vowed to, seek consensus on reforms. This could prove difficult and could stall much needed reforms, as the secular elite remains highly suspicious of Erdogan and his Islamist agenda. Still, with the largest share of the vote in nearly half a century, the re-election of the AKP party provides stability and removes uncertainty in a time and region rife with volatility.

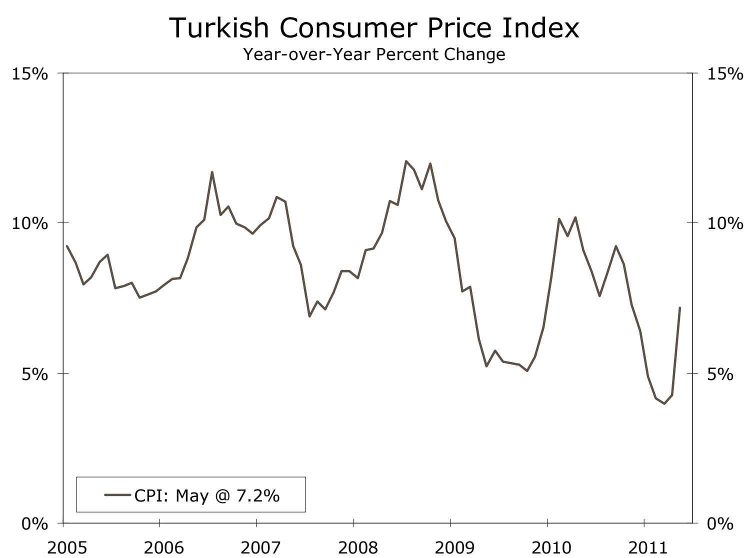
The markets cheered the news as the results ensure a third term for the AKP, which has presided over economic progress and relative stability during its nine years in power. Outside of two recessions, the Turkish economy has seen year-over-year growth in the high single digits over the past decade and has enjoyed a few double-digit prints as well. The economy grew 9.2 percent year-over-year in the fourth quarter of 2010, driven by strong domestic consumption and investment. Unfortunately, the robust domestic economy, which has been fueled by rapid credit growth, has also fostered strong growth in imports. This has led to significant widening in the trade and current account deficits. Following a sharp narrowing during the global financial crisis, the trade deficit has widened again and has resumed the trend seen before the crisis, coming in at $9.1 billion in April. Similarly, following one brief month of surplus in October 2009, the current account deficit has widened to $7.7 billion as of April. In the 12 months through April, the current account deficit is running at $63.4 billion, or 8.6 percent of GDP, compared to the government's forecast of $42 billion for the year.

Thus, although economic growth has been solid recently, the need to cool down a possibly overheating economy, as well as to shore up the external imbalance, could lead to a somewhat slower growth path in the near-to medium-term. In addition to possible interest rate hikes and higher bank reserve requirements, the government will introduce a revised budget in the second quarter that may include spending cuts. However, the consensus nature of the negotiations going forth suggests fiscal consolidation may not be terribly rapid in nature.

Turkey has been a diamond in the rough in the region on two fronts. While several countries in the Middle East and Northern Africa have seen, or will soon see, their leaders ejected from power, Turkey has voted to keep its current ruling party and leader for a third term, which would make Erdogan Turkey's longest-serving leader since the country's founder Mustafa Kemal Ataturk. Similarly, while some European countries are getting bailed out by the IMF, Turkey not only decided against IMF loans during the recession, but is on track to pay off the remaining $5.0 billion of the $26 billion the IMF lent to the country after its 2001 banking crisis. These factors should enhance Turkey's bid to join the European Union but accession is still many years away.



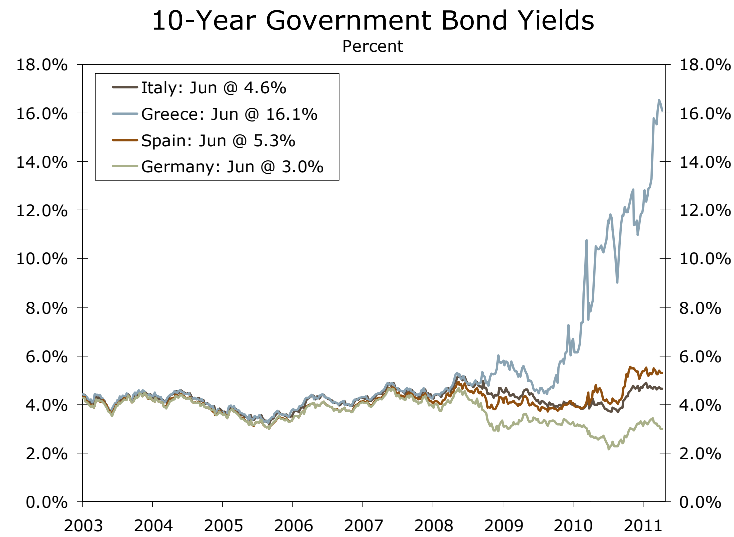


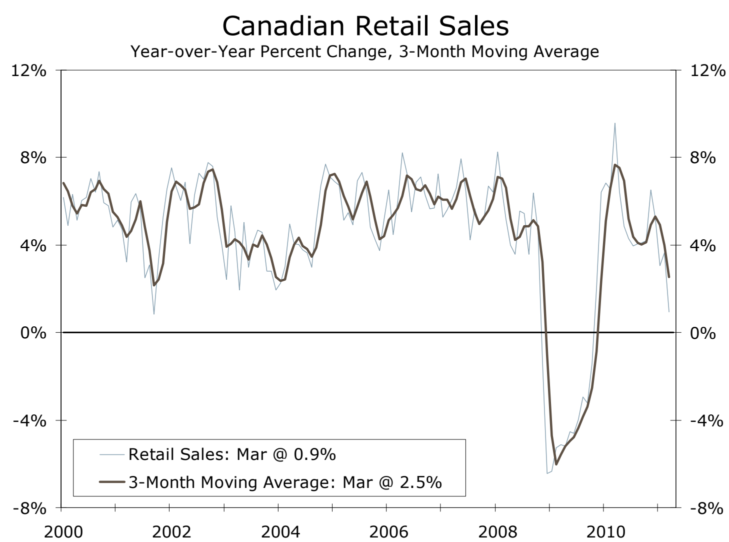


EU Finance Ministers' Meeting • Monday

Finance ministers from the European Union countries meet on Sunday and Monday to try to hammer out a deal to save Greece from eventually defaulting. Last May, Greece received a bailout package worth €110 billion, and the hope at the time was that the Hellenic Republic would be able to tap markets again in 2012. However, with Greek borrowing costs in the stratosphere, the government is unable to access private funding at reasonable costs.

Germany and a few other countries are willing to provide funding for a second rescue package, but they want private sector creditors to participate in the deal by voluntarily rolling over debt or by extending maturities. The ECB, France and some other countries think that any "reprofiling" of Greek debt would mean that Greece would technically be in default. They fear that contagion could spread to other countries, which could eventually lead to debt restructurings by those governments.





Canadian Retail Sales • Tuesday

Growth in Canadian retail sales have slowed since last autumn. Some of the slowdown in the year-over-year growth rate reflects base effects. That is, auto sales rose significantly early last year, which helped boost overall retail spending in the early months of 2010. That said, there is more to the slowdown in overall retail spending than simply the effect of auto sales. To wit, growth in retail sales ex-autos has also slowed as well. Consequently, the Bank of Canada, which has kept its main policy rate unchanged since last September, will likely keep rates on hold at its next policy meeting on July 19.

Although not widely followed by market participants, the leading economic index for May will also be released on Tuesday. The leading index has trended higher since last autumn, suggesting that the expansion in Canada will remain intact in the months ahead.

Previous: 0.0%

Consensus: 0.6% (Month-over-Month)

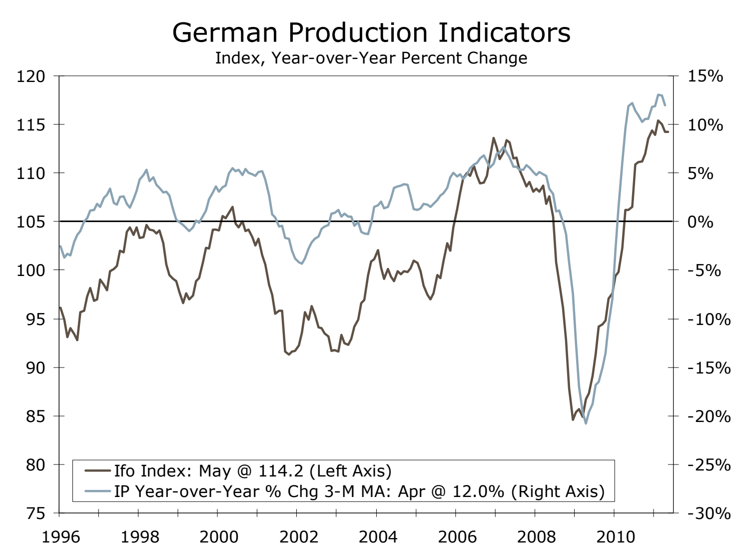
German Ifo Index • Friday

The Ifo index of German business sentiment rose to an all-time high in the post re-unification period in February. Although the index has edged a bit lower over the past three months, it remains at a very elevated level that is consistent with continued expansion in German industrial production. The release of the June index on Friday will shed some insights into the current state of the German manufacturing sector.

The "flash" estimates of the purchasing managers' indices for the overall Eurozone in June will be released on Thursday. The indices for both the manufacturing and service sectors posted sizeable declines in May, although both indices remain well above the demarcation line that separates expansion from contraction. "Hard" data on factory orders in the Eurozone in April will print on Wednesday.

Previous: 114.2

Consensus: 113.5

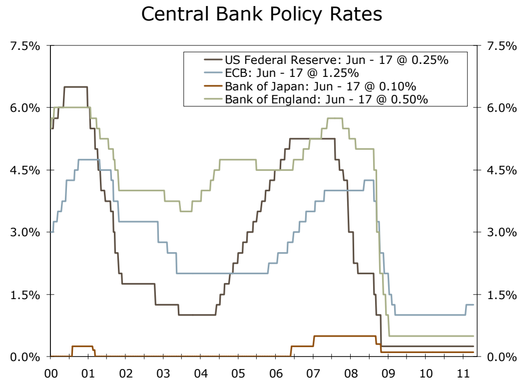


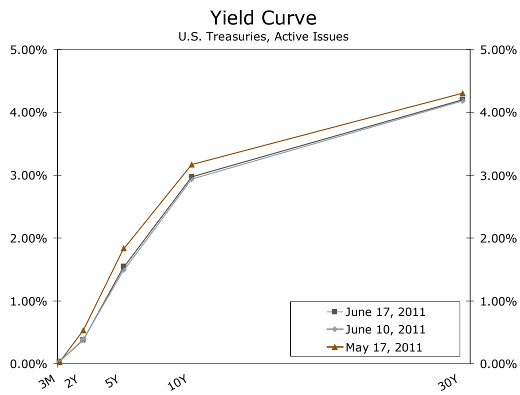
Interest Rate Watch

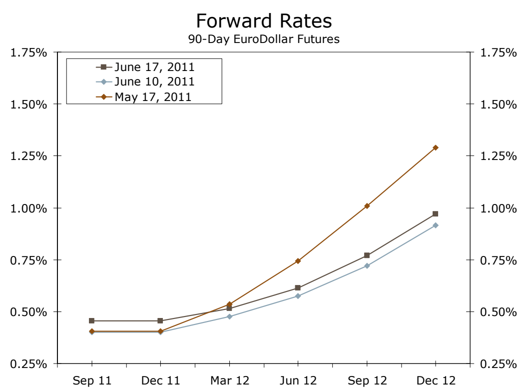
Inflation Up but Fed Stays on Hold

The news this week that the Producer Price Index and the Consumer Price Index are beginning to pick up has led some to question the time table for monetary policy tightening. In addition to the current inflation indicators pointing upward, inflation expectations are also edging upward as evidenced by the University of Michigan's measure of 5-year inflation expectations, which is now at 3.0 percent.

Even in light of this week's data, we still expect that next week's meeting of the FOMC will not result in significant changes to monetary policy. The slower pace of economic growth over the near term combined with the ongoing high rate of unemployment will serve as a limiting factor in the Fed's decision to raise rates. We believe that next week's meeting will result in increased discussion among the members on the current economic climate. We still expect that the Fed will end its second round of quantitative easing this month and continue to reinvest the proceeds from agency and mortgage-backed securities into Treasuries. The continued reinvestment into Treasury securities will help keep the lower interest rate environment in place at least in the near term. The ongoing challenge for the Federal Reserve will be to determine the relative costs and benefits of addressing only one aspect of its dual mandate of containing inflation, while at the same time keeping the unemployment rate in check. These mandates require different types of policies that are contradictory in nature. The loosening of monetary policy, in the form of quantitative easing has been the monetary policy response to increase inflation expectations and to some extent reduce the unemployment rate by freeing up capital. On the other hand, keeping inflation in check requires a tightening of monetary policy in the form of rising interest rates. While we expect these discussions to reflect the slower pace of economic growth, we do not expect a QE3 program that would send future inflation expectations even higher. The bottom line is that the Fed is likely in a holding pattern for the time being.







Credit Market Insights

Credit Market Borrowing on the Rise

The recently released *Flow of Funds* report showed an increase in credit market borrowing for businesses in the first quarter. Debt through credit market instruments at nonfinancial corporations (NFC) rose at a $512.9 billion annual rate in the first quarter, the fastest clip in three years. As in previous quarters, corporate bond liabilities accounted for the bulk of the increase. Although rising at a slower rate than in the fourth quarter, corporate bond debt increased by $377.5 billion. Also contributing to the rise in NFC debt was the largest quarterly increase in bank loans since the first quarter of 2008. Bank loans, which include commercial and industrial loans, increased at a $107.8 billion annual rate. NFCs also increased their short-term borrowing in the first quarter, as commercial paper liabilities rose at a $31.7 billion annual rate. Mortgage debt continued to weigh on net borrowing and contracted for the eighth consecutive quarter. However, the pace slowed to an annualized decline of $46.4 billion from a $108.3 billion decline in the fourth quarter of 2010.

Corporate bonds continue to be the instrument of choice for NFCs and increased to a record 65 percent of credit market borrowing in the first quarter. With the potential for markets to tighten later this year as QE2 comes to an end and debt concerns in Europe are still unresolved, firms are clearly taking advantage of historically low interest rates in the market.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.50%	4.49%	4.61%	5.08%
15-Yr Fixed	3.67%	3.68%	3.80%	4.39%
5/1 ARM	3.27%	3.28%	3.48%	4.10%
1-Yr ARM	2.97%	2.95%	3.15%	4.05%
MBA Applications				
Composite	584.6	517.5	534.8	659.9
Purchase	191.1	182.9	188.6	180.0
Refinance	2,883.7	2,475.7	2,568.2	3,461.5

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

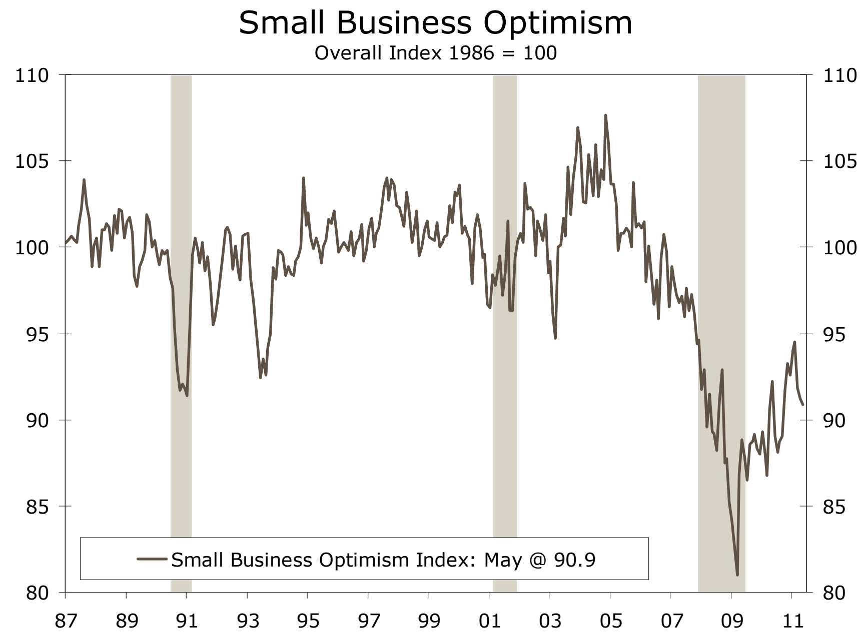
Topic of the Week

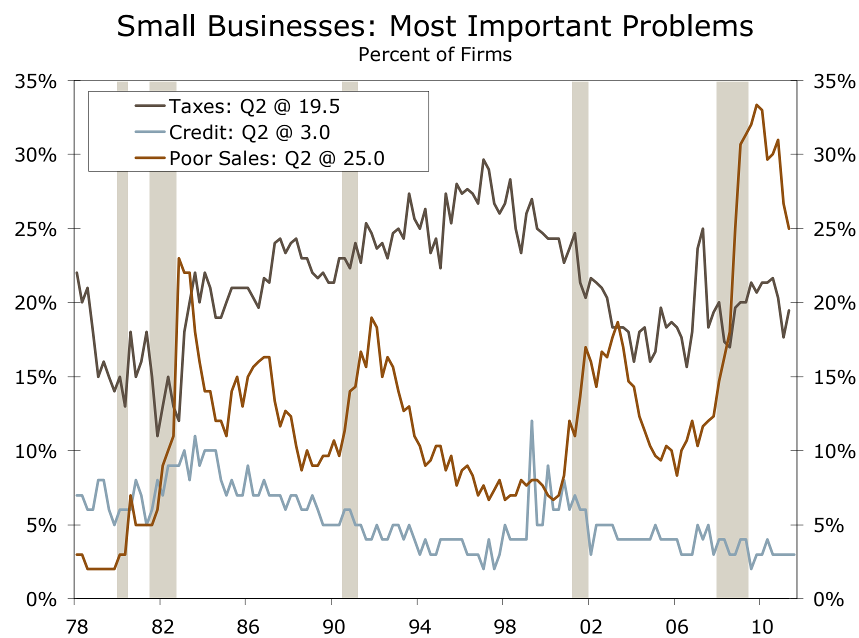
Weak Sales Weigh Down Small Business

The NFIB Small Business Optimism Index fell to 90.9 in May, the lowest level in eight months. While many point to tight lending standards as the most significant issue faced by small businesses, 25 percent of owners reported that weak sales continue to be the top business problem. Credit availability was a major concern for only 3 percent of small business owners surveyed in May. In fact, weak sales have been the biggest problem for small business owners since mid-2008. We expect consumer spending to grow at a modest 2.5 percent annual rate in 2011, as many households continue to unwind debt and stash away cash for the next rainy day. The slow pace of consumer spending suggests small business owner sentiment will likely remain at depressed levels. Prior to the slow down in consumer demand, taxes prevailed as the largest issue for small business owners.

With small business optimism still at recessionary levels, it is not surprising that many owners are still not looking to hire. When asked about hiring plans over the next three months, 13 percent plan to increase their workforce, while 8 percent plan to reduce their workforce. Consequently, net hiring fell one percent in May, the first decline since September. The decline in small business hiring plans is consistent with the renewed weakness in the labor market. With small business employment accounting for 45 percent of private sector gains, according to ADP employment figures, small business hiring is a critical component of employment growth.

Small businesses also continued to be less optimistic about future economic activity. For the third consecutive month, the net percentage of small business owners that expect better economic conditions contracted. Much of the economic uncertainty felt by small business owners is likely due to weak sales, which are expected to remain weak through 2012.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 6/17/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.02	0.04	0.09
3-Month LIBOR	0.25	0.25	0.54
1-Year Treasury	0.14	0.16	0.16
2-Year Treasury	0.37	0.40	0.70
5-Year Treasury	1.53	1.56	1.98
10-Year Treasury	2.94	2.97	3.19
30-Year Treasury	4.19	4.18	4.12
Bond Buyer Index	4.49	4.49	4.40

Foreign Exchange Rates

	Friday 6/17/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.432	1.435	1.239
British Pound ($/£)	1.619	1.623	1.482
British Pound (£/€)	0.885	0.884	0.836
Japanese Yen (¥/$)	80.110	80.320	91.010
Canadian Dollar (C$/$)	0.980	0.980	1.028
Swiss Franc (CHF/$)	0.846	0.843	1.112
Australian Dollar (US$/A$)	1.062	1.054	0.869
Mexican Peso (MXN/$)	11.901	11.907	12.587
Chinese Yuan (CNY/$)	6.476	6.480	6.829
Indian Rupee (INR/$)	44.866	44.721	46.315
Brazilian Real (BRL/$)	1.597	1.597	1.780
U.S. Dollar Index	74.986	74.795	85.688

Foreign Interest Rates

	Friday 6/17/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.45	1.41	0.66
3-Month Sterling LIBOR	0.83	0.82	0.73
3-Month Canadian LIBOR	1.18	1.20	0.81
3-Month Yen LIBOR	0.20	0.20	0.24
2-Year German	1.51	1.54	0.52
2-Year U.K.	0.77	0.82	0.84
2-Year Canadian	1.49	1.45	1.72
2-Year Japanese	0.18	0.17	0.16
10-Year German	2.96	2.96	2.66
10-Year U.K.	3.20	3.22	3.48
10-Year Canadian	2.94	3.01	3.30
10-Year Japanese	1.12	1.14	1.23

Commodity Prices

	Friday 6/17/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	93.40	99.29	76.79
Gold ($/Ounce)	1539.20	1531.65	1245.15
Hot-Rolled Steel ($/S.Ton)	748.00	760.00	660.00
Copper (¢/Pound)	412.00	405.20	290.25
Soybeans ($/Bushel)	13.61	13.96	9.53
Natural Gas ($/MMBTU)	4.38	4.76	5.16
Nickel ($/Metric Ton)	21,568	23,175	19,970
CRB Spot Inds.	605.95	604.67	479.25

Next Week's Economic Calendar

	Monday 20	Tuesday 21	Wednesday 22	Thursday 23	Friday 24
U.S. Data		**Existing Home Sales** April 5.05M May 4.76M (W)	**FOMC Rate Decision** Previous 0.25% Expected 0.25% (W)	**New Home Sales** April 323K May 311K (W)	**GDP** Q1 (2nd) 1.8% Q1 (3nd) 1.8% (W) **Durable Goods Orders** April -3.6% May 1.6% (W) **Durables Ex Transp.** April -1.6% May 1.3% (W)
Global Data	**Eurozone** **E.U. Finance Ministers** N/A	**Canada** **Retail Sales (MoM)** Previous (Mar) 0.0%	**Brazil** **Unemployment Rate** Previous (Apr) 6.4% **Eurozone** **Consumer Confidence** Previous (May) -9.8%	**Eurozone** **PMI Composite** Previous (May) 55.8 **Mexico** **Unemployment Rate** Previous (Apr) 5.1%	**Germany** **Ifo Business Climate** Previous (May) 114.2 **Italy** **Retail Sales (MoM)** Previous (Mar) -0.2%

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

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