July 01, 2011

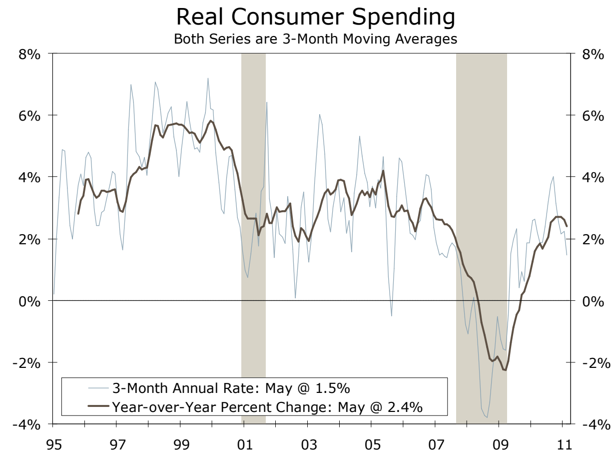
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Second Quarter Ends Poorly – Better Times Ahead

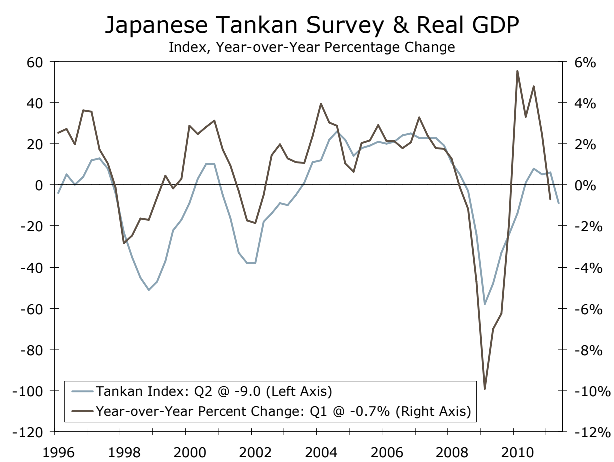
- Weaker-than-expected consumer spending and income growth for May are causing many economists to further scale back their consumer spending and GDP growth forecasts for the second quarter. Expectations for a second-half growth rebound remain intact, however, although the evidence to date remains scant.
- U.S. manufacturing gains remained modest in June if the ISM manufacturing and regional manufacturing surveys are to be believed. On the bright side, capital and durable goods orders rebounded strongly in May increasing the odds of a manufacturing rebound in Q3.



Global Review

Life in Japan Continues, Despite Earthquake

- The Tankan survey shows tantalizing evidence that economic activity in Japan will rebound during the second half of the year following the collapse of manufacturing activity after the March earthquake.
- However, the Tankan Survey also showed that not everything is rosy in the "Land of the Rising Sun." While output is clearly recovering from the disruptions created by the natural and human disasters, the business sentiment index took a relatively strong hit during the survey, going to -9 in the current survey from a value of six in the previous survey.



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	1.9	1.8	2.7	3.0	0.0	-2.6	2.9	2.3	2.5
Personal Consumption	1.9	2.2	2.4	4.0	2.2	1.8	1.9	3.0	-0.3	-1.2	1.7	2.4	2.1
Inflation Indicators [2]													
"Core" PCE Deflator	1.8	1.5	1.2	0.8	0.9	1.2	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	3.4	3.6	3.8	3.8	-0.3	1.6	3.3	3.0
Industrial Production [1]	8.1	7.1	6.7	3.1	4.2	1.7	6.9	3.1	-3.3	-11.1	5.3	4.3	3.7
Corporate Profits Before Taxes [2]	37.6	37.0	26.4	18.3	10.2	6.2	6.0	6.2	-16.4	-0.4	29.2	7.1	7.0
Trade Weighted Dollar Index [3]	76.1	78.8	73.6	73.2	70.6	70.4	69.5	71.0	74.3	77.7	75.6	70.4	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	0.55	0.59	0.64	0.90	0.55	0.58	0.59	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	4.64	4.90	5.00	6.04	5.04	4.69	4.85	5.33
10 Year Note	3.84	2.97	2.53	3.30	3.47	3.18	3.30	3.40	3.66	3.26	3.22	3.34	3.73

Forecast as of: July 1, 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

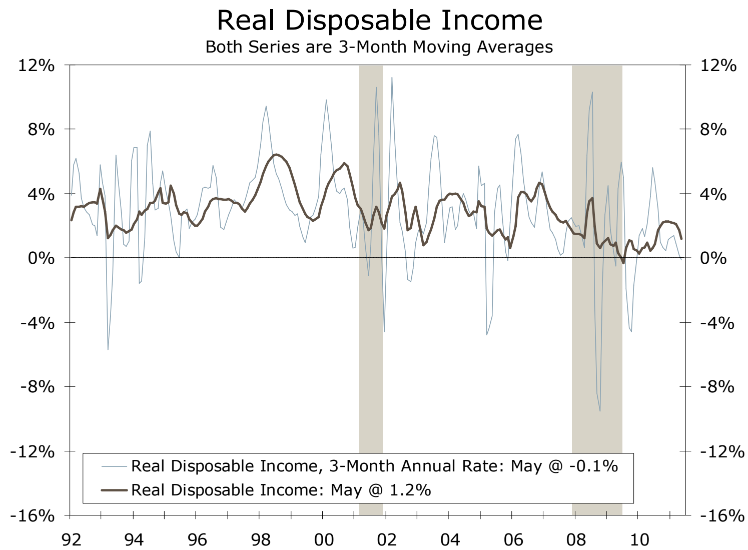
U.S. Review

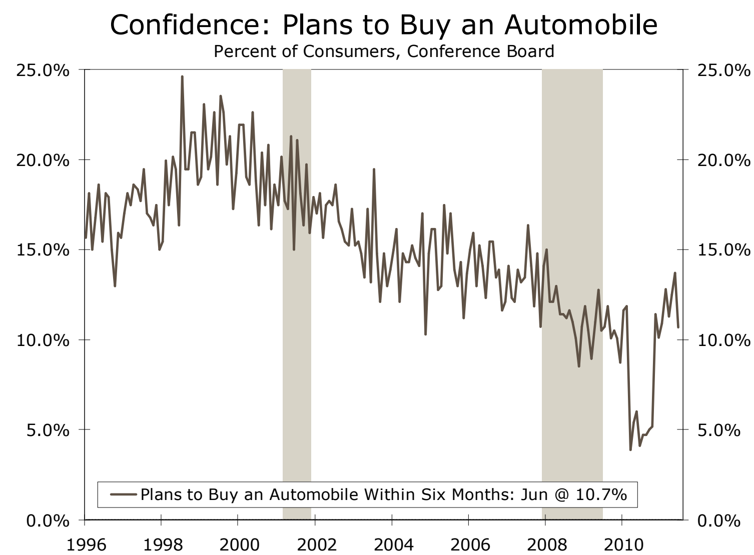
More Disappointment in the Third Quarter?

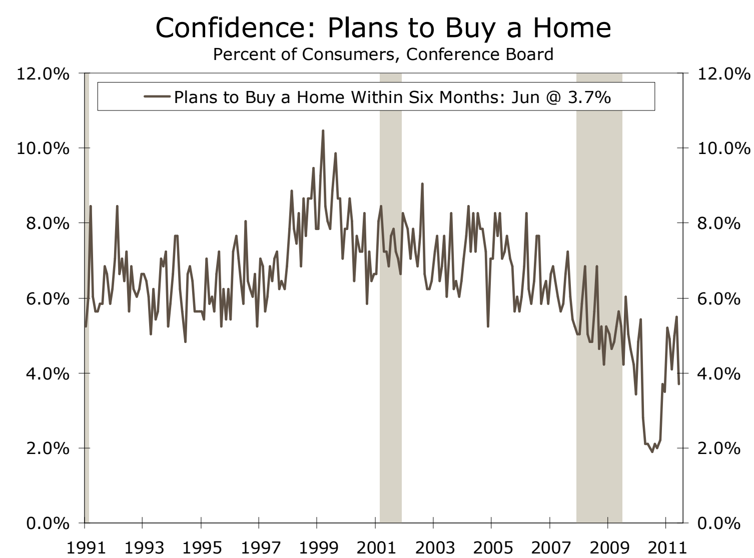
Economists are counting on a solid third quarter bounce in GDP growth in part due to reduced supply disruptions from Japan, which should allow for a robust resurgence in auto production and sales. Wards Auto is estimating a U.S. motor vehicle assembly rate of 9.5 million units on an annualized basis in July that is nearly a 20 percent increase over the May assembly rate of 7.9 million units. Moreover, the recent decline in oil and gasoline prices, as global demand slackens and 28 countries unite to release 60 million barrels of oil from their strategic petroleum reserves, should help restore some real disposable purchasing power to consumers. West Texas Intermediate crude oil prices are currently trading at around $95.00 a barrel, about 17 percent lower than two months ago, while average retail gasoline prices have fallen nearly ten percent to $3.63 per gallon. The gasoline price drop alone could save U.S. consumers around $40.0 billion dollars in gasoline purchases if maintained over a year's time. But with the 4th of July holiday fast approaching these rosy economic forecasts will soon be tested in the real world. The economic indicators released this week show little evidence of a bounce in activity so far.

In fact, estimates for second quarter GDP continue to be trimmed. The personal spending and income report for May came in weaker than the consensus expected, pushing down estimates for second quarter real consumer spending growth. The gory details of the report revealed a U.S. consumer treading water under the weight of rising consumer prices and sluggish wage and income growth. Personal spending actually contracted at a 0.1 percent pace over the past two consecutive months in real terms. It is not that consumers do not want to grow their spending it is the fact that real disposable incomes are making it impossible to do so. There has been no real disposable income growth for U.S. consumers since January. Reinforcing the weakness in May consumer spending and income, the Conference Board's June consumer confidence measure plunged to 58.5 from 61.7 in May with declines in both the present situation and expectations components. Readings on the labor market softened, with the jobs plentiful minus jobs hard to get differential deteriorating to -38.6 in June from -37.8 in May. At the same time, plans to buy autos, homes, appliances, and a vacation all fell from levels in April and May.

June manufacturing does not appear to be fairing much better. Several regional manufacturing surveys including the Empire State, Philly Fed, and Dallas Fed fell into mild contraction territory in June. However, the national, and most watched, ISM Manufacturing Index, improved in June. These data foreshadow another month of modest payroll and industrial production growth in June. The best thing we can say about the second quarter of 2011 is that it is just about over and with a new quarter comes the chance for economic resurgence. New durable and capital goods orders rebounded in May, suggesting that a pickup in production is in the works for the second half.





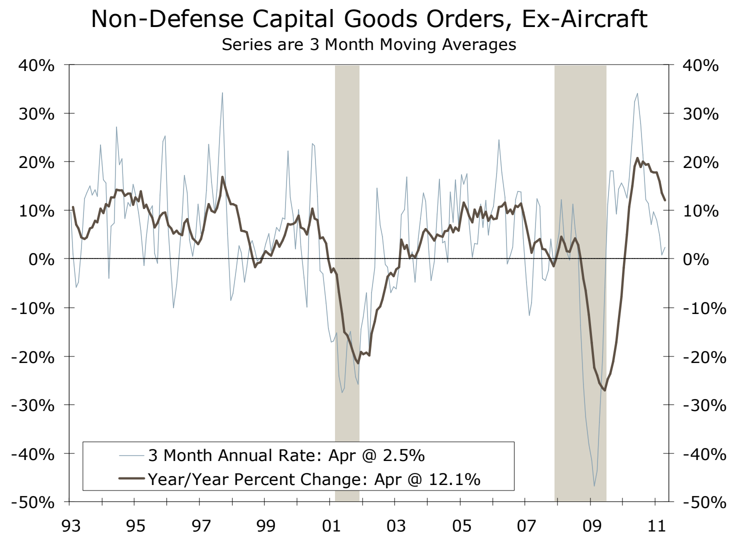


Factory Orders • Tuesday

Manufactures continued to see less demand for manufactured goods in May, with factory orders falling 1.2 percent following a 3.8 percent increase in the previous month. While some of the decline is likely payback from April, new orders have been down for two of the past three months. Much of the decline is due to volatile components such as transportation and defense, which fell 9.3 percent and 1.6 percent, respectively. To get a better gauge of the trend in factory orders, we look at capital goods non-defense orders excluding aircraft on a three-month annualized basis, which increased 2.5 percent on the month. The gain in capital goods non-defense excluding aircraft suggests modest strength in the manufacturing sector. Moreover, regional manufacturing surveys continued to show modest gains in June. Consequently, we expect factory orders to increase a modest 1.1 percent in June.

Previous: -1.2% **Wells Fargo: 1.1%**

Consensus: 1.0% (Month-over-Month)

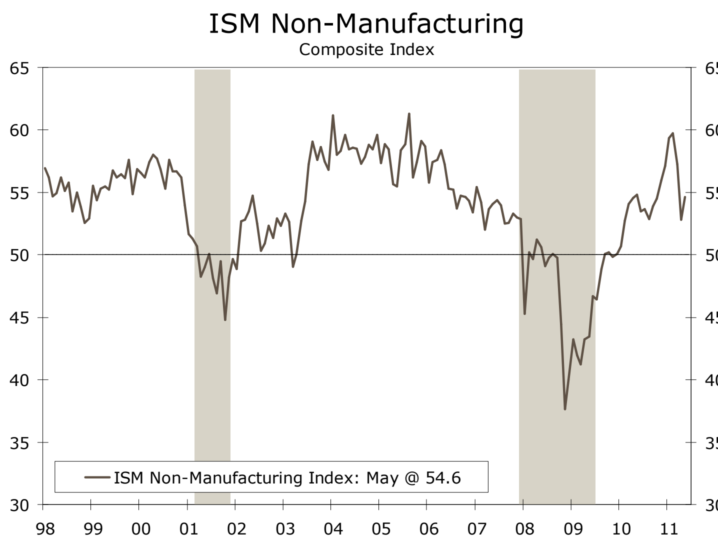


ISM Non-Manufacturing • Wednesday

Despite a soft patch in manufacturing, the service sector continued its positive momentum with the headline non-manufacturing index rising to 54.6 in May. This second consecutive monthly increase was largely due to a jump in the new orders and employment components. The forward-looking new orders component is now at 56.8, but well off of its January high of 64.9, which suggests further service sector gains but at a slower pace. Employment also rose and is now at 54, but due to renewed weakness in the labor market, we could see a bit of a pullback. Another encouraging component of the survey is that export orders have outpaced imports in three of the past four months, which may translate into better trade balance figures. With 16 industries reporting growth, we continue to expect the service sector to support the economic recovery in the coming months.

Previous: 54.6 **Wells Fargo: 53.7**

Consensus: 53.7

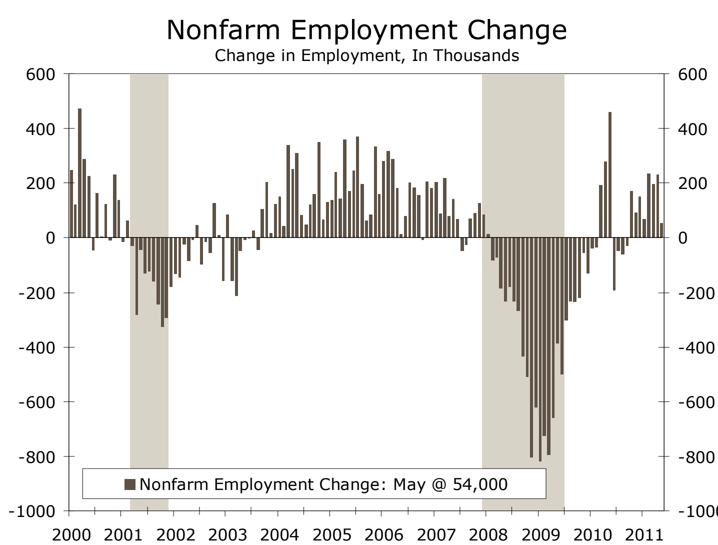


Employment • Friday

Nonfarm employment sorely disappointed in May with only 54,000 jobs added following an average of 220,000 job gains in the previous three months. While nonfarm payrolls registered a less-than-expected increase, much of the pullback was likely due to technical factors such as weather and the Japanese earthquake. We expect that while most of these temporary factors have run their course, we could see another below-trend reading in June. Initial jobless claims have been above 400,000, which is the level consistent with modest job gains, for the past three months and regional manufacturing surveys also showed a pullback in the employment component for June. The unemployment rate should remain unchanged at 9.1 percent in June. While some of the labor market weakness is due to cyclical factors, structural factors continue to play a large role.

Previous: 54K **Wells Fargo: 88K**

Consensus: 90K (Month-over-Month)



Global Review

Life in Japan Continues, Despite Earthquake

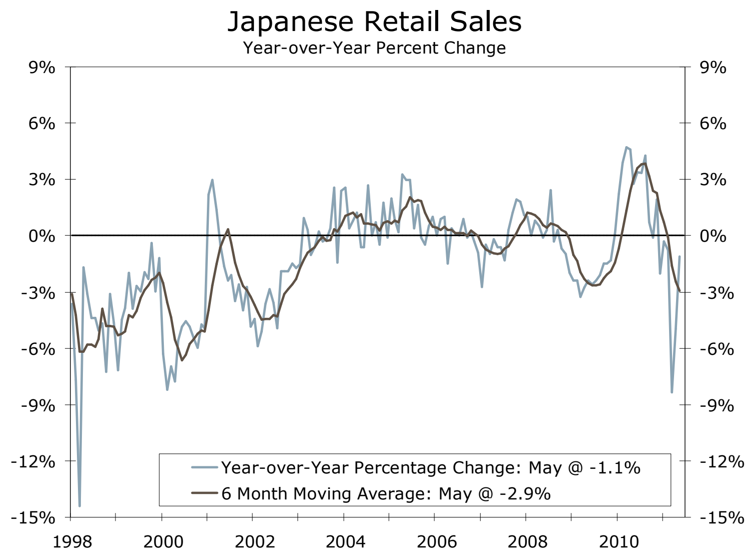
While the eyes of the financial world have been focused on what has been happening in Greece (see our Topic of the Week section), life in the rest of the world has progressed without much fanfare. The Japanese economy has been at the top of the economic news with several important releases, from retail sales, small business confidence, industrial production and vehicle production. Overall, even if the releases showed a negative number, they mostly came in better than market expectations and showed a clear improvement compared to previous months. This is a clear sign that the Japanese economy is overcoming the problems created by the earthquake, tsunami, and nuclear crisis.

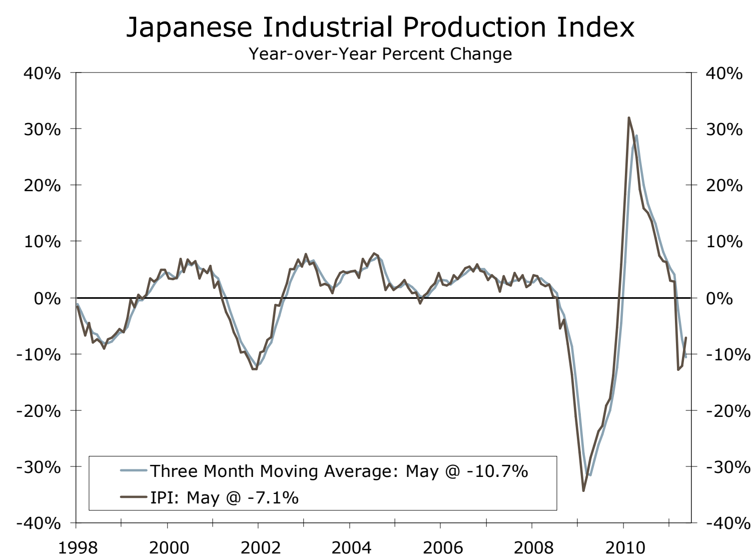
For instance, retail sales were down by "only" 1.3 percent on a year-earlier basis on May compared to a drop of 4.8 percent in April, while the market was expecting them to drop by 2.2 percent. Meanwhile, seasonally adjusted retail sales increased by 2.4 percent compared to a market expectation of only 1.2 percent. Meanwhile, the industrial production index increased by a strong 5.7 percent on a seasonally adjusted basis in May. The year-earlier industrial production index dropped by 5.9 percent but this is an improvement from April's drop of 13.6 percent.

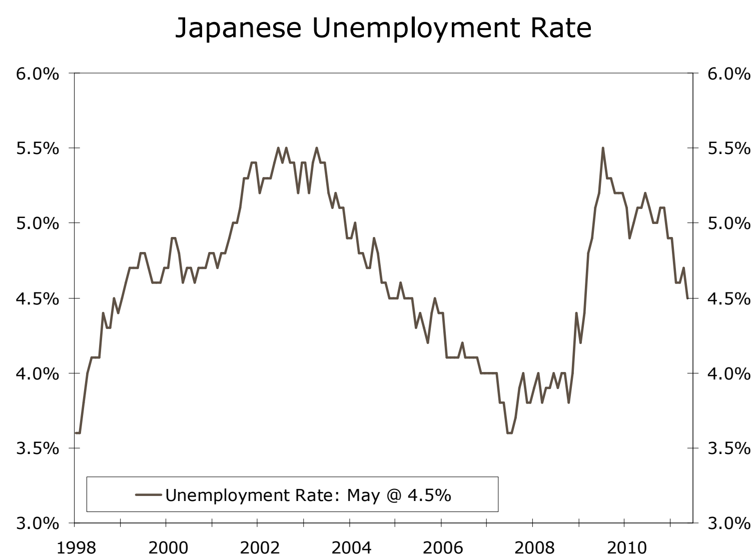
While the Markit/JMMA Manufacturing PMI was lower, at 50.7 in May compared to 51.3 in April, it remained above the 50 level, which indicates that the manufacturing sector is still expanding, albeit at a slower pace. We even saw some relative improvement in the auto sector, with vehicle production in May dropping by "only" 30.9 percent compared to a drop of 60.1 percent during April. Thus, while the Japanese economy is still reeling from the March disasters, the economy is on its way to a relatively swift recovery. This behavior is not uncommon for this type of crisis, as the earthquake and tsunami stopped all operations and everything is now coming back on line.

A clear example of this recovery was the release of the quarterly Tankan Survey on Japanese economic activity. The Tankan survey shows tantalizing evidence that economic activity in Japan will rebound during the second half of the year following the collapse of manufacturing activity after the March earthquake. While the Tankan report still showed some weakness, it is nevertheless in the recovering phase. We have to take into consideration that the earthquake, tsunami and nuclear crisis occurred during the last month of Q1 so the effects of these events were also intense during the first months of the second quarter.

However, the Tankan Survey also showed that not everything is rosy in the "Land of the Rising Sun." While output is clearly recovering from supply-chain disruptions, the business sentiment index took a relatively strong hit during the survey, going to -9 in the current survey from a value of 6 in the previous survey. This was the first drop in the past five quarters. However, on the positive side, firms indicated that they expect future conditions to improve considerably. What is important from this survey is that while things are still not great today, the direction on the path of the Japanese economy is on the upswing.





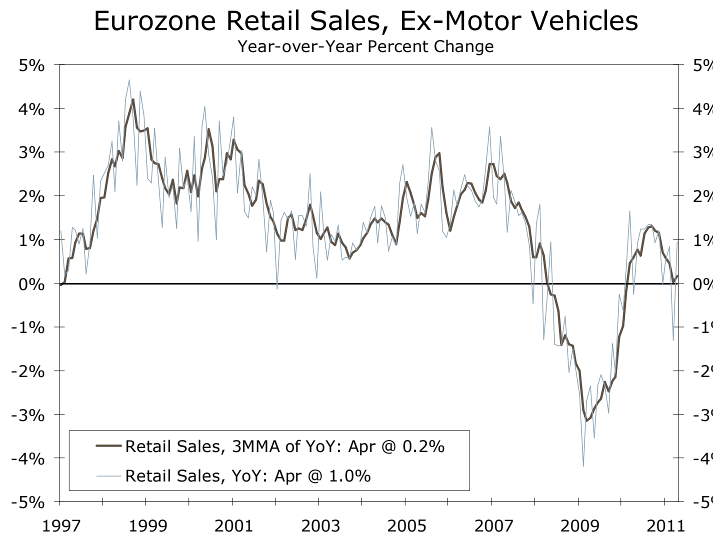


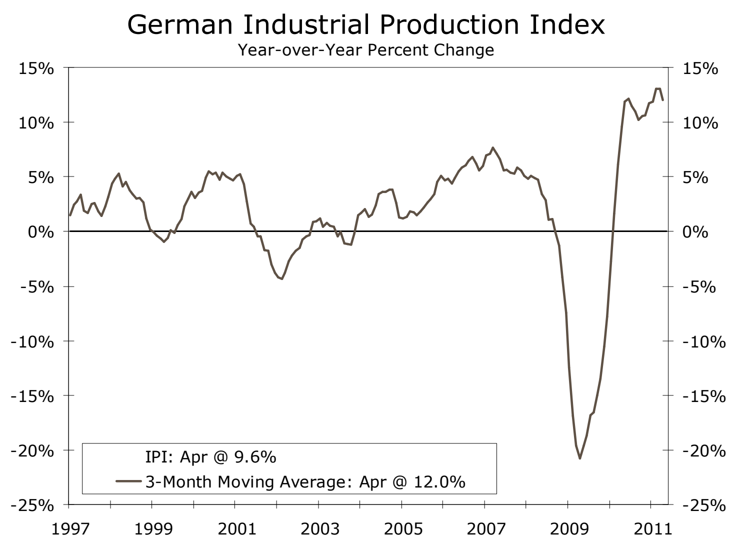
Eurozone Retail Sales • Tuesday

Eurozone retail sales jumped 0.9 percent month over month in April, but that was largely a snapback from the 0.9 percent decline in March. Sales in March were hampered by renewed concerns about periphery country debt after having been relegated to the back burner of international news for a time. In March, retail sales plunged 2.9 percent in Greece and 5.6 percent in Portugal as their respective governments once again came under pressure to tighten their belts, leading to a reduction in consumer confidence. Interestingly, Germany also saw a decline in retail sales in March. While auto sales dropped in Germany, due in part to the Japanese earthquake, sales of food, clothing and household goods also fell. Thus, weakness in March Eurozone sales was not confined to debt-laden countries and was not just due to poor auto sales. Following the April snapback, Eurozone retail sales will likely remain weak on trend amid continued social, political and economic discord.

Previous: 0.9%

Consensus: -0.1% (Month-over-Month)





Germany Industrial Production • Thursday

German industrial production fell 0.6 percent month over month in April, the first decline in four months, following a 1.2 percent increase in March. The year-over-year increase slowed to 9.6 percent from 11.4 percent. The April decline was led by a 5.7 percent drop in construction output. Manufacturing and mining also fell 0.6 percent, the first decline since November, as consumer goods production fell 0.2 percent, while capital goods production dropped 1.5 percent. Intermediate goods production inched up by 0.1 percent. Weak production in Germany in April shows just how far and wide the effects of the region's debt crisis are being felt. While Germany's economy has been the star of the Eurozone and the labor market has continually improved for two years, it is clear that the Eurozone debt crisis and the Japanese earthquake are putting a dent in Germany's output. While this will lead to slower growth, Germany will remain the Eurozone's economic engine.

Previous: -0.6%

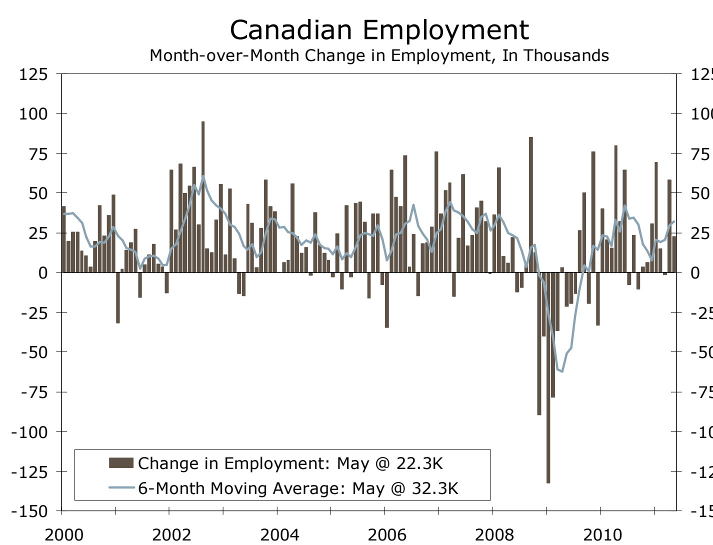
Consensus: 0.5% (Month-over-Month)

Canada Employment • Friday

Canada's economy added 22,300 jobs in May following a 58,300 gain in April. The gain in jobs, along with a 27,800 decline in the labor force, pushed the unemployment rate down to 7.4 percent from 7.6 percent the prior month. Retail and wholesale led the job gains with 34,400 new jobs. Education employment dropped by 26,800, while manufacturing fell by 22,500. Thus, while the economy added jobs on net, it added lower paying jobs while losing some higher paying jobs. In addition, average hourly earnings growth slowed to 2.0 percent year over year, the slowest since October, from 2.5 percent in April. As core inflation accelerated, the central bank increased the main policy rate three times from April 2010 to September 2010. But as economic growth has tapered, the central bank has held the policy rate steady at one percent for the past nine months. Now that oil prices have pulled back, it is likely that the central bank will hold rates at current levels for awhile.

Previous: 22,300

Consensus: 10,000 (Month-over-Month)



Interest Rate Watch

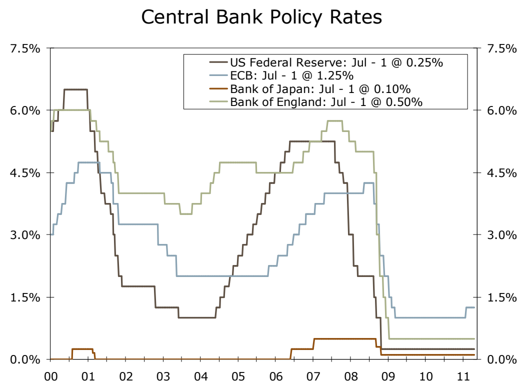
ECB Likely to Hike Rates

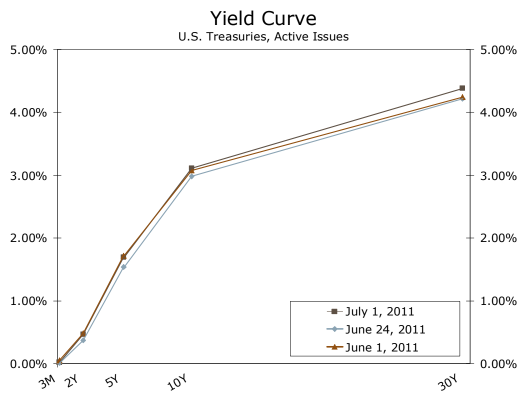
The European Central Bank (ECB) holds its regular monthly policy meeting on July 7 and most analysts, including ourselves, look for the ECB to hike rates. If the ECB follows through, it would be the second 25-bps rate hike since April. The move was telegraphed at last month's policy meeting when ECB President Trichet said "strong vigilance is warranted" in regard to the outlook for price stability. In the past, policymakers have used the phrase "strong vigilance" to indicate that a rate hike was imminent. The 2.7 percent CPI inflation rate is above the rate that the ECB considers desirable, making another rate hike more likely.

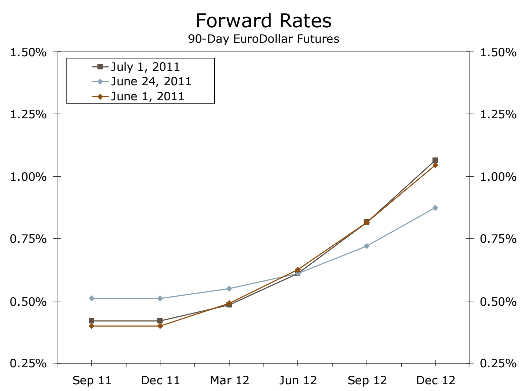
Had the Greek parliament voted down austerity measures this week, financial markets likely would have been in turmoil. (We discuss the Greek debt situation further on page 7.) In that event, the ECB arguably would have reasoned that it would be appropriate to keep rates on hold at the present time. The Greek decision to move ahead with further austerity measures, however, gives the ECB the wherewithal to tighten policy. After next week's expected move, we look for one more 25-bps rate hike by the end of the year.

Unchanged Policy in London

Across the English Channel in London, the Bank of England is widely expected to keep its main policy rate unchanged at 0.50 percent, where it has been maintained since March 2009. At 4.5 percent, CPI inflation is well above the target of s2 percent that the Bank is mandated to achieve in the medium term. However, most members of the Monetary Policy Committee (MPC) believe that the rise in inflation is largely due to transitory factors, and that inflation will eventually return to target because the slow rate of economic growth that the U.K. economy is presently experiencing will keep wages and prices in check in the future. We are in line with the consensus forecast. We expect the MPC will keep rates on hold until the end of the year when we look for a very modest pace of monetary tightening to commence.







Credit Market Insights

Slow Small Business Lending

Lending to the small businesses sector continues to remain very limited. The question that arises is whether this trend is due to a drop in demand for loans or the reluctance of lenders to provide loans to smaller firms. In reality, there is a combination of these two factors that is resulting in lower levels of lending to this sector of the economy. Some smaller firms are reluctant to seek lending in light of reduced optimism about future revenue expectations. The latest Wells Fargo Small Business Survey indicated that less than 50 percent of the small businesses surveyed expected revenue increases in the second quarter of the year. Given the less than optimistic outlook on the part of these firms, there is little incentive to seek new lending opportunities, even in light of low interest rates. On the other hand, lenders have remained reluctant to lend to smaller firms due to tighter credit standards in the wake of the recession. However, there is now some evidence to suggest that lending standards are beginning to ease. The April Federal Reserve Survey of Senior Loan Officers indicated that banks are beginning to loosen lending standards for small businesses. The survey also indicated that the quality of firms seeking lending is also improving. This trend suggests that smaller firms are likely restructuring their balance sheets before seeking additional capital. If this trend holds true, small business lending will likely continue to improve in the year ahead.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.51%	4.50%	4.55%	5.08%
15-Yr Fixed	3.69%	3.69%	3.74%	4.39%
5/1 ARM	3.22%	3.25%	3.41%	4.10%
1-Yr ARM	2.97%	2.99%	3.13%	4.05%
MBA Applications				
Composite	534.9	549.9	519.4	675.9
Purchase	180.3	185.8	191.4	172.1
Refinance	2,604.4	2,675.2	2,442.9	3,613.1

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

Topic of the Week

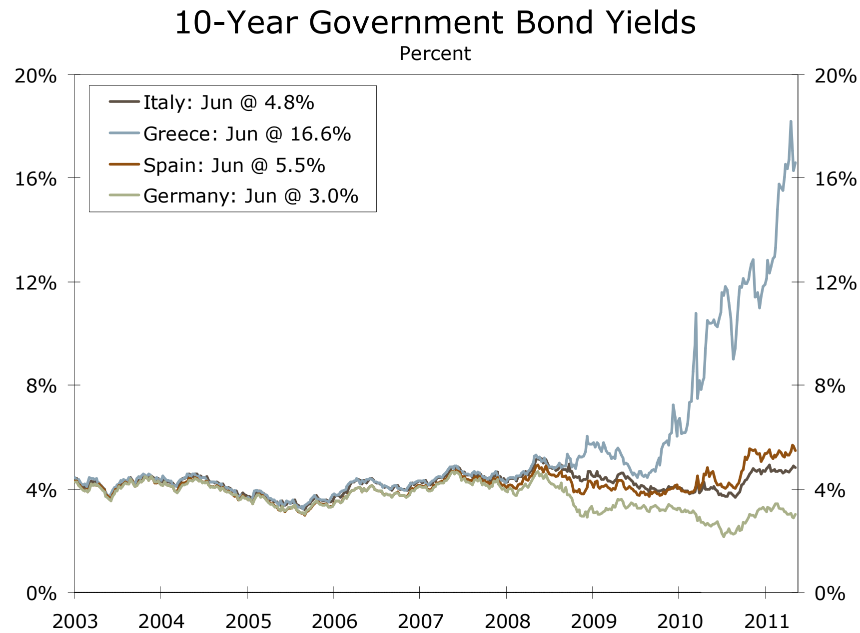
Greek Crisis Dies Down, for Now

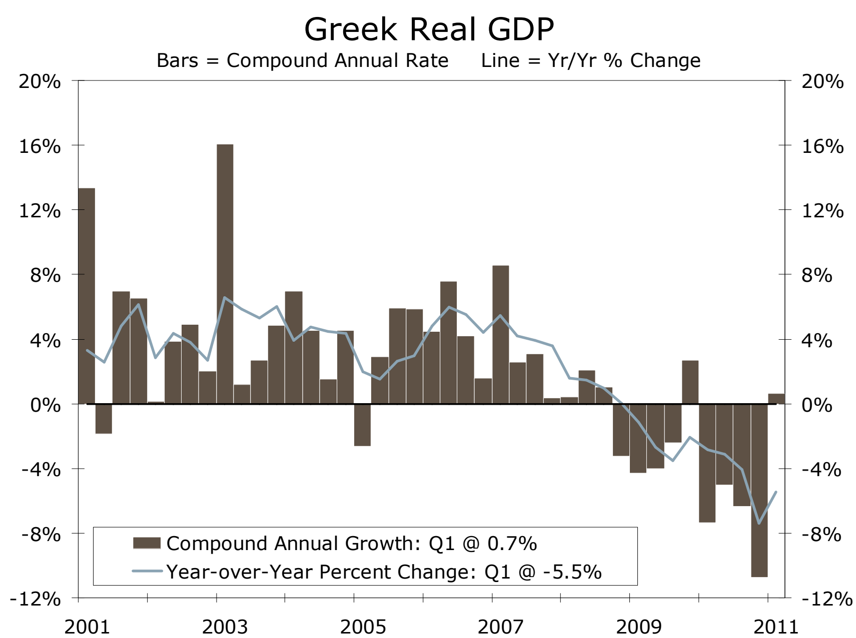
This week, the Greek parliament narrowly approved an austerity package worth €78 billion (about $110 billion) of spending cuts, revenue increases, and asset sales. Focus now shifts to other actors in the ongoing Greek drama. The first actor is the European Union (EU), which must approve another lending package to get Greece through 2014. (The initial package that was put in place in May 2010 envisioned that Greece would be able to tap private credit markets again in 2012, which clearly is not viable now.) The EU is expected to approve the package on July 3 (Sunday).

With the Greek austerity package in place and with fresh commitments lined up from the EU, the way would then be clear for the IMF to advance Greece its next tranche of €12 billion that will allow the Hellenic Republic to make payments on maturing debt. Without this money, Greece would default. It is widely expected that the IMF board will approve the next tranche.

Finally, private sector creditors have a role to play. There is about €108 billion worth of bonds that mature over the next three years. The French government has proposed a scheme whereby creditors would receive, at maturity, cash for 30 percent of face value of the bond. The other 70 percent would be converted into bonds with 30-year maturities that are collateralized by AAA-rated securities. Eighty percent of bondholders would need to participate for the scheme to become effective.

Conceivably, the EU, the IMF, or the private sector may not play their assigned roles, but we think there is a low probability of that occurring. In our view, the Greek crisis likely will die down for the time being. However, the debt-to-GDP ratio of the Greek government is near an eye-popping 150 percent and the French rollover scheme does not involve any debt forgiveness. (Maturities are simply extended.) Therefore, if growth does not pick up in Greece, or if the government misses deficit targets, we easily could be back at square one in the not-too-distant future.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 7/1/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.02	0.01	0.17
3-Month LIBOR	0.25	0.25	0.53
1-Year Treasury	0.17	0.13	0.03
2-Year Treasury	0.45	0.33	0.63
5-Year Treasury	1.75	1.37	1.80
10-Year Treasury	3.15	2.86	2.95
30-Year Treasury	4.36	4.18	3.89
Bond Buyer Index	4.59	4.46	4.38

Foreign Exchange Rates

	Friday 7/1/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.447	1.419	1.253
British Pound ($/£)	1.602	1.596	1.518
British Pound (£/€)	0.903	0.889	0.825
Japanese Yen (¥/$)	80.820	80.430	87.600
Canadian Dollar (C$/$)	0.965	0.989	1.060
Swiss Franc (CHF/$)	0.847	0.833	1.059
Australian Dollar (US$/A$)	1.069	1.049	0.843
Mexican Peso (MXN/$)	11.682	11.900	13.009
Chinese Yuan (CNY/$)	6.465	6.474	6.781
Indian Rupee (INR/$)	44.583	44.995	46.575
Brazilian Real (BRL/$)	1.565	1.605	1.791
U.S. Dollar Index	74.515	75.665	84.716

Foreign Interest Rates

	Friday 7/1/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.50	1.47	0.72
3-Month Sterling LIBOR	0.83	0.83	0.73
3-Month Canadian LIBOR	1.18	1.17	0.84
3-Month Yen LIBOR	0.20	0.20	0.24
2-Year German	1.62	1.36	0.68
2-Year U.K.	0.81	0.70	0.76
2-Year Canadian	1.59	1.45	1.39
2-Year Japanese	0.17	0.16	0.15
10-Year German	3.01	2.83	2.57
10-Year U.K.	3.37	3.13	3.32
10-Year Canadian	3.10	2.90	3.07
10-Year Japanese	1.14	1.11	1.07

Commodity Prices

	Friday 7/1/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	94.18	91.16	72.95
Gold ($/Ounce)	1484.74	1502.65	1198.95
Hot-Rolled Steel ($/S.Ton)	722.00	750.00	615.00
Copper (¢/Pound)	426.85	409.85	286.50
Soybeans ($/Bushel)	13.16	13.28	9.44
Natural Gas ($/MMBTU)	4.33	4.23	4.85
Nickel ($/Metric Ton)	23,395	22,099	19,679
CRB Spot Inds.	600.62	595.56	475.45

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	4	5	6	7	8
U.S. Data		**Factory Orders** April -1.2% May 1.1% (W)	**ISM Non-Mfg** May 54.6 June 53.7 (W)		**Nonfarm Payrolls** May 54K June 88K (W) **Unemployment Rate** May 9.1% June 9.1% (W)
Global Data		**Japan** **Retail Sales (MoM)** Previous (Apr) 4.1%	**Japan** **IP (MoM)** Previous (Apr) 1.6% **Canada** **CPI (YoY)** Previous (Apr) 3.3%	**Eurozone** **CPI (YoY)** Previous (May) 2.7% **China** **PMI Manufacturing** Previous (Apr) 52.0	**U.K.** **PMI Manufacturing** Previous (May) 52.1 **Brazil** **IP (YoY)** Previous (Apr) -1.3%

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

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