July 08, 2011

Economics Group

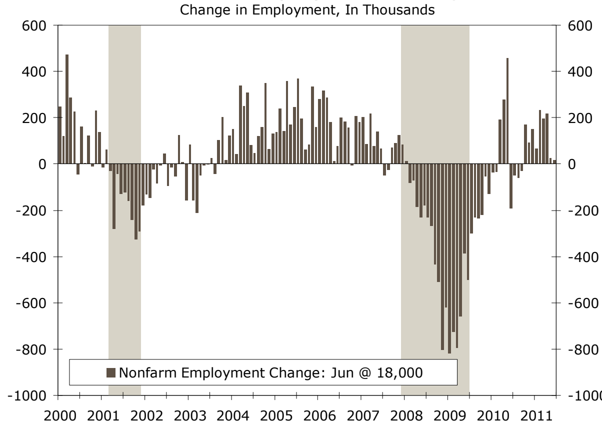
Weekly Economic & Financial Commentary

U.S. Review

Weak Jobs, a One-off or a Trend?

- This week's employment report is a challenge to our view that the economy is leaving the spring slowdown behind and moving into a period of trend-like growth of 3 percent with moderate job growth as well.
- Yet, the longer-term problems of a generation of overpromising and underfunding challenges both public and private decision makers. Federal and state policymakers have consistently failed to adequately fund entitlement spending. Meanwhile, households have underfunded their retirement ambitions. The adjustments in both areas are still ahead of us.

Nonfarm Employment Change

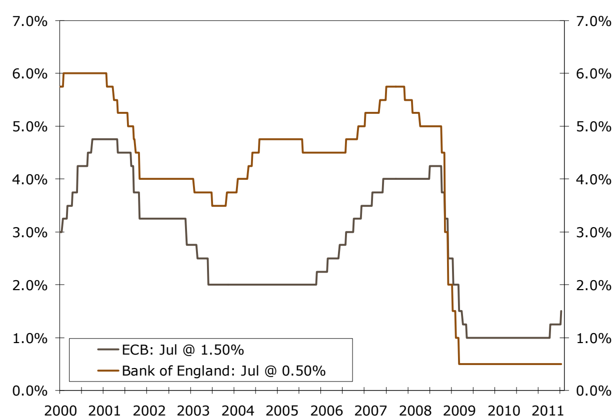


Global Review

Central Banks of the World, Unite: Not a Chance!

- The European Central Bank (ECB), after a brief interlude, pushed ahead with its campaign to increase interest rates to fend off any further increase in inflation and inflationary expectations. It raised its benchmark interest rates 25 bps to 1.5 percent.
- Although the Bank of England (BoE) has the same mandate as the ECB, that is, keeping inflation contained, it stayed put even as inflation is, today, more than twice as much as the central bank's target of 2 percent. The difference between the two banks is a new chapter on the age-long debate of rules versus discretion.

European Central Bank Policy Rates



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	1.6	2.8	2.8	0.0	-2.6	2.9	2.3	2.4
Personal Consumption	1.9	2.2	2.4	4.0	2.2	1.3	2.2	2.8	-0.3	-1.2	1.7	2.3	2.0
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	3.4	3.6	3.8	-0.3	1.6	3.1	2.9
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	69.4	69.5	71.0	74.3	77.7	75.6	70.1	75.3
Unemployment Rate	9.7	9.6	9.6	9.6	8.9	9.1	9.0	8.9	5.8	9.3	9.6	9.0	8.7
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	0.50
Conventional Mortgage Rate	4.97	4.74	4.35	4.71	4.84	4.51	4.90	5.10	6.04	5.04	4.69	4.84	5.33
10 Year Note	3.84	2.97	2.53	3.30	3.47	3.18	3.30	3.50	3.66	3.26	3.22	3.36	3.73

Forecast as of: July 8, 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

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U.S. Review

Weak Jobs, a One-off or a Trend?

This week's employment report challenges our view that the economy is leaving the spring slowdown behind and moving into a period of trend-like growth of 3 percent and moderate job growth. Moreover, the recent ISM reports seem to support the case for better growth ahead.

For the second half of this year we expect gains in growth of 3 percent compared to GDP growth of 1.8-2.0 percent in the first half of this year. While the consumer should continue to contribute to growth, the real improvements appear in equipment & software investment, structures and residential construction. Meanwhile, net exports and inventory spending should also contribute to growth. The breadth of gains across sectors is the biggest untold story. While the federal sector should contract, all private sectors we follow should contribute to growth. The breadth of these gains supports our view that there is no double dip and the spring slowdown did not suggest that economic growth would remain weak for the year ahead. For 2011, our estimate for growth is at 2.3 percent compared to the FOMC estimate of 2.7-2.9 percent. Our estimate for the core PCE deflator is at 2.1 percent compared to the FOMC expectation for 1.5-1.8 percent.

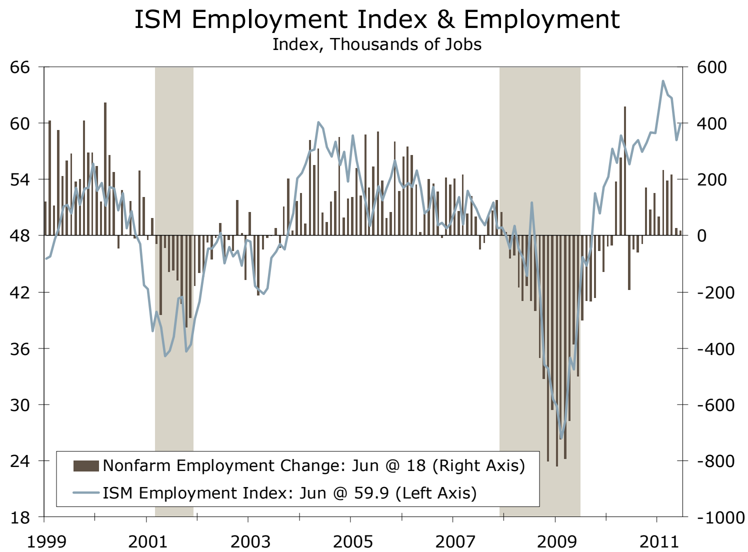
Employment: Disappointing at the Least

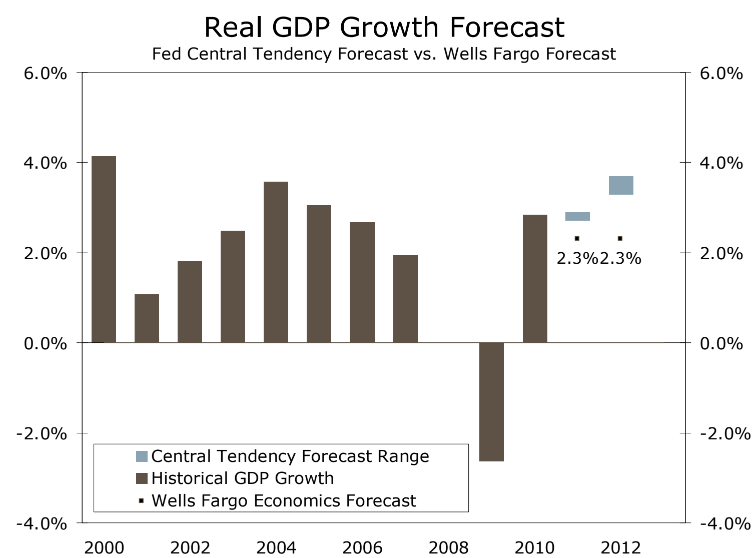
Nonfarm payrolls rose just 18,000 and are clearly below the pace of the past six months. Moreover, the aggregate hours worked index suggests a very small labor contribution to output at the end of the second quarter. Government jobs fell 39,000 with state & local government jobs down 25,000. There were job gains in manufacturing, trade & transportation as well as leisure & hospitality. For the second half of 2011, our expectation is for 170,000 jobs per month as we believe the end of the soft patch will allow the economy to resume trend growth.

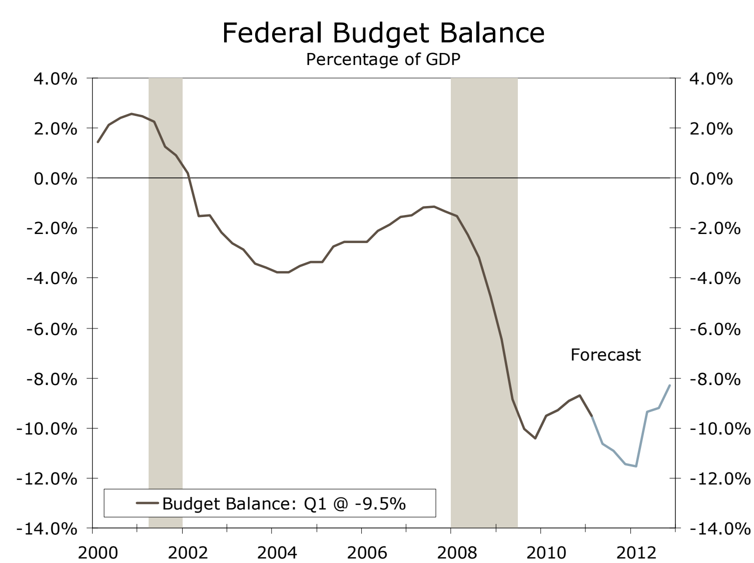
Better Cyclical Growth Does not Remove the Secular Barriers

Yet, the longer-term problems of a generation of overpromising and underfunding challenges both public and private decision makers. Federal and state policymakers have consistently failed to adequately fund entitlement spending. Meanwhile, households have underfunded their retirement ambitions. The adjustments in both areas are still ahead of us.

While we expect that a debt deal will get done before the U.S. defaults, the reality for decision makers will be whether the promises that policymakers make for the out-years, read post next presidential election, will ever be delivered. We remain doubtful. Instead, Washington simply kicked the can down the road just pass the next election and like the generation of politicians before them, has failed to deliver real solutions to a growing entitlement imbalance. We, as a society, continue to overpromise and underfund. While this was possible before the era of the baby-boom retirement and the emergence of true globalization of the economy, the failure to deal with the obvious problem will require more difficult adjustments in the future.





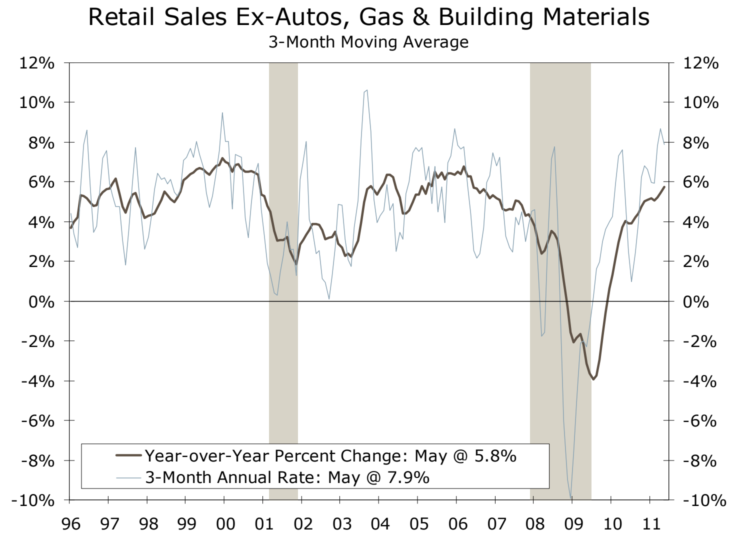


Retail Sales • Thursday

Retail sales fell 0.2 percent in May largely reflecting weak motor vehicle and parts sales. The decline in autos is likely due to supply chain disruptions, which appear to be transitory. Auto dealer sales will likely disappoint again in June, however, as unit sales from manufacturers to dealers were down 3.0 percent on the month. Excluding motor vehicles, gasoline, and building materials, core retail sales are far more encouraging and are currently running at a 5.0 percent annual rate for April and May. The solid increase in core retail sales should ensure modest growth in real personal consumption outlays in the second quarter. In fact, same-store sales were up 6.9 percent in June on a year-ago basis, which means retail sales could post a solid reading. Lower energy prices should provide some near-term relief for consumers, but a sustainable pickup in spending depends on job and income growth.

Previous: -0.2% **Wells Fargo: -0.2%**

Consensus: 0.0% (Month-over-Month)

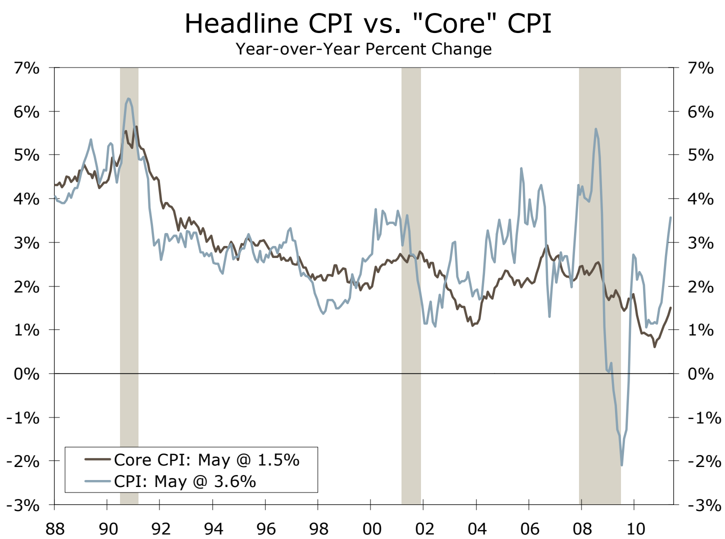


Consumer Price Index • Friday

Headline consumer prices trended modestly higher in May and are up 3.6 percent on year-ago basis. While energy prices have increased over the past 10 months, consumers finally received a welcome reprieve with energy prices falling 1.o percent in May. Core consumer prices, however, which exclude energy and food, inched higher and are up 1.5 percent, year over year. While the increase in core consumer prices were broad based, autos and apparel saw the largest gains. Improved demand and supply shortages for some popular models of new and used cars helped push auto prices up 1.0 percent on the month. We continue to expect moderate upward price pressure on the headline and core measures. Headline consumer prices will likely rise 3.3 percent in 2011 and 3.0 percent in 2012. Core consumer prices could rise 1.7 percent in 2011, which is still below the Fed's implicit comfort level.

Previous: 0.2% **Wells Fargo: -0.1%**

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

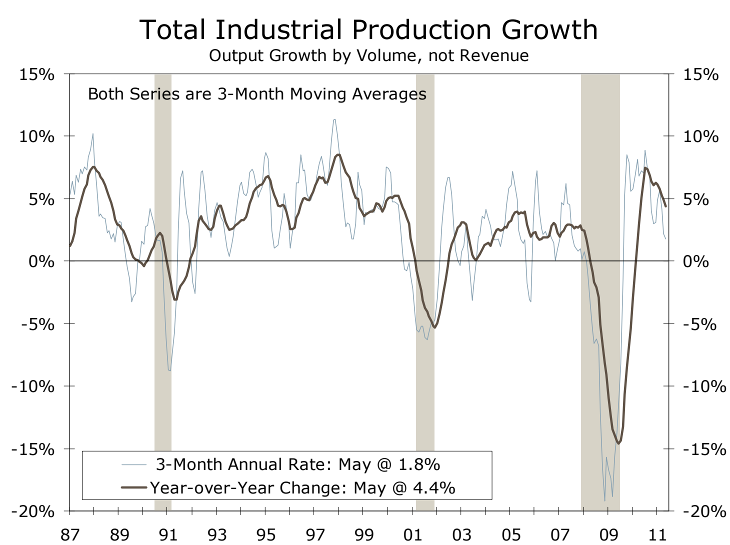


Industrial Production • Friday

The factory sector ran into a bit of a soft patch over the past two months with industrial output rising a modest 0.1 percent and flat in April. Much of the weakness in industrial production was due to a drop in motor vehicles & parts output, which have been impacted by supply chain disruptions and should be transitory. Moreover, unseasonably cool weather led to a drop in utility production. While industrial production is up only 0.7 percent over the past three months, we continue to expect positive momentum from the factory sector, albeit at a modest pace. In fact, the ISM manufacturing survey increased to a reading of 55.3 in June, up from 53.5 in May. Moreover, the forward looking new orders component rose slightly to 51.6, but is down significantly from its peak of 68 in February. Regional manufacturing surveys in June were also weak. Our outlook is for continued growth in industrial output in 2011, but at a modest pace.

Previous: 0.1% **Wells Fargo: 0.2%**

Consensus: 0.3% (Month-over-Month)



Global Review

Central Banks of the World, Unite: Not a Chance!

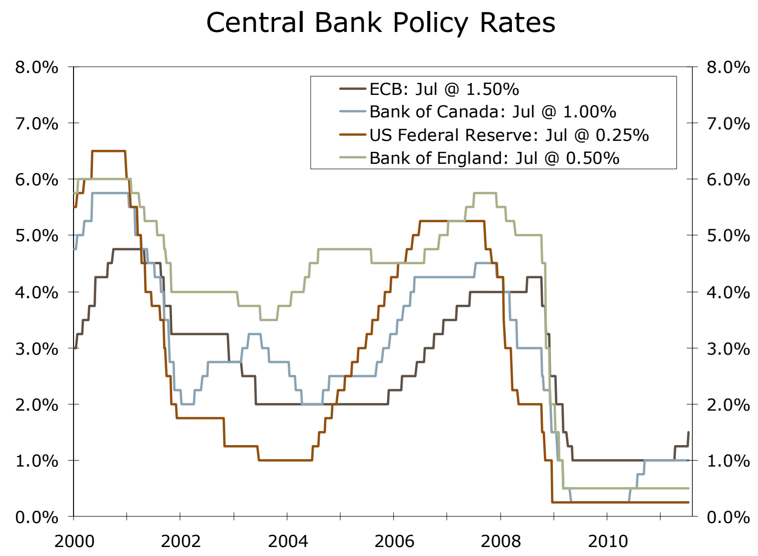
There is an old debate in economics that has to do with the difference between rules and discretion in either monetary and/or fiscal policy. This week's central bank decisions across the world on interest rates are basically an indication that the debate is still alive and well. In terms of monetary policy, the debate probably centers on whether a central bank is responsible, or has a mandate for, one or more than one objective. That is, the U.S. Federal Reserve's mandates include low inflation as well as low unemployment. However, the mandate for the ECB is only one, to keep inflation low.

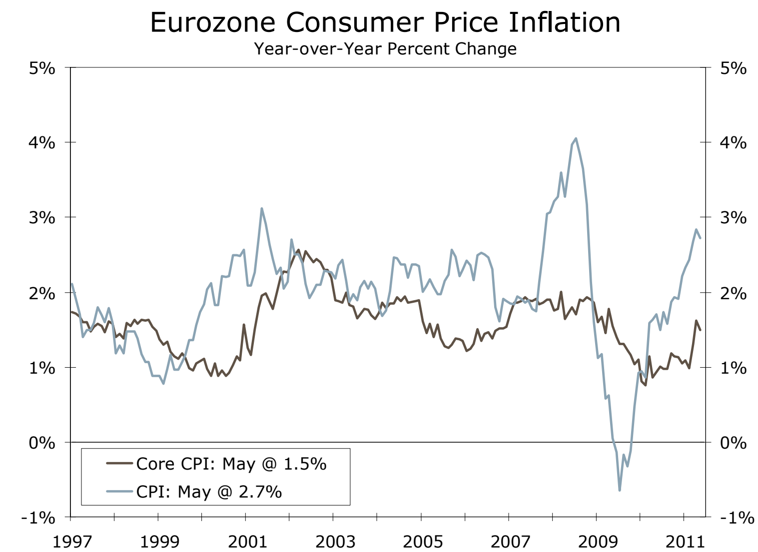
Thus, we could say that while the U.S. Federal Reserve has more discretion in terms of monetary policy, the ECB is basically constrained to following one rule, that is, that inflation remains low, irrespectively of what happens to other variables like employment. This is why the ECB pushed the issue of rules versus discretion forward this week by rising interest rates, this time by 0.25 percent to 1.5 percent to, according to them, fend off inflationary pressures. Furthermore, the ECB also insisted that it was ready to continue to increase interest rates in the coming months because "our monetary policy stance remains accommodative."

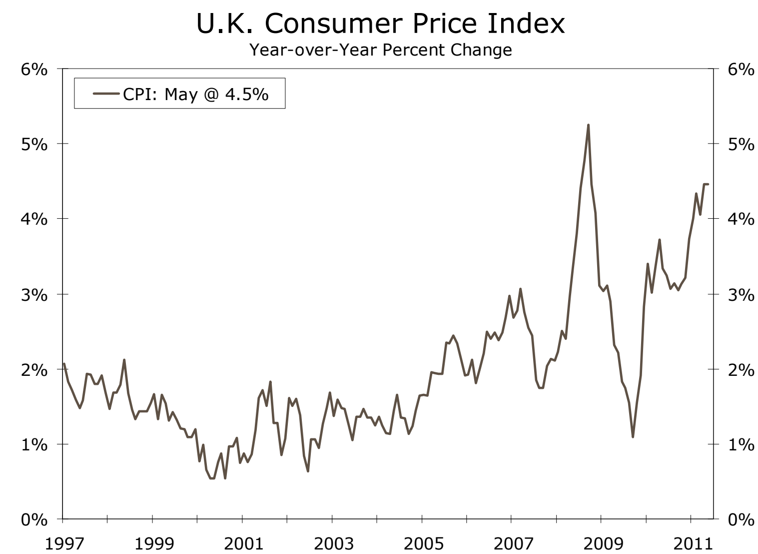
But this difference is never so easy or so clear. For example, the Bank of England also has one mandate, which is to keep inflation low. However, this week's decision to keep its benchmark interest rates at 0.5 percent even though inflation is running at 4.5 percent, or more than twice as much as the central bank's target, shows that discretion is also present at institutions that are supposed to follow only one rule.

Meanwhile, the central bank of China (BoC) also followed through this week with its own increase in interest rates to also fend off inflationary pressures. The central bank increased its benchmark interest rates to 6.56 percent from 6.31 percent. This was the third time the Bank of China increased interest rates during this year. But the Bank of China is not only relying on interest rate increases, as it has also increased reserve requirements for banks in order to slow down lending at financial institutions to help keeping inflation at bay. The BoC inflation target is 4 percent but inflation is already running at 5.5 percent and the expectation is for inflation to remain higher than the central bank's target for the rest of this year and into next year.

The difference between the Bank of England and the European Central Bank seems to underscore the fate of those that entered the Eurozone and those that did not. For the United Kingdom, today's events show the ability of an independent central bank to adapt and determine what is best for the country at any point in time while Eurozone countries have no ability to independently decide if they are going to increase or decrease interest rates. This decision is left to a supra-national institution that has a mandate and is sticking to it no matter what. It is anybody's guess whether Greeks are second guessing their decision to enter the Eurozone. But what seems to be clear is that Greek politicians are not.





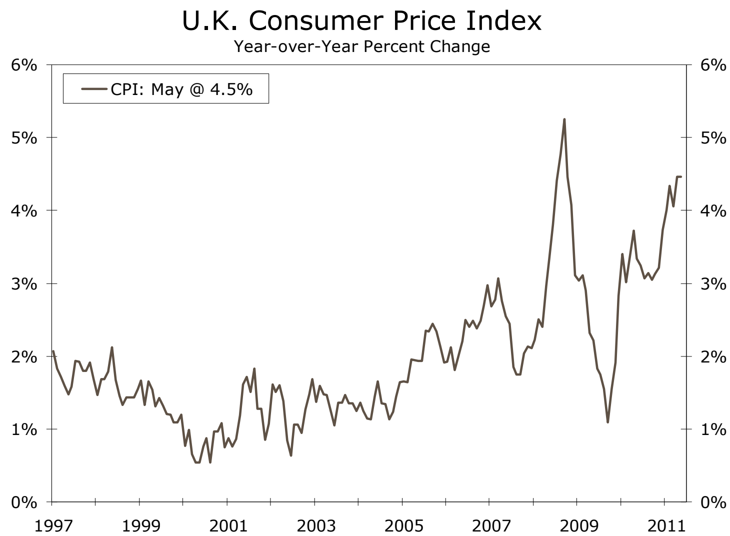


U.K. CPI • Tuesday

The overall rate of CPI inflation in the United Kingdom has trended higher over the past several months. As we noted in the international review section above, the inflation rate is well above the 2 percent target that the government mandates the Bank of England to maintain in the "medium term." The BoE attributes the recent run up in inflation to the increase in the value-added tax that took effect on Jan. 1, 2011, the sharp rise in energy prices over the past year, and the effects of the sterling's depreciation that has helped to raise import prices. Accordingly, most of the members of the Monetary Policy Committee (MPC) view the rise in the inflation rate as a confluence of one-off factors. But there is some dissention as other members of the MPC have voted to increase the key lending rate despite the supposed temporary nature of these factors. Markets will get a clue as to the next BoE move when June CPI data prints on Tuesday.

Previous: 4.5% **Wells Fargo: 4.5%**

Consensus: 4.5% (Year-over-Year)



Chinese GDP • Wednesday

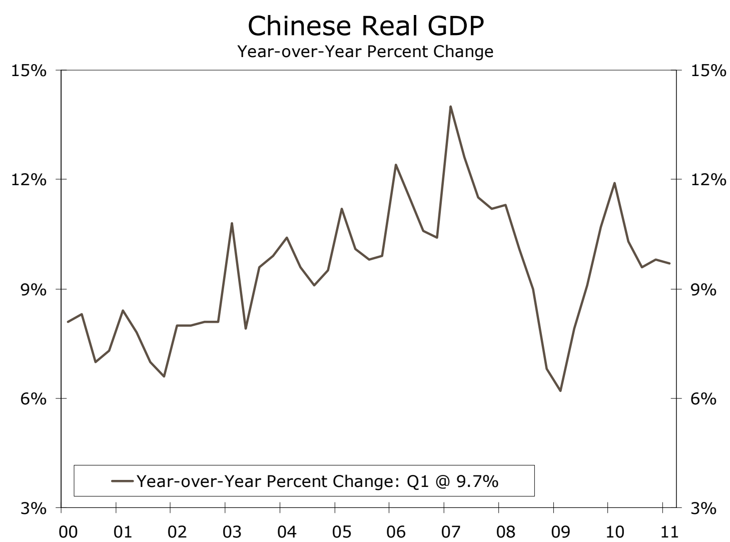
The Chinese economy continues to boom with year-over-year GDP growth coming in at 9.7 percent in the first quarter. The Chinese government has taken measures to temper inflation and reign in runaway growth by raising the reserve requirement at Chinese banks and tightening monetary policy.

We will get a sense of how the Chinese economy is faring with these measures when second quarter GDP data hits the wire on Wednesday of next week. We expect GDP in China probably grew 9.2 percent on a year-over-year basis through the second quarter.

While strong GDP growth in China is a net positive for global GDP growth, the inflation situation in China appears to be getting worse, despite the various tightening measures. Indeed the year-over-year percent change in the Chinese Consumer Price Index has risen to 5.5 percent through June.

Previous: 9.7% **Wells Fargo: 9.2%**

Consensus: 9.3% (Year-over-Year)



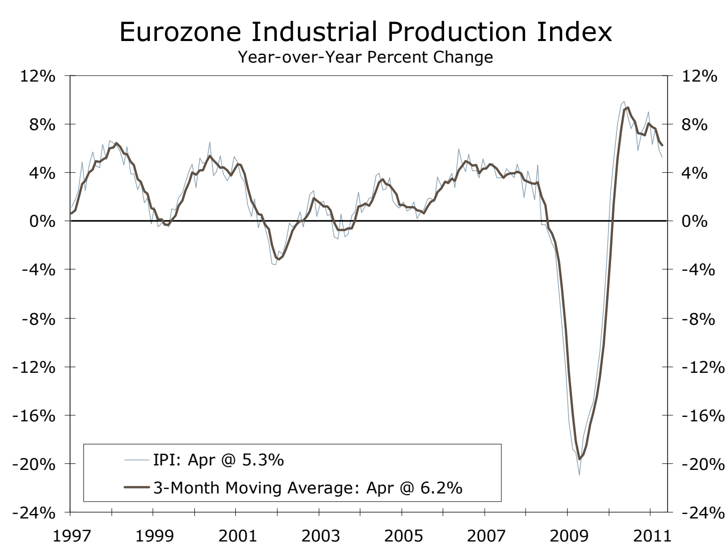
Eurozone IP • Wednesday

Despite ongoing challenges from the sovereign debt situation in the Eurozone, the economy there continues to expand. Indeed, Eurozone GDP expanded at a 3.4 percent annualized rate in the first quarter, although the Eurozone economy is still 2.1 percent smaller than it was at its pre-recession peak.

We will get a sense of how things played out in the second quarter when industrial production numbers for the Eurozone hit the wire on Wednesday of next week. Manufacturing output has been positive on a year-over-year basis for the better part of the past year and a half. Survey data suggest that the momentum will continue in May and June. The Eurozone PMI has come down somewhat during those months but at 52.0 for the month of June, this key measure of business sentiment still signals expansion in the factory sector.

Previous: 5.3%

Consensus: 4.8% (Year-over-Year)



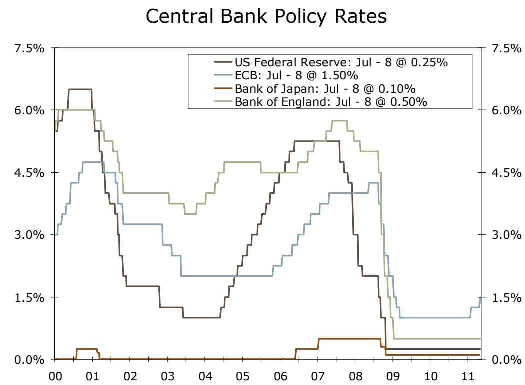
Interest Rate Watch

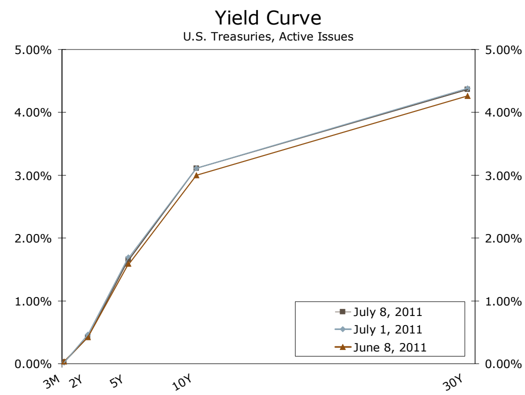
Financing Growth

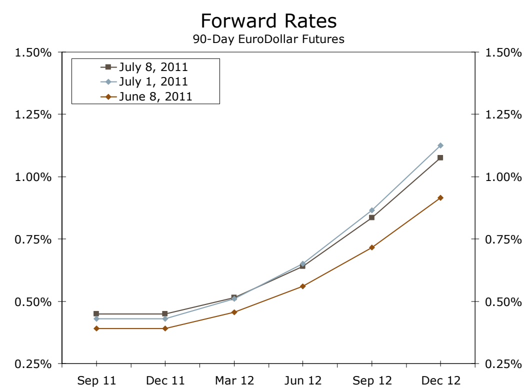
With passage of the Greek budget and promises of aid from the IMF and the European community we have witnessed the downshift in risk assessments of weaker economic growth and the credit risks associated with bank lending and interbank relationships. As a result, the flight to safety trade, which had supported the recent Treasury interest rate decline, has now faded away. As a result, Treasury rates have moved up and our expectation is that benchmark Treasury rates are expected to continue to move up for the rest of this year.

Meanwhile, we also expect a renewal of corporate high-grade and high-yield issuance. This pattern reflects an improved economic outlook for the second half of this year as well as for 2012. In addition, we expect investors will be more willing to take on more risk and seek higher yield. Risk is present in any investment. In fact, there is risk in not investing. Today, with better economic expectations the rewards for investing in corporate debt appears to be sufficient to us to compensate for the risk and is a better tradeoff than the Armageddon trade that favored Treasury debt over the past three months. In another arena, ABS and CMBS issuance in 2011 exceeds that of 2010 and suggests that credit markets are opening up for securitized credit. In turn, better markets for ABS and CMBS suggests that credit will be more available to the ultimate credit card/auto and commercial real estate borrower for the months ahead. This reinforces our view that the economy will become better as the availability of credit improves. In the latest Senior Loan Officer Opinion Survey, we have seen that credit terms have been eased for small and large firms. Meanwhile, credit demand from these same small and large firms has also picked up. From the NFIB survey, the top issue for small businesses remains sales, not credit.

For the rest of this year, we retain our forecast of no Fed action. Therefore, with benchmark Treasury interest rates rising, we expect a steeper yield curve for the rest of this year.







Credit Market Insights

"Full Faith and Credit" at Risk

In the global marketplace, the exchange value of the U.S. dollar reflects the "full faith and credit of the United States." In recent years, this value has declined and while the weaker dollar has made our exports cheaper and supported export manufacturing, it has also led to higher import prices, such as on energy and commodity products and thereby, in turn, higher gasoline prices have reduced consumer discretionary spending in recent months.

As evidenced by the employment report, weaker spending has meant more caution on hiring. This in turn will raise questions on the pace of improvement in consumer financial fundamentals. Now that America's 235th birthday has passed, decision makers must deal with the debt limit negotiations. Moreover, the tax/spending decisions associated with any decision by Congress will alter the credit quality and financial viability of many individual household and firm decisions. U.S. financial markets are certainly not immune to global investors' concerns about fiscal responsibility. While we can borrow or print money to pay our debts with greater ease because of our reserve currency position, this is not a cart blanche. At some point, global investors expect that the U.S. will make good on its debt payments with a mix of inflation, interest rates and the value of the currency close to the present set of market expectations. Finally, it is those expectations that will influence the quality of credit ahead.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.60%	4.51%	4.49%	5.08%
15-Yr Fixed	3.75%	3.69%	3.68%	4.39%
5/1 ARM	3.30%	3.22%	3.28%	4.10%
1-Yr ARM	3.01%	2.97%	2.95%	4.05%
MBA Applications				
Composite	507.0	534.9	517.5	721.5
Purchase	188.9	180.3	182.9	168.6
Refinance	2,363.6	2,604.4	2,475.7	3,944.6

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

Topic of the Week

Slow GDP Growth Impedes CRE Recovery

Demand for commercial real estate has improved over the past couple of quarters, but the pace of the recovery is beginning to moderate reflecting slower economic growth. Real GDP growth in the first quarter increased at only a 1.9 percent pace and the private sector added only 495,000 jobs. Consequently, according to REIS, early second quarter commercial real estate data suggest operating fundamentals across property types have either slowed or remained unchanged.

Office Fundamentals at a Standstill

Office fundamentals appear to be at a standstill with vacancy rates remaining at 17.5 percent in the second quarter. Completions remained depressed with only 1.8 million square feet delivered, the lowest level on record. While only a paltry 3.7 million square feet were absorbed, demand marginally outpaced completions, which left the vacancy rate unchanged. Office-asking and effective rent, however, continued to increase suggesting landlords are still hopeful.

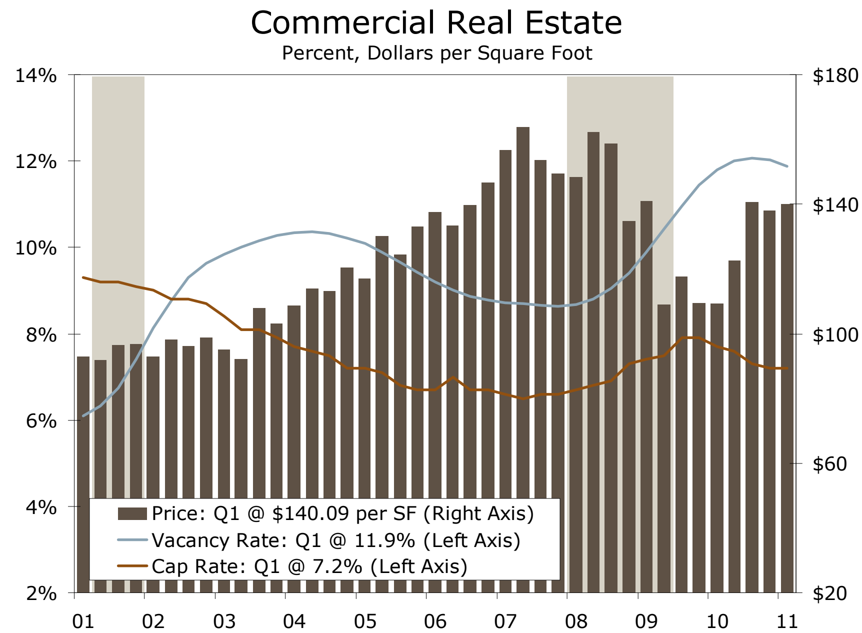
Much of the pullback in office fundamentals is likely due to the weak labor market. Office-using employment has increased only 1.7 percent over the past year and with the unemployment rate remaining stubbornly above 9.0 percent, we remain cautious.

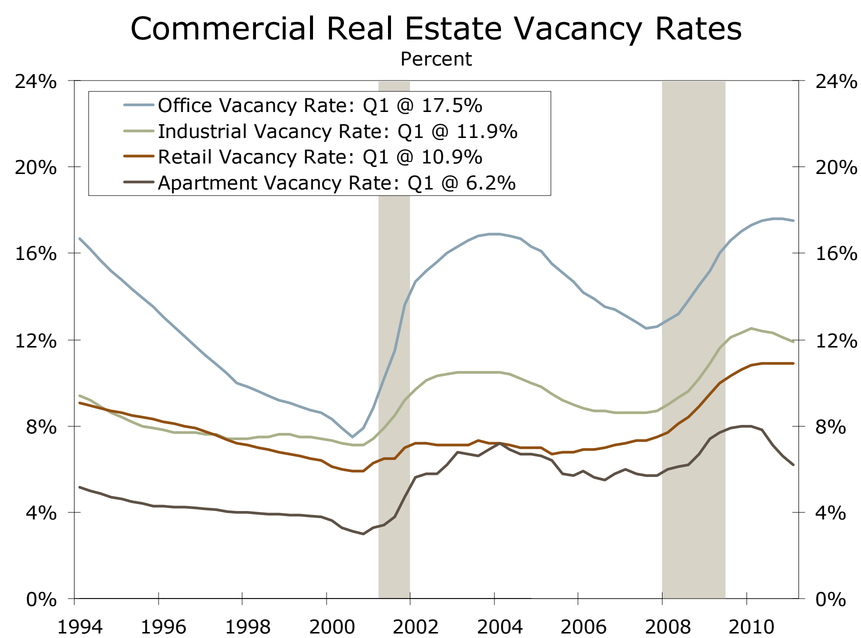
Apartment Demand Still Improving

While the apartment market continues to outperform, the pace of the recovery has also slowed. As private-sector job growth and household formation continue to increase, albeit at a moderate pace, the apartment vacancy rate fell to 6.0 percent in the second quarter from 6.2 percent in the first quarter.

Not Out of the Woods Yet

While transitory factors have slowed economic growth in the first half of the year, we continue to believe real GDP growth will likely remain relatively sluggish through 2012. Modest economic growth could make an already sluggish turnaround in fundamentals even slower.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 7/8/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.02	0.02	0.15
3-Month LIBOR	0.25	0.25	0.53
1-Year Treasury	0.18	0.18	0.03
2-Year Treasury	0.38	0.47	0.62
5-Year Treasury	1.57	1.78	1.81
10-Year Treasury	3.03	3.18	3.03
30-Year Treasury	4.31	4.39	4.01
Bond Buyer Index	4.65	4.59	4.36

Foreign Exchange Rates

	Friday 7/8/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.426	1.453	1.270
British Pound ($/£)	1.605	1.607	1.517
British Pound (£/€)	0.889	0.904	0.837
Japanese Yen (¥/$)	80.680	80.830	88.360
Canadian Dollar (C$/$)	0.965	0.959	1.042
Swiss Franc (CHF/$)	0.838	0.848	1.049
Australian Dollar (US$/A$)	1.072	1.077	0.877
Mexican Peso (MXN/$)	11.623	11.607	12.765
Chinese Yuan (CNY/$)	6.465	6.465	6.776
Indian Rupee (INR/$)	44.328	44.583	46.865
Brazilian Real (BRL/$)	1.565	1.556	1.761
U.S. Dollar Index	75.071	74.349	83.824

Foreign Interest Rates

	Friday 7/8/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.53	1.50	0.75
3-Month Sterling LIBOR	0.83	0.83	0.73
3-Month Canadian LIBOR	1.18	1.18	0.85
3-Month Yen LIBOR	0.20	0.20	0.25
2-Year German	1.46	1.65	0.72
2-Year U.K.	0.76	0.82	0.77
2-Year Canadian	1.51	1.59	1.65
2-Year Japanese	0.17	0.17	0.15
10-Year German	2.83	3.03	2.63
10-Year U.K.	3.20	3.39	3.37
10-Year Canadian	2.98	3.11	3.20
10-Year Japanese	1.18	1.14	1.15

Commodity Prices

	Friday 7/8/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	96.22	95.42	75.44
Gold ($/Ounce)	1542.55	1487.78	1198.10
Hot-Rolled Steel ($/S.Ton)	705.00	722.00	605.00
Copper (¢/Pound)	437.00	427.20	300.70
Soybeans ($/Bushel)	13.55	13.44	9.86
Natural Gas ($/MMBTU)	4.19	4.37	4.40
Nickel ($/Metric Ton)	23,868	23,395	19,092
CRB Spot Inds.	603.50	598.95	471.98

Next Week's Economic Calendar

	Monday 11	Tuesday 12	Wednesday 13	Thursday 14	Friday 15
U.S. Data		**Trade Balance** April -$43.7B May -$46.4B (W)	**Import Price Index** May 0.2% June -0.9% (W)	**PPI** May 0.2% June -0.5% (W) **Retail Sales** May -0.2% June -0.2% (W) **Business Inventories** April 0.8% May 0.7% (W)	**CPI** May 0.2% June -0.1% (W) **Industrial Production** May 0.1% June 0.2% (W) **Capacity Utilization** May 76.7% June 76.8% (W)
Global Data	**Japan** **BoJ Target Rate** Previous (Jun 12) 0.1%	**U.K.** **CPI (MoM)** Previous (May) 0.2% **China** **GDP (YoY)** Previous (Q1) 9.7%	**Eurozone** **IP (YoY)** Previous (Apr) 5.3%	**Eurozone** **CPI (MoM)** Previous (May) 0.0%	

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

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