July 15, 2011

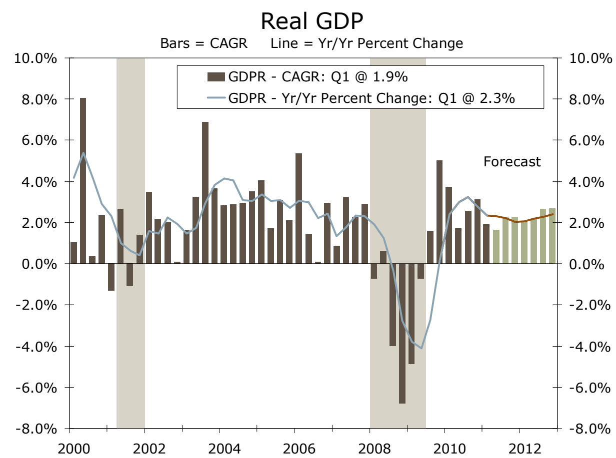
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Mixed Economic Data Points to Moderate Growth

- Retail sales came in slightly higher than expected in June as higher sales at automobile dealers offset reduced spending at gasoline stations. With household budgets stretched thin, discretionary spending in most major categories remained weak.
- Inflation measures over the past week indicated that the pace of inflation is slowing; however, core inflation measures are still picking up.
- The trade deficit widened in May as crude oil imports jumped on both higher prices and volumes while exports were pulled down by weak industrial supplies demand.



Global Review

Is the Chinese Economy Coming In for a “Soft Landing?”

- Real GDP in China grew at a year-over-year rate of 9.5 percent in the second quarter, which was stronger than most analysts had expected. For a global economy desperate for growth wherever it can be found, the Chinese news was a welcome development.
- The overall rate of CPI inflation continues to move higher, despite recent tightening measures. Due to the recent decline in food prices, we expect the overall CPI inflation rate to move lower in the months ahead. If inflation continues to rise, however, authorities could tighten the screws even further.

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	1.9	1.6	2.2	2.3	0.0	-2.6	2.9	2.2	2.2
Personal Consumption	1.9	2.2	2.4	4.0	2.2	1.1	1.6	2.3	-0.3	-1.2	1.7	2.2	1.9
Inflation Indicators [2]													
"Core" PCE Deflator	1.8	1.5	1.2	0.8	0.9	1.2	1.5	1.9	2.3	1.5	1.3	1.4	1.9
Consumer Price Index	2.4	1.8	1.2	1.2	2.2	3.3	3.1	3.1	3.8	-0.3	1.6	2.9	2.5
Industrial Production [1]	8.1	7.1	6.7	3.1	4.8	0.8	6.2	3.0	-3.3	-11.1	5.3	4.2	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	0.56	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	0.25
Conventional Mortgage Rate	4.97	4.74	4.35	4.71	4.84	4.51	4.80	5.00	6.04	5.04	4.69	4.79	5.13
10 Year Note	3.84	2.97	2.53	3.30	3.47	3.18	3.20	3.30	3.66	3.26	3.22	3.29	3.45

Forecast as of: July 15, 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

Mixed Economic Data Points to Moderate Growth

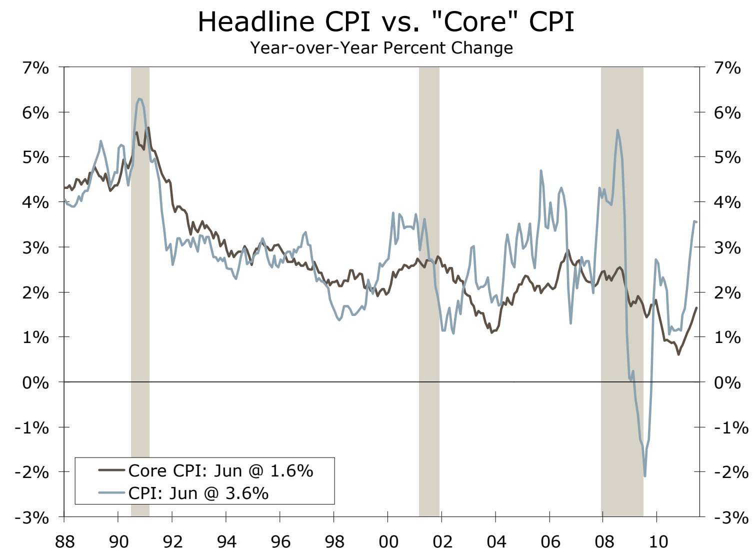
It was a mixed week for economic data, with inflation concerns subsiding somewhat and the trade data still likely providing support to second-quarter GDP growth. Retail sales, on the other hand, demonstrated that consumers remain reluctant to spend with a continually uncertain job market. Our forecast has changed slightly over the past week as our expectations for consumer spending were lifted by the stronger-than-expected retail sales numbers. Consumer spending will make a slightly larger contribution to second quarter growth, with some payback in the third quarter. The stronger-than-expected pace of inventory building in April and May pushed our forecast for Q2 inventories slightly higher. We are still calling for a moderate pace of economic growth for the year and real GDP growth will come in around 1.6 percent for the second quarter.

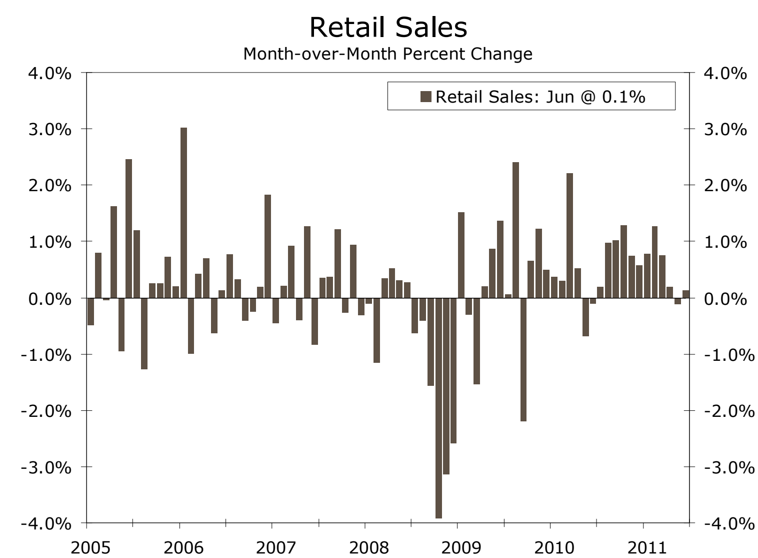
This week's indicators of headline inflation showed some signs of slowing. Core inflation measures, however, which exclude volatile food and energy prices, continue to reflect the lagged spillover effects of higher oil and commodity prices observed in April and May. The producer price index fell 0.4 percent while the consumer price index posted a 0.2 percent decline. However, both the core PPI and core CPI rose 0.3 percent over the previous month. Prices of imports fell in June on news of lower commodity prices, but remain up 13.6 percent over last year.

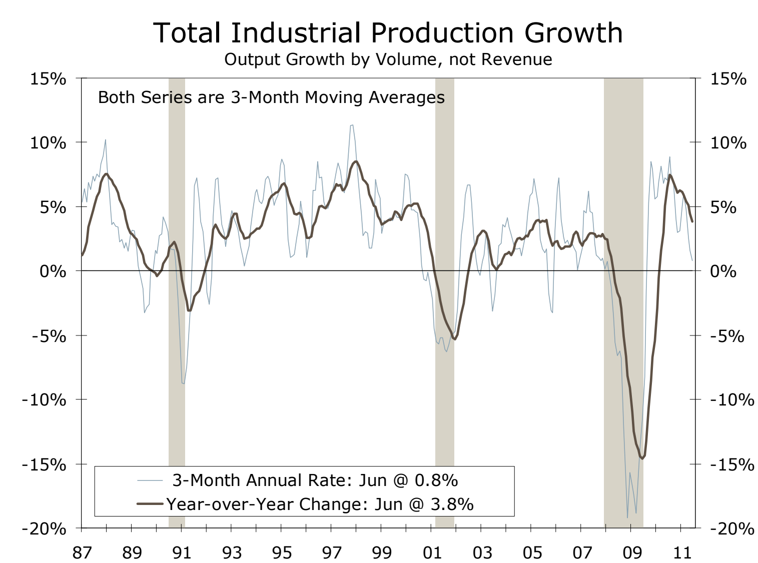
Retail sales came in slightly higher than expectations, improving a slight 0.1 percent for June due to higher sales at automobile dealers, which offset reduced spending at gasoline stations. With household budgets stretched thin, discretionary spending in most major categories remained weak. The absence of discretionary spending is a sign household budgets are still under pressure from higher gas prices. With weak employment growth and continued absence of personal income gains, the sluggish pace of consumer spending is likely to remain in place.

The trade deficit widened a bit in May as crude oil imports jumped on both higher prices and volumes. Exports fell on the month, pulled down by weak demand for industrial supplies. The wider-than-expected trade deficit in May is still not enough to reverse the positive contributions from trade already observed in the second quarter.

Industrial output remained in positive territory in June, growing at a moderate 0.2 percent pace. Manufacturing output was flat in June as model year changeovers led to a 2 percent decline in motor vehicle production. The current rate of industrial output remains consistent with our view for a slow pace of growth going forward. The 1 percent increase in business inventories in May marks the third straight month with a 1 percent or higher monthly increase in inventories. The faster pace of inventory building, even in the wake of the Japanese supply chain disruptions, hints that inventory building was stronger in Q2 than many thought. If this trend continues without a rebound in sales, the potential for further slowing in manufacturing output in the second half of the year will become more likely.





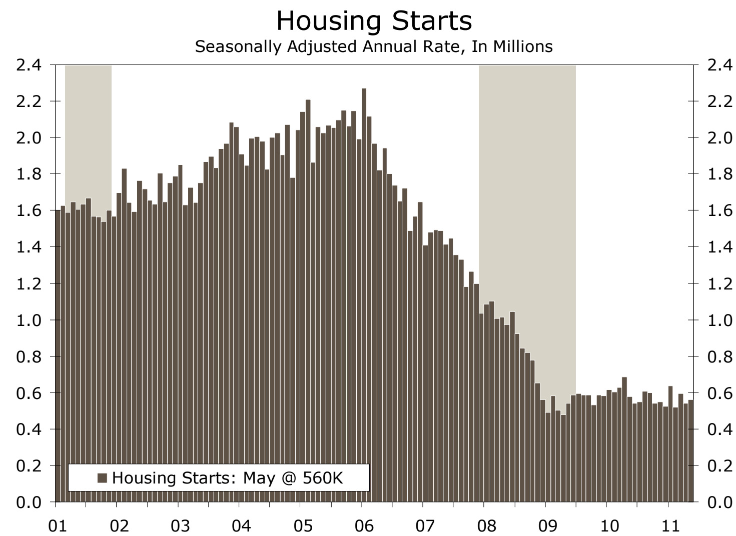


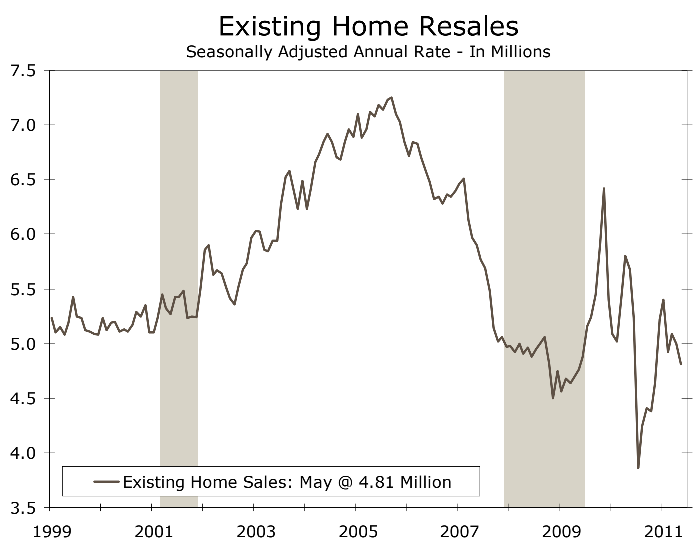
Housing Starts • Tuesday

Housing starts rose 3.5 percent to a 560k-unit pace in May. Gains were broad-based, with single-family starts increasing 3.7 percent and multifamily starts rising 2.9 percent. While the increase is encouraging, starts remain at an extremely depressed level. Single-family starts, in particular, are still very much "dead in the water" and will likely not show any meaningful increase until the number of distressed transactions moderates and the oversupply of existing homes is cleared. The NAHB/Wells Fargo Housing Market Index plummeted in June to its lowest level in nine months. With builder sentiment at such depressed levels, expectations for future single-family sales fell for the third consecutive month. Housing permits, which are forward looking, rose 8.7 percent in May. Much of the gain, however, was due to an increase in multifamily permits. Multifamily permits are up 40.8 percent on a year-ago basis, which suggests solid gains in multifamily starts in the coming months.

Previous: 560K **Wells Fargo: 585K**

Consensus: 575K





Existing Home Sales • Wednesday

Unusually harsh weather and tight credit underwriting constrained existing home sales for the second consecutive month. Sales of existing homes fell 3.8 percent in May, following a 1.8 percent drop the prior month. Weather conditions were particularly harsh in April and early May, with tornados, severe thunderstorms and floods keeping buyers away. The weather cleared in late May, which should lead to higher sales in June and July. Foreclosure sales fell in many states, which led to a sharp pullback in distressed sales. According to the National Association of Realtors, foreclosure and short sales accounted for 31 percent of all transactions, down from 37 percent in April. While the pace of foreclosure sales has retrenched, the overhang of distressed properties continues to weigh down home prices. Existing home sales have averaged a 5.04 million-unit pace through the first five months of the year. We expect sales to increase 5.4 percent above this pace in 2011.

Previous: 4.81M **Wells Fargo: 4.90M**

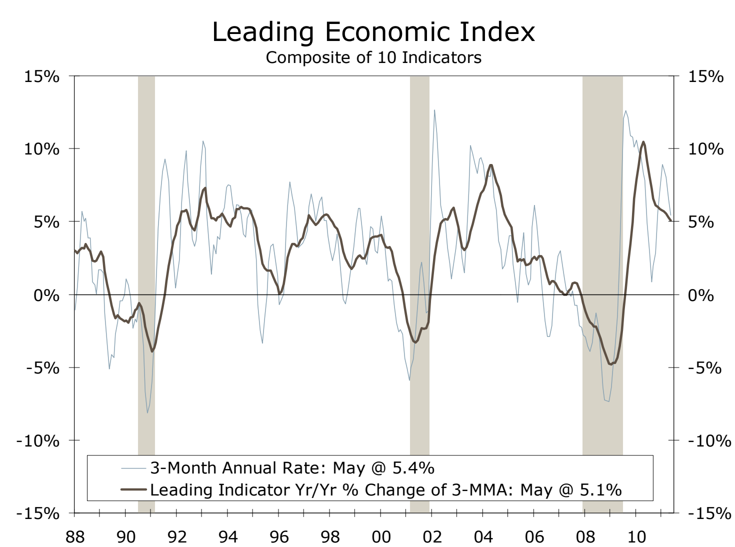
Consensus: 4.92M

Leading Indicators • Thursday

The Conference Board Leading Economic Index (LEI) increased 0.8 percent in May, following a 0.4 percent decline in April. The largest contributions came from the interest rate spread, consumer expectations and housing permits. While 9 of 10 components were positive, the May LEI still reflects moderating economic growth. Consumer goods and nondefense capital goods orders were both barely in positive territory, and the vendor performance component contracted. While some of the contraction in supplier deliveries can be attributed to supply chain disruptions, the slowdown in the manufacturing sector is likely also responsible. We expect real GDP to grow at a 1.6 percent pace in the second quarter, but to pick up in the second half of the year as transitive factors, such as higher energy prices, weather, and supply chain disruptions, wind down. Our outlook is for real GDP to increase at a 2.2 percent pace in 2011 and 2012.

Previous: 0.8% **Wells Fargo: 0.3%**

Consensus: 0.2% (Month-over-Month)



Global Review

Is the Chinese Economy Coming In for a "Soft Landing?"

Data released this week showed that real GDP in China grew at a year-over-year rate of 9.5 percent in the second quarter (see chart on front page). Not only was the outturn stronger than most analysts had expected, but it represents only a miniscule amount of slowing from the 9.7 percent rate that was recorded in the preceding quarter.

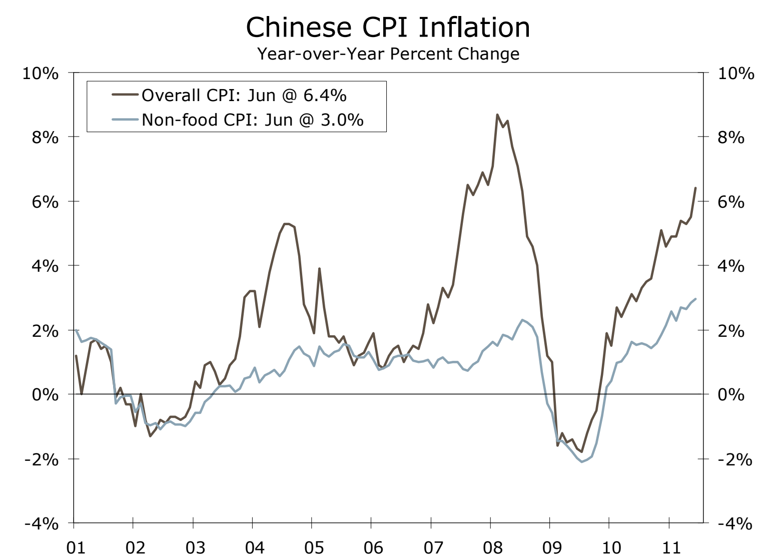
On one hand, the announcement that China grew at a stronger-than-expected rate is good news. With the United States and most other advanced economies still mired in sluggish recoveries, the global economy can surely use every amount of economic growth it can get. A breakdown of the Chinese GDP data into its underlying demand components is not readily available, but it appears that growth in domestic demand remains strong, which helps to pull in imports from the rest of the world. Retail sales rose at a year-over-year rate of 17 percent in the second quarter, and the country's measure of fixed investment spending continues to grow at roughly 25 percent. Imports were up 23 percent in the second quarter, a bit more than the 22 percent growth rate registered by exports (top chart). The country still incurs large amounts of black ink in its trade accounts, but the $45 billion surplus that China recorded in the first half of 2011 is smaller than the $55 billion surplus it racked up during the same period last year.

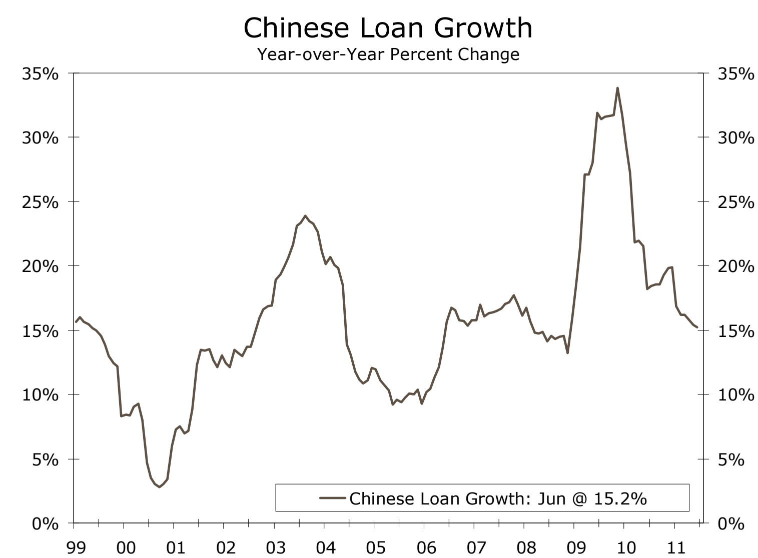
Or Is the Economy Still in Danger of Overheating?

On the other hand, however, continued rapid growth in China is a bit disconcerting in light of the country's inflation dynamics. The overall rate of CPI inflation rose to 6.4 percent in June, which was higher than most analysts had expected (middle chart). The marked rise in inflation since the beginning of 2010 reflects, at least in part, sharp increases in food prices. Indeed, food prices were up 14.4 percent in June, the largest year-over-year increase since early 2008. If inflation were limited to strictly food, Chinese authorities may be willing to tolerate it. However, price acceleration is more widespread than simply in food. Excluding food, the consumer price index is currently up about 3 percent. Although 3 percent is hardly hyperinflation, it represents the highest year-over-year inflation rate in at least a decade.

In response to increasing inflationary pressures over the past year or so, Chinese authorities have tightened policies. The central bank has hiked its benchmark 12-month lending rate by 100 bps since October, and it has raised banks' required reserve ratio by 450 bps over the same period. More importantly, the central bank has instructed commercial banks to rein in lending growth (bottom chart). Despite these measures, the economy continues to boom along, at least for now.

We expect inflation to moderate in the months ahead. Food prices have generally moved lower in recent months, and tightening usually works with a lag. However, if inflation continues to rise, Chinese authorities could tighten even further, which raises the risk of a sharp economic slowdown at some point in the future. Stay tuned.





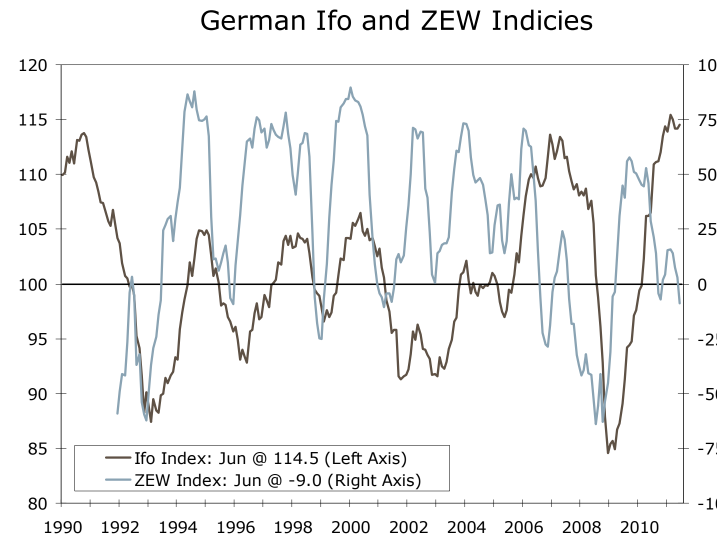
German Zew & IFO • Tuesday & Friday

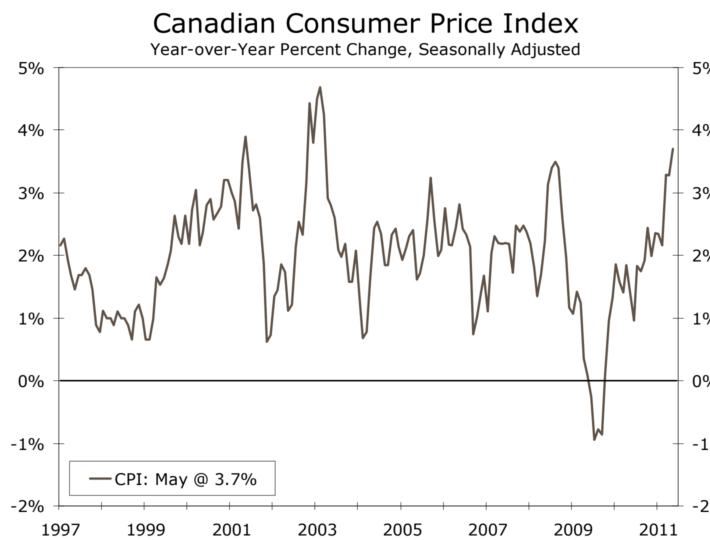
The German economy faired rather well in the past few years despite the deterioration of the sovereign debt situation in other parts of the Eurozone. But that does not mean confidence in Germany is unshaken. Investor confidence, as measured by the Zew survey, dropped to a two and a half year low in June. We should get a sense of whether recent negative developments in Italy will further weigh on German sentiment when the Zew Survey for July prints on Tuesday.

The IFO index reflects business sentiment, and, after topping out at a multiyear high in February, this measure has been more resilient and has lost just a bit of ground in recent months, slipping from 115.4 in February to 114.5 in June. A new number for this index is due out on Friday.

Previous: 87.6 (Zew) 114.5 (IFO)

Consensus: 85.3 (Zew) 113.6 (IFO)





Bank of Canada Rate • Tuesday

The Bank of Canada (BoC) endeavors to keep consumer inflation between 1 percent and 3 percent and as close as possible to the midpoint of 2 percent. The recent run-up in oil and other commodity prices has pushed the CPI to 3.7 percent on a year-over-year basis through May, clearly above the BoC's target.

While the BoC did not hesitate to raise rates earlier in this cycle, when inflation was heating up, we suspect the bank will sit at its Tuesday meeting this week for two reasons: Oil and other commodities seem to be coming back down and expectations of slower economic growth will likely bring consumer inflation back into the target range. Speaking of inflation, the June reading of the Canadian Consumer Price Index is due out next Friday. It will likely be too soon for the expected drop in prices to show up here. Even if prices are flat in the month, the annual rate should still be 3.5 percent.

Previous: 1.00% **Wells Fargo: 1.00%**

Consensus: 1.00%

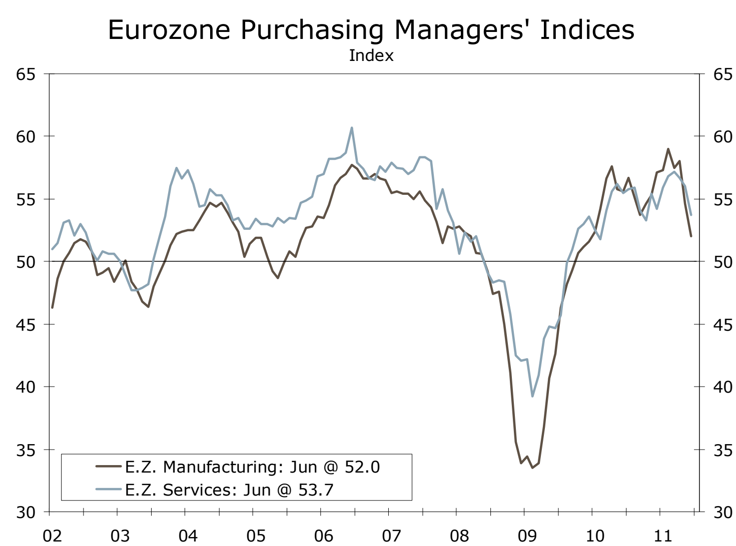
Eurozone Manufacturing PMI • Thursday

Despite the ongoing turmoil in the peripheral Eurozone and the recent run-up in the cost of financing for Italy, the Eurozone's economic growth continues to outperform low consensus expectations. First-quarter GDP grew at a 3.4 percent annualized rate, somewhat faster than the consensus estimate.

That said, there is evidence that there has been a loss of momentum in recent months. The manufacturing PMI for the Eurozone has been losing ground, slipping from 58.0 in April to just 52.0 in June. The July reading for the Eurozone PMI is due out on Thursday of next week. Consensus expectations look for further deterioration in business sentiment to 51.5. If realized, such a reading would signal painfully slow growth in the Eurozone, while a number below 50 could raise red flags about the sustainability of the tepid recovery presently underway.

Previous: 52.0

Consensus: 51.5



Interest Rate Watch

Debt Ceiling Sideshow–Not Core Issue

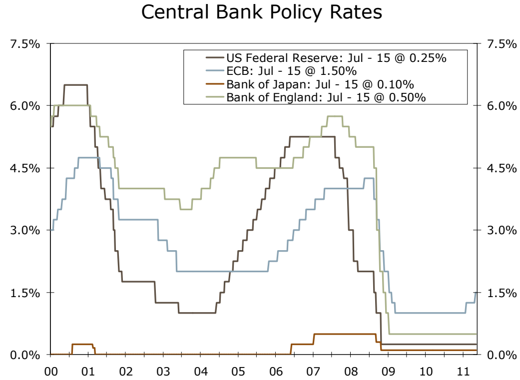
While the media may focus on the Aug. 2 date for the debt ceiling, the economic story is the persistent imbalance between spending and revenues. Moreover, the reality is the deeper imbalance between a generation of unfunded political promises and the moderate economic growth that cannot support those promises. In this way, the U.S. financial situation is reminiscent of Greece and Portugal—too many promises with no economic engine to fund them. The vice of public financial imbalances is closing.

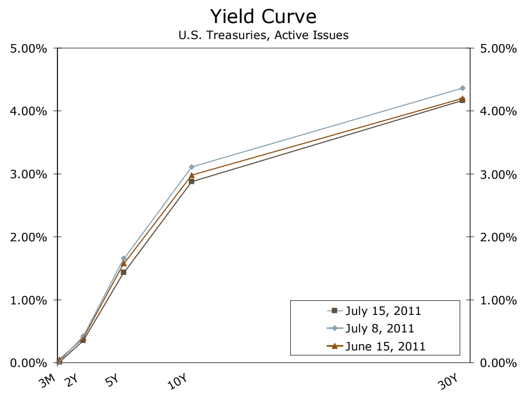
For a generation, Social Security funding relied on an outsized generation of baby boomers to fund the prior-WWII generation. Funding Social Security in this context was easy—too easy, in fact, such that political policy makers in the federal government continued to promise more benefits to seniors without the need to address the long-term funding. Medicare also was underfunded for the long term, especially given the advances in medical technology, the rising life expectancy of seniors and, most importantly, the rapid escalation of lifestyle expectations of seniors and especially the baby boomers. These expectations are evident in all of the commercials for free medical devices and lifestyle drugs in the media.

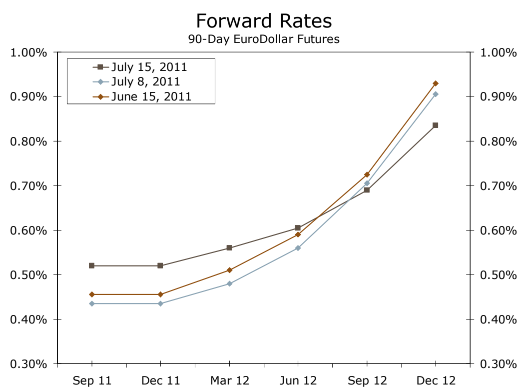
The second edge of the vice on federal finances is being pushed by the lack of growth in the economy and the possibility that trend U.S. economic growth has downshifted and, as such, can no longer generate a pace of tax revenue that will meet the promises of the prior generation of federal policymakers.

This vice, not the Aug. 2 date, is the driving force behind questioning the investment rating of federal debt issuance because, like Greece and Portugal, the federal government is living beyond its means.

Finally, too much focus is given to the short-term behavior of Treasury interest rates as a barometer of the credit crisis. The fallout of declining credit quality of U.S. debt may also be reflected in the decline of the dollar, the rise of inflation and the weak U.S. economic growth itself.







Credit Market Insights

Unemployment and Delinquencies

Over the past 30 years, the unemployment rate and the mortgage delinquency rate have had a fairly strong correlation of about 64 percent. In the most recent recession, the mortgage delinquency rate actually led the unemployment rate by a couple quarters. This is likely due to the fact that the expansion preceding the recession was largely driven by borrowing against soaring home values. When adjustable mortgage payments jumped and home prices fell, homeowners started missing mortgage payments even before they lost their jobs.

When unemployment rises, it becomes more difficult for homeowners to make the mortgage payment, pushing delinquency rates up even further. Thus, the rebound in the unemployment rate in Q2 suggests we could see another increase in the mortgage delinquency rate when the second-quarter data are released in a few weeks. This would not be good news for a housing market that simply cannot escape the grips of the worst housing bust since the Great Depression. Factor into the mix the fact that nearly half of the jobs lost during the recession were in housing-related industries, and we appear to be in a "Catch-22" situation: we cannot get a housing recovery without more jobs, but we likely will not see strong job growth without a housing recovery. With QE2 now complete, federal stimulus funds largely spent and the payroll tax cut set to expire at year's end, job growth could disappoint, which does not bode well for mortgage credit quality.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.51%	4.60%	4.50%	5.08%
15-Yr Fixed	3.65%	3.75%	3.67%	4.39%
5/1 ARM	3.29%	3.30%	3.27%	4.10%
1-Yr ARM	2.95%	3.01%	2.97%	4.05%
MBA Applications				
Composite	481.3	507.0	584.6	700.3
Purchase	183.9	188.9	191.1	163.3
Refinance	2,217.3	2,363.6	2,883.7	3,831.2

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

Topic of the Week

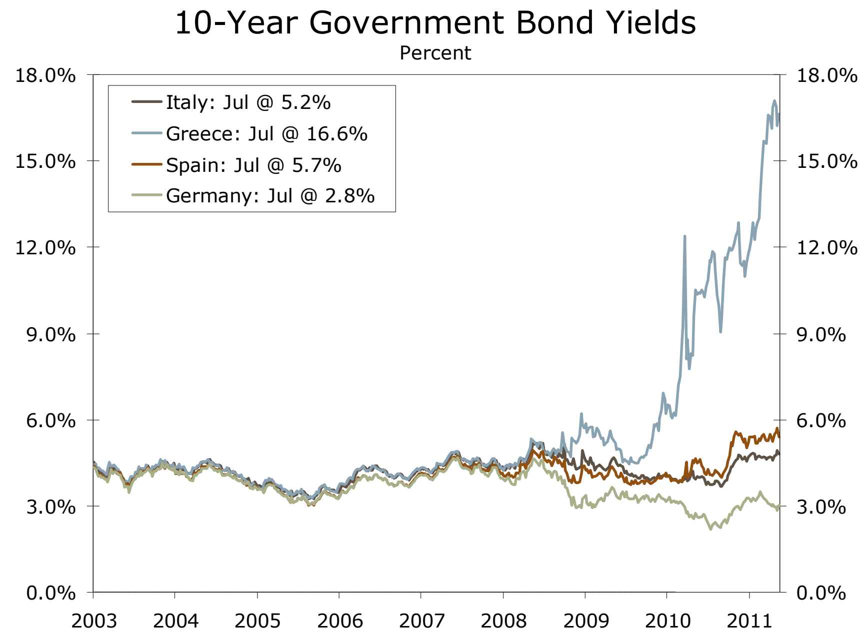
Sovereign Debt Crisis Enters Dangerous Phase

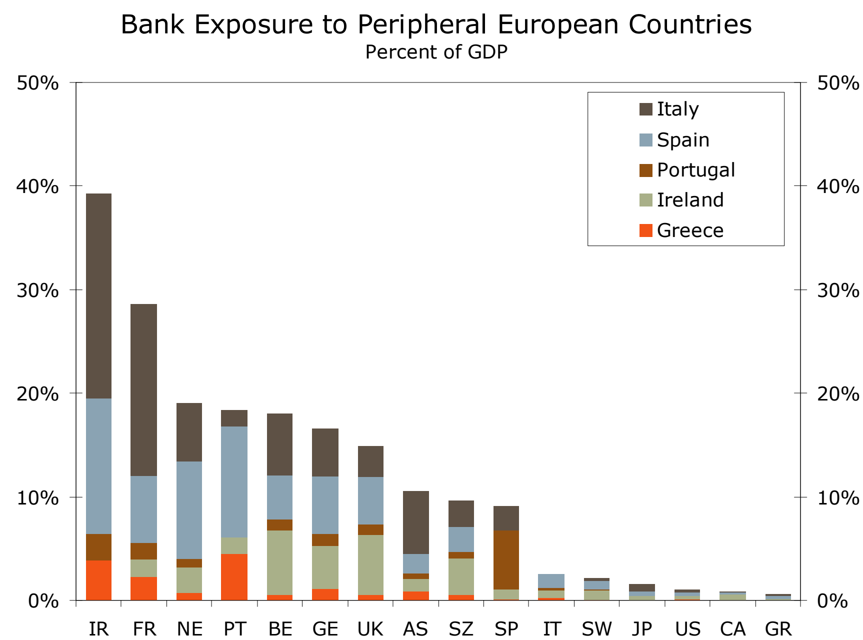
The European sovereign debt crisis has entered a more dangerous phase. Up until now, the crisis has been largely confined to Greece, Ireland and Portugal. However, Spain and Italy have now entered the fray, with yields on Italian and Spanish government bonds shooting up to their highest rates since the crisis began more than a year ago (top chart).

Why now? Some European politicians have started to publicly discuss the conditions under which Greece would be allowed to default on some of its debt. If the Hellenic Republic defaults, could the same thing happen in Ireland and Portugal? What about Spain and Italy? Second, the €40 billion austerity package that recently was proposed by the Italian government is back-loaded and is short on some details. In addition, there has been political bickering between Italian Prime Minister Berlusconi and Finance Minister Tremonti, calling into question the cohesiveness of the Italian government.

Why is the situation dangerous? The European Union and the IMF have pledged enough funds to bail out Ireland, Portugal and Greece (for the second time), but Spain and Italy are different animals. Outstanding government debt and scheduled interests payments in Spain and Italy total about €850 billion and €2.1 trillion, respectively. A bailout for Spain, should one prove necessary, would essentially exhaust the rescue facility. Nobody has the money (or at least the will) to bail out Italy, forcing the country to restructure its debts if it is unable to raise the funds to service them. European financial institutions would need to write down hundreds of billions of euros worth of bond holdings.

Due to the inter-connectedness of the global financial system, the United States is not immune from the debt crisis in Europe. Strains in interbank funding markets could cause LIBOR rates to move higher, affecting most U.S. businesses. Although another financial crisis is a worst-case scenario, the situation in Europe warrants close watching.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 7/15/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.01	0.02	0.15
3-Month LIBOR	0.25	0.25	0.52
1-Year Treasury	0.14	0.18	0.34
2-Year Treasury	0.37	0.39	0.60
5-Year Treasury	1.47	1.58	1.76
10-Year Treasury	2.94	3.03	2.99
30-Year Treasury	4.27	4.28	3.99
Bond Buyer Index	4.51	4.65	4.37

Foreign Exchange Rates

	Friday 7/15/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.414	1.427	1.295
British Pound ($/£)	1.614	1.606	1.546
British Pound (£/€)	0.876	0.888	0.838
Japanese Yen (¥/$)	79.050	80.640	87.400
Canadian Dollar (C$/$)	0.954	0.963	1.038
Swiss Franc (CHF/$)	0.816	0.837	1.041
Australian Dollar (US$/A$)	1.065	1.076	0.884
Mexican Peso (MXN/$)	11.716	11.626	12.772
Chinese Yuan (CNY/$)	6.464	6.465	6.778
Indian Rupee (INR/$)	44.518	44.328	46.605
Brazilian Real (BRL/$)	1.573	1.563	1.763
U.S. Dollar Index	75.089	75.179	82.558

Foreign Interest Rates

	Friday 7/15/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.55	1.53	0.78
3-Month Sterling LIBOR	0.83	0.83	0.73
3-Month Canadian LIBOR	1.17	1.18	0.88
3-Month Yen LIBOR	0.20	0.20	0.24
2-Year German	1.22	1.45	0.79
2-Year U.K.	0.70	0.76	0.78
2-Year Canadian	1.44	1.50	1.66
2-Year Japanese	0.15	0.17	0.15
10-Year German	2.70	2.83	2.65
10-Year U.K.	3.08	3.19	3.38
10-Year Canadian	2.91	2.96	3.23
10-Year Japanese	1.09	1.18	1.09

Commodity Prices

	Friday 7/15/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	97.35	96.20	76.62
Gold ($/Ounce)	1589.00	1544.15	1208.25
Hot-Rolled Steel ($/S.Ton)	715.00	725.00	610.00
Copper (¢/Pound)	439.60	440.25	300.50
Soybeans ($/Bushel)	13.93	13.55	10.10
Natural Gas ($/MMBTU)	4.51	4.21	4.59
Nickel ($/Metric Ton)	24,176	23,868	19,339
CRB Spot Inds.	596.26	603.50	472.58

Next Week's Economic Calendar

	Monday 18	Tuesday 19	Wednesday 20	Thursday 21	Friday 22
U.S. Data		**Housing Starts** May 560K June 585K (W)	**Existing Home Sales** May 4.81M June 4.90M (W)	**LEI** May 0.8% June 0.3% (W)	
Global Data		**Germany** **Zew Econ. Sentiment** Previous (Jun) -9.0% **Canada** **Bank of Canada Rate** Previous (May) 1.00%	**Japan** **Trade Balance** Previous (May) -¥855.8B	**Eurozone** **PMI Manufacturing** Previous (Jun) 52.0 **U.K.** **Retail Sales (MoM)** Previous (May) -1.4%	**Germany** **IFO Current Assessment** Previous (Jun) 123.3 **Canada** **CPI (MoM)** Previous (May) 0.7%

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

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