July 22, 2011

Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Economic Data Mixed, but Debt Deal Seems Viable

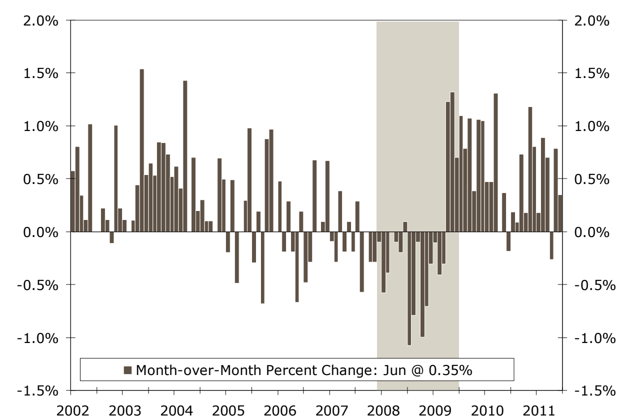
- Economic data released this week came in with largely mixed results and continue to point to an economy that is emerging from a soft patch but with slow momentum.
- The Leading Economic Index rose 0.3 percent in June with 5 of 10 components posting gains and the largest contributions coming from financial indicators.
- Market watchers remained focused on debt ceiling negotiations. Our baseline expectation is that Congress will likely strike a last-minute deal to raise the debt ceiling and the ramifications to the financial markets could be neutral in the short term.

Global Review

EU Leaders Agree to Second Greek Package

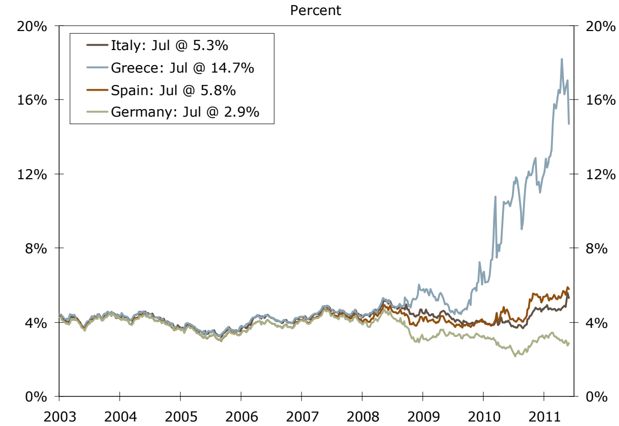
- Meeting in an extraordinary summit in Brussels on Thursday, EU leaders agreed to a number of steps to provide relief to Greece and other highly indebted European countries. In our view, the steps will ease the crisis, at least for now. However, many questions about the long-run efficacy of the program remain. We continue to analyze the steps and plan to write a more detailed special report next week.
- This week's data suggest that the third quarter got off to a fairly weak start in the Eurozone.

Leading Economic Index



10-Year Government Bond Yields

Percent



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	2.2	2.3	0.0	-2.6	2.9	2.2	2.2
Personal Consumption	1.9	2.2	2.4	4.0	2.2	1.0	1.6	2.3	-0.3	-1.2	1.7	2.2	1.8
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	0.58	0.60	0.64	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	0.25
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 22, 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

It will take More than Raising the Roof to Secure Solid Growth

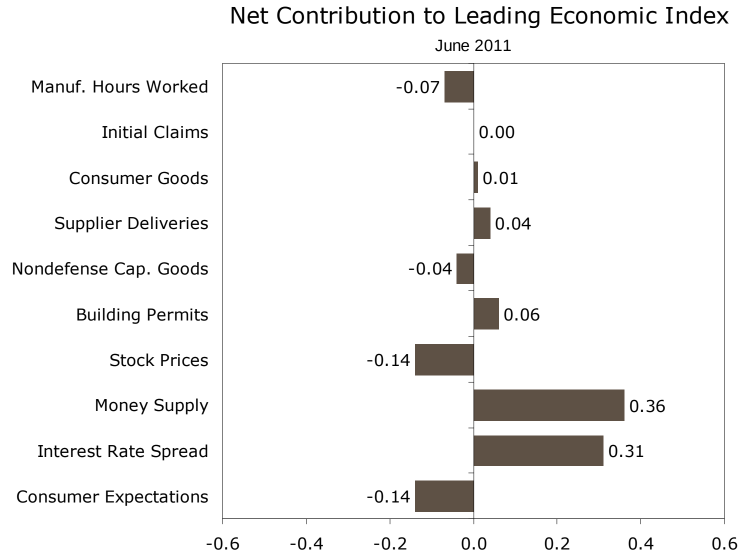
Economic data released this week came in with largely mixed results and continue to point to an economy that is emerging from a temporary soft patch but with slow momentum. The Leading Economic Index rose 0.3 percent in June with 5 of 10 components posting gains. The largest contributions came from financial indicators such as the money supply and steep yield curve, which more than offset declining stock prices and consumer expectations. That said, we continue to expect slow economic growth in the second quarter with the pace of real GDP gaining modest momentum in the second half of the year.

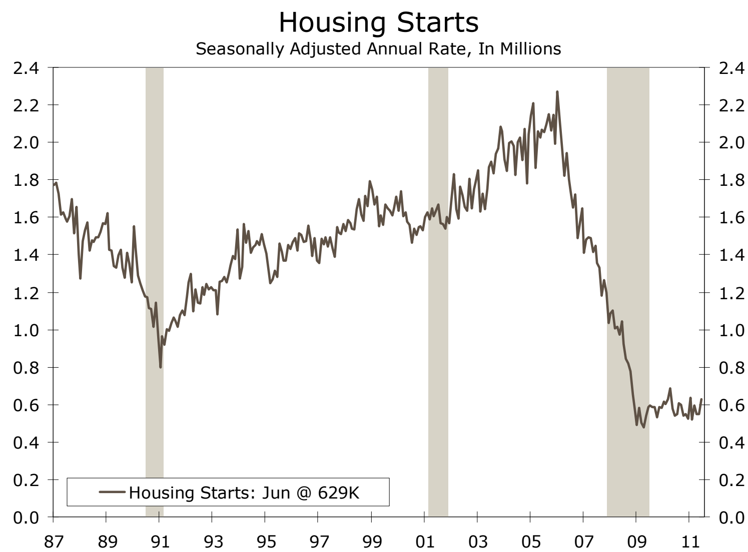
We have frequently noted that, during this recovery, once the temporary storm of exogenous shocks passes by, as long as the economy remains hostage to a weak-housing market, the pace of economic growth is not likely to exceed a 3.0 percent annual rate. Indeed, most housing market indicators released during the week came in better than expected, but peeling back the headline reveals that housing activity and prices still remain at very depressed levels.

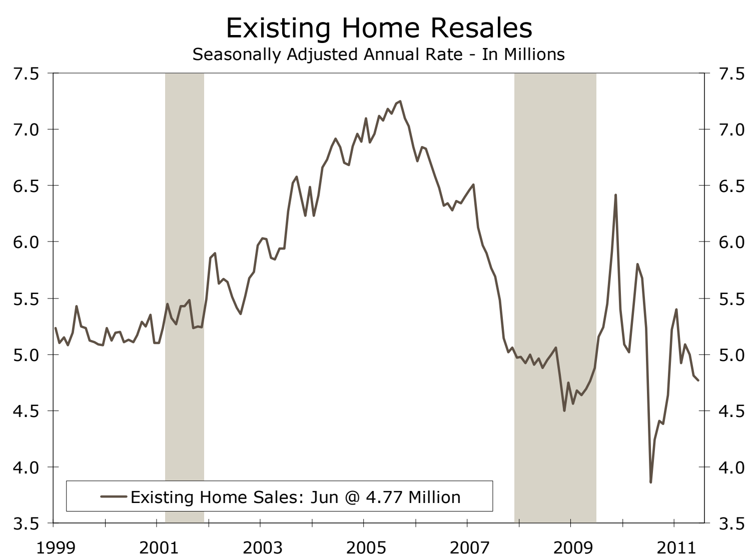
Housing starts rose 14.6 percent to a 629,000-unit pace in June. Much of the gain, however, was due to a 30.4 percent jump in multifamily starts. The surge in multifamily starts reflects firming in the apartment market as vacancy rates have fallen steadily over the past year and rents continue to rise. Single-family starts rose 9.4 percent and seem to be gaining traction from the lows hit after the homebuyer tax credit program ended. However, starts remain at a level significantly below its historical long-run trend, which could remain unattainable for at least the next 5 to 7 years.

In contrast, existing home sales slipped 0.8 percent in June to a 4.77 million-unit pace. The National Association of Realtors reported that contract cancellations spiked 16 percent, the highest on record. The increase in contract cancellations likely reflects buyers and sellers increasingly running up against conservative appraisals and tight underwriting. The headline increase also points to a change in the mix of sales with fewer first-time buyers and less distressed sales. The change in composition and looming expiration of conforming loan limits for Fannie Mae and Freddie Mac guaranteed loans has helped increase the median price of a home to $184,600 in June from $169,800 in May as buyers rushed to get ahead of the deadline to purchase homes that exceed the $629,000 limit.

Economic indicators for the week, however, went relatively unnoticed as market watchers remained focused on debt ceiling negotiations. Signs of progress helped propel the Dow Jones Industrial Average 245 points, or 1.96 percent over the past week. While equity markets have found some level of peace with recent deal talk developments, rating agencies have reported that the U.S. government's AAA rating is not solely dependent on raising the debt limit but also on fixing the longer-term funding gap. Our baseline expectation is that Congress will likely strike a last minute deal to raise the debt ceiling and ramifications to the financial markets will be neutral in the short term.





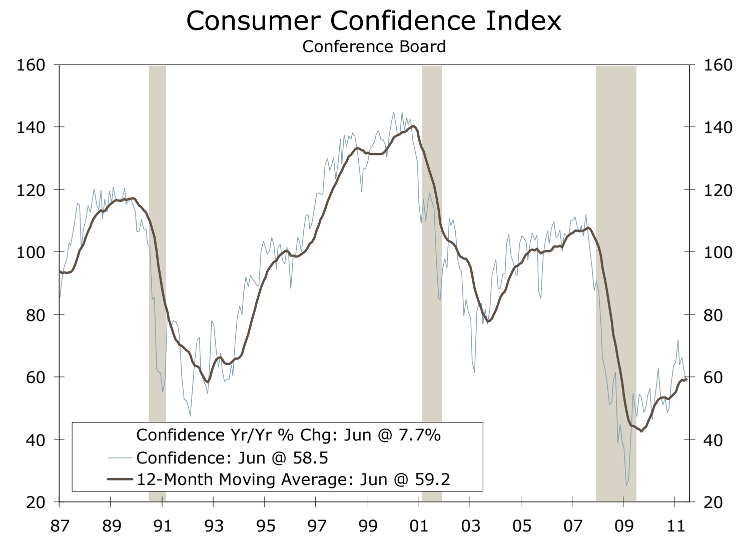


Consumer Confidence • Tuesday

Consumer confidence dipped to 58.5 in June from 61.7 in May. The present situation index fell to 37.6, while the expectations component dropped to 72.4, the lowest since October. The share of respondents saying jobs were hard to get rose for the second month in a row, while the share expecting more jobs in the next six months fell to 14.2 percent, the lowest since July 2010. Similarly, the share expecting incomes to increase fell to 13.9 percent, the lowest since the new methodology came into use in November. Plans to buy an auto or home in the next six months were the lowest since December. We expect continuing labor market weakness in July, (in June only 18,000 jobs were added), along with a housing market stuck in a rut and falling real hourly earnings. These will keep consumer confidence subdued for July. The lack in confidence has led to the first back-to-back declines in real consumer spending since March-April 2009.

Previous: 58.5 **Wells Fargo: 55.0**

Consensus: 57.9

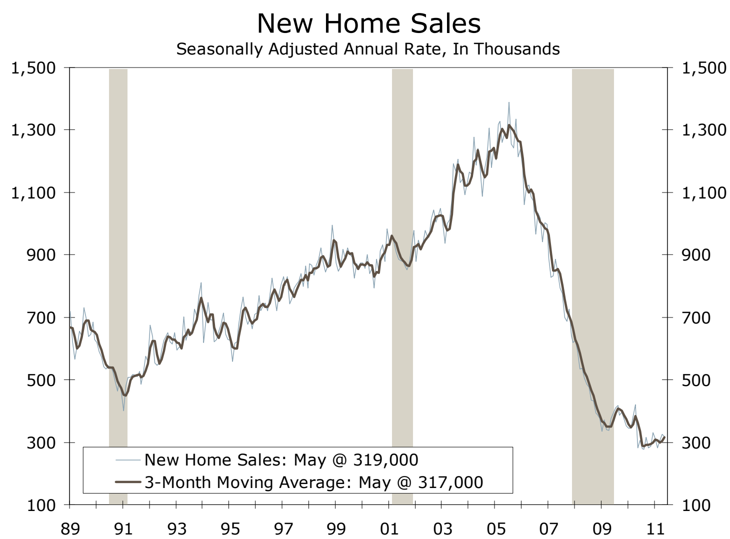


New Home Sales • Tuesday

New home sales fell to a 319,000 unit annualized rate in May. With a record-low 166,000 new homes for sale, inventory fell to 6.2 months' worth, the lowest since April 2010. A weak job market and competition from a swath of distressed properties is weighing heavily on new home sales. While the median price rose to $222,600, the increase was largely seasonal in nature. Compared to a year ago, prices were down 3.4 percent, the biggest year-over-year decline since October. With consumers reporting less optimism on jobs and incomes in June, as well as fewer plans to purchase a home, new home sales look to be in a protracted slump for some time to come. The present and future sales indices rose in July as reported in the Wells Fargo/NAHB Housing Market Index on July 18. However, the vast majority of those sales will likely be existing homes. Existing home sales account for about 94 percent of all sales currently, up from 85 percent six years ago.

Previous: 319K **Wells Fargo: 330K**

Consensus: 320K

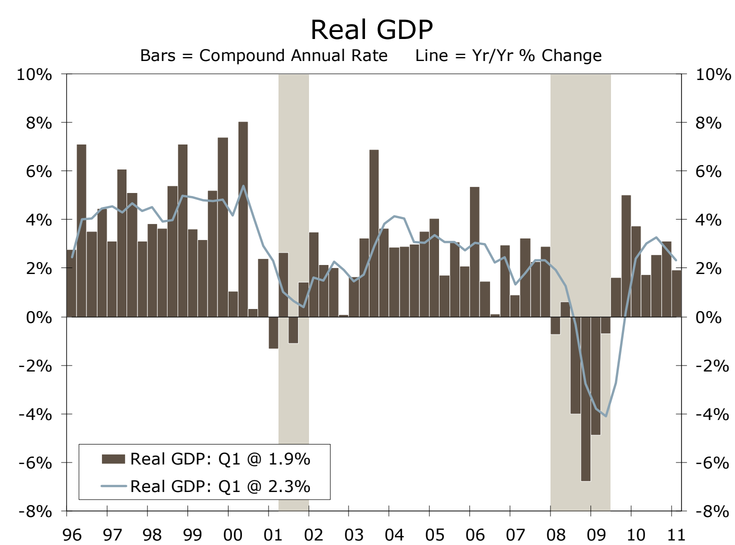


GDP • Friday

Real GDP rose at a 1.9 percent annualized rate in the first quarter, following a 3.1 percent pace in the fourth quarter. The slowdown was led by weaker consumer spending, which rose only 2.2 percent, slightly better than half the 4.0 percent pace in the fourth quarter. Business fixed investment was also quite weak, rising only 2.0 percent, as investment in structures plunged 14.8 percent. Residential construction also contributed to the decline, falling by 1.9 percent. In addition, government spending plunged 5.8 percent, the biggest decline since 1983. For the second quarter, we are forecasting a similar rate of growth in real GDP, about 1.7 percent. We expect consumer spending slowed by half again, to about one percent. Business fixed investment is expected to rebound on stronger investment in structures. Residential construction will likely be a drag again as the housing market remains in the doldrums. Trade will likely account for the bulk of GDP growth.

Previous: 1.9% **Wells Fargo: 1.6%**

Consensus: 1.8% (Quarter-over-Quarter, Annualized)



Global Review

EU Leaders Agree to a Second Greek Package

At a summit meeting in Brussels on Thursday, leaders of the European Union announced new steps to address the sovereign debt crisis that has engulfed the Eurozone for more than a year. First, they agreed to pony up an additional €109 billion to help the Hellenic Republic meet its obligations over the next few years. Importantly, the interest rate that Greece must pay for its borrowing from the EU has been reduced to 3.5 percent from about 5 percent, and the repayment period has been pushed out to a minimum of 15 years from 7 years. These new terms will help to ease Greece's debt burden over the next few years.

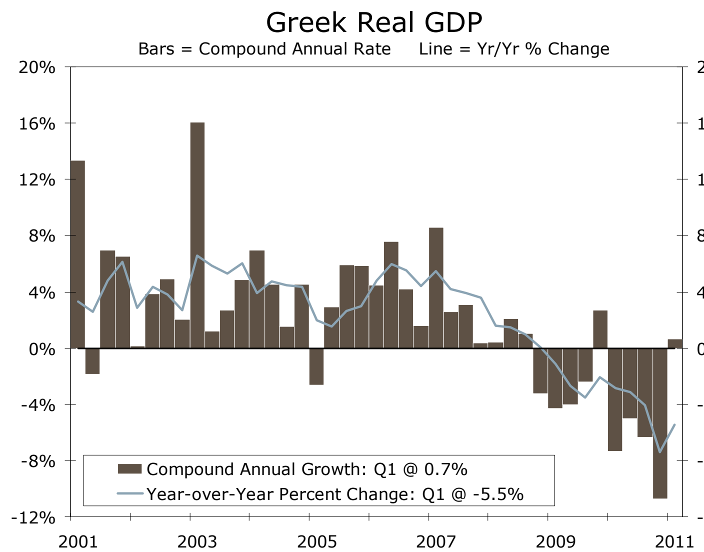
To ease the debt burden further, the private sector was asked, and largely agreed, to bear some costs as well. A number of different debt exchanges and debt buybacks are expected to produce an approximate 20 percent reduction in the net present value of Greece's debt.

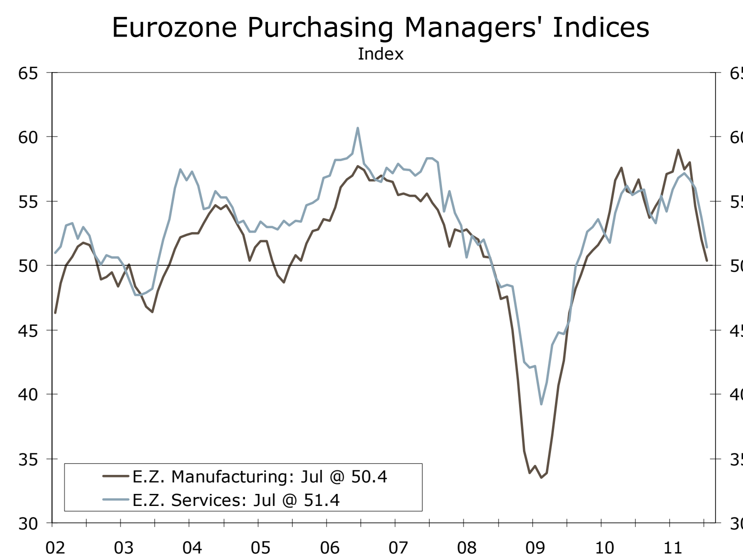
There are also provisions that are designed to prevent the crisis from spreading further. Ireland and Portugal, which also have received financial support from the EU, will be eligible for the lower interest rates and longer maturities that have been granted to Greece. The powers of the European Financial Stability Facility (EFSF), which is the €440 billion war chest that the EU had already put in place to provide emergency financing to highly indebted countries, have been expanded. Specifically, the EFSF can now buy government debt in the secondary market and it can provide loans on a precautionary basis (i.e., before an official EU or IMF program would be necessary).

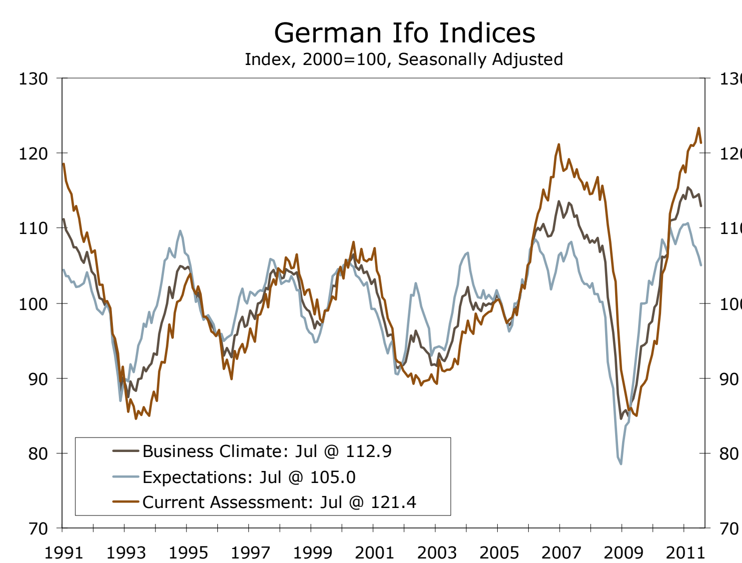
The initial market reaction to the news was positive, with yields on government bonds in Greece, Ireland, Portugal, Italy and Spain declining significantly (see graph on front page). In our view, the steps announced on Thursday should ease the crisis, at least in the near term. However, we are not completely convinced yet that Greece and other indebted countries are completely "out of the woods." Many questions about some of the specifics of the announcements and the long-run efficacy of the program still remain. We will continue to analyze the program, and plan to release our views about the long-run effectiveness of the program in a special report next week.

More Signs of Slower Growth in the Second Quarter

Meanwhile, the economic data released this week suggested that the third quarter got off to a fairly weak start. The purchasing managers' indices for the manufacturing and service sectors in the overall Eurozone edged down further in July (middle chart). The manufacturing PMI is now within spitting distance of the demarcation line that typically separates expansion from contraction. The Ifo index of German business sentiment also declined in July as the components that measure current business conditions and expectations for the future both moved lower (bottom chart). That said, the Ifo indices all remained at fairly high levels, suggesting that German growth remains positive. Indeed, we expect that economic growth in the overall euro area will remain positive, albeit rather slow, in the quarters ahead.





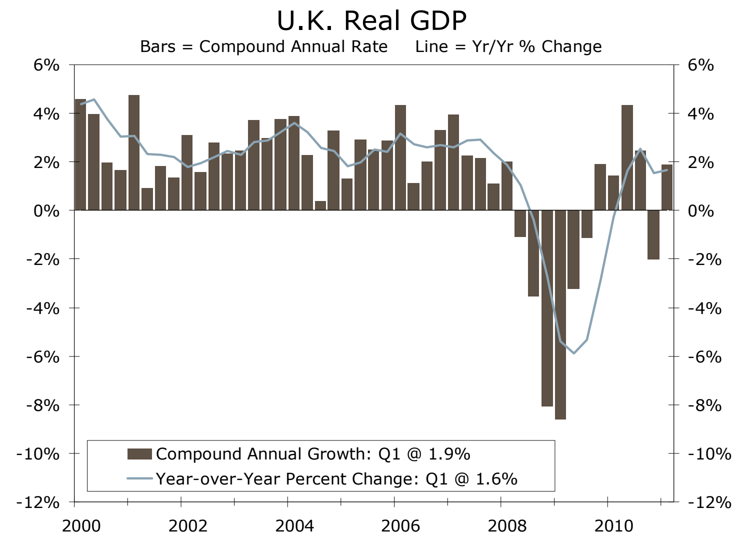


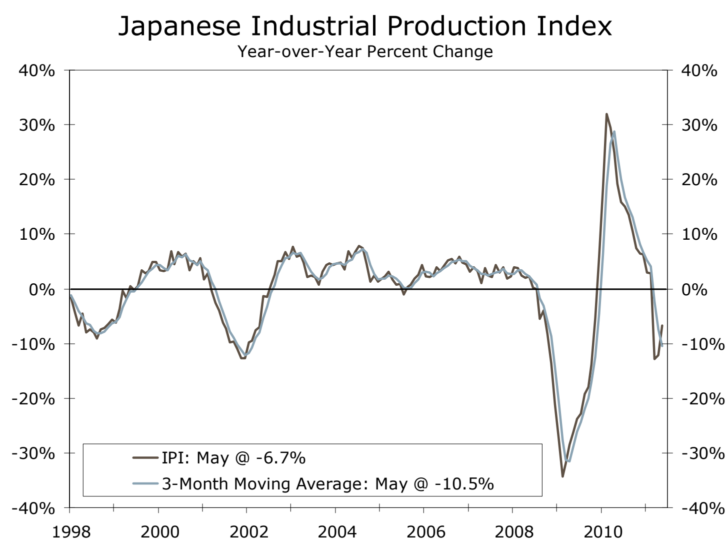
U.K. GDP • Tuesday

On Tuesday, we are going to be able to take a first look at the performance of the U.K. economy with the release of the GDP number for the second quarter of the year. Markets expect an increase of 0.2 percent quarter-over-quarter compared to a 0.5 percent during the first quarter of the year, all on a seasonally adjusted basis. Thus, this means that the expectation is for the U.K. economy to have slowed down during the quarter after the relatively surprising performance during the first quarter of the year. Any better results will come in handy to the Cameron administration as it tries to validate the administration's conservative agenda of large government expenditure cuts at a time when many have been calling for just the opposite. Thus, a second consecutive quarter of better-than-expected results could cement the view that the administration is on the right path even as it faces mounting political criticisms on the News Corp. fallout.

Previous: 0.5% **Wells Fargo: 0.3%**

Consensus: 0.2% (Quarter-over-Quarter)





Japan Industrial Production • Thursday

Japan releases its industrial production index for June on Thursday and the expectation is for the industrial sector to continue to show its recovery from the earthquake, tsunami, and ensuing nuclear fallout. However, the interesting thing will be to see if the industrial sector's momentum carries over without the effects of the crisis. A stronger-than-expected reading could point to an improved environment going forward.

We will also have the release of the consumer price index for June with markets expecting a year-over-year rate of just 0.2 percent, down from a 0.3 percent rate for the year ended in May. Thus, a higher-than-expected inflation rate will be welcome news for the battered Japanese economy as it tries to shy away from the ghost of deflation once again. Furthermore, on Friday, we will get the number on June's vehicle production and that number is going to be a good indicator of the strength of the recovery.

Previous: -5.5%

Consensus: -1.2% (Year-over-Year)

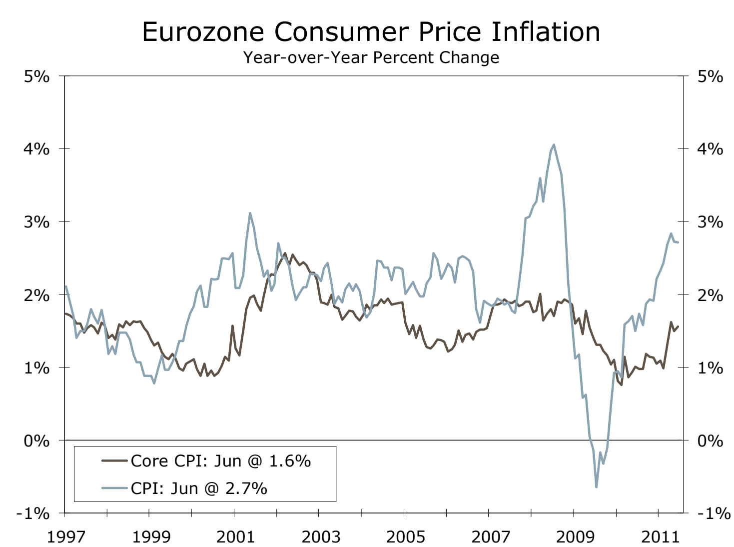
Eurozone CPI • Friday

On Friday we get the flash CPI release for the Eurozone in July and a better-than-expected number could indicate that the European Central Bank (ECB) may start to relax a bit in terms of its fear of inflation. The recent decrease in the price of petroleum and overall commodities could also bring some relief to the European price index as it has done for the overall price index in the United States However, it will be interesting to see if this improvement in the measure of overall inflation translates into a slower core CPI increase for July. For that we will have to wait further into August when the Eurozone releases its core CPI number.

On Thursday, Germany is expected to release its July unemployment rate and a further decrease in the rate could reassure markets that the Eurozone locomotive of growth is still pushing ahead and that the Eurozone could still count on Germany's excellent performance to drive its economy forward.

Previous: 2.7% **Wells Fargo: 3.1%**

Consensus: 2.7% (Year-over-Year)



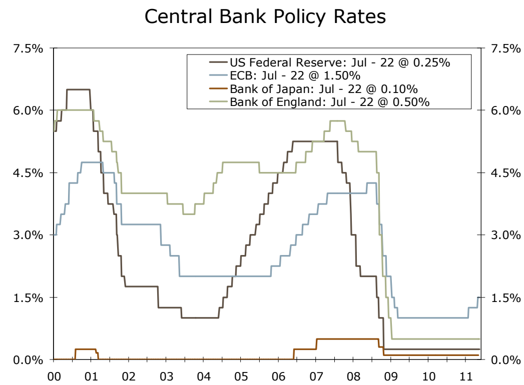
Interest Rate Watch

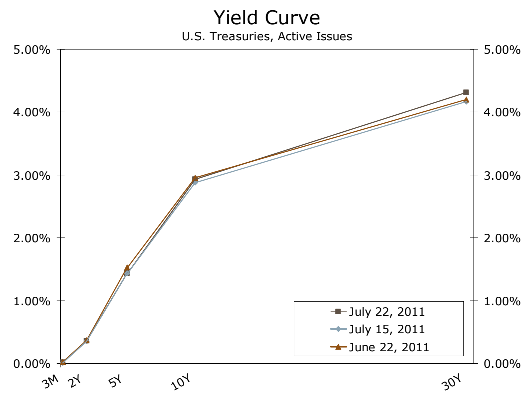
The Bond Market Expects a Deal

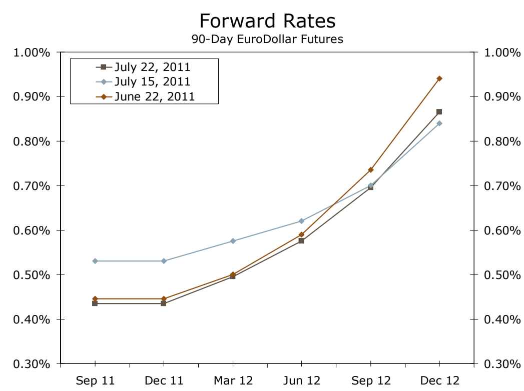
Even though the headlines waver from hour to hour and day to day, the financial markets appear to be anticipating that a deal will be reached to raise the Treasury's debt ceiling. Treasury yields did rise slightly on the week, as modestly better news on housing starts and the Philadelphia Fed survey offset weaker reports on existing home sales and weekly first-time unemployment claims. The economy appears to be bouncing back from this spring's "soft patch" but the rebound has so far been a little less than hoped.

The prospect of a deal that cuts spending by around $3 trillion over the next 10 years and raises taxes by about $1 trillion over some unknown but in all likelihood sooner timeframe will do little to promote economic growth. While the deal would remove some of the near-term uncertainty, the revenue increases will further stymie business investment and hiring and ultimately do little to reduce the size of the federal budget deficit as a share of GDP, particularly if you assume real GDP growth averages something closer to the 2.5 percent pace in our forecast instead of the 3.5 percent growth assumed by the CBO. It is also an open question as to whether a deal of this size would meet the criteria set by Moody's and S&P to avoid a downgrade of the U.S. AAA credit rating. We examined the potential consequences of such a move this week in a special report titled: *Moody's Blues: Implications of a U.S. Downgrade.*

Of course raising the debt ceiling means the Treasury will be borrowing even more money this summer and thereafter, which can be expected to put at least some modest upward pressure on interest rates. Rates will also likely back up once a deal is actually reached, particularly if it is along the lines of the one rumored to be offered by the so called Gang of Six. Such a deal pushes off the truly hard decisions on the deficit beyond the 2012 election, merely replacing near-term uncertainty with intermediate-term uncertainty. We see the 10-year Treasury ending the year at around 3.30 percent but rates would rise even more than that if economic growth comes back faster than we currently expect.







Credit Market Insights

Consumer Credit Improved In May

Consumer credit increased 2.5 percent in May led by a 5.1 percent increase in revolving credit and a 1.3 percent increase in non-revolving credit. The increase in consumer credit is in part tied to loosening credit standards, particularly in the revolving credit market. Even with the fragile economic recovery, banks are still willing to relax credit standards with the expectation that consumer spending and personal incomes will improve. One possible metric that may be guiding banks' decision making is the degree to which consumers have delevered. When looking at the amount of consumer debt as a percentage of disposable personal income, the amount of debt declined 3.7 percent to 20.7 percent of disposable income. This ratio is now at its lowest level since 1996. While the decline in the level of debt is welcomed news, there is some evidence to suggest that these consumers did not deleverage by choice. At the beginning of the recession when unemployment began to pickup, many individuals who lost their jobs were forced to work out credit repayment plans, resulting in a large amount of consumer deleveraging. While the decline in household debt has been substantial, we continue to expect further deleveraging due to existing consumer debt reduction plans. In addition, home mortgage issues, along with slow personal income growth, suggest that it may be some time before consumers are ready to aggressively utilize more credit.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.52%	4.51%	4.50%	5.08%
15-Yr Fixed	3.66%	3.65%	3.69%	4.39%
5/1 ARM	3.27%	3.29%	3.25%	4.10%
1-Yr ARM	2.97%	2.95%	2.99%	4.05%
MBA Applications				
Composite	556.0	481.3	549.9	753.5
Purchase	183.7	183.9	185.8	168.9
Refinance	2,728.6	2,217.3	2,675.2	4,161.9

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

Topic of the Week

Implications of a U.S. Downgrade

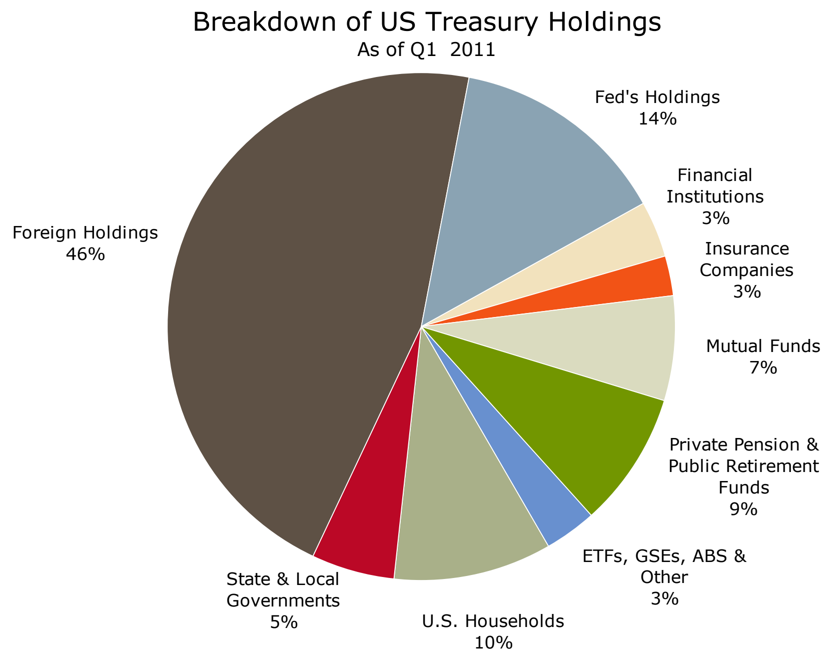
Rating agencies have put the sovereign debt rating of the United States on review for a potential downgrade. Our baseline expectation is that Congress will strike a last minute deal to raise the debt ceiling, although that does not necessary preclude a downgrade.

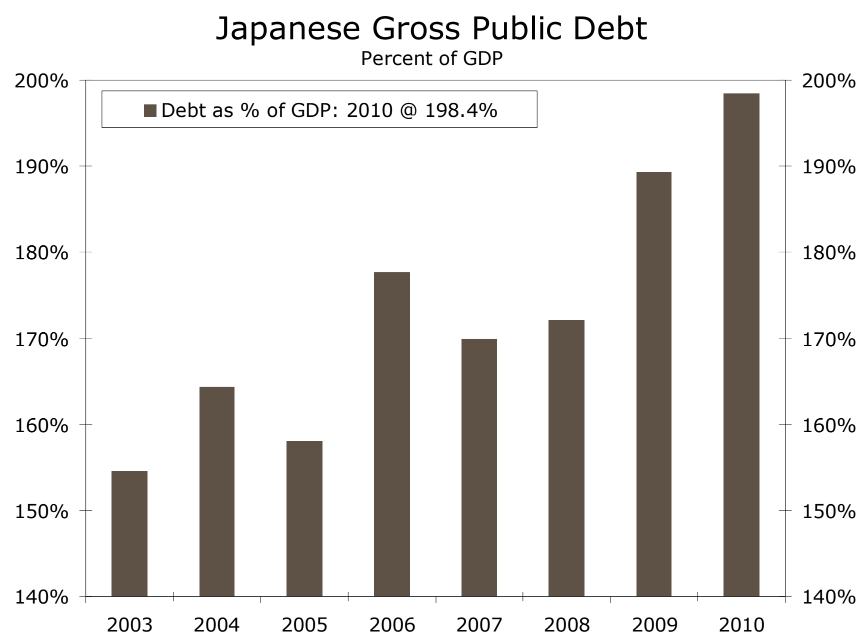
The most pressing concern for many seems to be the fear that financial markets will rush to sell Treasuries in the wake of a downgrade. Although we do not wish to be dismissive of that concern, we suspect it may be somewhat overblown. Foreign investors, whose Treasury holdings make up the largest share of outstanding Treasury holdings, are not likely to dump Treasuries en masse in the wake of a downgrade for the simple fact that there are not many alternatives to U.S. government debt. The Eurozone still lacks a unified debt security, and most Asian capital markets are still developing and do not have nearly as much liquidity as Treasury markets. Japanese debt would serve as a nice alternative to U.S. Treasuries if it were not for the simple fact that the fiscal outlook for Japan is even more frightening than that of the United States.

Many have speculated that a downgrade would cause forced selling of Treasuries at institutions that are required by prospectus to hold AAA-rated securities in fixed-income portfolios. This worry may be a bit overblown, too. We reviewed the prospectuses for U.S. government bond funds at some of the country's largest mutual funds and found that in many cases there are no such mandates.

The impact on the repo market is uncertain, but it seems likely that a downgrade would squeeze money market funds even tighter at time when yields remain low. With so little meat on the bone, though, the potential for further tightening in repo markets is a small probability.

For more information regarding the potential implications of a downgrade, see our *Moody's Blues: Implications of a U.S. Downgrade* report.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 7/22/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.03	0.01	0.15
3-Month LIBOR	0.25	0.25	0.50
1-Year Treasury	0.16	0.14	0.31
2-Year Treasury	0.38	0.35	0.56
5-Year Treasury	1.50	1.44	1.67
10-Year Treasury	2.97	2.91	2.94
30-Year Treasury	4.28	4.25	3.95
Bond Buyer Index	4.46	4.51	4.26

Foreign Exchange Rates

	Friday 7/22/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.437	1.416	1.289
British Pound ($/£)	1.628	1.614	1.526
British Pound (£/€)	0.882	0.877	0.845
Japanese Yen (¥/$)	78.440	79.130	86.950
Canadian Dollar (C$/$)	0.949	0.953	1.037
Swiss Franc (CHF/$)	0.817	0.815	1.043
Australian Dollar (US$/A$)	1.085	1.065	0.893
Mexican Peso (MXN/$)	11.636	11.742	12.771
Chinese Yuan (CNY/$)	6.447	6.464	6.780
Indian Rupee (INR/$)	44.355	44.518	47.128
Brazilian Real (BRL/$)	1.554	1.575	1.758
U.S. Dollar Index	74.225	75.126	82.595

Foreign Interest Rates

	Friday 7/22/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.56	1.55	0.82
3-Month Sterling LIBOR	0.83	0.83	0.74
3-Month Canadian LIBOR	1.18	1.17	0.94
3-Month Yen LIBOR	0.20	0.20	0.24
2-Year German	1.41	1.22	0.70
2-Year U.K.	0.73	0.70	0.80
2-Year Canadian	1.49	1.42	1.55
2-Year Japanese	0.16	0.15	0.15
10-Year German	2.85	2.70	2.67
10-Year U.K.	3.14	3.08	3.36
10-Year Canadian	2.95	2.88	3.20
10-Year Japanese	1.10	1.08	1.07

Commodity Prices

	Friday 7/22/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	98.58	97.24	79.30
Gold ($/Ounce)	1602.03	1593.55	1194.95
Hot-Rolled Steel ($/S.Ton)	709.00	715.00	600.00
Copper (¢/Pound)	441.20	440.50	316.05
Soybeans ($/Bushel)	13.94	13.93	10.18
Natural Gas ($/MMBTU)	4.45	4.55	4.64
Nickel ($/Metric Ton)	23,910	24,176	19,419
CRB Spot Inds.	593.97	596.26	473.13

Next Week's Economic Calendar

	Monday 25	Tuesday 26	Wednesday 27	Thursday 28	Friday 29
U.S. Data		**Consumer Conf.** June 58.5 July 55.0 (W) **New Home Sales** May 319K June 330K (W)	**Durable Goods Ord.** May 2.1% June 0.4% (W) **Durables Ex Transp.** May 0.7% June 0.5% (W)		**GDP** Q1 (3rd) 1.9% Q2 (A) 1.6% (W) **Employment Cost** Q1 0.6% Q2 0.5% (W)
Global Data		**U.K.** **GDP (QoQ)** Previous (Q1) 0.5% **Mexico** **Trade Balance** Previous (May) $555M		**Japan** **IP (YoY)** Previous (May) -5.5% **Japan** **CPI (YoY)** Previous (May) 0.3%	**Eurozone** **CPI (YoY)** Previous (Jun) 2.7% **Germany** **Retail Sales (MoM)** Previous (May) -2.5%

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

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