August 05, 2011

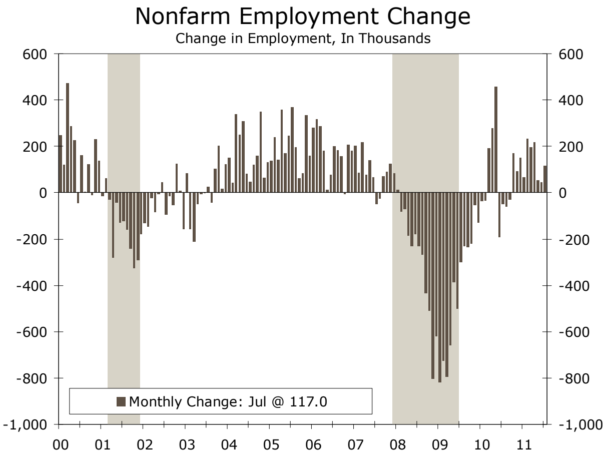
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Zoo Wee Mama!: Employment Surprises to the Upside

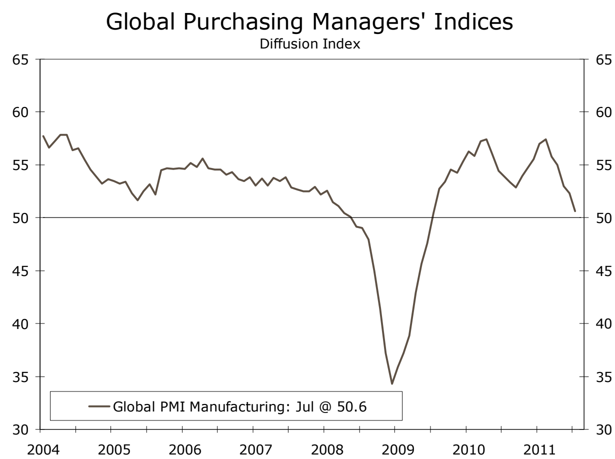
- Employment posted a better-than-consensus gain of 117,000 in July with net upward revisions to previous months' data. While the report is promising, we are not out of the woods yet. The government sector continues to shed jobs and the decline in the unemployment rate was largely due to a drop in the labor force participation rate.
- While the equity market sell-off is disconcerting, stocks have a history of sending false signals. In fact, the frequently used "bear market" indicator of a 20 percent drop in stock prices has occurred in as many expansions as recessions. The employment report could quell fears.



Global Review

Manufacturing Slows; European Debt Crisis Spreads

- Manufacturing activity slowed noticeably across the globe in July. In addition to the drop in the U.S. ISM Manufacturing Index, indices also dropped in most of the world's major economies and were in contractionary territory in some of them. While the Japan effects will soon fade, austerity measures, China's monetary tightening and still-high input costs remain headwinds.
- Markets sold off hard on Thursday amid growing concerns about the need for a bailout for Italy, the Eurozone's third-largest economy. Meanwhile, the widening debt crisis has now spread to Cyprus.



Wells Fargo U.S. Economic Forecast

	Actual 2010 1Q	2010 2Q	2010 3Q	2010 4Q	2011 1Q	2011 2Q	Forecast 2011 3Q	2011 4Q	Actual 2008	2009	2010	Forecast 2011	2012
Real Gross Domestic Product [1]	3.9	3.8	2.5	2.3	0.4	1.3	2.3	2.0	-0.4	-3.6	3.0	1.7	1.9
Personal Consumption	2.7	2.9	2.6	3.6	2.1	0.1	1.6	2.0	-0.7	-2.0	2.0	2.0	1.6
Inflation Indicators [2]													
"Core" PCE Deflator	1.7	1.5	1.3	1.0	1.1	1.3	1.5	1.8	2.3	1.5	1.4	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	4.5	3.7	-3.3	-11.1	5.3	4.0	3.6
Corporate Profits Before Taxes [2]	46.7	41.5	27.4	18.2	8.8	6.2	6.0	6.2	-16.4	7.9	32.2	6.8	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	9.1	9.0	5.8	9.3	9.6	9.0	8.8
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	4.30	4.50	6.04	5.04	4.69	4.54	4.95
10 Year Note	3.84	2.97	2.53	3.30	3.47	3.18	2.70	2.90	3.66	3.26	3.22	3.06	3.43

Forecast as of: August 5, 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

Together we'll go far

U.S. Review

Better-Than-Expected Jobs Report Cages the Bears

The spate of weak economic data released in the past two weeks and the drop in the stock market that harkens back to 2008 has reignited fears about a double-dip recession. Even with the passing of the Budget Control Act of 2011 and Moody's dialing back the threat of a U.S. debt downgrade, equity markets have sold off more than 11.0 percent in the past two weeks and 10-Year Treasury yields have slipped 50 bps. While the equity market sell-off was disconcerting, the fate of an economic downturn does not rest solely on the shoulders of the stock market. The equity market has a history of sending false signals. In fact, the frequently used "bear market" indicator of a 20 percent drop in stock prices has occurred in as many expansions as recessions. Moreover, the statistic has heralded recessions less than 25 percent of the time. We believe that part of the anxiety in the stock market was due to uncertainty around the impending employment report.

What About Weak Economic Data?

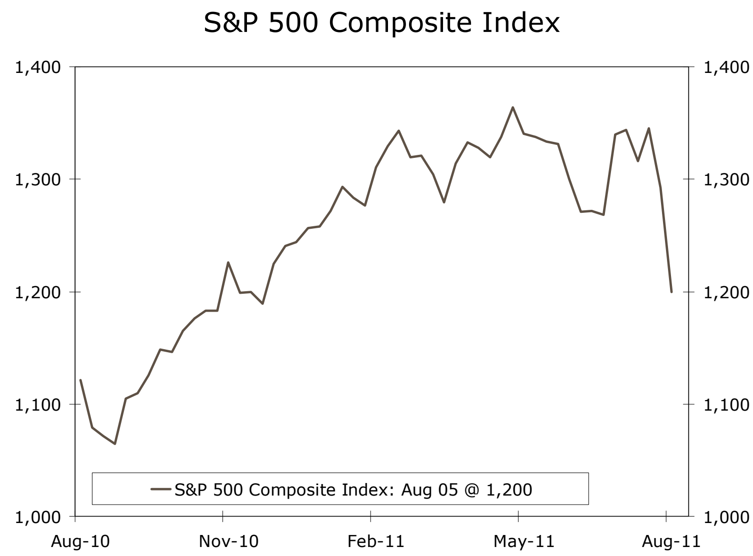
Well, the jobs report is the "mother" of all economic indicators and with employment posting a better-than-consensus gain of 117,000 in July and net upward revisions of 56,000 to previous months' data, financial market anxiety should be quelled. Moreover, average hourly earnings increased 0.4 percent in July, manufacturing and construction added a cumulative of 32,000 jobs and private payrolls rose 154,000, but we are not out of the woods yet. The government sector shed 37,000 jobs and the drop in the unemployment rate to 9.1 percent in July was largely due to a decline in the labor force participation rate. The labor force participation rate now sits at 63.9 percent. Consequently, while the nonfarm payroll report was promising, the labor market still shows signs of weakness.

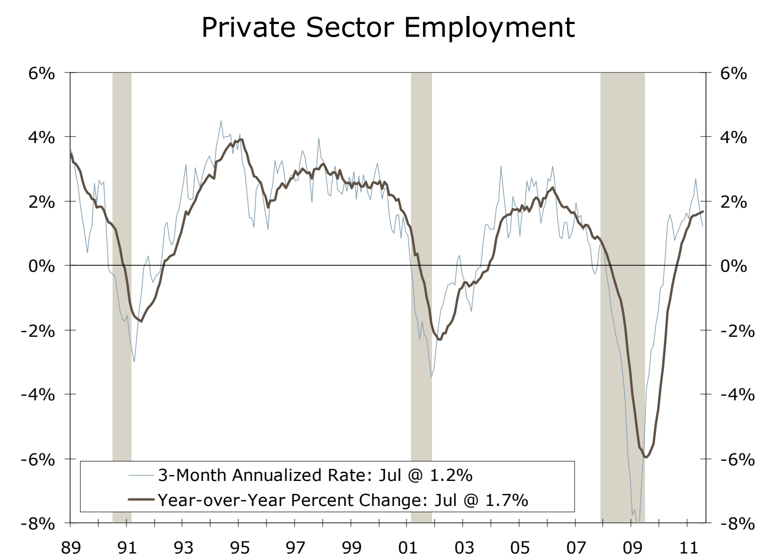
What Does the ISM Manufacturing Survey Tell Us?

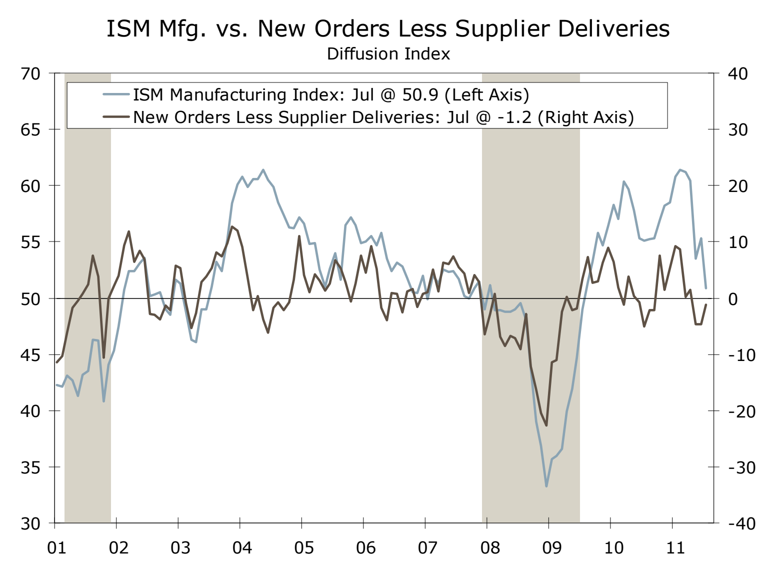
The ISM manufacturing index came in at a paltry 50.9 in July, which is barely in expansionary territory. Moreover, the forward-looking new orders component fell below the breakeven threshold of 50 and is now in contractionary territory. While new orders can be a leading indicator, one month does not a make a trend. Moreover, we find supplier deliveries to have more predicative power in foretelling a downturn. While supplier deliveries fell to 50.4 in July, the component is still above the threshold. One point that may cause pause, is the difference between new orders and supplier deliveries, which gives an indication of cancellations. The measure has dipped in two of the past three months. That said, the statistic has a mixed record in forecasting recessions. Nevertheless, the pace of the decline is moderating and we expect the headline index to improve in the coming months.

So Are We in a Recession?

We don't think so, at least in the near term. Our proxy for economic growth which considers productivity growth, is consistent with real GDP increasing at a 2.5 percent annual pace in the third quarter. While there are clear downside risks, we still do not see a double-dip recession.





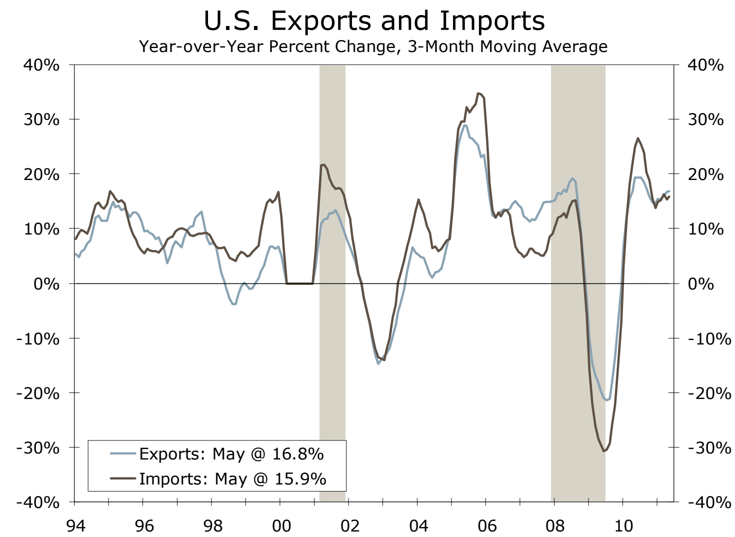


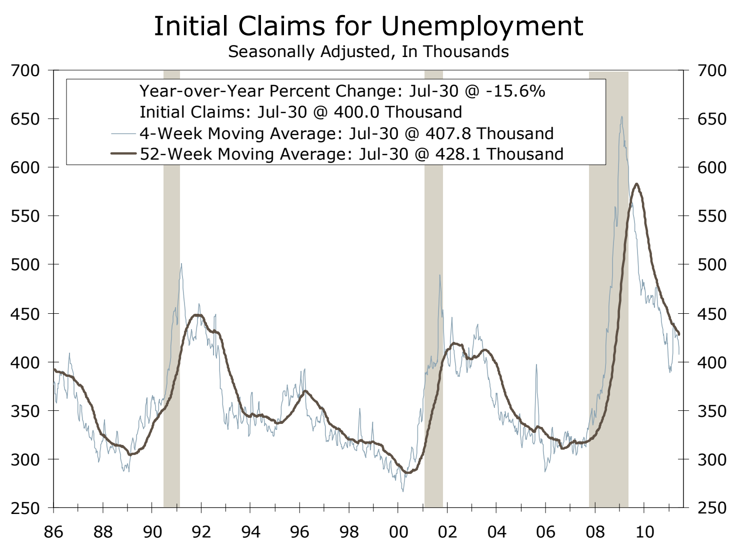
Trade Balance • Thursday

The trade balance widened sharply in May as oil imports jumped and exports fell on weak demand for industrial supplies. Both exports and imports of autos rebounded in May following weakness from the Japanese supply chain disruptions that occurred earlier in the year. Regional port data pointed toward a slowdown in trade activity for the month of June. With the apparent pullback in global demand, we expect that the U.S. trade balance narrowed for the month to -$48.0 billion. The pullback in global demand will also continue to put a drag on exports. Thus, we expect net exports to detract 0.3 percent from third quarter GDP. Our outlook for 2012 anticipates that imports will begin to pick up in the later half of 2012 as consumer spending gradually returns. The bump in imports should lead to a further widening of the trade deficit and would result in detraction from headline GDP growth in the second half of next year.

Previous: -$50.2B **Wells Fargo: -$48.0B**

Consensus: -$47.6B





Initial Jobless Claims • Thursday

Initial jobless claims have remained stubbornly high. This week claims fell to 400,000 from the previous week's level of 401,000. The four-week moving average, a better indication of the overall trend, remains above 400,000 which continues to signal that sluggish job gains will likely continue. We still expect somewhat stronger job gains later in the second half of the year. As such, initial jobless claims should begin to fall at a much faster pace later this fall. Our employment outlook calls for an average of 119,000 jobs per month in the third quarter and a slight improvement in the fourth quarter to an average of 135,000 jobs. The slow pace of job growth will result in a continually elevated unemployment rate that will remain around 9.0 percent through the end of the year. With a persistently high unemployment rate, the consumer sector will not be in a position to contribute significantly to third quarter growth.

Previous: 400,000

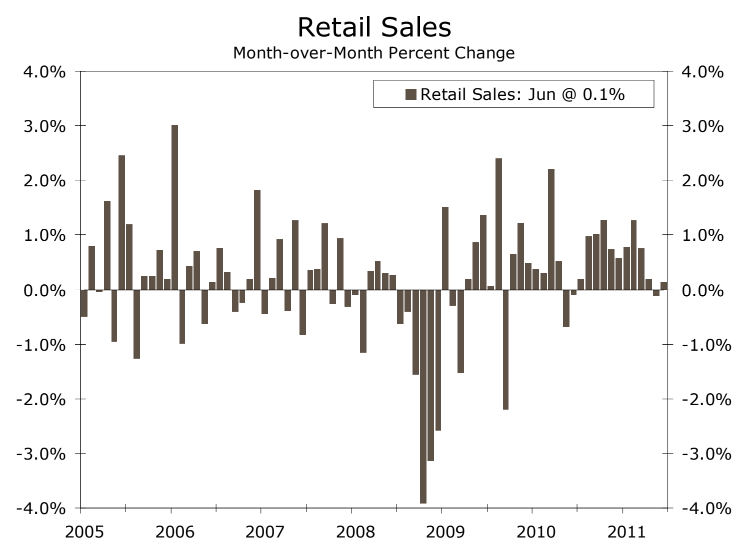
Consensus: 401,000

Retail Sales • Friday

Retail sales rose slightly in June as stronger sales at auto dealers were offset by reduced spending at gasoline stations. June also saw a large amount of discounting on the part of department stores that also supported sales. We expect that retail sales pulled back in July as consumers faced more uncertainty over the job market and consumer price pressures began to ease. We are forecasting a 0.1 percent decline in retail sales for the month. Retail sales are likely to remain weak in the third quarter. Given the back to school season, department stores will continue their discounting campaigns in order to drive traffic into their stores. Even with the discounting, the National Retail Federation expects spending to be lower this year over last year. Another factor that may prove to be a drag on third quarter retail sales could be the slower pace of auto sales. The reduction in dealer incentives this fall may hold back automobile sales volumes at least initially.

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

Consensus: 0.5% (Month-over-Month)



Global Review

Manufacturing Slows Across the Globe

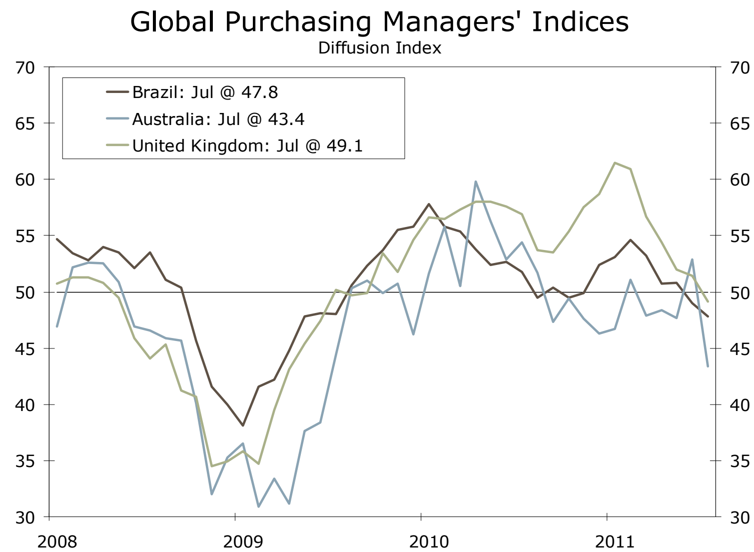
Manufacturing activity slowed noticeably across the globe in July. In addition to the big decline in the U.S. ISM Manufacturing Index from 55.3 in June to 50.9 in July, manufacturing indices also dropped in Europe, Brazil, Russia, India, China, Australia and Mexico. The industry was in contractionary territory in Brazil, Russia, Australia and the United Kingdom, while barely hovering above the break-even point in the United States and China. The supply disruptions emanating from the Japan disasters were still certainly a factor. In addition, the ongoing European debt crisis and related austerity measures, the U.S. debt ceiling negotiations, monetary tightening in China and high commodity prices have been weighing on the manufacturing industry recently.

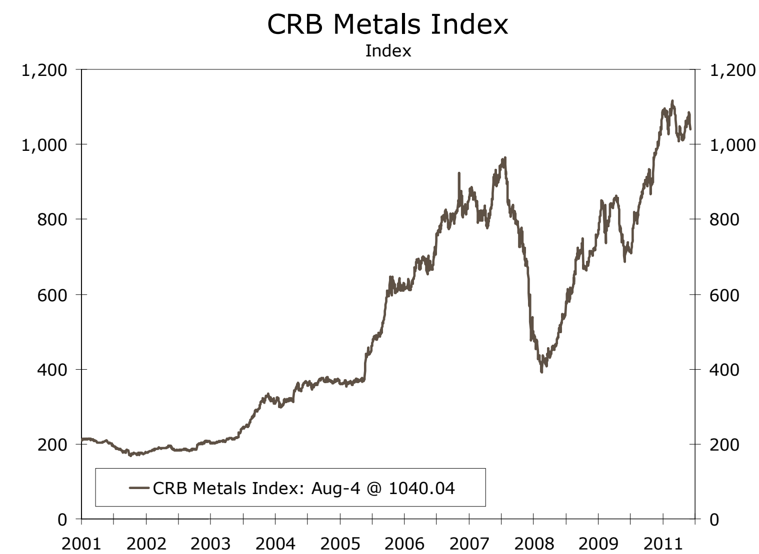
We expect the Japan disruptions to eventually fade, giving support to production of vehicles and electronics in the third quarter. The debt ceiling agreement in the United States should also help to remove some uncertainty, at least regarding default. On the other hand, manufacturing will continue to battle austerity measures sweeping the developed world, as well as China's efforts to engineer a soft landing. Input costs will also remain a concern. Although prices for commodities and metals have fallen back in recent days amid concerns about a global slowdown, they are still much higher than a year ago and many producers have locked in these high prices with futures contracts. Corn prices are significantly higher than a year ago, which will keep upward pressure on input costs for food manufacturers. At least wheat prices have dropped back to year-ago levels though. All in all, with demand softening and many input costs still high, manufacturing profits and job growth will be under pressure in the near term. That does not bode well for global growth, as manufacturing has been a pillar of strength in the global recovery.

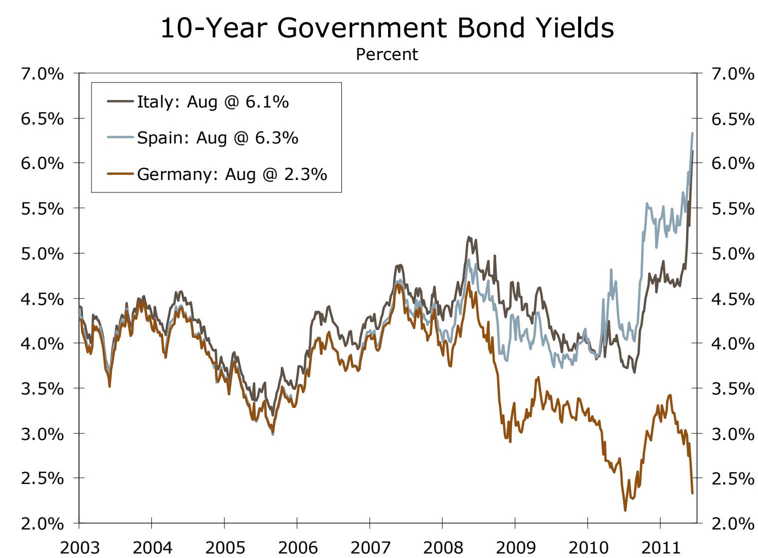
European Debt Crisis Spreading Like Wildfire

Global markets plunged on Thursday as investors became increasingly worried about the prospects of Italy and Spain needing a bailout. Italy's borrowing rates reached record highs this week, even surpassing Spain's, which has long been considered a much weaker and more vulnerable economy. Opposition parties called for Prime Minister Silvio Berlusconi's resignation on his lack of economic credibility to solve the fiscal crisis. This creates more uncertainty around whether or not the country will be able to institute the needed reforms to tackle its bloated 120 percent debt-to-GDP ratio. Pressure on Italy has spread to Belgium and France, two of the Eurozone's most stable economies.

What's more, now it appears that even the small island nation of Cyprus is being caught up in the European debt crisis. Political and economic turmoil has engulfed the country following a deadly munitions blast in July and the recent exit of the ruling coalition party from government. But these events only exacerbated concerns about the widening budget deficit. This, along with the banking system's exposure to Greece, led rating agencies to downgrade the country's credit rating recently.





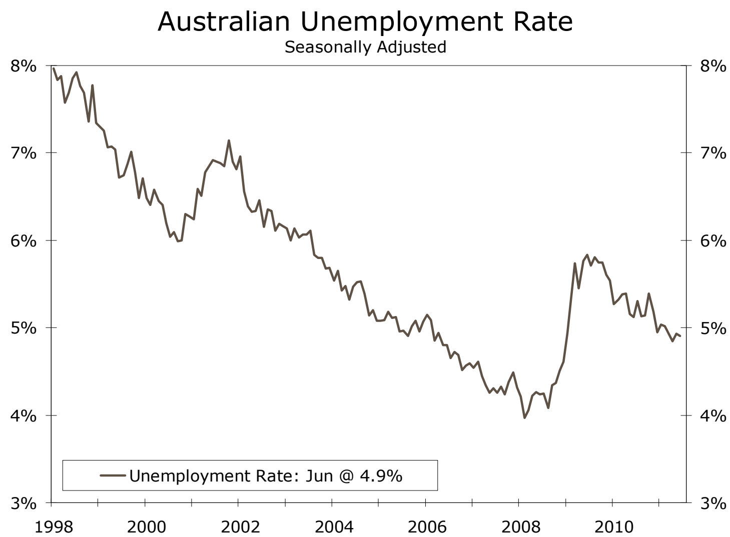


Tuesday • Chinese Industrial Production

Chinese economic growth has slowed from a double-digit percentage pace of growth in early 2010 to "just" 9.5 percent in the second quarter. Some of that slowdown reflects challenging year-over-year comparisons. Still, the tightening measures by Chinese authorities have undoubtedly contributed to the slowdown. Industrial growth figures for July are due out on Tuesday of next week and will offer an early look at how the third quarter is shaping up in China. Also due out that day are both consumer and producer price data. Inflation has become the primary economic challenge facing China at the moment. The jump in food prices earlier this year has caused the overall CPI inflation rate to rise above 6 percent. Moreover, there are some indications that price pressures are becoming more widespread. Non-food price inflation is running around 3 percent at present, the highest rate in at least a decade.

Previous: 15.1%

Consensus: 14.6% (Year-over-Year)



Thursday • Australian Unemployment Rate

Australian economic activity contracted in the first quarter as the economy there absorbed the damage from massive storms and flooding as well as a drop off in exports to Japan–Australia's largest trading partner. Despite these blows, the economy downunder remains among the strongest in the developed world.

The strength of the job market in Australia should continue to be supportive of consumer spending. Aussie employers added 23,400 workers to payrolls in July and the 4.9 percent unemployment rate there is among the lowest in the developed world. We will learn if employers continued to add to payrolls in July when the employment report prints on Thursday of next week.

Previous: 4.9%

Consensus: 4.9%

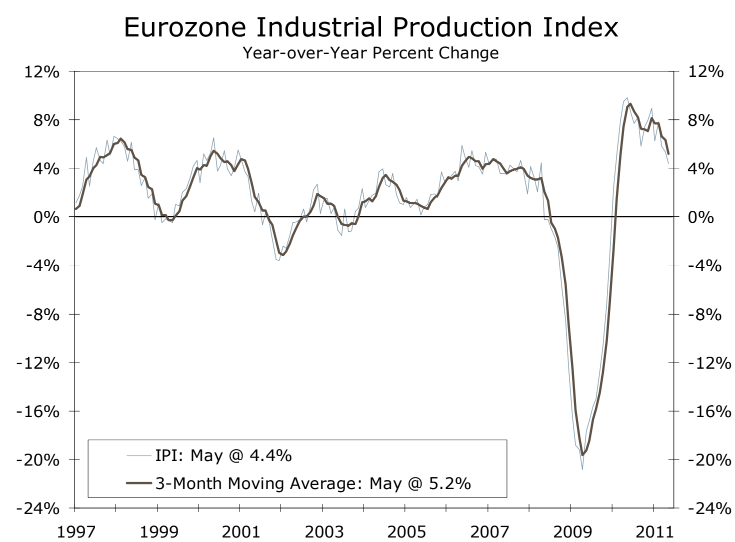
Friday • Eurozone Industrial Production

Obviously the primary concern in the Eurozone at the moment is the spread of the sovereign debt crisis. While credit markets may move as much on sentiment as momentum these days, economic fundamentals still matter. That is why attention will focus on Friday's industrial production report in the Eurozone.

The annual rate of output growth has slowed in recent months as year-ago comparisons have gotten a bit tougher. That said, manufacturing sentiment appears to be deteriorating somewhat as well. The Eurozone manufacturing PMI slipped to 50.4 in July. While this is still technically in expansion territory, it portends a significantly slower pace of growth compared to the readings in the high 50s just a few months ago.

Previous: 4.5%

Consensus: 4.2% (Year-over-Year)



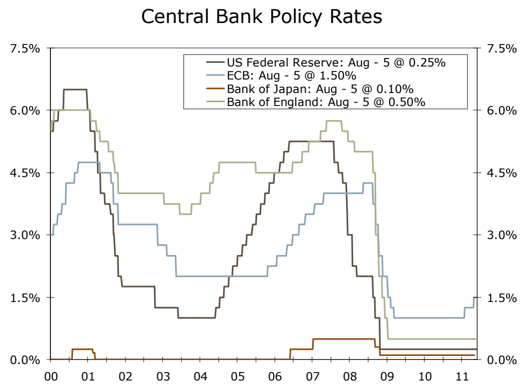
Interest Rate Watch

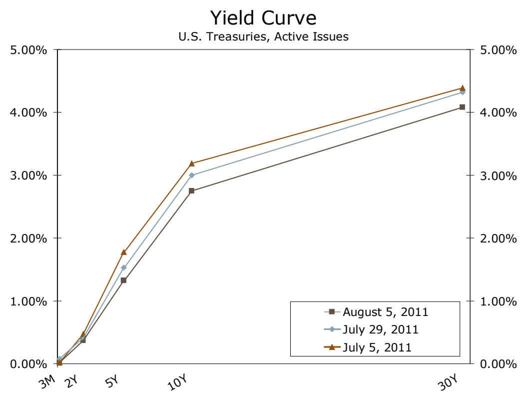
Is the Fed Set to Twist and Shout?

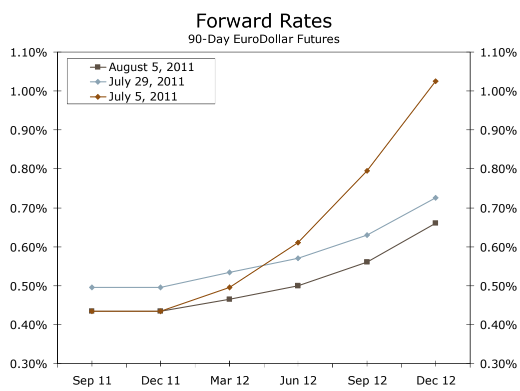
There has been quite a bit of hyperbole over the past few days, and some prominent forecasters are placing the probability that the U.S. economy will soon slide into recession at better than 50 percent. Friday's better-than-expected employment report has alleviated some of these fears. The rise in nonfarm payrolls, upward revision to the June data, a drop in the unemployment rate and a rise in hours worked is consistent with modest economic gains in the third quarter. The report still shows the economy losing momentum, however, and did not change our call of the odds of a recession at one in three.

Assigning probabilities of a recession should involve the use of a consistent econometric model. We use a probit model that assigns the probability of a recession based on hard economic data, including employment conditions, manufacturing activity, stock prices and other leading economic indicators. Although, our model still rates the odds of a recession as relatively low, it does show them rising. We believe some of the higher probabilities of recession either reflect our forecaster gut instincts or models that give too much weight to the stock market. The stock market has easily predicted twice as many recessions as we have actually had in the past 50 years.

Given the changes in our model, the Fed's model also likely shows the risks of recession rising and it is now likely actively searching for an appropriate policy response. Another round of quantitative easing may be back on the table but we believe the bar for such a move remains quite high. A more likely course of action would be for the Fed to lengthen the duration of its portfolio by replacing short-term securities with longer-term securities. Such a move would help push long-term interest rates lower, while raising short-term rates modestly. This would be similar to Operation Twist, which the Fed did in the early 1960s and would help reduce mortgage rates, reinvigorate mortgage refinancing, and perhaps even help boost home sales, without further expanding the Fed's balance sheet.







Credit Market Insights

Tide Turning for Corporate Bonds?

The high-grade corporate bond market has recently seen an influx of investors looking for highly rated bonds. One possible explanation for this trend is a reallocation from U.S. Treasuries into the corporate bond market given the uncertainty over the past few weeks over the debt ceiling debate. The strong corporate profit growth in the first half of the year, driven mostly from international demand, has also made the high-grade bonds of globally diverse firms attractive to investors. However, international demand is showing some signs of cooling, calling into question whether or not the current trend will continue. With a deal to raise the debt ceiling in place and the pace of growth in the U.S. economy appearing to downshift, some have begun to wonder if there may be some pullback in corporate bond investments. Given the absence of investments that offer the same level of security likely means that bond yields could continue to fall. In fact, the average yield on the investment grade bonds is now nearing record low levels. The lower yields continue to support low rates of borrowing on the part of corporations. Although the low yields at this point do not appear to be a strong incentive to seek additional leverage. Firms continue to maintain a large amount of cash on their balance sheets and do not see an immediate need for new issuance. The light issuance will also supporting low yields due to the relative scarcity of high-grade bonds.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.39%	4.55%	4.60%	5.08%
15-Yr Fixed	3.54%	3.66%	3.75%	4.39%
5/1 ARM	3.18%	3.25%	3.30%	4.10%
1-Yr ARM	3.02%	2.95%	3.01%	4.05%
MBA Applications				
Composite	565.3	528.0	507.0	730.2
Purchase	185.8	176.7	188.9	174.9
Refinance	2,780.5	2,578.8	2,363.6	3,969.0

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

Topic of the Week

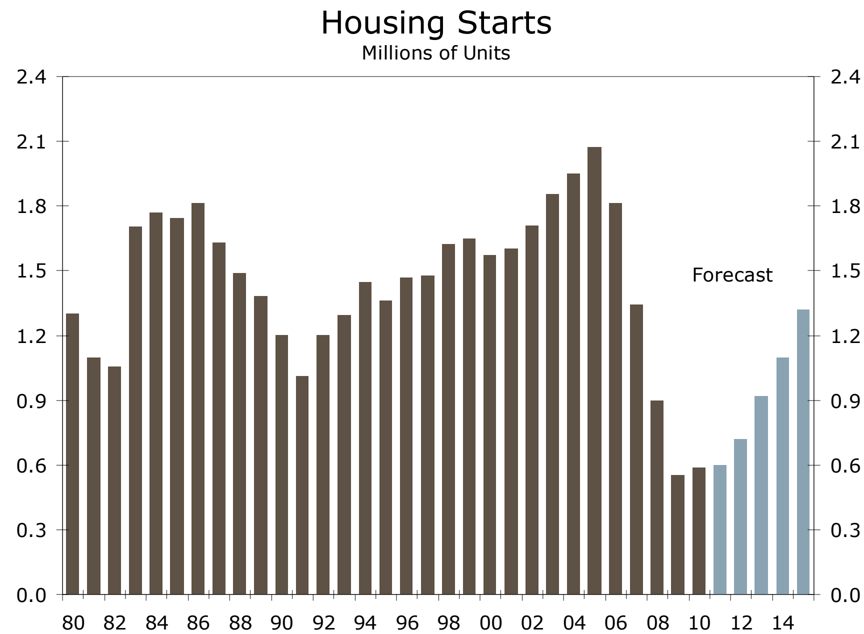
Housing: A Bottom, but No Recovery Just Yet

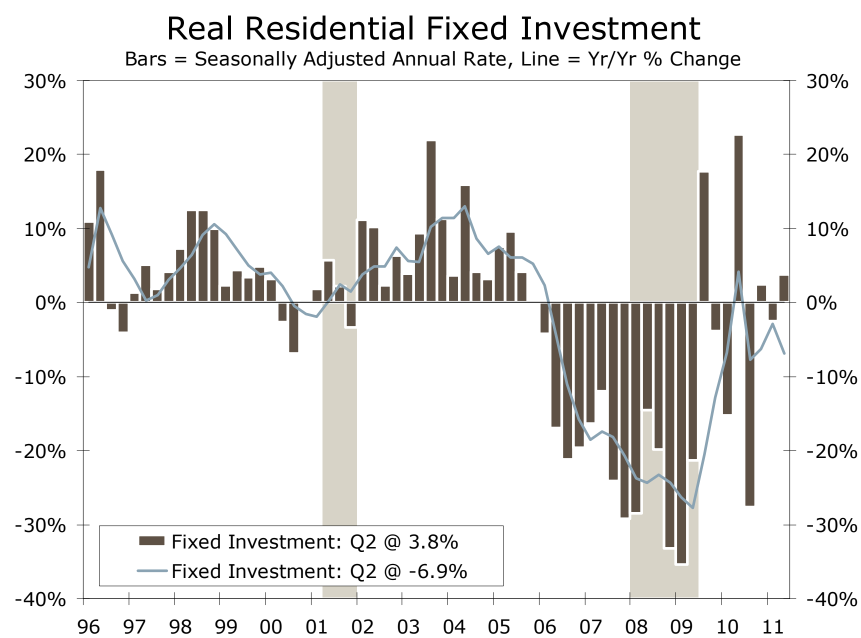
We are seeing more and more signs suggesting that home sales and new home construction have effectively found a bottom. Sales and new home construction have fluctuated a great deal during the past two years, soaring with the two tax-credit programs and then crashing afterward. The past nine months have largely been clear of these distortions, and sales of existing homes have averaged a 4.3 million-unit pace during the period, while sales of new homes have hovered around a 300,000-unit pace. Housing starts accelerated to a 629,000-unit pace in June and building permits rose 2.5 percent on the month. Residential construction spending grew at a solid 3.8 percent annual rate during the second quarter and, with building permits up solidly, appears poised for modest gains in the current period.

On the negative side, foreclosure inventories continue to grow, and the inventory of homes likely to enter the foreclosure process in the next few years remains large. Foreclosure and bank sales continued to drag on overall home indices, but excluding distressed transactions prices are down just 0.4 percent. Though we expect prices to continue to fall over the next year, there is evidence of firming and we expect home prices to begin rising again in the 2012 homebuying season.

Disappointingly, homeownership rates continue to fall due to tighter lending standards and the increase in foreclosure activity. However, housing affordability has reached record levels, especially in many long-term depressed markets, which has brought international homebuyers back into the fray. Many coastal areas such as Florida and California have seen a strong pickup in international and cash transactions from investors ready to take advantage of rock bottom prices.

Housing is approaching a bottom, but a true recovery may still be months away. For a more in-depth analysis of current housing trends please see our recent report "*Housing Chartbook: July 2011: A Bottom, but No Recovery Just Yet.*"





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/5/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.01	0.09	0.14
3-Month LIBOR	0.27	0.26	0.42
1-Year Treasury	0.13	0.20	0.29
2-Year Treasury	0.29	0.36	0.53
5-Year Treasury	1.19	1.36	1.57
10-Year Treasury	2.48	2.80	2.90
30-Year Treasury	3.75	4.12	4.05
Bond Buyer Index	4.19	4.47	4.16

Foreign Exchange Rates

	Friday 8/5/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.418	1.440	1.319
British Pound ($/£)	1.638	1.643	1.590
British Pound (£/€)	0.866	0.876	0.830
Japanese Yen (¥/$)	78.490	76.760	85.820
Canadian Dollar (C$/$)	0.984	0.955	1.017
Swiss Franc (CHF/$)	0.763	0.786	1.046
Australian Dollar (US$/A$)	1.041	1.099	0.916
Mexican Peso (MXN/$)	12.000	11.735	12.564
Chinese Yuan (CNY/$)	6.441	6.437	6.771
Indian Rupee (INR/$)	44.740	44.188	46.185
Brazilian Real (BRL/$)	1.593	1.549	1.752
U.S. Dollar Index	74.918	73.897	80.825

Source: Bloomberg LP and Wells Fargo Securities, LLC

Foreign Interest Rates

	Friday 8/5/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.52	1.56	0.83
3-Month Sterling LIBOR	0.83	0.83	0.74
3-Month Canadian LIBOR	1.14	1.18	1.01
3-Month Yen LIBOR	0.20	0.20	0.24
2-Year German	0.81	1.16	0.75
2-Year U.K.	0.57	0.63	0.79
2-Year Canadian	1.02	1.48	1.53
2-Year Japanese	0.14	0.16	0.15
10-Year German	2.36	2.54	2.56
10-Year U.K.	2.71	2.86	3.24
10-Year Canadian	2.56	2.88	3.11
10-Year Japanese	1.01	1.08	1.04

Commodity Prices

	Friday 8/5/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	85.41	95.70	82.01
Gold ($/Ounce)	1660.63	1627.88	1194.95
Hot-Rolled Steel ($/S.Ton)	673.00	680.00	560.00
Copper (¢/Pound)	417.05	447.40	335.05
Soybeans ($/Bushel)	13.32	13.70	10.38
Natural Gas ($/MMBTU)	3.95	4.15	4.60
Nickel ($/Metric Ton)	23,614	24,512	21,885
CRB Spot Inds.	586.81	596.57	492.21

Next Week's Economic Calendar

	Monday 8	Tuesday 9	Wednesday 10	Thursday 11	Friday 12
U.S. Data		**Nonfarm Productivity** Q1 1.8% Q2 0.3% (W) **Unit Labor Costs** Q1 0.7% Q2 1.5% (W) **FOMC Rate Decision** Previous 0.25% Expected 0.25% (W)		**Trade Balance** May -$50.2B June -$48.0B (W)	**Retail Sales** June 0.1% July 0.1% (W) **Retail Sales Ex Autos** June 0.0% July -0.2% (W) **Business Inventories** May 1.0% June 0.7% (W)
Global Data	**China** **IP (YoY)** Previous (Jun) 15.1%	**U.K.** **IP (YoY)** Previous (May) -0.8% **Japan** **Machine Tool Orders** Previous (Jun) 53.5%	**Mexico** **Gross Fixed Investment** Previous (Apr) 7.1% **Australia** **Unemployment Rate** Previous (Jun) 4.9%	**Canada** **Merchandise Trade** Previous (May) -0.8B **Brazil** **Retails Sales (MoM)** Previous (May) 0.6%	**Eurozone** **IP (YoY)** Previous (May) 4.5%

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

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