August 12, 2011

Economics Group

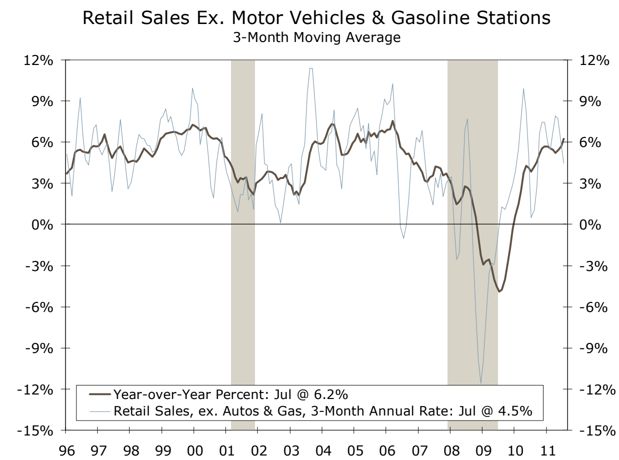
WELLS FARGO SECURITIES

Weekly Economic & Financial Commentary

U.S. Review

Despite Volatile Markets, Recession Risks Are Fading

- In what was one of the most volatile weeks on Wall Street since traders and speculators first gathered under the old buttonwood tree, economic data actually showed improvements in the economy that diminish the odds of recession.
- Despite a widening in the trade deficit that will weigh on Q2 growth, economic indicators were upbeat. Initial jobless claims finally broke through the key 400,00 level—a good sign for jobs. Retail sales figures for July showed the largest monthly jump in consumer spending since March.



Global Review

Chinese Growth Generally Remains Solid

- With the global economy needing every bit of growth it can muster, recent economic news out of China, which generally show that growth remains solid, is mildly encouraging. In that regard, industrial production grew 14 percent on a year-ago basis in July.
- China obviously is not immune to a slowdown in the United States and the Eurozone. However, the Chinese government has the policy flexibility to help the economy cope with any near-term slowdown that emerges from the recent bout of financial market volatility.

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]	3.9	3.8	2.5	2.3	0.4	1.3	2.2	1.9	-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	1.9	-0.7	-2.0	2.0	2.0	1.5
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	2.4
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	6.9	6.5	6.7	-16.4	7.9	32.2	7.2	7.1
Trade Weighted Dollar Index[3]	76.1	78.8	73.6	73.2	70.6	69.4	69.0	70.0	74.3	77.7	75.6	69.7	72.8
Unemployment Rate	9.7	9.6	9.6	9.6	8.9	9.1	9.1	9.1	5.8	9.3	9.6	9.1	9.0
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	0.75
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	4.10	6.04	5.04	4.69	4.44	4.78
10 Year Note	3.84	2.97	2.53	3.30	3.47	3.18	2.40	2.60	3.66	3.26	3.22	2.91	3.20

Forecast as of: August 10, 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

Despite Volatile Markets, Recession Risks Are Fading

To say it has been a volatile week is an understatement. We analyzed data for the Dow Jones Industrial Average to get a better sense of just how volatile this week was. We added together the absolute value of daily point swings in the Dow for each week going back to WWII. This captures the daily back and forth of up and down days to provide a measure of total market movement in a given week. Through Thursday, this is the second most volatile week in that period. A move of more than 267 points on Friday would put this week at the top of the list.

So you can not blame people who feel some degree of apprehension about the financial markets these days. So what is driving all the volatility? Is it the loss of a AAA rating for U.S. Treasuries? That is a commonly used explanation, but we would point out that the Dow and the S&P 500 had already come down more than 10 percent in the two weeks that preceded the downgrade. If anything, the recent rally in Treasuries signals that the flight-to-quality trade still means buying bonds backed by the full faith and credit of the U.S. government.

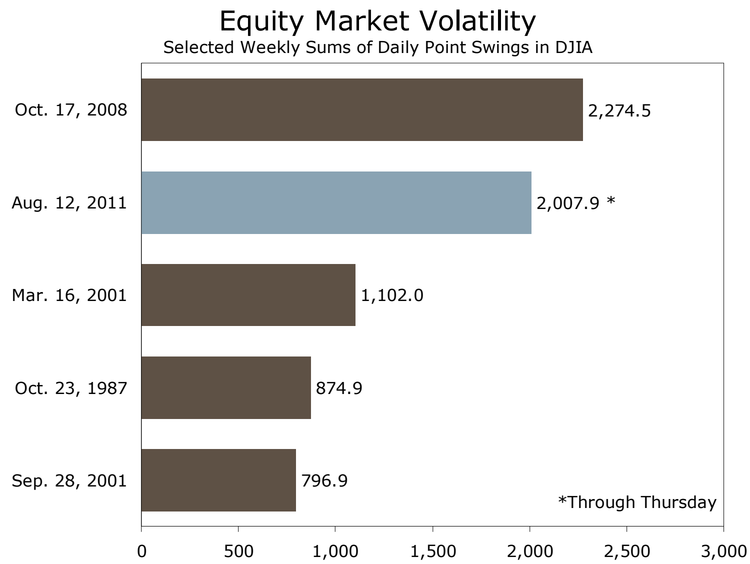
In our view, the volatility in markets is a realization that the days of 3.0 to 3.5 percent economic growth are in the rear view mirror, and the road ahead seems to be one of very slow growth for the United States. In addition, growth forecasts for many foreign economies are being revised lower as other nations sort out their sovereign debt problems as well.

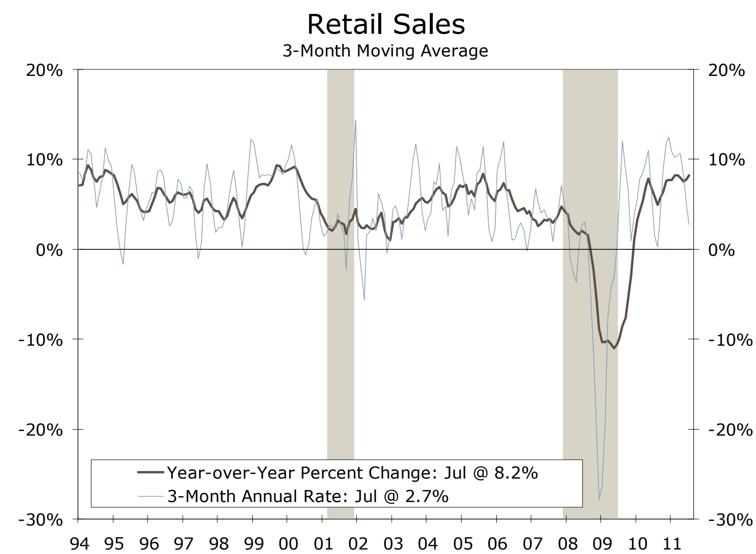
Equity markets tend to rise and fall with expectations for economic growth. While the market expectations have been dialed back, our forecast for very slow growth is roughly the same as it has been all year.

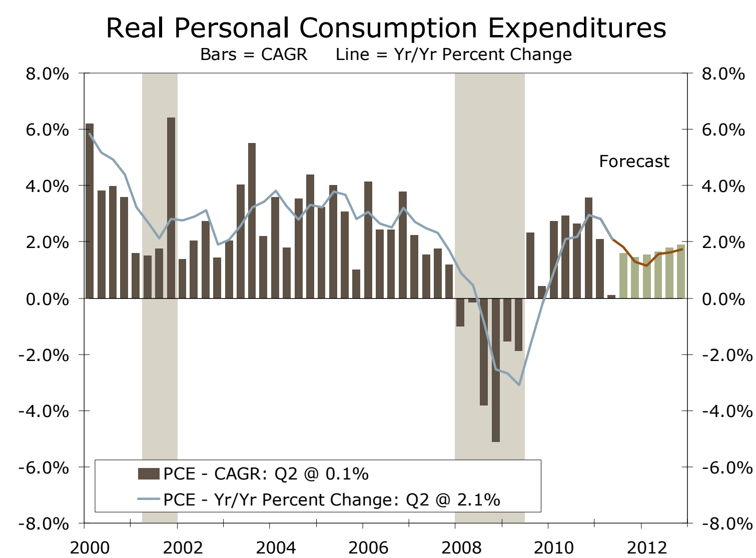
That view was bolstered this week by some welcome developments for the economy and for nerve-rattled equity markets. The number of people filing claims for unemployment insurance finally broke through the key 400,000 level. This level is important because historically jobless claims below that level allow the economy to add jobs at a fast enough rate to bring down the unemployment rate.

The second encouraging development was the July retail sales report. The headline number was right in line with consensus expectations, but June sales figures were revised higher. This suggests a better finish to the second quarter and more resilience on the part of U.S. consumers than most analysts would have expected given high unemployment and dismally low consumer confidence. Because gas prices can swing so much from month to month, and because building material sales can be influenced so dramatically by trends in the housing market, we like to look at what we call “core” retail sales, which excludes autos, as well as gas and building materials. This measure also increased in July and offers an encouraging sign that consumers are increasing their core spending.

Finally, a look at business inventories for June tells us that businesses are maintaining adequate inventory levels paced well with sales.





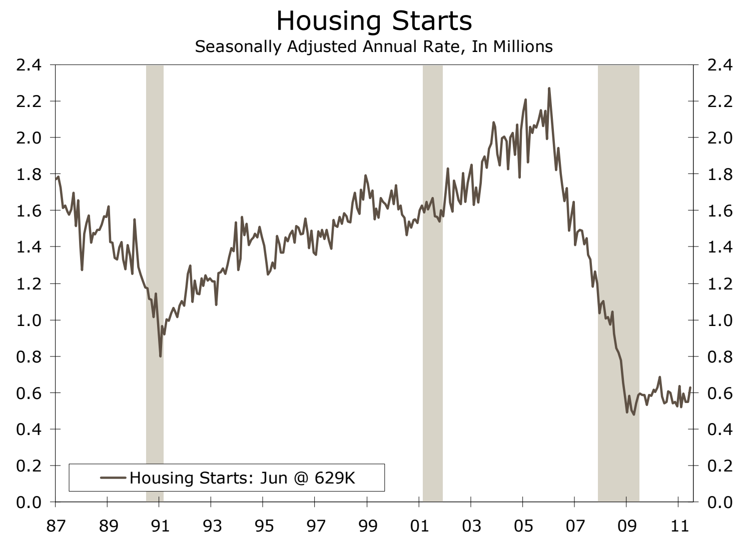


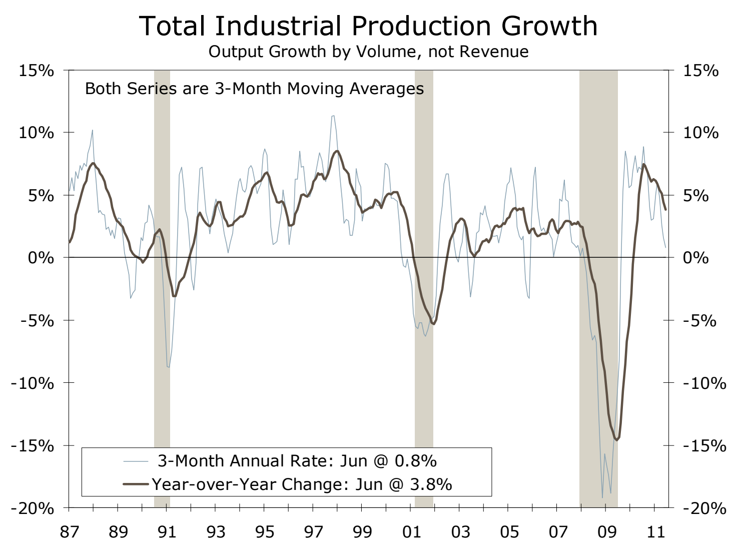
Housing Starts • Tuesday

Housing starts jumped in June by 14.6 percent led by a 30.4 percent increase in multifamily starts. Construction of single-family homes also rose, climbing 9.4 percent. The report reflected the strengthening demand in the apartment market. The trend in housing permits also pointed to some positive signs with a 2.5 percent rise led by the multi-family component. We expect housing starts pulled back a bit in July to 607,000 units. With such a large improvement in the volatile multi-family starts number in June, we expect that some payback will occur in July. Housing starts will continue to remain depressed as home prices struggle to stabilize, reducing the incentive of builders to begin new projects. Going forward, we expect that new home construction will continue to gradually improve. We expect an average of around 620,000 new housing starts through the end of this year, with the pace of construction picking up slightly in 2012.

Previous: 629K **Wells Fargo: 607K**

Consensus: 600K





Industrial Production • Tuesday

Industrial production grew at a sluggish 0.2 percent pace in June. While still in expansionary territory, there are signs that industrial output is slowing to a crawl. Capacity utilization, a measure of resource use in the industrial sector, continues to move sideways indicating a slow pace of output going forward. The July ISM-manufacturing index pointed to markedly slower manufacturing production for the month; however, the unusually hot weather in July should have supported utilities production. Thus, we expect that industrial production increased a slight 0.2 percent in July which reflects the slower pace of economic growth. Our forecast for the third quarter of this year calls for a moderate pace of industrial production with a 4.5 percent increase followed by a 3.7 percent pace in the fourth quarter. Industrial production will likely remain muted beyond 2011 as industrial output keeps pace with the slow demand in consumer spending.

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

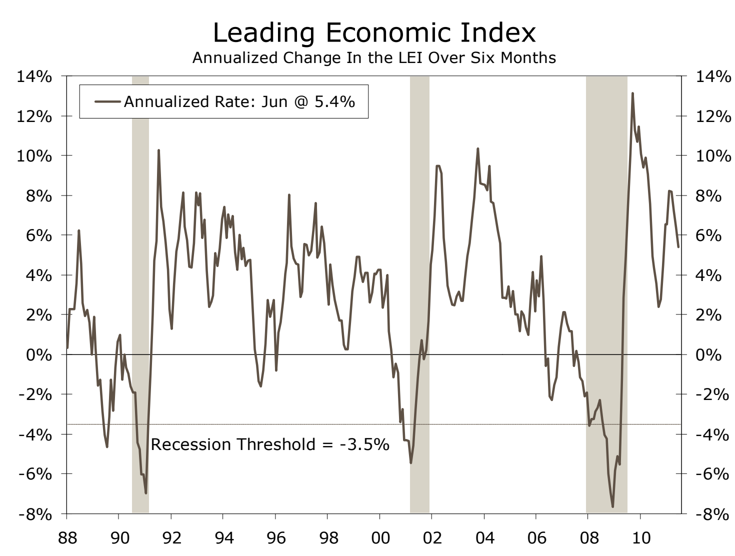
Consensus: 0.5% (Month-over-Month)

Leading Indicators • Thursday

Leading economic indicators rose 0.3 percent in June with the money supply and interest rate spread adding the most to the index. The report suggested a moderation in the pace of economic growth. We will be paying close attention to the July release of the LEI as analysts and markets continue to monitor the likelihood of the U.S. slipping back into a recession. As can be seen in the graph to the right, the LEI remains well above the historical threshold of a 3.5 percent decline in the annualized rate for the index which has typically indicated a recessionary environment. With consumer sentiment remaining weak and deliveries among suppliers falling off, these components will subtract from the July LEI reading. However, we expect that the index rose a modest 0.3 percent supported again by the yield spread and money supply components. The modest rise in the July index would be consistent with our view for a slow to moderate pace of growth through the end of the year.

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

Consensus: 0.2% (Month-over-Month)



Global Review

Chinese Growth Generally Remains Solid

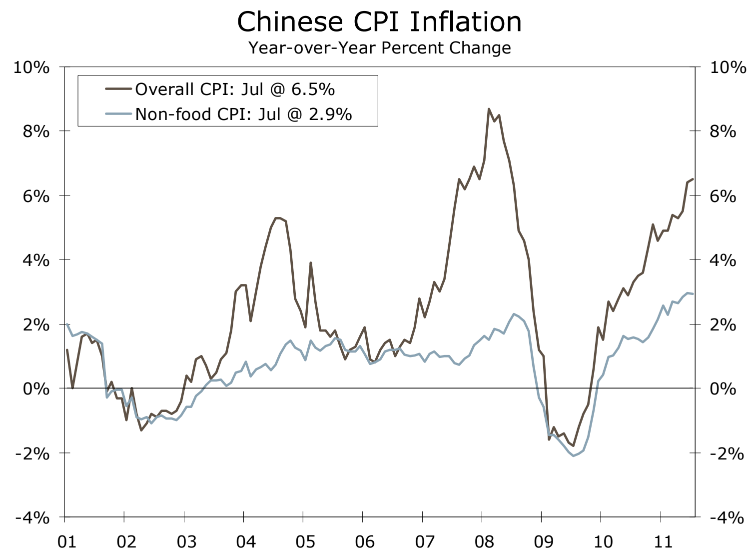
With the U.S. and Eurozone economies clearly struggling at present, the world needs every bit of growth it can muster. In that regard, recent economic news out of China has been mildly encouraging. Industrial production rose 14.0 percent on a year-ago basis in July (see graph on the front page). Indeed, the year-over-year growth rate has been holding relatively steady over the past few months. Some of the increase in Chinese industrial production may be attributed to the rest of the world as growth in the value of Chinese exports rose from about 18 percent in June to more than 20 percent in July. That said, growth in Chinese domestic demand appears to have remained solid as well. Growth in urban fixed-asset investment has been holding steady around 25 percent, and growth in retail spending has also been constant around 17 percent.

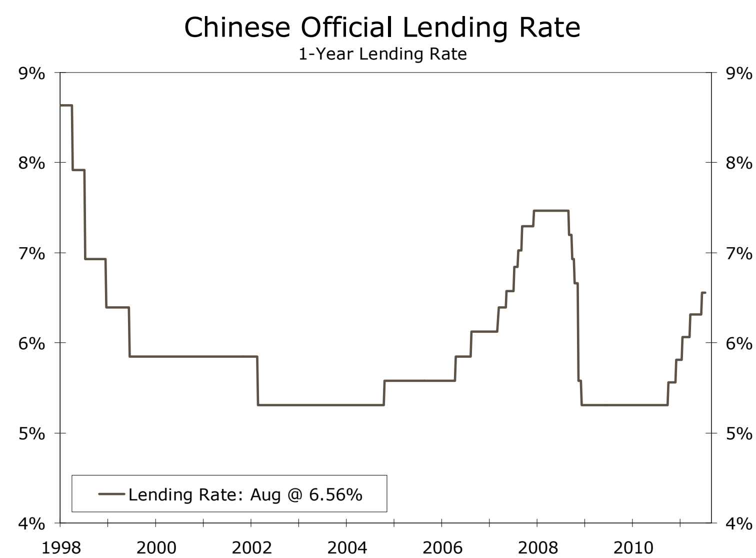
If there was a piece of data that was a bit disconcerting, it was the increase in the overall rate of CPI inflation to 6.5 percent in July, yet another post-2008 record (top chart). However, much of the increase in the overall rate of CPI inflation can be attributed to rising food prices. Excluding food, the CPI inflation rate held constant. With many food prices beginning to trend lower, it appears that the peak in the overall inflation should soon be reached, if it has not been already.

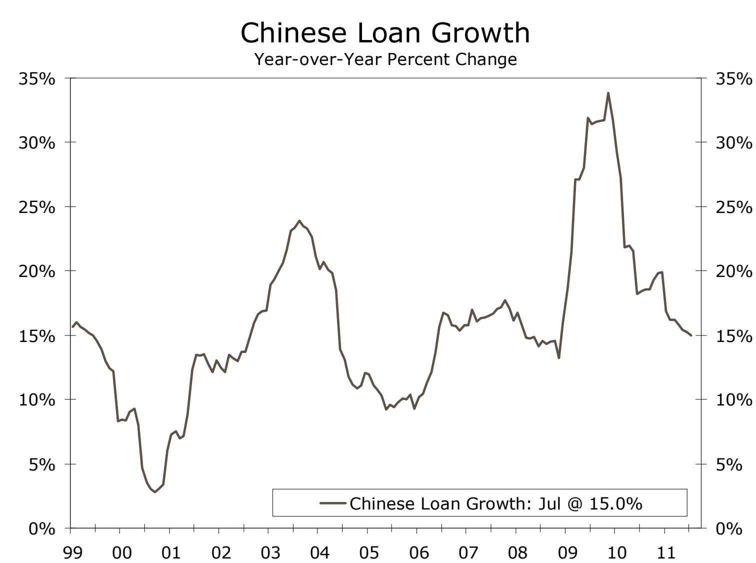
As inflation has risen, the People's Bank of China (PBoC) has tightened monetary policy. Since last October, the PBoC has raised its benchmark lending rate by 125 bps (middle chart), and it has increased the required reserve ratio by 450 bps over that period to drain out excess liquidity in the banking system. In addition, the government has issued directives to banks to rein in loan growth (bottom chart).

The Chinese economy is obviously not immune to economic and financial troubles in the rest of the world. To the extent that recent financial market volatility leads to slower economic growth in some of the world's major economies, China will eventually feel the effects via slower export growth. The United States and the Eurozone account for roughly 20 percent and 15 percent of China's exports, respectively. Therefore, the direct effects of a slowdown in those two major economies on the Chinese economy would not be negligible. Moreover, the United States and the Eurozone together account for more than 40 percent of global GDP. Significantly slower growth in those regions would cause economic activity in many other economies to decelerate as well, imparting a negative indirect effect on China.

The good news is that the Chinese government has the policy flexibility to respond to a significant slowdown, like it did in 2008-2009. The central bank could reverse course and cut interest rates and the required reserve ratio for the country's banks. In addition, the government could encourage banks to lend more and it could accelerate infrastructure spending again. Although a renewed burst of lending could come back to haunt China at some point in the future, it would help the economy cope with any near-term slowdown that emerges from the recent bout of financial market volatility.







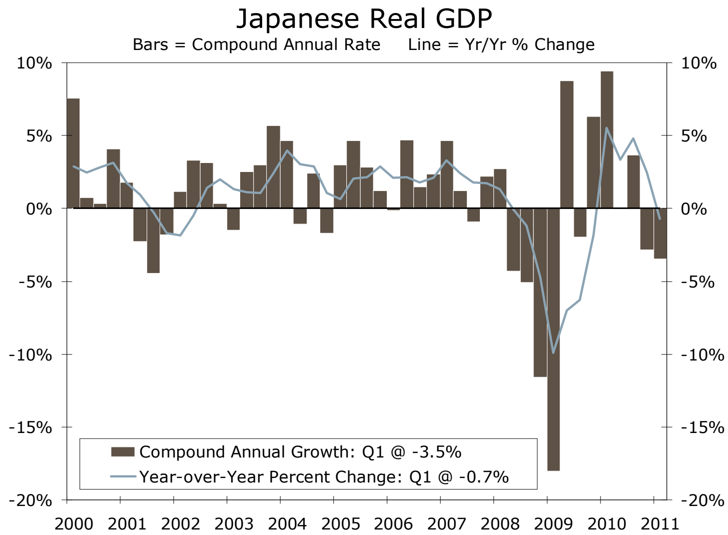
Japanese GDP • Monday

The Japanese economy has contracted for two consecutive quarters, which technically puts it back in recession and most analysts expect a third consecutive negative number when the GDP data for the second quarter print on Monday. The devastating earthquake and tsunami struck Japan on March 11, so much of the economic effect of the natural disasters was experienced in the second quarter. Indeed, monthly data show that industrial production tumbled at an annualized rate of 15.2 percent in the second quarter relative to the preceding quarter making a negative GDP print essentially a foregone conclusion.

Trade data for July, which are slated for release on Thursday, will give analysts some insights into the state of the Japanese economy at the beginning of the third quarter. Exports rebounded in May and June from the earthquake-induced drop, and another increase in July seems likely.

Previous: -3.5% **Wells Fargo: -2.1%**

Consensus: -2.5% (CAGR)



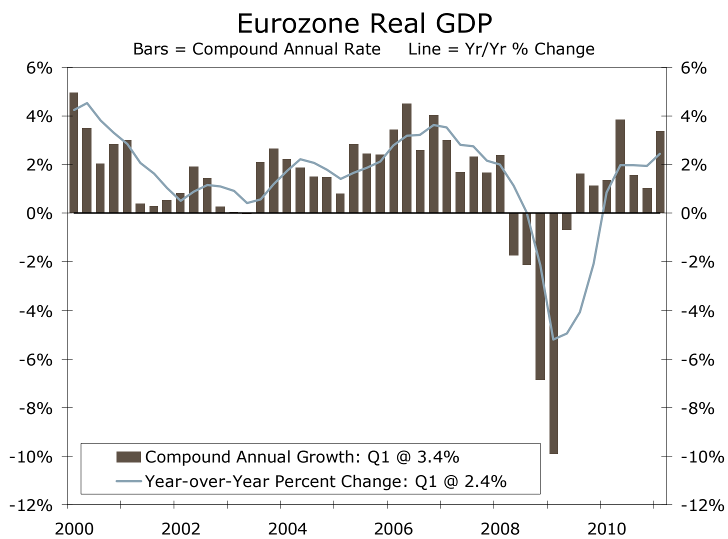
Eurozone GDP • Tuesday

Real GDP in the Eurozone rose 0.8 percent (not annualized) in the first quarter, spurred on by the 1.5 percent surge in German GDP. However, a repeat performance in the second quarter, in either Germany or in the broader Eurozone, seems highly unlikely. Indeed, monthly data indicate that real GDP grew at less than half of the first quarter's pace. A weaker-than-expected outturn could convince investors that the Eurozone economy has effectively stalled.

CPI data for July will be released on Wednesday. The "flash" estimate showed that the overall rate of CPI inflation edged down from 2.7 percent in June to 2.5 percent in July. More complete data next week will show what happened to the core rate of inflation. Although the ECB does not seem inclined to raise rates, a rise in core CPI inflation from its current 1.6 percent rate could forestall rate cuts even if the growth outlook continues to deteriorate.

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

Consensus: 0.3% (Quarter-over-Quarter)



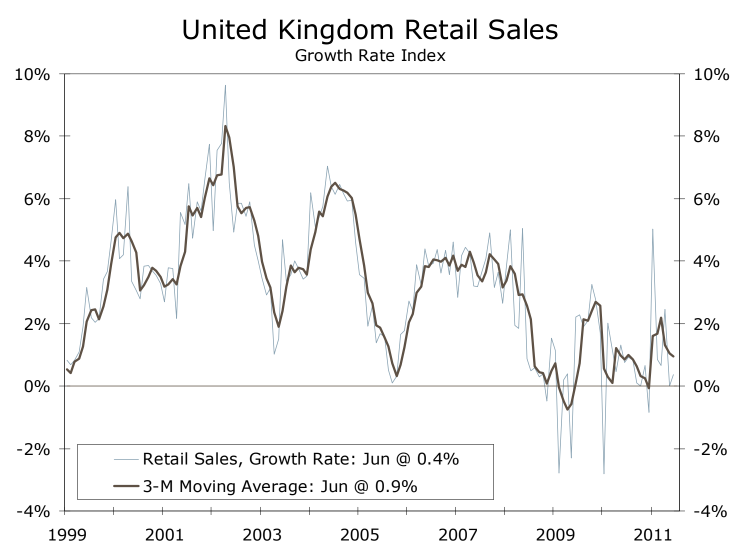
U.K. Retail Sales • Thursday

British retail sales rose 0.8 percent in June relative to the previous month, and survey data suggest that July was a halfway decent month for retailers as well. However, as measured by the year-over-year growth rate, which is essentially flat, the pace of consumer spending is generally anemic at present. Next week's release of "hard" data on retail spending in July will give analysts further insights into the current state of the British economy. Data on unemployment in July, which are slated for release on Wednesday, will show what shape the labor market is in at present.

Most of the attention at present is on the real side of the economy. However, the CPI data that print on Tuesday will also draw attention. Higher-than-expected inflation could cause the Bank of England to delay any easing moves that could help to tamp down financial market volatility.

Previous: 0.8%

Consensus: 0.4% (Month-over-Month)



Interest Rate Watch

Fed on Hold for Two Years?

The Fed's Federal Open Market Committee FOMC) surprised many investors this week when it announced that economic conditions "are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013." Until this week, the Fed had been stating that the fed funds rate would stay low "for an extended period," which most analysts had interpreted as a commitment to keep rates low over the next few FOMC meetings but probably not for two years.

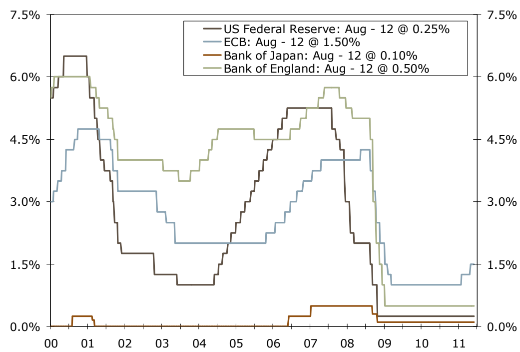
By putting an explicit date that is two years in the future in its announcement, the Fed hoped to pull down longer-term interest rates. It appears to have been successful, at least partially, in its efforts with yields in the 2-year to 7-year part of the Treasury curve 5 bps-1o bps lower than they were prior to the Fed's announcement. Of course, the efficacy of the Fed's decision on the real economy will depend on movements in private sector borrowing costs. With financial markets remaining volatile, the jury is still out on whether long-term borrowing costs for the private sector will decline as well.

Does 2013 Really Mean 2013?

So will the Fed really be on hold until mid-2013? It depends. The FOMC did leave itself some wiggle room by stating that economic conditions *likely* (emphasis ours) will warrant a low fed funds rate until 2013. If the economy strengthens significantly, which does not seem very *likely* right now, the Fed could change its mind. Moreover, the FOMC did not commit to keep the fed funds rate between zero and 0.25 percent, where it currently is. It only said that it would keep the rate *low*. Would 0.50 percent or even 1.00 percent still be considered *low*? The Fed did not say.

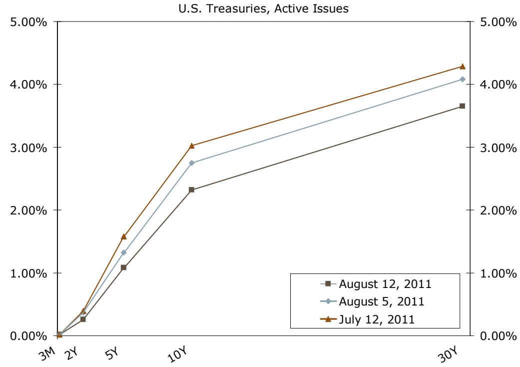
That said, if our forecast, which calls for subpar economic growth through the end of 2012, comes to pass, then we believe the FOMC will indeed keep its target for the fed funds rate between zero and 0.25 percent until at least mid-2013. With the yield on the 2-year Treasury security below 0.20 percent at present, the market seems to take the Fed at its word as well.

Central Bank Policy Rates



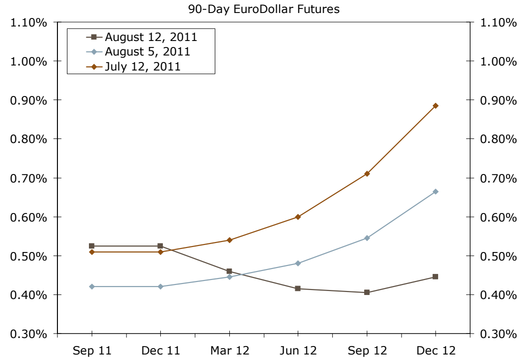
Yield Curve

U.S. Treasuries, Active Issues



Forward Rates

90-Day EuroDollar Futures



Credit Market Insights

CMBS Spreads Widen

The nascent commercial real estate recovery hit a snag as the yield spread between commercial mortgage-backed securities (CMBS) and Treasuries widened in recent weeks. The confluence of factors that have added to financial market volatility including downward revisions to economic growth, S&P downgrading the U.S. credit rating, and European sovereign debt aided in slowing improvement.

Market swings caused many investors to curb their appetite for new issue CMBS deals. While deal activity has slowed in recent weeks, we expect as economic conditions become more certain, the sector will regain its modest momentum. Consequently, our outlook for commercial real estate has not changed much. In fact, our Structured Products Research Group continues to project new issuance of $40 billion in 2011.

Demand for apartments should remain solid as homeownership has now become out of reach for much of the population. Industrial space should also hold up as inventory building increases over the next year. Improvement in the office and retail market will continue to lag, however.

We continue to expect economic growth to strengthen modestly during the second half of the year, with real GDP rising at around a 2 percent annual pace. Job growth should remain relatively sluggish, but the modest increase will be enough to sustain the recovery in this sector.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.32%	4.39%	4.51%	5.08%
15-Yr Fixed	3.50%	3.54%	3.65%	4.39%
5/1 ARM	3.13%	3.18%	3.29%	4.10%
1-Yr ARM	2.89%	3.02%	2.95%	4.05%
MBA Applications				
Composite	688.0	565.3	481.3	734.3
Purchase	184.2	185.8	183.9	175.4
Refinance	3,625.7	2,780.5	2,217.3	3,993.0

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

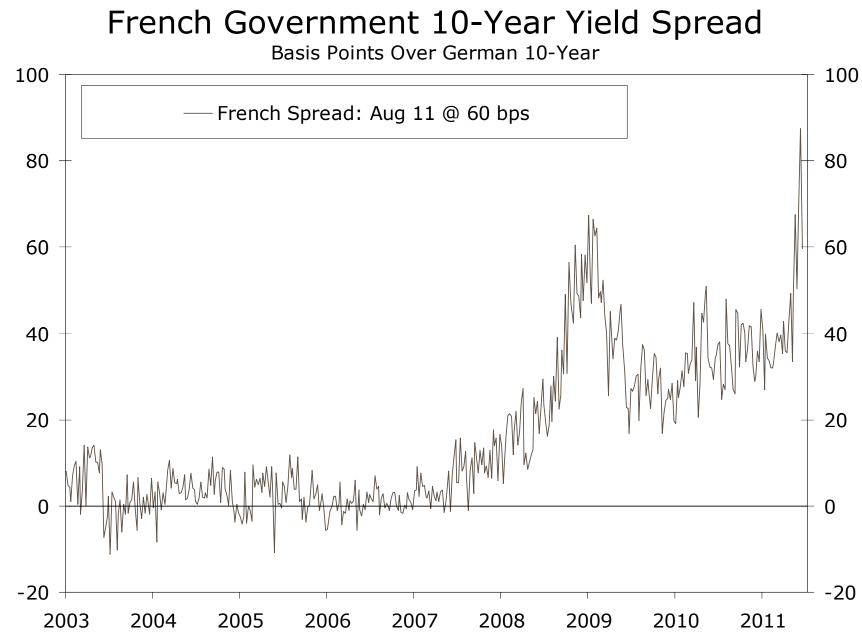
Topic of the Week

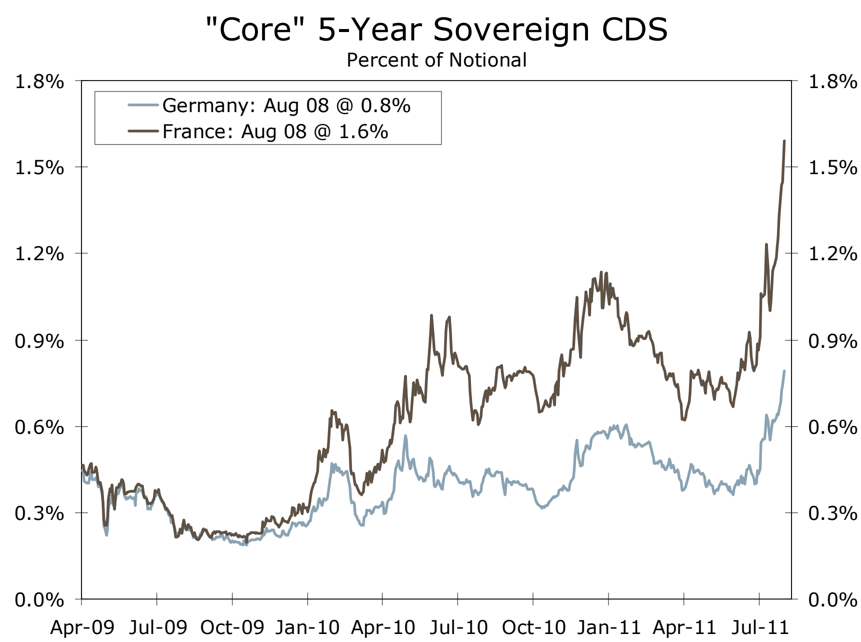
France Now in the Crosshairs

The French economy weathered the past recession better than most other European countries: it experienced a milder recession and has made more progress in regaining its prerecession peak. However, France's government finances have been generally worse than its Eurozone partners. Standing at 84 percent in 2010, France's debt-to-GDP ratio is not nearly as worrisome as Italy's staggering 119 percent ratio, but France's debt burden jumped by 32 percent during the recession while Italy's expanded by just 15 percent. In 2010, France's deficit rose to 7.7 percent of GDP compared with just 4.6 percent in Italy. Ratings agencies have recently affirmed their AAA ratings for France, but the country has put forth ambitious austerity measures to rein in deficits to just 3 percent in 2013 and 2 percent in 2014.

France's three major banks experienced a heavy rout in recent market activity stemming from their relative weakness and exposure to the Eurozone periphery. French banks are not as well capitalized as their Eurozone peers and rely more heavily on wholesale funding markets than peer financial institutions. French banks are second only to Germany in terms of exposure to the Eurozone periphery, totaling nearly 30 percent of GDP. In addition, 38 percent of Tier 1 capital in the French banking system has southern European exposure. These factors raise the risk that the French financial sector may require recapitalization in the event of a further worsening of the Eurozone sovereign debt crisis and/or a drying up of money markets.

With state finances already heavily in the red, a full-scale recapitalization of the financial system would make the current deficit reduction plan untenable. In turn, this would exacerbate the debt-to-GDP ratio and increase the likelihood of a downgrade to France's sovereign debt, further worsening the quality of capital in the financial system. France has little room for error in the coming months.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/12/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.01	0.01	0.15
3-Month LIBOR	0.29	0.27	0.38
1-Year Treasury	0.10	0.13	0.26
2-Year Treasury	0.19	0.29	0.54
5-Year Treasury	0.98	1.25	1.48
10-Year Treasury	2.30	2.56	2.75
30-Year Treasury	3.76	3.85	3.95
Bond Buyer Index	3.97	4.19	4.06

Foreign Exchange Rates

	Friday 8/12/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.428	1.428	1.283
British Pound ($/£)	1.629	1.639	1.558
British Pound (£/€)	0.877	0.871	0.824
Japanese Yen (¥/$)	76.590	78.400	85.900
Canadian Dollar (C$/$)	0.986	0.982	1.042
Swiss Franc (CHF/$)	0.772	0.767	1.050
Australian Dollar (US$/A$)	1.034	1.044	0.896
Mexican Peso (MXN/$)	12.290	11.991	12.735
Chinese Yuan (CNY/$)	6.390	6.441	6.785
Indian Rupee (INR/$)	45.338	44.740	46.780
Brazilian Real (BRL/$)	1.612	1.576	1.770
U.S. Dollar Index	74.444	74.598	82.635

Foreign Interest Rates

	Friday 8/12/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.49	1.52	0.83
3-Month Sterling LIBOR	0.85	0.83	0.74
3-Month Canadian LIBOR	1.12	1.14	1.02
3-Month Yen LIBOR	0.19	0.20	0.24
2-Year German	0.71	0.77	0.66
2-Year U.K.	0.64	0.55	0.72
2-Year Canadian	0.94	1.08	1.36
2-Year Japanese	0.15	0.14	0.14
10-Year German	2.35	2.35	2.42
10-Year U.K.	2.52	2.69	3.12
10-Year Canadian	2.43	2.64	3.00
10-Year Japanese	1.05	1.01	1.01

Commodity Prices

	Friday 8/12/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	86.73	86.88	75.74
Gold ($/Ounce)	1750.88	1663.80	1213.85
Hot-Rolled Steel ($/S.Ton)	665.00	673.00	565.00
Copper (¢/Pound)	400.45	423.10	325.25
Soybeans ($/Bushel)	13.27	13.32	10.27
Natural Gas ($/MMBTU)	4.11	3.94	4.30
Nickel ($/Metric Ton)	21,551	23,614	21,624
CRB Spot Inds.	564.93	586.81	496.54

Next Week's Economic Calendar

	Monday 15	Tuesday 16	Wednesday 17	Thursday 18	Friday 19
U.S. Data	**TIC** May $23.6B June $30.2B	**Import Price Index** June -0.5% July 0.2% (W) **Housing Starts** June 629K July 607K (W) **Industrial Production** June 0.2% July 0.2% (W)	**PPI** June -0.4% July 0.0% (W) **Core PPI** June 0.3% July 0.2% (W)	**CPI** June -0.2% July 0.0% (W) **Existing Home Sales** June 4.77M July 4.90M (W) **LEI** June 0.2% July 0.3% (W)	
Global Data	**Japan** **GDP (CAGR)** Previous (Q1) -3.5%	**Eurozone** **GDP (QoQ)** Previous (Q1) 0.3% **U.K.** **CPI (MoM)** Previous (Jun) -0.1%	**Eurozone** **CPI (MoM)** Previous (May) 0.0%	**U.K.** **Core Retail Sales** Previous (Jun) 0.8%	**Canada** **CPI (MoM)** Previous (Jun) -0.7% **Mexico** **GDP (YoY)** Previous (Q1) 4.6%

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

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