August 17, 2012

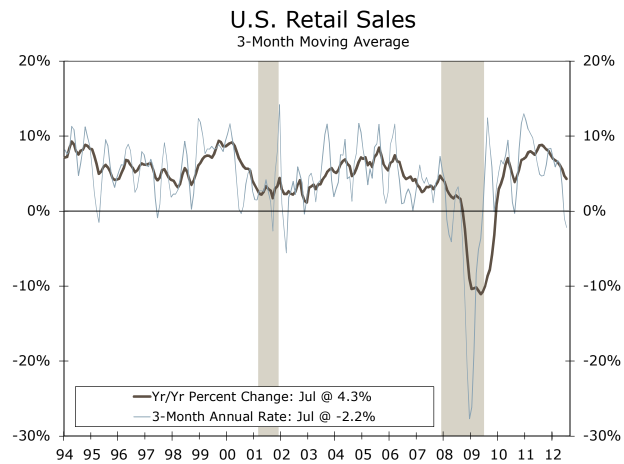
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Economic Growth Remains in Positive Territory

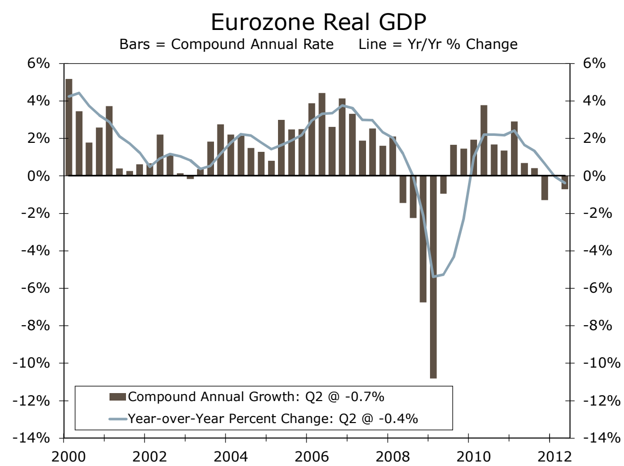
- The heavy week of economic indicators continues to reflect slow but steady economic growth. One positive surprise was the stronger-than-expected increase in retail sales in July. The retail sales "control group" showed a solid gain on the month, which should put some of the recession anxiety to rest.
- Housing starts, however, fell in July, but the trend is more promising than the headline suggests. Permits rose 6.8 percent, which is a good sign that starts will continue to climb in the coming months. Despite the drop in starts in July, the housing market continues to stabilize.



Global Review

Confirmation of Slower Global Growth

- In recent weeks in this space, we have pointed to indications of potentially slower global growth. Real GDP data from around the world this week confirmed our suspicions. From Japan to Mexico, an environment of slower growth seems to have taken hold.
- In some parts of the world, a slower pace of growth is giving way to outright declines. The Eurozone economy contracted at a 0.7 percent annualized rate in the second quarter. This is the second time in the past three quarters that the Eurozone has seen an outright decline in real GDP.



Wells Fargo U.S. Economic Forecast

	Actual 2011				Forecast 2012				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2009	2010	2011	2012	2013
Real Gross Domestic Product [1]	0.1	2.5	1.3	4.1	2.0	1.5	1.9	1.1	-3.2	2.4	1.8	2.2	1.5
Personal Consumption	3.1	1.0	1.7	4.1	2.4	1.5	1.5	1.3	-2.0	1.8	2.5	1.8	1.1
Inflation Indicators [2]													
PCE Deflator	1.8	2.6	2.8	2.5	2.4	1.6	1.2	1.1	0.4	1.9	2.4	1.6	1.1
Consumer Price Index	2.1	3.3	3.8	3.3	2.8	1.9	1.2	1.4	-0.3	1.6	3.1	1.8	2.0
Industrial Production [1]	4.4	1.2	5.6	5.1	5.8	2.5	4.1	2.2	-11.3	5.4	4.1	4.3	2.6
Corporate Profits Before Taxes [2]	4.6	10.8	4.7	9.2	10.3	6.0	5.7	5.3	7.5	26.8	7.3	6.7	5.5
Trade Weighted Dollar Index [3]	70.6	69.4	72.8	73.3	72.7	74.5	72.5	74.0	77.7	75.6	70.9	73.4	76.5
Unemployment Rate	9.0	9.0	9.1	8.7	8.3	8.2	8.3	8.3	9.3	9.6	9.0	8.3	8.1
Housing Starts [4]	0.58	0.57	0.61	0.68	0.71	0.74	0.76	0.76	0.55	0.59	0.61	0.74	0.85
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	0.25	0.25	0.25	0.25	0.25
Conventional Mortgage Rate	4.84	4.51	4.11	3.96	3.95	3.68	3.10	3.20	5.04	4.69	4.46	3.48	3.55
10 Year Note	3.47	3.18	1.92	1.89	2.23	1.67	1.60	1.60	3.26	3.22	2.78	1.78	1.85

Forecast as of: August 17, 2012
[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

Source: U.S. Department of Commerce, U.S. Department of Labor, Federal Reserve Board, IHS Global Insight and Wells Fargo Securities, LLC

Inside

Together we'll go far

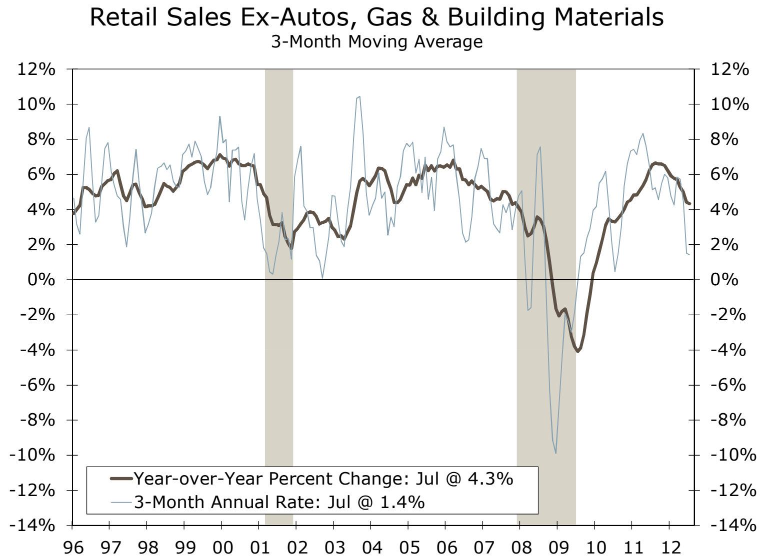
U.S. Review

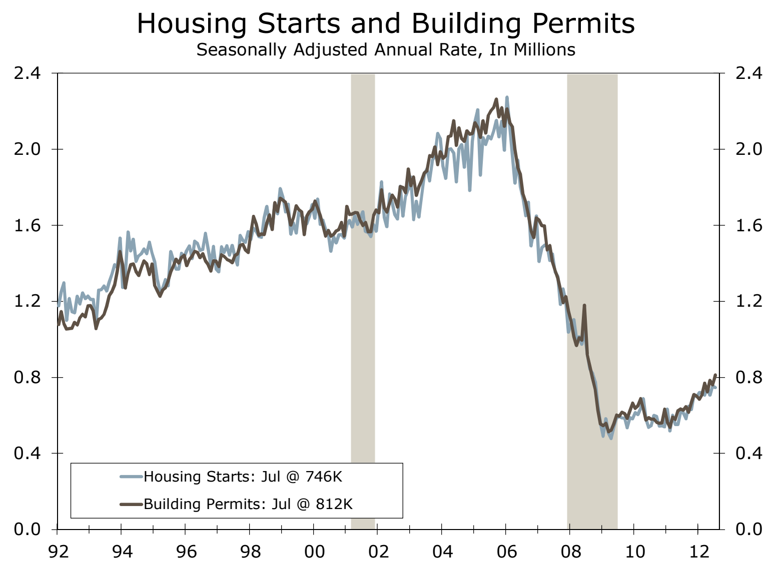
A Heavy Week of Indicators, but No Change to the Story

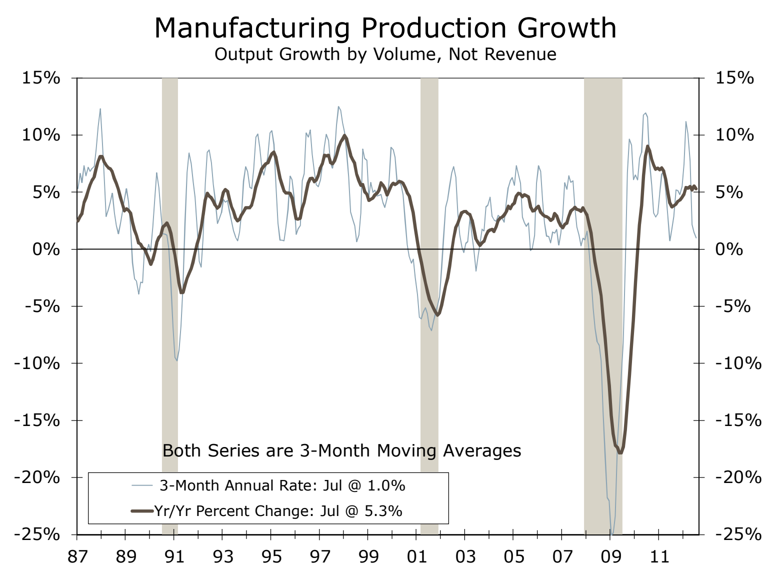
Economic indicators released this week continued to suggest a moderate economic recovery is still under way. This week we got a pulse for the consumer, the manufacturing and residential sectors which showed continued modest improvement. Previous monthly declines in retail sales and successive drops in the Philadelphia Fed manufacturing index brought into question whether economic growth slipped into negative territory. However, an unexpected solid gain in retail sales in July and an increase in manufacturing output should keep naysayers at bay. Moreover, inflation indicators released during the week continue to suggest the near-term inflation picture remains benign, which leaves the Fed additional wiggle room if necessary. While we expect economic growth will remain positive, indicators still are showing that growth remains slow. A good example is the July retail sales report. Following three consecutive months of declines, retail sales came in stronger than expected, rising 0.8 percent in July with nearly broad-based gains. While much of the focus was on the surprise pop in headline sales, some of the excitement should be tempered as a bit of the increase could be payback for the previous string of declines. Moreover, the downward revision to the previous month made an already modest decline a bit sharper.

However, before we rain on the retail sales parade, July's bounce in retail sales suggests that the third quarter is off to a good start. In fact, the component of retail sales used to calculate real GDP, known as the "control group," which excludes gasoline station, building materials and auto sales, rose 0.9 percent on the month and is now up 3.3 percent on a year-ago basis. Speaking of economic growth, one bright spot in the economy is new home construction. Despite the disappointing pullback in July, the housing market continues to stabilize with home prices firming and builders a bit more confident about future prospects and buyer traffic. Moreover, the record low levels of completions almost have compelled builders to cautiously ramp up activity. Indeed, while housing starts fell a disappointing 1.1 percent to a 746,000-unit annual rate in July, some monthly volatility is expected. The entire decline was concentrated in single-family starts which dipped 6.5 percent, the first decline in five months. Given the strength in other housing indicators, the dip in single-family starts does look a little suspicious, however. Looking ahead, building permits rose 6.8 percent, which is a good sign starts will continue to climb in the coming months.

Industrial production also increased in July, which is in contrast to the four consecutive monthly declines in the Philadelphia Fed manufacturing index. While the Philadelphia Fed manufacturing index traditionally has been a good harbinger for the manufacturing industry and, at times, economic growth, industrial production is a more reliable gauge of manufacturing output and is one of the monthly indicators used to determine whether the economy has entered into a recession. Reflecting continued improvement, industrial production increased 0.6 percent in July with manufacturing output rising 0.5 percent.







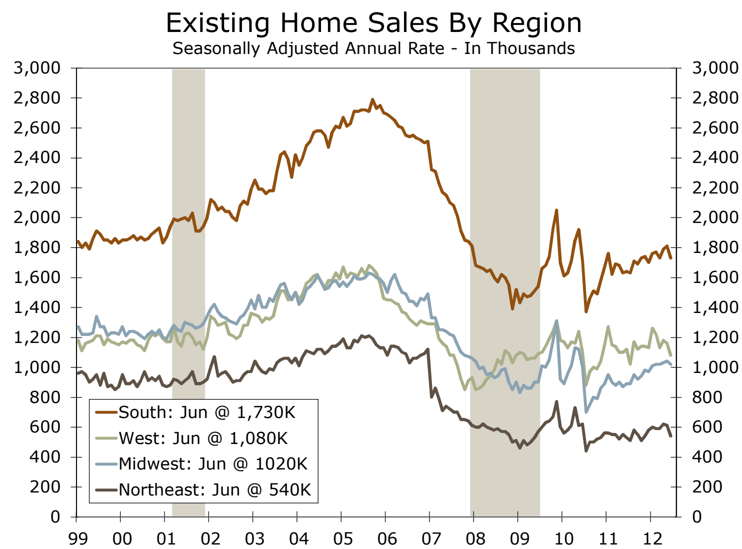
Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities, LLC

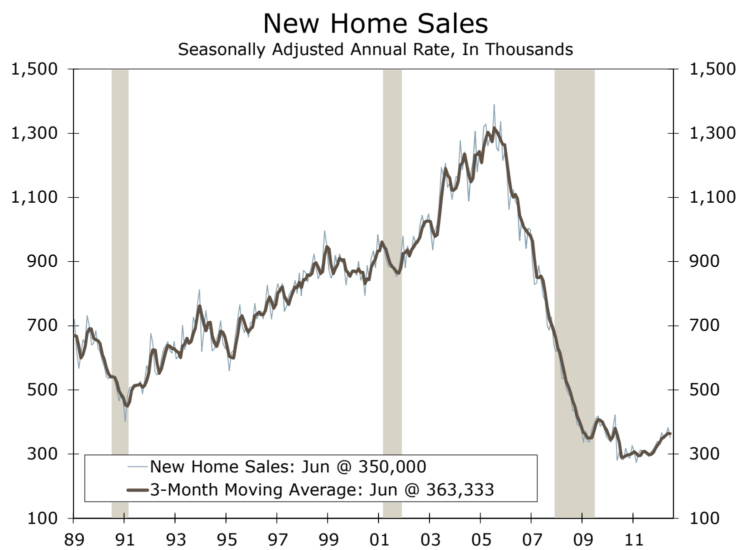
Existing Home Sales • Wednesday

Existing home sales slumped in June, falling 5.4 percent to a 4.37 million unit pace. The surprise slide in existing home sales was experienced across all four regions. Existing home sales fell 11.5 percent in the Northeast, 1.9 percent in the Midwest, 6.9 percent in the West and 4.4 percent in the South. The widespread weakness aside, existing home sales remained up 4.5 percent from last year's levels. Median existing home prices were up 7.9 percent from a year ago, the fifth consecutive monthly gain as the number of foreclosure sales continued to decline. We expect the pace of existing home sales to improve again in July, rising 4.8 percent for the month to a 4.58M unit pace. Existing home sales should continue to improve slowly through year-end. The drop in inventories of affordable existing homes in some regions, should help support further building activity.

Previous: 4.37M **Wells Fargo: 4.58M**

Consensus: 4.52M





New Home Sales • Thursday

New home sales pulled back in June, falling 8.4 percent for the month. Even with the disappointing drop in June, new home sales are still up 18.9 percent over the last six months. The story of depressed new home sales inventories remains as inventory levels remain at 4.9 months. On a regional basis, new home sales rose in the Midwest and West while sales in the South and Northeast fell. The pace of regional improvement remains tied to the inventory of existing homes and fundamental factors such as local population growth. There are signs that the new home market will continue to improve as homebuilder sentiment remains at a five-year high. In addition, the price differential between new and existing homes continues to close, making new home purchases more attractive to would-be buyers. We expect the pace of new home sales to improve again in July by 4 percent to a 364K unit pace.

Previous: 350K **Wells Fargo: 364K**

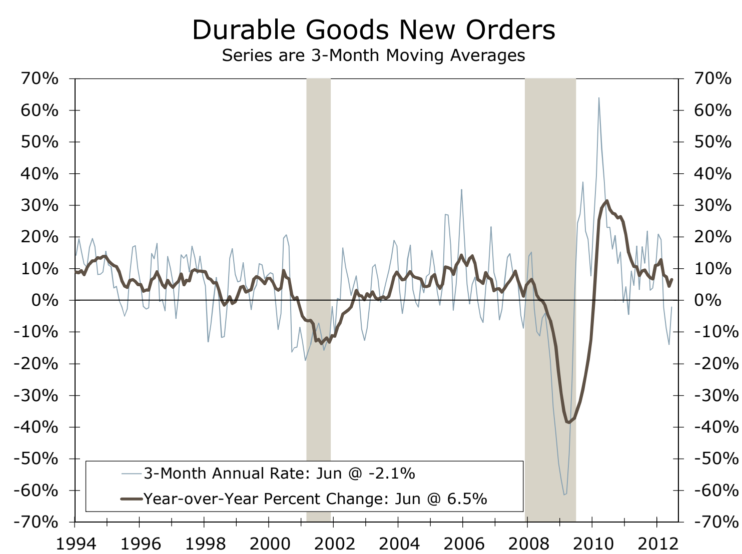
Consensus: 365K

Durable Goods Orders • Friday

Durable goods orders jumped in June as orders for transportation goods climbed for the month. In addition, defense orders came in stronger than expected for the month. Excluding the volatile transportation orders, new durable goods orders fell 1.1 percent, the weakest month for the component since January. More importantly, nondefense capital goods orders excluding aircraft fell 3.1 percent, signaling a likely decline in equipment and software orders and thus business investment in the months ahead. Our expectation for July's durable goods orders is for a modest bounce-back of 1.2 percent. Given the increased economic and tax policy uncertainty, businesses and consumers may pull back spending as the year progresses. The slower pace of consumer and business spending over the next several months should keep a lid on growth in new durable goods orders for the time being.

Previous: 1.3% **Wells Fargo: 1.2%**

Consensus: 2.5%



Source: U.S. Department of Commerce, National Association of Realtors and Wells Fargo Securities, LLC

Global Review

Weakening in Japanese Growth

Economic growth in Japan slowed to an annualized rate of just 1.4 percent in the second quarter. The outturn was weaker than expected, though the disappointment was softened a bit because the Japanese economy grew faster in the first quarter than had previously been reported. Still, the report raises doubts about the ability of domestic demand to drive Japanese economic growth. Indeed, consumer spending grew at just a 0.6 percent annualized rate, the slowest rate of consumer spending growth in five quarters.

Japanese exports rose at an annualized rate of 4.8 percent, much slower than the 14 percent growth rate reported in the first quarter. Japan's economy minister pointed to the weakening outlook for the global economy in a news conference following the report, saying that the Japanese government "needs to be alert to further deterioration in overseas economies."

Eurozone Growth Falters, Draghi to the Rescue?

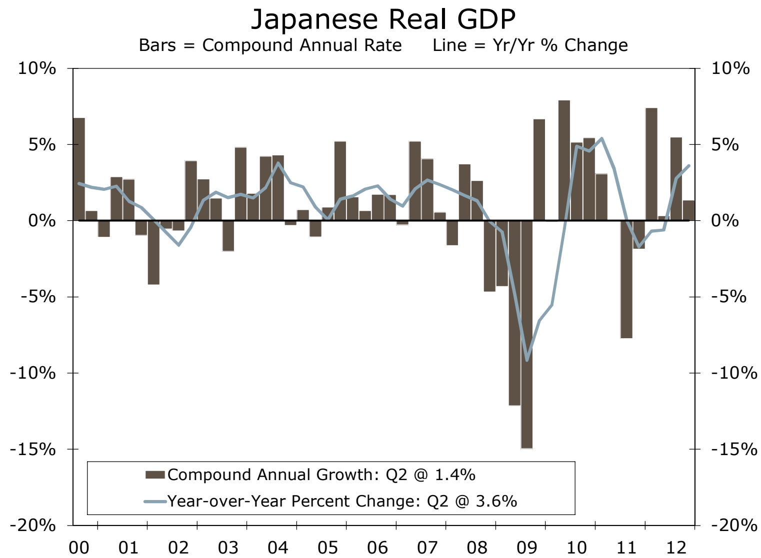
We also learned this week that real GDP in the Eurozone contracted at a 0.7 percent annualized rate in the second quarter. The Eurozone has side-stepped two consecutive quarters of negative GDP growth, thereby avoiding one popular definition of recession. However, with output having declined in two out of the past three quarters and real GDP in the second quarter off 0.4 percent on a year-ago basis, the Eurozone economy is clearly weak.

The 0.2 percent decline in GDP in the overall Eurozone in Q2 masks significant divergence among countries. Germany and the Netherlands experienced modest GDP growth. French GDP was flat. Economic activity in the countries most affected by the sovereign debt crisis was weak. Real GDP in Spain fell 0.4 percent in the second quarter, and Italian GDP plunged 0.7 percent. Seasonally adjusted numbers from Greece are not available, but officials in that country announced that real GDP in the second quarter dropped 6.2 percent on a year-ago basis. Greek GDP has nose-dived more than 15 percent from its peak in 2008, and further declines appear likely.

With growth very weak and inflation generally benign, we look for the European Central Bank (ECB) to reduce its main policy rate by another 25 bps in the next month or two. Moreover, the ECB may eventually be forced to undertake more unconventional measures to honor ECB President Draghi's promise to do "whatever it takes" to save the euro.

Way Down Here, You Need a Reason to Move

Last month, announcements from the Mexican central bank made clear that it did not intend to make an immediate move to a more accommodative monetary policy. This week, we learned that Mexican GDP slowed in the second quarter, though not enough to sway Governor Agustin Carstens, who said on Aug. 15 that the economy had held up well in the face of slowing global demand. Thus, we expect that The Bank of Mexico will remain on hold for the foreseeable future.



Source: IHS Global Insight and Wells Fargo Securities, LLC

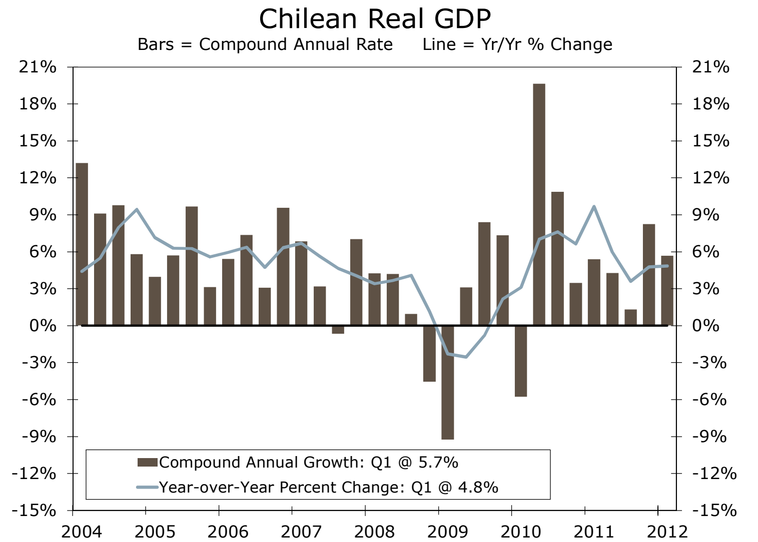
Chile GDP • Monday

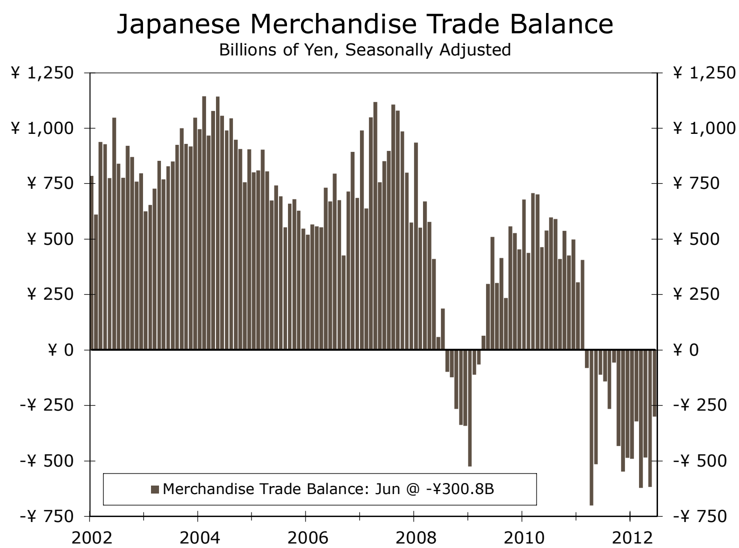
The Chilean economy remained strong even as the rest of the global economy have weakened considerably during the first half of the year. However, this may be changing in the next several quarters as the decrease in commodity prices, but more specifically in copper consumption and prices, starts to make a dent in the country's production and export sector.

For now, however, we expect the Chilean GDP to have advanced by 5.4 percent during the second quarter of the year compared to the year earlier period after printing a 5.7 percent rate of growth quarter over quarter. With Chinese economic growth and a strengthening of the U.S. dollar behind the drop in copper prices, the country's economy has remained resilient due to its strong macro prudential policies and its trade links to the rest of Asia and the U.S. market. However, this strength could be challenged during the second half of the year.

Previous: 5.6% (Year-over-Year)

Consensus: 5.4%





Japan Trade • Tuesday

The continued weakness in economic activity across the world probably will be reflected in Tuesday's release of the Japanese trade balance which is expected to post a ¥270.0 billion deficit in July. For July, exports are expected to drop 3.0 percent year-over-year in July, compared to 2.3 percent in June. At the same time, imports are expected to grow 3.0 percent year-over-year after dropping 2.2 percent during the previous month.

This behavior again will put the Japanese trade balance into negative territory after the revised surplus of ¥60.3 billion recorded in June. For a country with an economy that depends so heavily on trade, this is not good news and shows that the worldwide slowdown in economic activity remains in place. A surprise positive performance by Japanese exports will definitely be a welcome sign, however, don't count on it.

Previous: ¥60.3B

Consensus: -¥270.0B

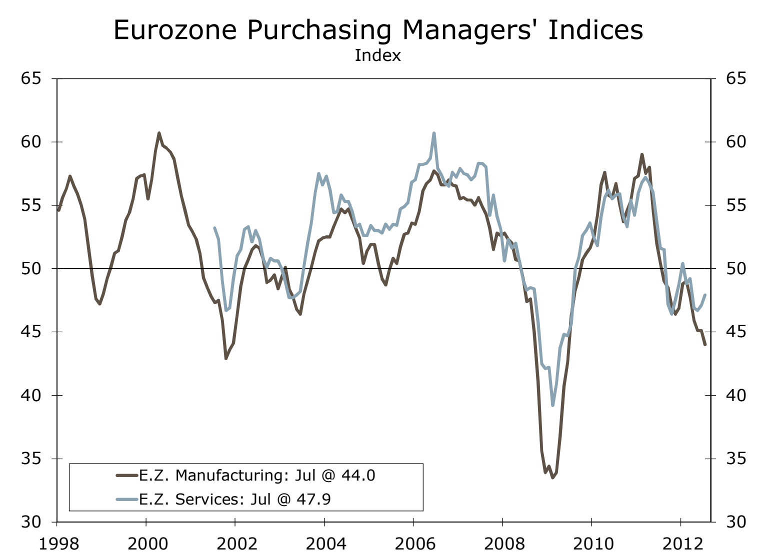
Eurozone PMI • Thursday

The preliminary numbers on the Eurozone PMIs will be released on Thursday with the expectation that the Eurozone remains in recession and the economy is stagnant. Perhaps, the stagnant part is the good news, meaning that, at least, things are not getting worse even as the sovereign debt crisis continues to rattle the region and the rest of the world.

Both PMIs, manufacturing as well as services, are expected to remain almost unchanged in August with the manufacturing PMI moving marginally up from 44.0 in July to 44.2 in August but remaining in contraction territory. Meanwhile, the services PMI is expected to inch down to 47.7 in August, slightly less than the reading in July. Thus, the positive news regarding the Eurozone region is that things seem to be at a stand-still with markets waiting for more news so they can assess what the future holds for the region.

Previous: Manufacturing: 44.0 Services: 47.9

Consensus: Manufacturing: 44.2 Services: 47.7



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

Rising Rates: A Good Sign

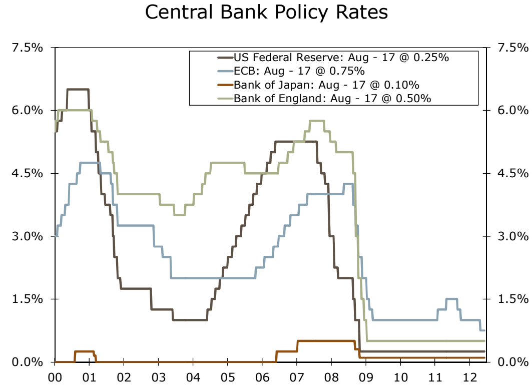
Over the past few weeks, the benchmark 10-year Treasury rate has risen. We view this as a good sign for the economy and a move to more rationale pricing, in line with economic fundamentals for fixed income instruments.

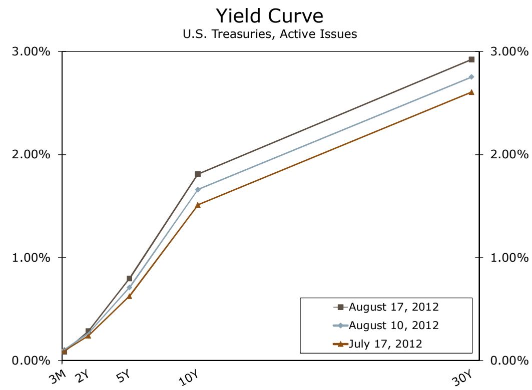
Growth and No Fed Move

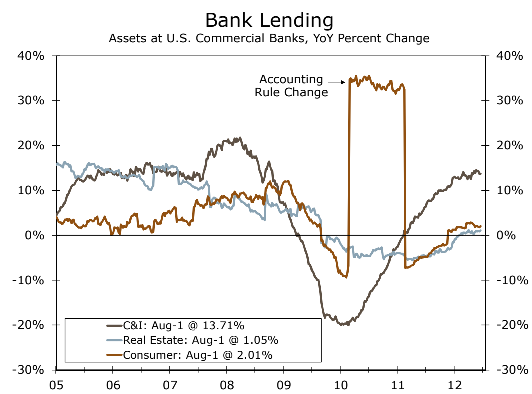
Two factors appear to have motivated the market to re-price Treasury debt. First, there is less likelihood of a recession. So, those investors betting on a recession now have to reassess and unwinding their long positions; therefore rates have risen. In essence, the distribution of market expectations on growth has shifted towards more growth and the left-tail expectations for recession have disappeared. Our monthly outlook calls for sub-2.0 percent economic growth and no recession. While growth in consumer spending and business investment has been disappointing relative to trend, neither is giving signs of recession. Moreover, housing markets appear to be improving. Second, with the improved economic outlook, the expectations for some form of additional policy stimulus at the September FOMC meeting also have diminished. We do not expect QE3. In addition, while Europe is certainly not out of the woods—the Ardennes is a deep, dark forest—there is no sign of collapse as some had discounted a few months ago. Therefore, the distribution of expectations for Europe has also shifted to persistent recession/low growth and away from collapse.

Interest Rates: A More Rationale Pricing

At the short end of the Treasury curve, we expect the Fed to keep the funds rate low and to pursue its Operation Twist program through the year end, given the downside uncertainties cited in its mid-year economic outlook. At the intermediate (5-7 year) and longer (10-year) ends of the curve we expect that the recent rise in rates reflects moderate growth and, low inflation but no Eurozone collapse and continued large federal fiscal deficits. As we indicated earlier this year, the then low rates were an opportunity to borrow and recent gains in housing reflect that.







Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities

Consumer Credit Insights

Senior Loan Officer Opinion Survey

Data from the latest Senior Loan Officer Opinion Survey (SLOOS) showed that conditions for loan growth have remained favorable in the third quarter. For commercial and industrial (C&I) loans, demand increased and standards eased at a majority of banks over the past three months. In addition, spreads continued to decline at a net percentage of banks, making loans relatively more affordable to borrowers. Conditions have similarly improved for consumer loans and residential mortgage borrowers, with a net percent of banks reporting an increase in demand and less stringent standards across loan types.

On the surface it may seem like full steam ahead for loan growth, given that demand is rising, standards are easing, and spreads are narrowing. However, the SLOOS reports the number of banks changing standards over the period, not the degree to which they did. In a special question in this quarter's survey, the Fed asked loan officers where current standards are relative to their average since 2005. A majority of loan officers reported that credit standards are currently tighter for consumer loans and mortgages than the average level since 2005, while standards for C&I loans are near the period's midpoint. The latest survey suggests that lending is ripe to increase further in the near-term, but that despite improvement in conditions thus far in the recovery, we are not back to the easy credit of the 2000s.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.62%	3.59%	3.53%	4.15%
15-Yr Fixed	2.88%	2.84%	2.83%	3.36%
5/1 ARM	2.76%	2.77%	2.69%	3.08%
1-Yr ARM	2.69%	2.65%	2.69%	2.86%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,458.5	28.45%	9.26%	13.71%
Revolving Home Equity	$533.6	-5.08%	-6.96%	-4.47%
Residential Mortgages	$1,574.6	20.89%	4.92%	5.73%
Commerical Real Estate	$1,410.7	-5.26%	-4.33%	-1.67%
Consumer	$1,113.2	19.48%	-0.40%	2.01%

Source: Freddie Mac, Federal Reserve Board and Wells Fargo Securities, LLC

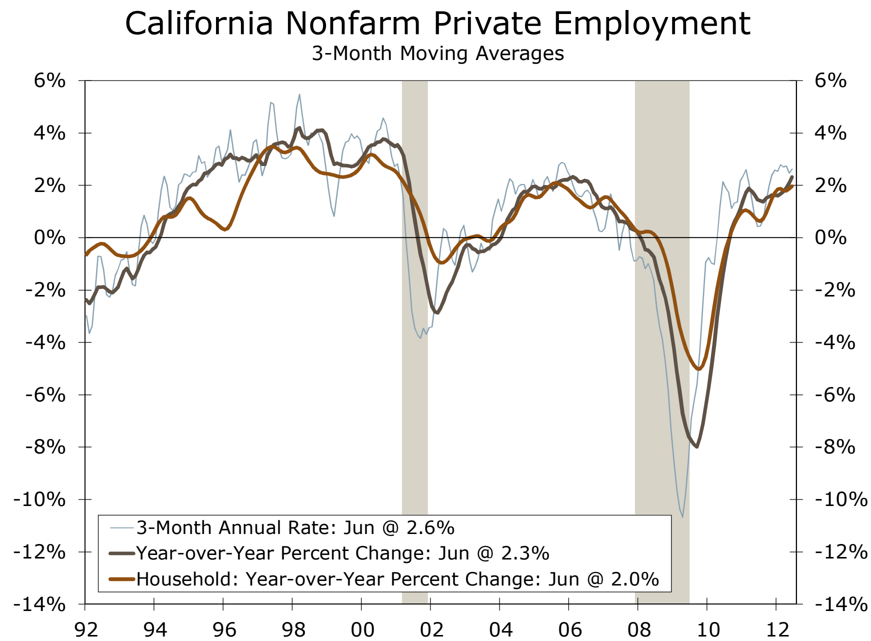
Topic of the Week

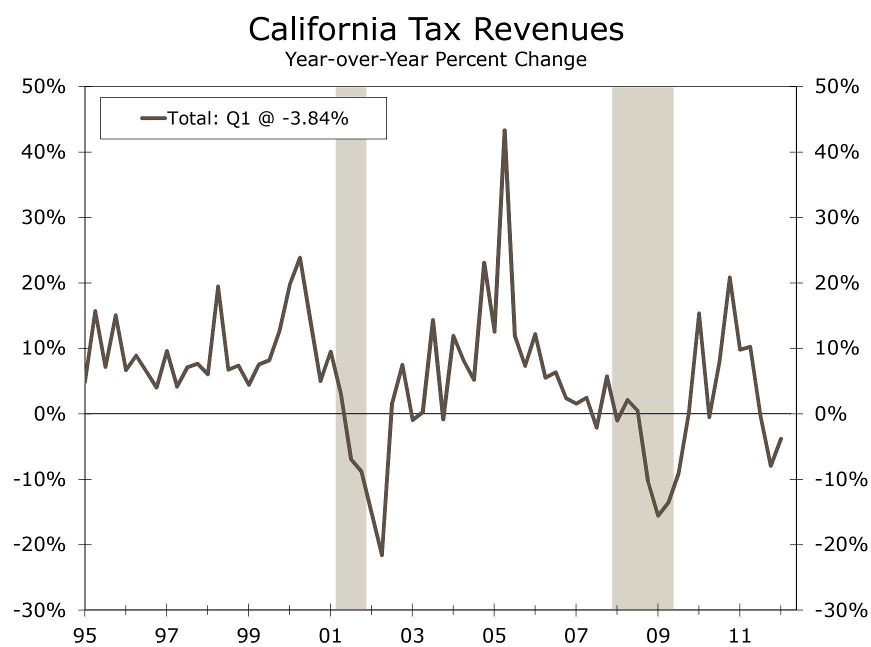
California Recovers Amidst Setback Risks

California's recovery has gained considerable momentum over the past year. The state's gross domestic product grew 2.0 percent in 2011 and likely accelerated during the first half of this year. Most measures of aggregate economic activity have shown consistent improvement in recent quarters. Nonfarm employment rose 1.6 percent from the middle of 2011 to the middle of 2012, as private sector employers added nearly 270,000 jobs, accounting for 15 percent of all private sector jobs added in the country over the past 12 months. Sales of existing single-family homes have increased 16.7 percent over the past year and permits for new home construction have risen 16.1 percent. The state's coincident index has risen 3.0 percent over the past year, compared to a 2.2 percent rise over the previous year and the leading index remains solidly in positive territory.

However, even with recent gains, the Golden State still faces a long and arduous road to recovery and could need another 2.5-3.0 years simply to recover the jobs lost during the Great Recession. Concerns are beginning to mount that the underwhelming IPO for Facebook and lingering questions about the long-term potential for social networking and interactive entertainment might set the state up for a letdown along the lines of what was seen following the dot-com crash a decade ago. Moreover, the slowdown in global economic growth, particularly in China, may soon undermine strong gains in international trade.

Fiscal conditions at the state level remain tenuous. Tax revenues came in weaker than forecasted in fiscal year 2012, while healthcare and welfare program spending ran over budget. Also, fiscal conditions at the local level remain tight, as illustrated by the recent headlines surrounding bankruptcies for the cities of Stockton and San Bernardino. For more on California's recovery and conundrum, please see our report, *California's Economy: Gaining Momentum,* on our website.





Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities, LLC

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/17/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.08	0.10	0.01
3-Month LIBOR	0.43	0.44	0.30
1-Year Treasury	0.22	0.00	0.09
2-Year Treasury	0.28	0.26	0.19
5-Year Treasury	0.79	0.71	0.91
10-Year Treasury	1.81	1.66	2.17
30-Year Treasury	2.92	2.75	3.56
Bond Buyer Index	3.80	3.75	3.83

Foreign Exchange Rates

	Friday 8/17/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.234	1.229	1.443
British Pound ($/₤)	1.569	1.569	1.654
British Pound (₤/€)	0.786	0.783	0.872
Japanese Yen (¥/$)	79.390	78.280	76.600
Canadian Dollar (C$/$)	0.989	0.991	0.981
Swiss Franc (CHF/$)	0.973	0.977	0.790
Australian Dollar (US$/A$	1.043	1.058	1.055
Mexican Peso (MXN/$)	13.233	13.083	12.169
Chinese Yuan (CNY/$)	6.358	6.360	6.387
Indian Rupee (INR/$)	55.745	55.285	45.410
Brazilian Real (BRL/$)	2.022	2.016	1.588
U.S. Dollar Index	82.502	82.553	73.674

Foreign Interest Rates

	Friday 8/17/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.20	0.22	1.49
3-Month Sterling LIBOR	0.70	0.71	0.86
3-Month Canadian LIBOR	1.29	1.29	1.13
3-Month Yen LIBOR	0.19	0.20	0.19
2-Year German	-0.04	-0.07	0.70
2-Year U.K.	0.16	0.11	0.59
2-Year Canadian	1.23	1.13	0.95
2-Year Japanese	0.09	0.09	0.15
10-Year German	1.50	1.39	2.20
10-Year U.K.	1.67	1.54	2.43
10-Year Canadian	1.96	1.78	2.39
10-Year Japanese	0.84	0.80	1.03

Commodity Prices

	Friday 8/17/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	95.29	92.87	87.58
Gold ($/Ounce)	1613.40	1620.20	1791.25
Hot-Rolled Steel ($/S.Ton)	645.00	641.00	665.00
Copper (¢/Pound)	340.20	339.25	403.20
Soybeans ($/Bushel)	16.60	16.93	13.45
Natural Gas ($/MMBTU)	2.70	2.77	3.93
Nickel ($/Metric Ton)	15,462	15,438	21,657
CRB Spot Inds.	507.69	510.90	568.70

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	20	21	22	23	24
U.S. Data			**Existing Home Sales** June 4.37M July 4.58M (W) **FOMC Minutes**	**New Home Sales** June 350K July 364K (W)	**Durable Good Orders** June 1.3% July 1.2% (W) **Durables Ex. Trans.** June -1.4% July 1.0% (W)
Global Data	**Chile** **GDP (YoY)** Previous (1Q) 5.6%	**Japan** **Trade Balance** Previous (Jun) ¥60.3B	**Canada** **Retail Sales** Previous (May) 0.3%	**Eurozone** **GDP (QoQ)** Previous (1Q) 0.3% **Eurozone** **PMI (MoM)** Previous (Jul) 43.0	**U.K.** **GDP (QoQ)** Previous (1Q) -0.7%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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