August 19, 2011

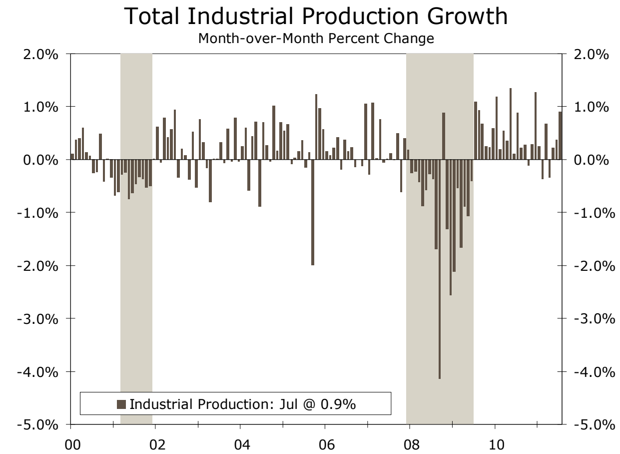
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

The Economy Continues to Lose Momentum

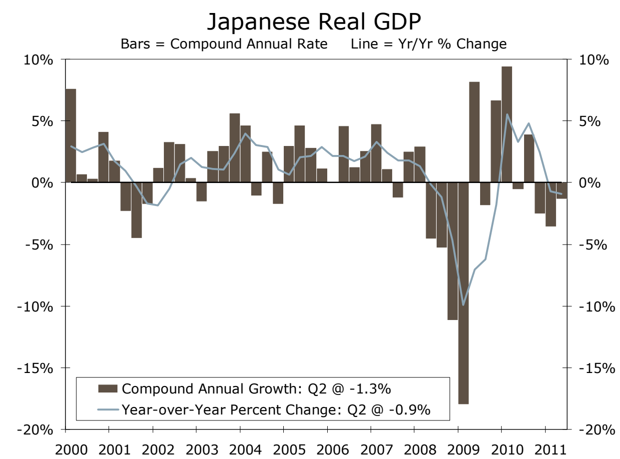
- In July, industrial production rose a solid 0.9 percent, but reports from the New York and Philadelphia Federal Reserve banks showed activity falling off in early August.
- Home sales and new home construction also appear to be losing momentum. Sales of existing homes fell 3.5 percent in July, while housing starts fell 1.5 percent. Mortgage applications for home purchases also declined, despite the recent drop in mortgage rates.
- Inflation is still running a little hotter than the Fed would like, with the CPI rising 0.5 percent in August and the "core" CPI rising 0.2 percent (1.8 percent y-o-y).



Global Review

Japanese GDP Fell in Q2, but Q3 Should Be Better

- Real GDP in Japan fell at an annualized rate of 1.3 percent in the second quarter due to sharp declines in exports and residential investment spending. A large increase in public investment spending, which reflects rebuilding efforts in the wake of the natural disasters, and stock-building helped to offset weakness elsewhere.
- The third quarter should be stronger, as the economy continues to rebound from the natural disasters. However, slow global growth and the recent appreciation of the yen pose some significant headwinds to the Japanese economy.



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	1.6	1.1	-0.4	-3.6	3.0	1.6	1.1
Personal Consumption	2.7	2.9	2.6	3.6	2.1	0.1	1.6	1.1	-0.7	-2.0	2.0	2.0	1.3
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	3.5	3.5	3.8	-0.3	1.6	3.1	2.4
Industrial Production [1]	8.1	7.1	6.7	3.1	4.8	1.0	5.7	1.4	-3.3	-11.1	5.3	4.0	2.9
Corporate Profits Before Taxes [2]	46.7	41.5	27.4	18.2	8.8	6.9	6.5	6.4	-16.4	7.9	32.2	7.1	6.3
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	9.2	9.4	5.8	9.3	9.6	9.1	9.4
Housing Starts [4]	0.61	0.60	0.58	0.54	0.58	0.57	0.58	0.55	0.90	0.55	0.58	0.57	0.64
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	3.70	3.60	6.04	5.04	4.69	4.16	3.95
10 Year Note	3.84	2.97	2.53	3.30	3.47	3.18	2.10	2.00	3.66	3.26	3.22	2.69	2.35

Forecast as of: August 19, 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

Timing Is Everything

Most of the hard data we received this week, including reports on industrial production, existing home sales, housing starts and the leading economic indicators, remain consistent with a slowly growing economy. The data, however, mostly reflect activity covering the period from the middle of June to the middle of July, which predates recent renewed recession concerns.

The soft data tell a decidedly different story, with manufacturing surveys from the Federal Reserve Banks of New York and Philadelphia showing considerable weakness for early August. Moreover, recent surveys of consumer confidence from the University of Michigan, Rasmussen and Bloomberg all show conditions worsening dramatically in late July and early August. In addition, the latest jobless claims data rose back above the key 400,000 level and anecdotal reports from homebuilders indicate activity has slowed considerably over the past four weeks.

Reconciling the differences between the stronger hard data and the weaker soft data is imperative to getting the forecast right. Ordinarily, we would give more weight to the hard data. Industrial production was quite strong, with a rebound in vehicle production and a jump in household electricity use driving output up 0.9 percent in July. Industrial production, however, is largely based on hours worked data, which comes from the employment report and covers the first half of the month.

July's 0.5 percent rise in the leading economic indicators also looks less impressive after digging into the details. The index's three financial components accounted for all of July's increase and then some, with the growth in the real money supply alone adding 0.7 percentage points to the total, the interest rates spread adding 0.3 percentage points and the then rebounding stock market adding 0.1 percentage points. Combined, the three components added 1.1 percentage points, which means the other seven components subtracted a combined 0.6 percentage points.

There is a good case for looking past the strength in the LEI's financial components. The stock market has obviously turned down since July and the extreme volatility alone will likely cause businesses to rethink investment and hiring decisions. The interest rate spread is virtually useless in today's environment, where short-term rates are close to zero. The sharp rise in the real M2 money supply may also be giving us some false hope. The recent volatility in the financial markets is likely leading to an increase in cash holdings, but is also likely further depressing the money multiplier and making a boost to real activity unlikely.

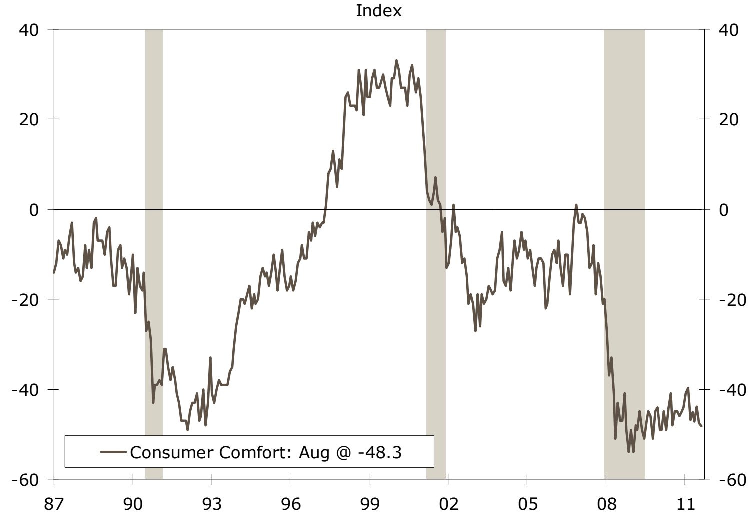
The weakness in the survey data is hard to dismiss. The Federal Reserve surveys have a long history and decent track record. The Empire Survey has now been negative for three months in a row. July's 33.9-point drop in the Philadelphia Fed survey was the largest since October 2008 and sent the index firmly into recession territory. Both reports show new orders weakening considerably, reflecting growing caution by businesses. If this loss of confidence is not reversed soon, the drop in orders will pull production lower later this year.

Net Contribution to Leading Economic Index

July 2011

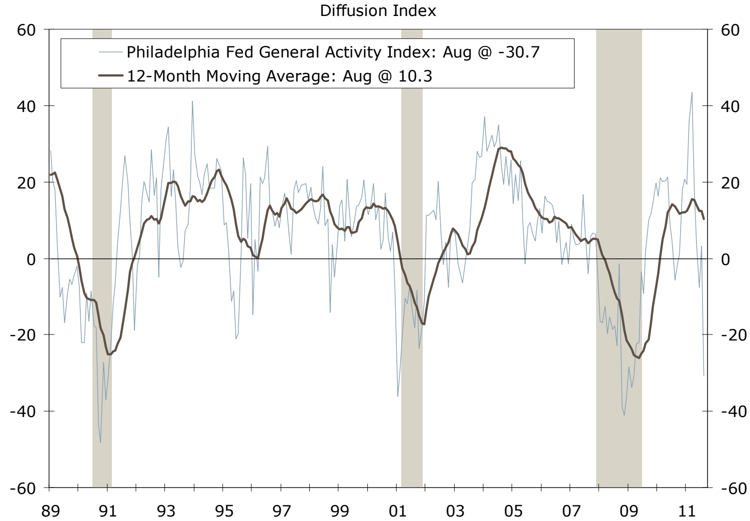
Bloomberg Consumer Comfort Index

Index



Philadelphia Fed General Activity Index

Diffusion Index

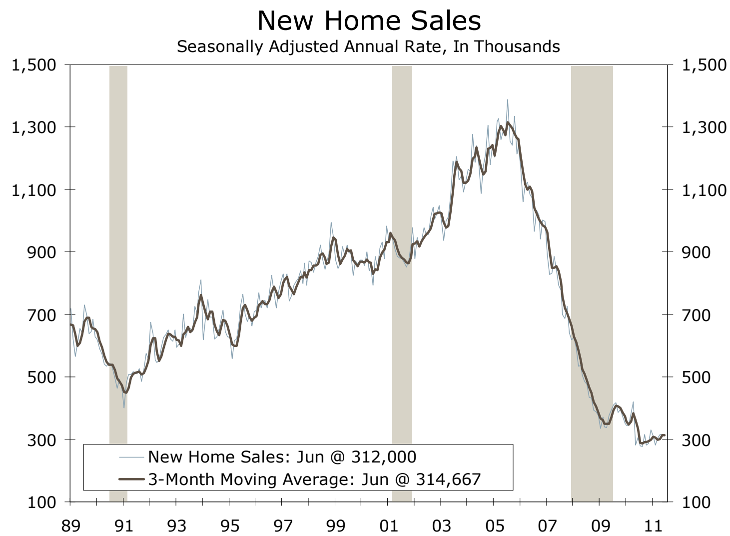


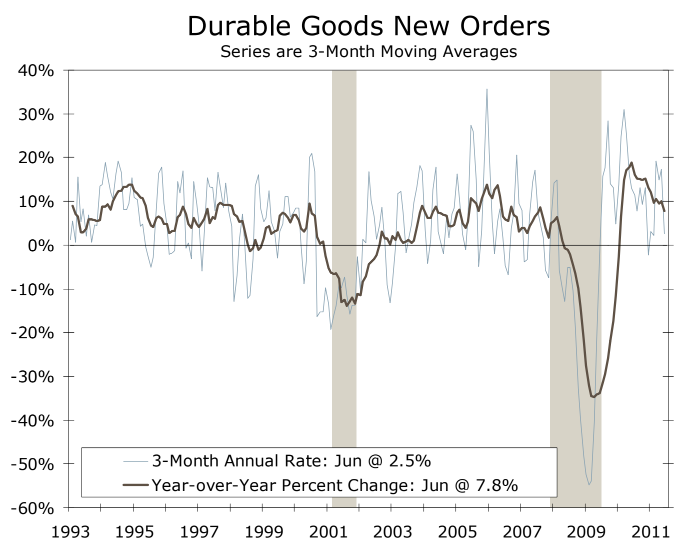
New Home Sales • Tuesday

Next week is a light week for economic data. New home sales for July will kick things off on Tuesday. We expect a modest increase in new home sales in July. But this increase in home sales is expected to only offset the declines over the past two months and will do little to dispel the notion that home sales are treading water at what remains a historically low level. Despite recent declines in mortgage rates, there is no sign yet that low rates are boosting new home demand. The NAHB/Wells Fargo housing market index, which tracks homebuilder sentiment, has been pretty flat since April and remains near levels seen a year ago. New home sales have grown fastest in the Midwest and the South over the past two months, while sales have declined in the Northeast and West. The lack of new home building continues to work off the supply of new homes, despite the weak home sales environment. New home inventories were 22.5 percent lower than a year ago in June.

Previous: 312K **Wells Fargo: 310K**

Consensus: 315K





Durable Goods Orders • Wednesday

The durable goods orders report on Wednesday gives the markets their first look at order figures for July. Given weaker-than-expected durable orders in June and weak economic data since, the markets will be bracing for some disappointment here. Regional manufacturing surveys have been signaling further weakness ahead for manufacturing orders in general. The consensus is still looking for a two percent bounce in July durable orders from June's weak data. Leading the bounce should be civilian aircraft orders. Boeing secured an order from American Airlines in July that boosted orders to 115 planes from 48 planes the month before. The July industrial production data also came in on the high side, jumping 0.9 percent on the month due to a strong rebound in U.S. auto production, as the Japanese earthquake and tsunami effects wear off. So look for strength in the vehicle and parts orders component as well.

Previous: -2.1% **Wells Fargo: 2.0%**

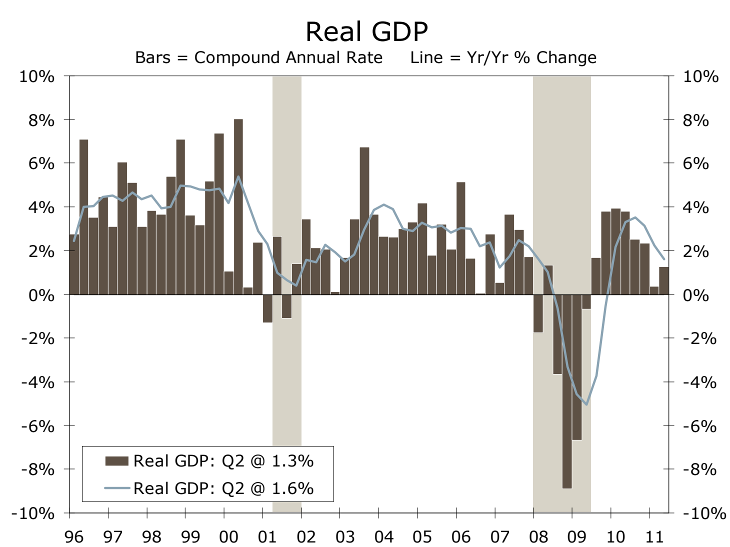
Consensus: 2.0% (Month-over-Month)

GDP (Second Release) • Friday

It is expected that the second release of U.S. GDP for the second quarter will show a slightly slower pace of activity than initially reported. There have been a few notable releases, particularly inventories and net exports, which were weaker than the government's initial estimates and point to a downward revision in their contribution to GDP. On the other hand, we could see some upward revision in the construction and consumer spending components that will nearly offset the downward revision in net exports and inventories. Real consumption growth in the second quarter was originally estimated at an anemic 0.1 percent in the advance release. Fixed investment appeared to strengthen a bit in the second quarter as commercial and residential construction added to GDP, after subtracting similar amounts from GDP growth in the first quarter. Government spending remained a drag on GDP growth in Q2, as it contracted for a third consecutive quarter.

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

Consensus: 1.1%



Global Review

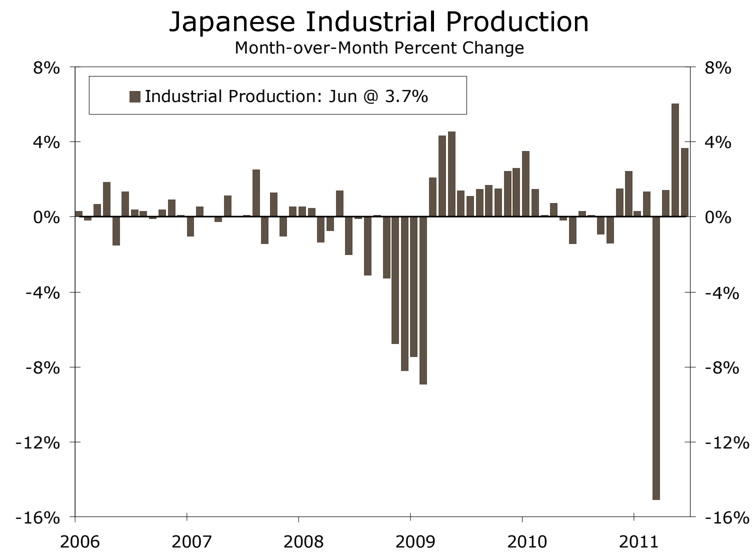
Japanese GDP Fell in Q2, but Q3 Should Be Better

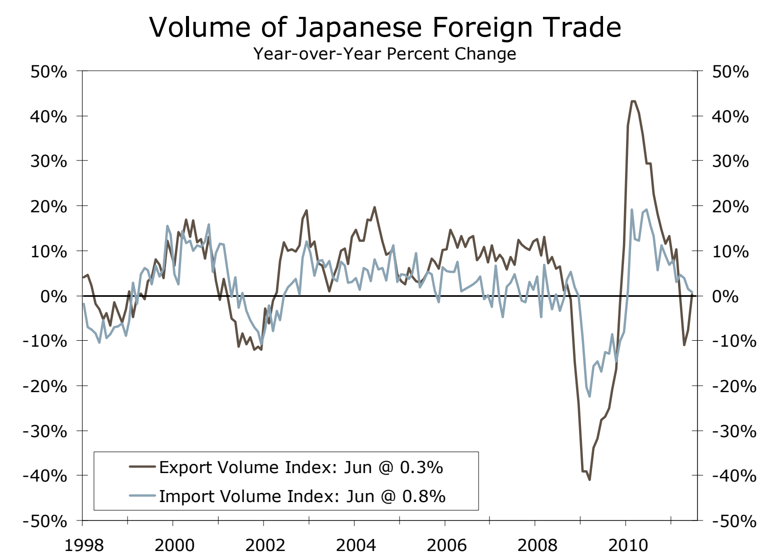
Data released this week showed that real GDP in Japan declined at an annualized rate of 1.3 percent in the second quarter, which marks the third consecutive quarter in which the Japanese economy has contracted (see graph on the front page). Although the decline was not quite as severe as expected—the consensus forecast had anticipated a 2.5 percent drop—the Japanese economy was weaker in the second quarter than the "headline" GDP data indicated.

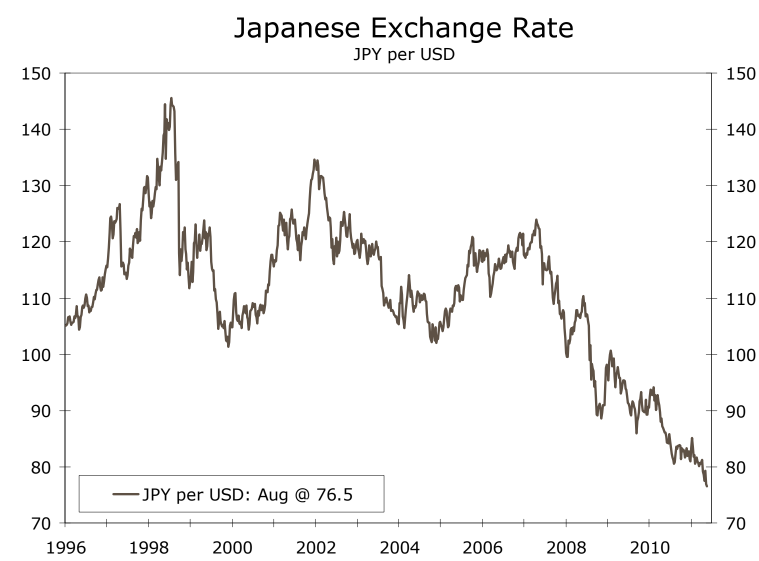
Namely, exports tumbled at an annualized rate of 18.1 percent in the second quarter, which likely reflects the supply disruptions in the wake of the March 11 earthquake and tsunami, and private residential investment was off more than seven percent. The "headline" GDP number was flattered by stock-building, which was probably unintentional, and by the 12.5 percent rise in public investment spending. Public investment spending likely will continue to rise, at least over the next few quarters, as the rebuilding effort continues.

Indeed, the good news is that economic growth in the present quarter likely will be quite strong. Industrial production (IP) tanked in March after the natural disasters, but it bounced back nicely in the second quarter (top chart). Moreover, the manufacturing PMI rose further in July, suggesting that IP probably increased again during the month. Even if production in July, August and September remains unchanged at June's level, then IP in the third quarter would still have shot up at an annualized rate of more than 19 percent relative to the depressed average in the second quarter. Not only have machinery orders bounced higher in recent months, which should translate into solid growth in business fixed-investment spending, but exports have also rebounded from their earthquake-induced drop (middle chart). Our forecast calls for Japanese real GDP to grow in excess of three percent (annualized rate) in the third quarter.

However, the bad news is that Japan faces some significant headwinds that will likely cause GDP growth to slow anew, but not necessarily turn negative again, in the quarters ahead. For starters, global economic growth remains sluggish, which will constrain growth in Japanese exports after the bounce-back from the earthquake runs its course. The recent appreciation of the yen represents another headwind on export growth and, by extension, on the overall Japanese economy. The U.S. dollar has recently dropped to an all-time low vis-à-vis the yen (bottom chart). Not only has the yen strengthened against the greenback, but it also has appreciated versus many other major currencies as well. The Japanese currency has risen about 12 percent against the euro since April, and it is up almost ten percent versus the Chinese renminbi over that period. With the United States, the Eurozone and China accounting for more than 40 percent of Japanese exports, the recent appreciation of the yen is not welcome news to Japanese manufacturers. With strong growth in Japanese consumer spending seemingly unlikely, Japan will probably continue to post lackluster overall GDP growth rates later this year and into next year.





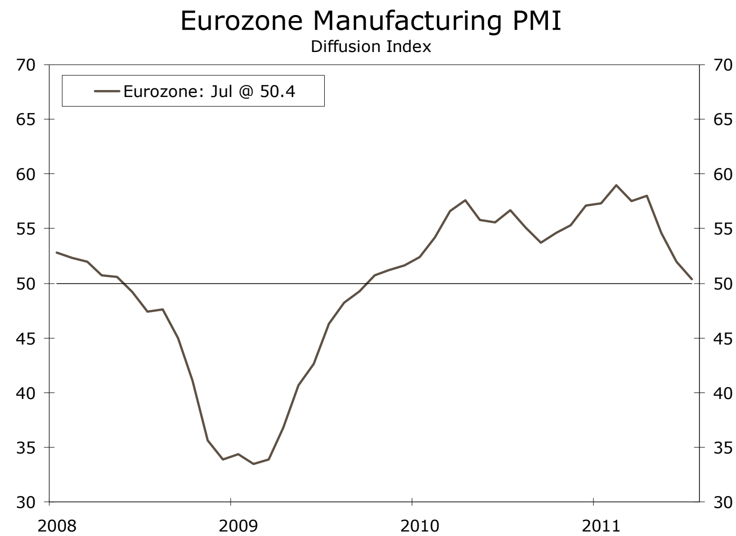


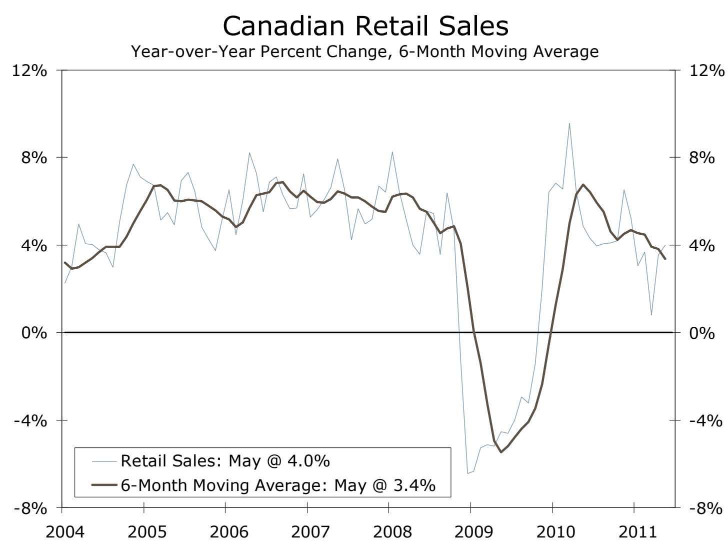
Eurozone Manufacturing • Tuesday

Manufacturing in the Eurozone followed the global downward trend in July, as the purchasing managers' index fell from 52.0 in June to 50.4 in July, barely in expansion territory. Slowing growth abroad, as well as falling demand in the region amid severe debt problems in several member countries, fueled the decline in the index. While the Eurozone battles its debt problems, the United States has embarked on its own austerity plan, as Congress finally agreed to nearly a trillion dollars in spending cuts over the next decade, which will be supplemented with another trillion or so in cuts to be passed by the end of this year. In addition, China remains concerned about rising inflation and a real estate bubble and has been raising interest rates and curbing lending. With the Eurozone in turmoil and the region's two biggest trading partners showing signs of weaker growth, we expect the manufacturing PMI will remain weak in August and may even fall into contraction.

Previous: 50.4

Consensus: 49.5





Canada Retail Sales • Tuesday

Canadian retail sales rose 0.1 percent in May from the prior month and 4.0 percent from a year earlier. Gasoline station sales rose 1.1 percent on the month and were up 23.1 percent from a year ago. Gasoline station sales were the highest in almost three years. Clothing sales rose 1.0 percent on the month, while building materials rebounded by 3.3 percent following two months of declines that were driven by wet weather. Auto sales did not fare too well, however. Motor vehicle and parts sales were down 1.0 percent from the prior month, with new car sales down 1.1 percent, as the supply disruptions from Japan continued to be felt. However, the decline in used car sales suggests supply disruptions were not the only factor driving weak sales. Although the unemployment rate continues to fall, retail sales growth has trended down over the past year. Some improvement in auto sales may have been offset by lower gasoline station sales in June as gas prices fell.

Previous: 0.1%

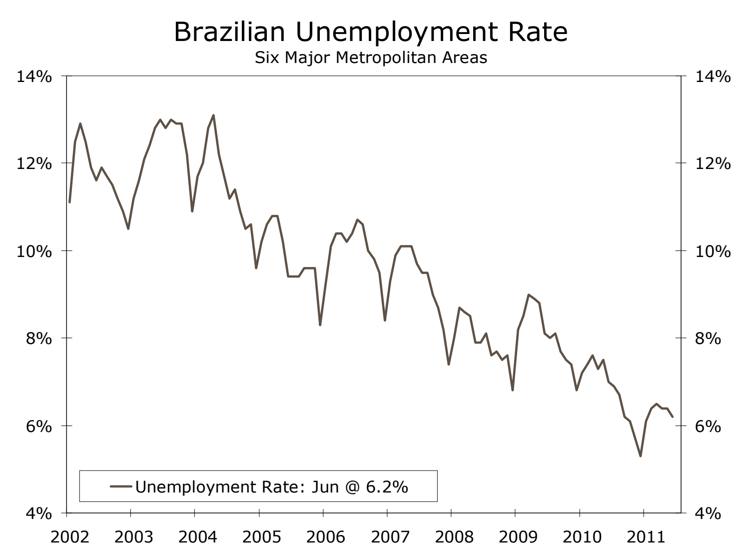
Consensus: 0.5% (Month-over-Month)

Brazil Unemployment Rate • Thursday

If you want a respite from all the doom and gloom coming out of the developed world, head on down to Brazil. The unemployment rate in Brazil has been on a steady downward trend since 2003 and came in at 6.2 percent in June. That is much lower than the 9.1 percent in the United States and the 9.9 percent in the Eurozone for June. With average real wages up 4.0 percent from a year ago in June and inflation rising at a 6.9 percent annual clip in July, the government is poised to raise interest rates further to bring inflation back into its 2.5 percent to 6.5 percent target range. However, as the global economy slows, it is likely that growth will moderate and inflation will start to cool in Brazil as well, which may take some of the pressure off the central bank to raise interest rates. Still, Brazil's economic growth of 4.2 percent year-over-year in the second quarter was an oasis compared to desert conditions in the United States and Europe.

Previous: 6.2%

Consensus: 6.1%



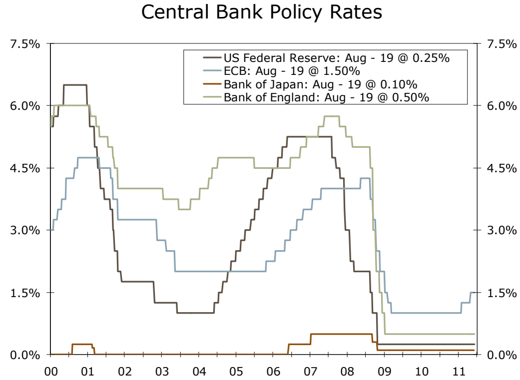
Interest Rate Watch

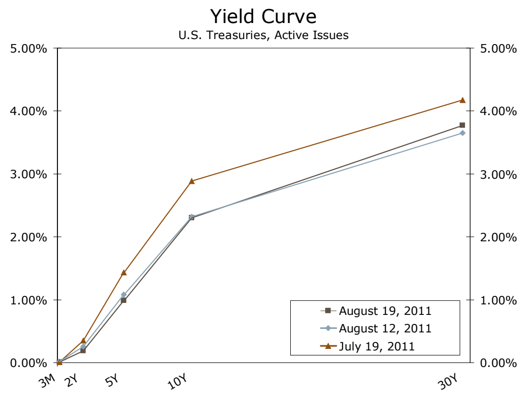
Foreign Central Banks on Hold Too

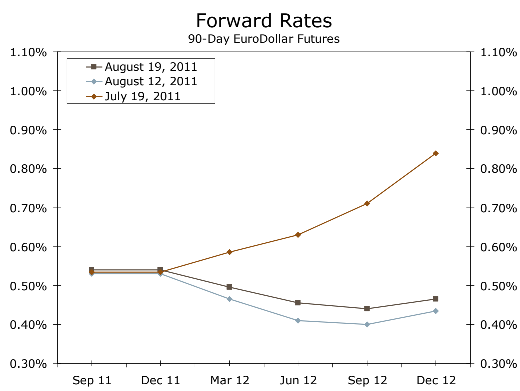
In this column last week, we discussed the FOMC's proclamation that it will likely keep the fed funds rate at low levels until mid-2013. Recent data suggest that many other major central banks will probably refrain from raising rates for the foreseeable future as well. As discussed on page 4, weak economic growth in Japan likely means that the Bank of Japan (BoJ) will not be hiking rates anytime soon. Indeed, essentially all analysts, ourselves included, look for the BoJ to remain on hold through at least the end of 2012.

Recent developments in Europe have probably dampened enthusiasm within the European Central Bank (ECB) for further tightening in the months ahead. Data released this week showed that real GDP in the overall euro area rose only 0.2 percent (not annualized) in the second quarter as the German economy, heretofore the star performer in the Eurozone, essentially stagnated. Available indicators point toward continued sluggish growth in the third quarter, and the core CPI inflation rate fell to only 1.2 percent in July from 1.6 percent in June. With the European sovereign debt crisis continuing to burn out of control, it seems unlikely that the ECB will tighten again—it hiked rates by 50 bps between April and July—anytime soon.

If there was any doubt that the Bank of England would be on hold for the foreseeable future, those doubts were put to rest this week with the release of the minutes from the last policy meeting. Between October and July at least two members of the Monetary Policy Committee (MPC) had voted to raise rates. However, the minutes from the August 4 meeting revealed that no MPC members were in favor of a rate hike at that meeting. Moreover, recent data show that economic growth in the United Kingdom remains very weak. The manufacturing PMI in July edged below the demarcation line that separates expansion from contraction, and the unemployment rate rose 0.2 percentage points in July. Rather than raising rates, the MPC may eventually sanction another round of quantitative easing.







Credit Market Insights

C&I Lending Demand Returning

In the months after the financial crisis had begun, one notable trend that emerged was a large drop-off in lending to commercial and industrial organizations. In all, the total amount of C&I loans fell 23.0 percent from their peak in October of 2008 until total C&I lending bottomed out in the third quarter of 2010. Over the past few months, C&I lending activity has gradually picked up as lending standards have begun to loosen, pointing toward stronger growth for these loans. This week's release of the Senior Loan Officer's Survey also pointed toward some modest pickup in the demand for C&I loans. While not a perfect metric, the fact that firms are seeking loans suggests there is some level of optimism about the pace of economic growth going forward. In addition, the net percentage of banks tightening standards for C&I loans continued to fall in July, as the total amount of C&I loans continued to improve. However, there is one caveat, C&I lending standards were loosened for medium and large businesses, but continued to remain tight for smaller firms. With the return of C&I lending, there is a strong indication that firms are taking advantage of low borrowing costs and taking steps to prepare for future demand. With new fears of another recession beginning to emerge on the heels of last week's extreme market volatility, the positive trend in commercial lending is at least one indicator that does not support the case for another economic contraction.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.15%	4.32%	4.52%	5.08%
15-Yr Fixed	3.36%	3.50%	3.66%	4.39%
5/1 ARM	3.08%	3.13%	3.27%	4.10%
1-Yr ARM	2.86%	2.89%	2.97%	4.05%
MBA Applications				
Composite	716.4	688.0	556.0	829.7
Purchase	167.5	184.2	183.7	169.4
Refinance	3,915.5	3,625.7	2,728.6	4,676.7

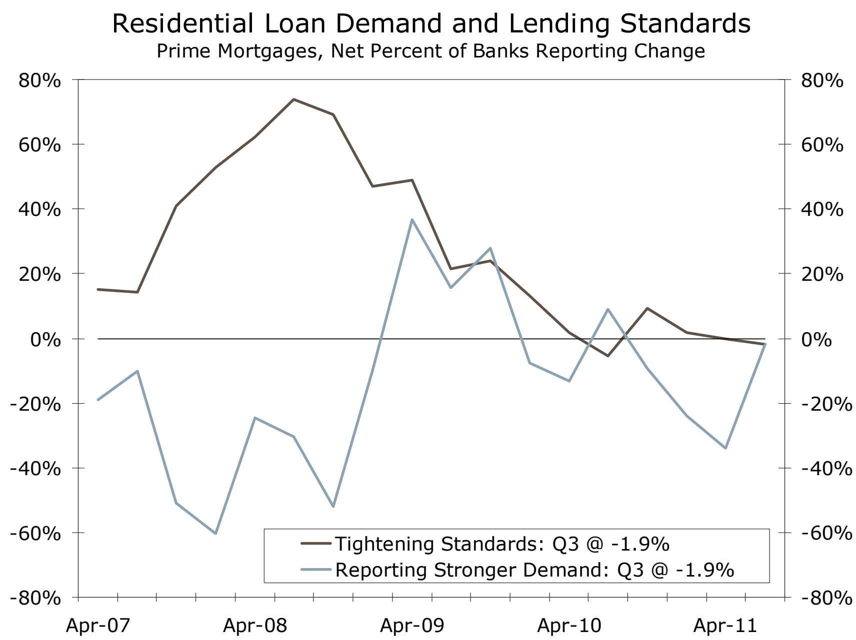
Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

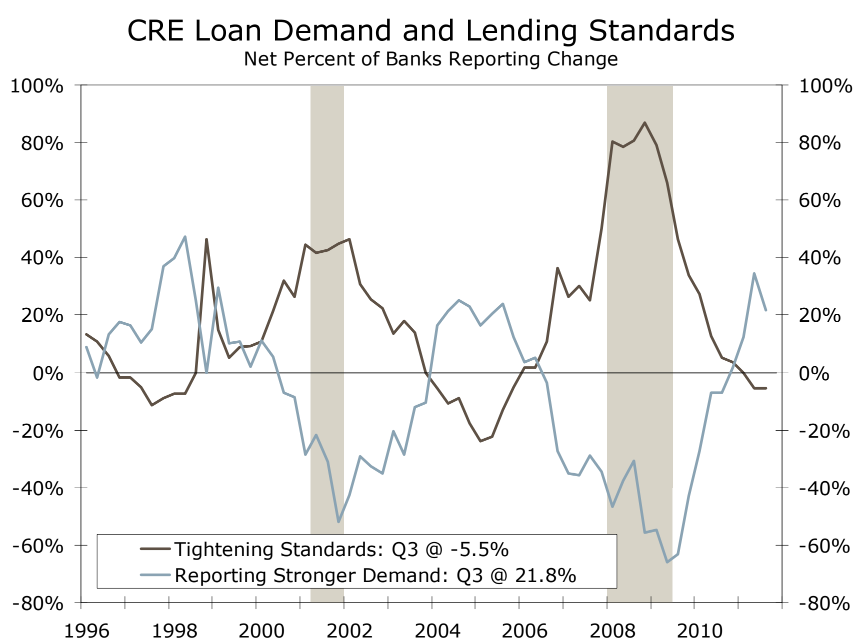
Topic of the Week

Residential Lending Remains Weak

Earlier this week, third quarter data from the Federal Reserve's Senior Loan Officer Opinion Survey (SLOOS) was released. In addition to providing data on demand and lending standards for C&I loans (see our Credit Market Insights section above), the report shed light on the state of residential lending. Demand for residential loans continued to fall in the third quarter with a majority of lenders reporting that they do not expect a pickup for the rest of the year. However, the survey was completed in late July before the recent turmoil in markets and the FOMC's pledge to keep interest rates low through mid-2013. Since then, mortgage rates have steadily declined to a historic low of 4.15 percent. The recent fall in mortgage rates is unlikely to be a panacea for the housing market, but may give a boost to lending through refinancing activity. MBA application data show an increase in refinance applications in four out of the past five weeks. However, with rates having already been at historic lows and many homeowners previously refinancing over the past few years, the recent uptick in re-fi's may be short-lived. Additionally, according to CoreLogic, 22.7 percent of homeowners remain underwater on their loan, making them unable to refinance and take advantage of lower rates.

Perceptions of tight credit standards may be contributing to the weak demand for home mortgages. On net, a small fraction of banks eased lending standards in the third quarter, but standards remain historically high, according to a special question in this quarter's SLOOS. This has kept many would-be buyers in the rental market—despite the increase in housing affordability over the past few years—and has benefitted the multifamily sector. Banks reported that demand for commercial real estate (CRE) loans increased for the fourth straight quarter, while standards for CRE loans eased for the second straight quarter. This supports our outlook for continued strength in the apartment sector, but tight standards and low demand for residential loans will continue to weigh on housing market activity.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/19/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.00	0.01	0.15
3-Month LIBOR	0.30	0.29	0.34
1-Year Treasury	0.10	0.10	0.26
2-Year Treasury	0.19	0.19	0.48
5-Year Treasury	0.90	0.96	1.40
10-Year Treasury	2.07	2.25	2.58
30-Year Treasury	3.39	3.73	3.65
Bond Buyer Index	3.83	3.97	4.03

Foreign Exchange Rates

	Friday 8/19/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.432	1.425	1.282
British Pound ($/£)	1.650	1.628	1.560
British Pound (£/€)	0.868	0.875	0.822
Japanese Yen (¥/$)	76.500	76.710	85.390
Canadian Dollar (C$/$)	0.991	0.987	1.040
Swiss Franc (CHF/$)	0.791	0.778	1.032
Australian Dollar (US$/A$)	1.037	1.036	0.893
Mexican Peso (MXN/$)	12.309	12.309	12.705
Chinese Yuan (CNY/$)	6.392	6.390	6.791
Indian Rupee (INR/$)	45.748	45.404	46.575
Brazilian Real (BRL/$)	1.599	1.626	1.753
U.S. Dollar Index	74.243	74.607	82.447

Foreign Interest Rates

	Friday 8/19/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.48	1.49	0.83
3-Month Sterling LIBOR	0.87	0.85	0.73
3-Month Canadian LIBOR	1.13	1.12	1.02
3-Month Yen LIBOR	0.19	0.19	0.24
2-Year German	0.64	0.69	0.66
2-Year U.K.	0.60	0.65	0.66
2-Year Canadian	0.86	0.93	1.37
2-Year Japanese	0.14	0.15	0.12
10-Year German	2.09	2.33	2.31
10-Year U.K.	2.36	2.53	3.01
10-Year Canadian	2.31	2.46	2.92
10-Year Japanese	0.99	1.05	0.94

Commodity Prices

	Friday 8/19/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	79.75	85.38	74.43
Gold ($/Ounce)	1872.80	1746.90	1232.15
Hot-Rolled Steel ($/S.Ton)	665.00	665.00	565.00
Copper (¢/Pound)	396.90	400.95	331.75
Soybeans ($/Bushel)	13.56	13.27	10.16
Natural Gas ($/MMBTU)	3.91	4.06	4.17
Nickel ($/Metric Ton)	21,260	21,551	21,831
CRB Spot Inds.	567.85	564.93	502.67

Next Week's Economic Calendar

	Monday 22	Tuesday 23	Wednesday 24	Thursday 25	Friday 26
U.S. Data		**New Home Sales** June 312K July 310K (W)	**Durable Goods Ord.** June -1.9% July 2.0% (W) **Durables Ex Tran.** June 0.4% July -0.1 (W)		**GDP** 2Q 1.3% 2Q 1.3% (W)
Global Data		**Canada** **Retail Sales (MoM)** Previous (May) 0.1% **Eurozone** **Manufacturing PMI** Previous (Jun) 50.4		**Brazil** **Unemployment Rate** Previous (Jun) 6.2% **Japan** **CPI (YoY)** Previous (Jun) -0.4%	**UK** **GDP (QoQ)** Previous (Q1) 0.2%

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

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