August 31, 2012

Economics Group

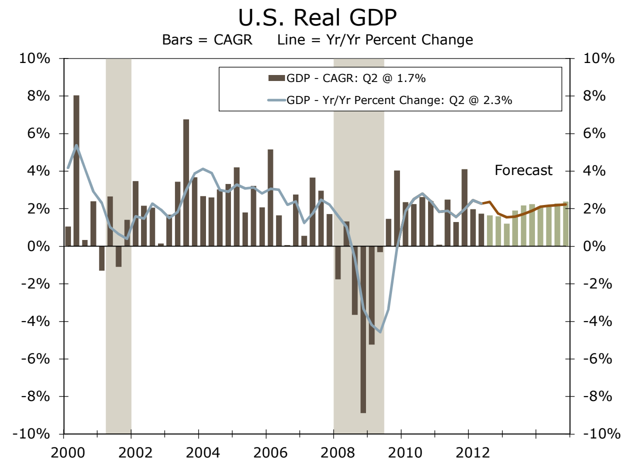
WELLS FARGO SECURITIES

Weekly Economic & Financial Commentary

U.S. Review

So, Where Is the Growth?

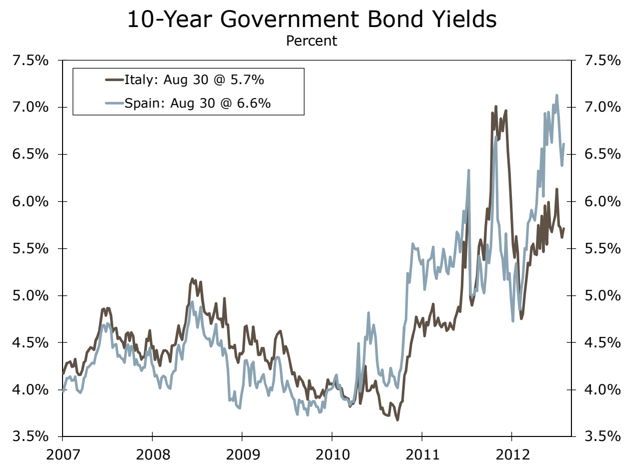
- Second quarter real GDP growth was revised slightly higher to a 1.7 percent annual rate. Consumer spending was not as weak as first reported, and there was less inventory building, which slightly raises hopes for Q3 growth prospects.
- Consumer confidence posted a surprising 4.8 point drop in August to 60.6, marking its low point for the year. The drop was mostly in expectations, with fewer jobs expected to be created in the coming months.
- Personal income and spending rose solidly in July, and early reports on the back-to-school season were stronger than expected.



Global Review

All Quiet in Europe, at Least for Now

- Europe has been on the back burner for the past month, but it is about to take center stage again. Catalonia, the largest region in Spain, requested a bailout from the central government in Madrid, and recent data confirm that the country remains mired in recession.
- Negotiations have intensified recently about Spain and Italy seeking formal financial rescue packages. If so, the ECB could engage in another round of government bond purchases to bring down borrowing costs. There is plenty that could go "right" or, conversely, "wrong" in the weeks ahead.



Wells Fargo U.S. Economic Forecast

	Forecast 2012 1Q	2Q	3Q	4Q	Forecast 2013 1Q	2Q	3Q	4Q	Actual 2010	Actual 2011	Forecast 2012	Forecast 2013
Real Gross Domestic Product [1]	2.0	1.7	1.6	1.6	2.1	2.1	2.3	2.4	2.4	1.8	2.2	1.7
Personal Consumption	2.4	1.7	1.3	1.3	1.3	1.2	1.3	1.4	1.8	2.5	1.8	1.2
Inflation Indicators [2]												
PCE Deflator	2.4	1.7	1.3	1.4	1.7	1.8	1.9	2.0	1.9	2.4	1.7	1.3
Consumer Price Index	2.8	1.9	1.4	1.7	2.3	2.2	2.1	2.1	1.6	3.1	2.0	2.2
Industrial Production [1]	5.8	2.5	3.7	2.0	3.3	3.9	4.1	4.1	5.4	4.1	4.2	2.6
Corporate Profits Before Taxes [2]	10.3	6.1	5.7	5.3	6.7	6.8	7.0	7.3	26.8	7.3	6.8	5.5
Trade Weighted Dollar Index [3]	72.7	74.5	72.5	74.0	79.0	79.5	80.0	80.5	75.6	70.9	73.4	76.5
Unemployment Rate	8.3	8.2	8.3	8.3	8.0	7.9	7.7	7.5	9.6	9.0	8.3	8.2
Housing Starts [4]	0.71	0.74	0.76	0.76	0.92	0.97	1.01	1.01	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
Conventional Mortgage Rate	3.95	3.68	3.62	3.50	0.00	0.00	0.00	0.00	4.69	4.46	3.69	3.60
10 Year Note	2.23	1.67	1.70	1.65	2.00	2.20	2.40	2.50	3.22	2.78	1.81	1.79

Forecast as of: August 31, 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

Still on the Slow Track

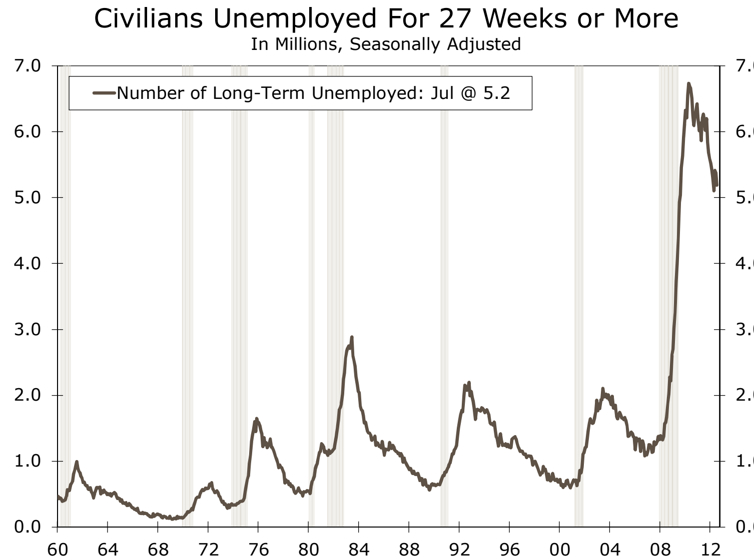
This week's economic reports were overshadowed somewhat by all of the political and monetary policy rhetoric coming from the GOP convention and Jackson Hole Federal Reserve Policy retreat. The talking will continue next week as the Democratic convention kicks into gear and we move closer to the Sept. 12-13 FOMC meeting. Expectations currently call for the Fed to extend the period of time it expects interest rates to remain near zero through 2015. The odds of additional quantitative easing have also increased but will depend on the data, particularly the employment data, leading up to the FOMC meeting. Federal Reserve Board Chairman Ben Bernanke's Jackson Hole speech drove home these points, and if anything, Bernanke appears to have upgraded his concern about the labor market, referring to the stagnation in the labor market as a "grave" concern and referring to persistence of high unemployment potentially wreaking long-term structural damage to the economy.

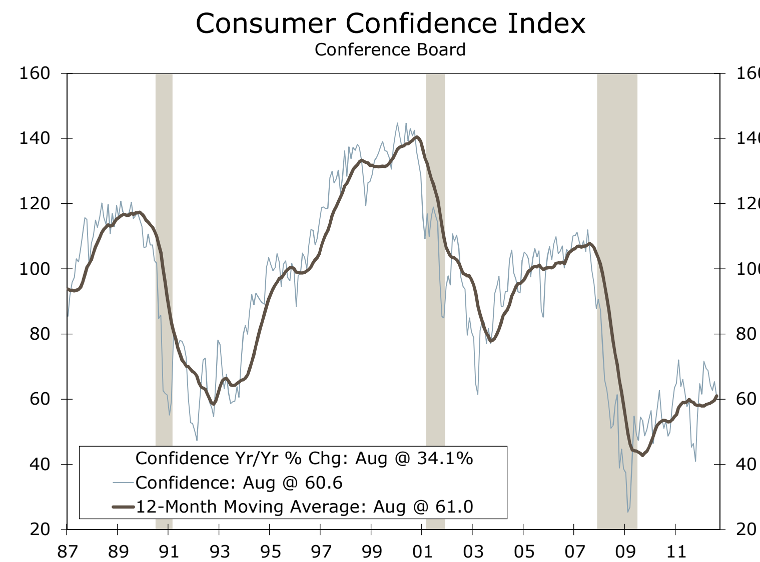
Aside from the somewhat obvious conclusion that Bernanke's speech implies additional monetary ease will likely be needed, another key takeaway is that the Fed is taking its cues on the labor market from measures other than the unemployment rate. The reference to the "enormous suffering and waste of human talent" that persistent high unemployment produces suggests the Fed is paying much more attention to structural issues, such as the epic slide in labor force participation and the stubbornly high number of long-term unemployed.

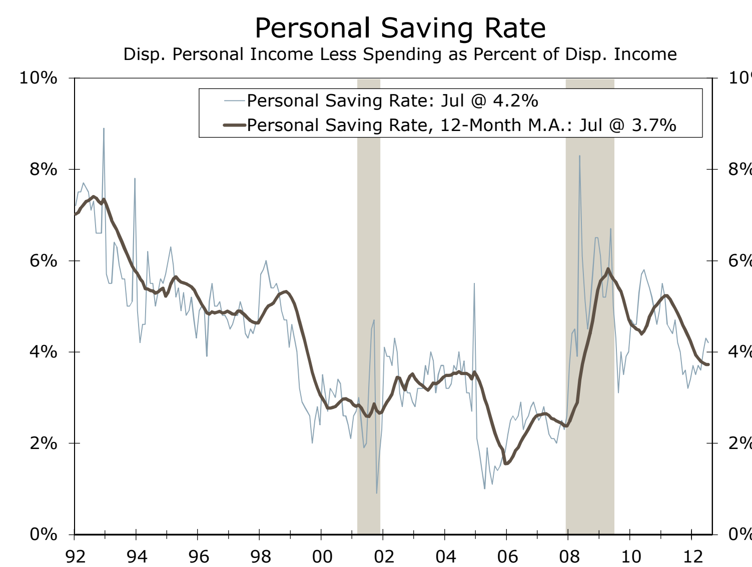
This past week's economic reports gave little hint that the U.S. economy is breaking away from its recent slumber. Real GDP growth was revised up slightly for the second quarter, with the previously reported drop in consumer spending on durable goods revised all the way to no change. Inventories also rose less than previously reported, which slightly raises expectations for growth in the current quarter. International trade made a larger contribution than first reported, but early signs for the current quarter suggest exports have slowed significantly.

The 4.8-point slide in consumer confidence in August was a significant downside surprise. Most of the drop was in the expectations series, which had inexplicably risen in July. One factor that may have contributed to consumers' heightened concerns about the future is the sharp run-up in gasoline prices during the month. The nationwide price of a gallon of regular gasoline increased by about a quarter during the four weeks leading up to the survey period and has continued to increase. Buying plans also decreased sharply, particularly for automobiles.

Paradoxically, back-to-school sales apparently got off to a strong start. The ICSC Chain Store Sales index rose 6 percent year-over-year in August, with apparel sales showing surprising strength. Retail sales are volatile on a month-to-month basis, however, and we would caution against reading too much into the surprising August figures. Overall personal consumption expenditures rose 0.4 percent in July, while income rose just 0.3 percent. The saving rate continues to retreat, as real after-tax income growth continues to show little to no improvement.







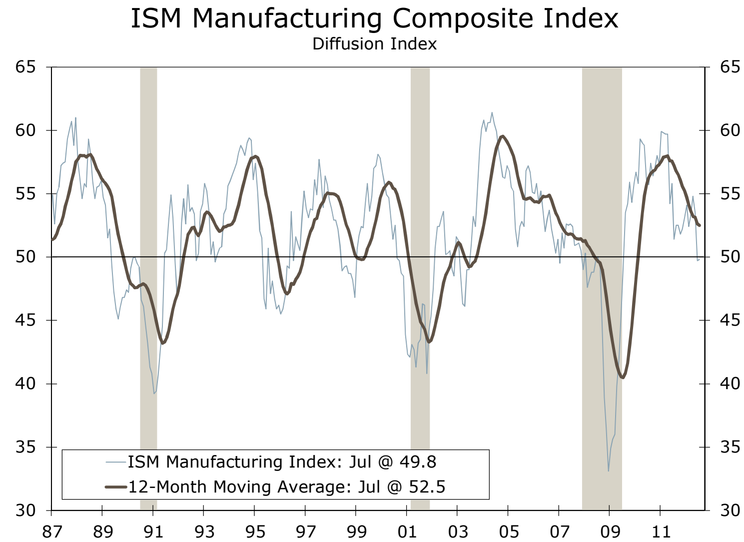
Source: Conference Board, U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

ISM Manufacturing • Tuesday

Reflecting weak domestic demand and the global economic slowdown, the ISM manufacturing index remained below the breakeven threshold for the second consecutive month. Much of the weakness was in new orders, supplier deliveries and inventories. While exports are not calculated in the composite index, the two consistent monthly declines largely weighed on the headline as exports make up significant portion of final demand. While the composite index fell below the symbolic threshold in July, the level is still not consistent with a recession at 49.8. A composite index reading below 42.6 generally reflects declining economic activity. Moreover, we suspect that some of the slow down in manufacturing activity is temporary and the index will likely reach expansionary territory in August. Regional manufacturing indexes released for August suggest further weakness ahead, but continued improvement in industrial production is far more reliable.

Previous: 49.8 **Wells Fargo: 50.3**

Consensus: 50.0

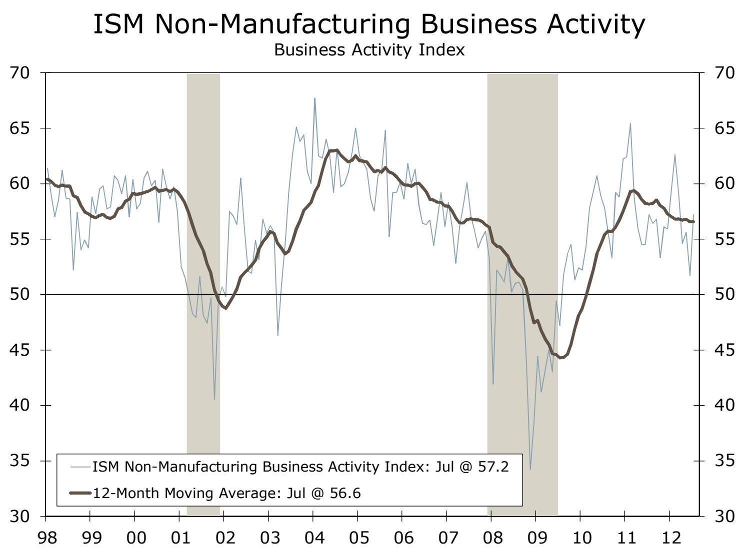


ISM Nonmanufacturing • Thursday

Activity in the service sector has declined since the beginning of the year, continuing to suggest slow economic growth. In contrast to the manufacturing sector, the ISM nonmanufacturing composite index remained above the breakeven threshold. In fact, business activity reached its highest level since March at 57.2 and new orders increased on the month to 54.3. Another positive note in the report was the increase in exports orders, while imports dipped into contractionary territory. Supplier deliveries and employment, however, slipped into negative territory, pulling the headline down to 52.6. Taken together, weak components of the ISM nonmanufacturing index point to general slowing in demand and overall economic activity. That said, we continue to expect economic growth to remain below trend with the second half of the year slowing to around a 1.6 percent annual pace. Trade is expected to make a modest contribution, while inventories remain flat.

Previous: 52.6 **Wells Fargo: 52.9**

Consensus: 52.5

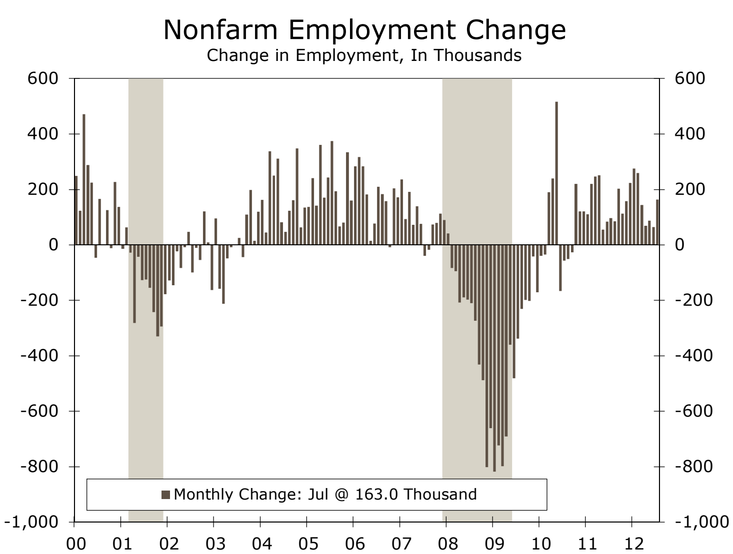


Employment • Friday

Following three consecutive months of lukewarm readings, nonfarm employment rose by 163,000 jobs in July. With the exception of construction and government, gains were broad-based and suggest continued improvement. The largest increases occurred in business services, education and health and leisure and hospitality. The labor force, however, dropped by 150,000 workers, continuing to reflect structural challenges in the labor market. With the drop in the labor force, the unemployment rate remained unchanged at 8.3 percent. In fact, the U-6 series, which is the broadest measure of discouraged workers, increased to its highest level since the beginning of the year. Moreover, we do not expect the rebound in the headline to stick as the employment component in the ISM manufacturing and ISM nonmanufacturing index continues to show weakness. Indeed, employment in the ISM nonmanufacturing index slipped into negative territory in July.

Previous: 163K **Wells Fargo: 75K**

Consensus: 125K



Source: Institute for Supply Management, U.S. Department of Labor and Wells Fargo Securities, LLC

Global Review

All Quiet in Europe, at Least for Now

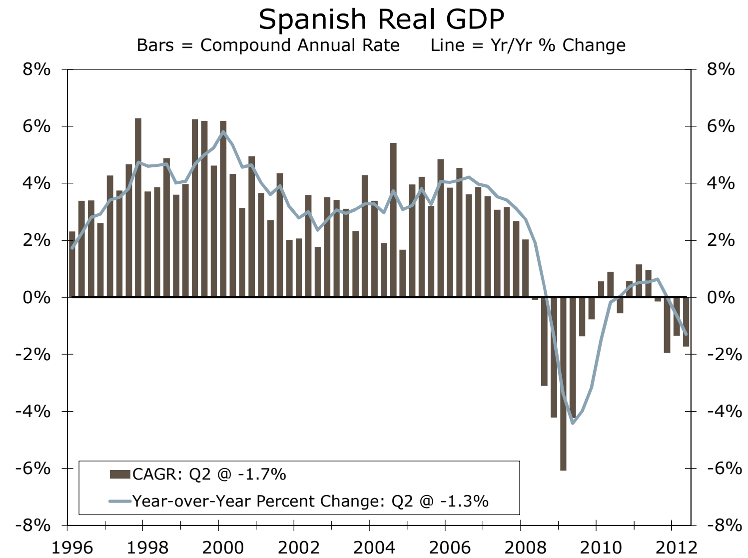
The sovereign debt crisis in the Eurozone has been off the front pages for the past month or so, and financial market tensions have dissipated somewhat. For example, government bond yields in Spain and Italy have receded from their highs of early August (see graph on front page). Markets stabilized about a month ago after ECB President Draghi said that European policymakers would do "whatever it takes" to save the euro. The debt crisis may be on the back burner now, but it has by no means gone away yet.

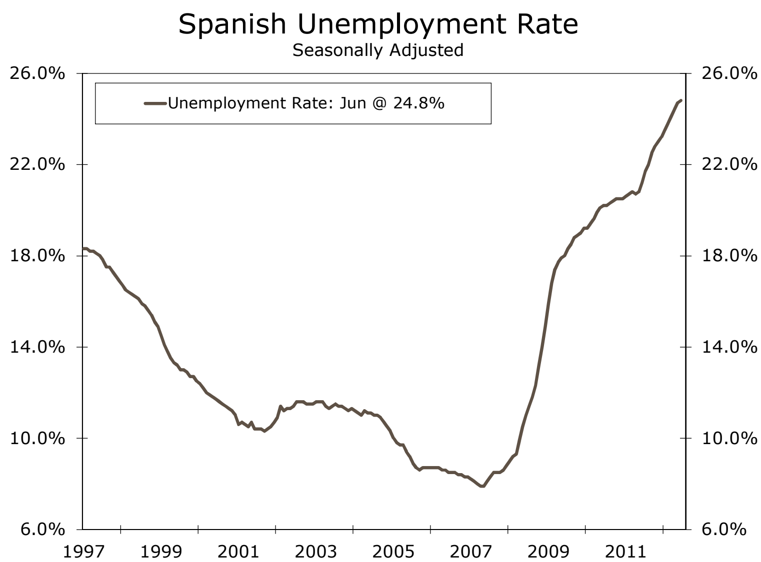
In that regard, Spain, which is now the epicenter of the crisis, was very much in the news this week. For starters, Catalonia, which has the largest economy among the country's regions, requested a €5 billion bailout package from the central government in Madrid. The announcement served as a poignant reminder that the fiscal crisis in Spain is far from resolved. In addition, the 0.4 percent (not annualized) decline in Spanish GDP in the second quarter that was announced a month ago was confirmed this week. Spanish GDP has contracted for four consecutive quarters, leaving the overall economy 1.3 percent smaller than it was a year ago (top chart). Moreover, the unemployment rate has skyrocketed to 25 percent, underlining the weakness in the economy (middle chart).

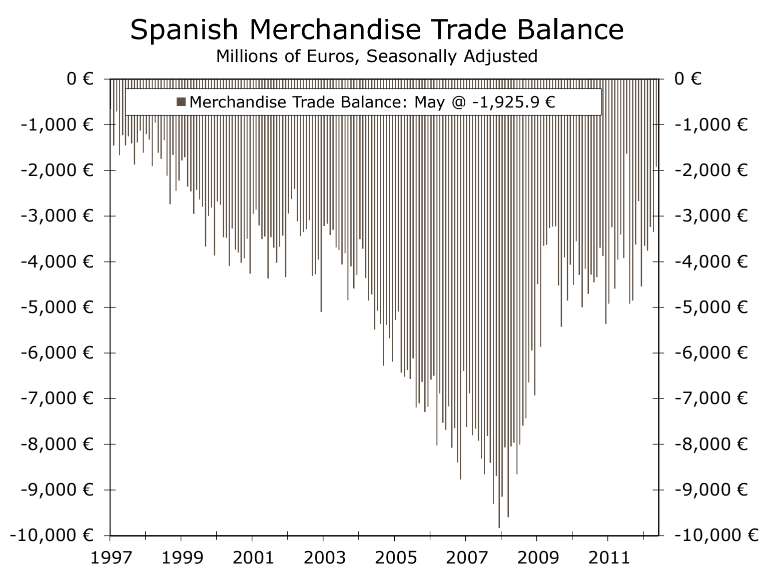
If there is any good news in the Spanish economy today, it is the sharp narrowing in the trade deficit that has occurred (bottom chart). Weakness in domestic demand—real household consumption fell 1.0 percent in Q2 and investment spending tumbled 3.0 percent—has contributed to the drop in imports (real imports of goods and services were down 5 percent on a year-ago basis in Q2). On the other hand, real exports of goods and services rose 3 percent in Q2. In other words, net exports have helped to blunt the contractionary effects on the Spanish economy of falling domestic demand. That said, with weakness in Spain's major trading partners—more than 50 percent of the country's exports go to other economies in the euro area—it is questionable how long exports can remain buoyant.

Although Europe has been generally quiet for the past month or so, it is about to take center stage again. The ECB holds a regularly scheduled policy meeting next week that will be closely watched, because another rate cut is a possibility. More important, the ECB could signal whether it is prepared to embark on another round of Italian and Spanish government bond purchases. However, ECB officials have hinted that the Spanish and Italian governments need to enter into a formal bailout package as a precondition for further ECB bond purchases, and there has been a flurry of diplomatic activity among European leaders in recent weeks. Will Italy and Spain formally seek financial assistance? Market participants will be closely watching.

In the following week, the German constitutional court will rule on the constitutionality of Germany participating in the bailout fund, while the Netherlands holds parliamentary elections. Further out, another summit of E.U. leaders will be held in Brussels on Oct. 18-19. There are plenty of opportunities in coming weeks for Europe to raise its ugly head again.







Source: IHS Global Insight and Wells Fargo Securities, LLC

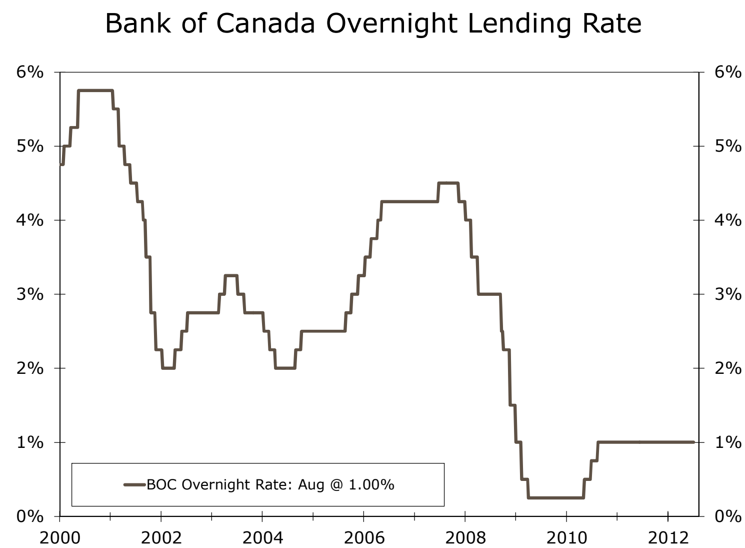
Bank of Canada Rate Decision • Wednesday

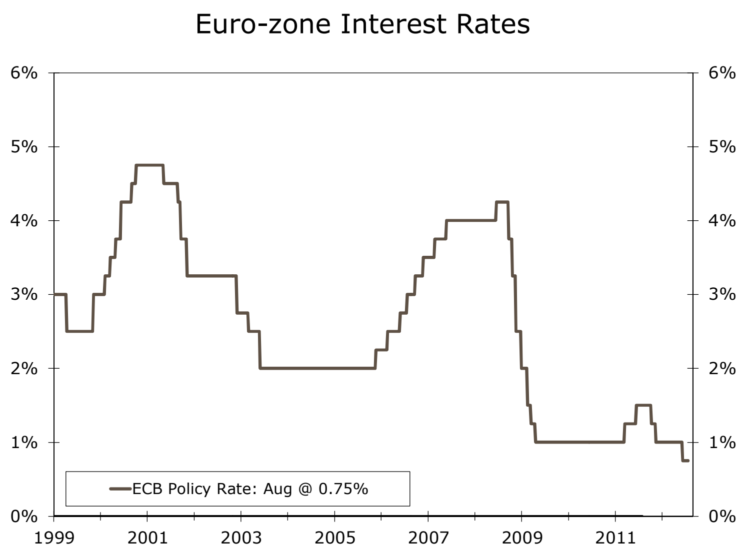
At its June meeting, the Bank of Canada (BoC) opted to leave the overnight lending rate in Canada unchanged at 1.0 percent, but it still left the door open to future rate increases. The main body of the BoC's press release noted that "Global growth prospects have weakened" but ultimately maintained a rosy assessment that domestic demand would underpin Canadian economic growth.

We learned this week that GDP in Canada grew at a 1.8 percent annualized rate in the second quarter. The outturn was better than expected. This probably means that the BoC will continue to hold out the possibility of another rate hike. But ultimately we suspect that slower growth in the U.S. and global economy will weigh on growth in Canada and the BoC ultimately decide not to raise rates this year.

Previous: 1.0% **Wells Fargo: 1.0%**

Consensus: 1.0%





ECB Rate Decision • Thursday

In the weeks that have passed since ECB President Draghi pledged to do "whatever it takes" to preserve the euro, Spanish and Italian government bonds have started to sell off and yields have begun creeping upward again as financial markets wait for definitive confirmation of a policy move from the ECB that would help alleviate Europe's troubles.

Given the challenges confronting Europe at present, the "fix" would require political decision making that is beyond the purview of the ECB. Those sorts of decisions would also require rather long lead times and meetings. For that reason, we do not expect a major policy announcement on Thursday of next week.

Previous: 0.75% **Wells Fargo: 0.75%**

Consensus: 0.75%

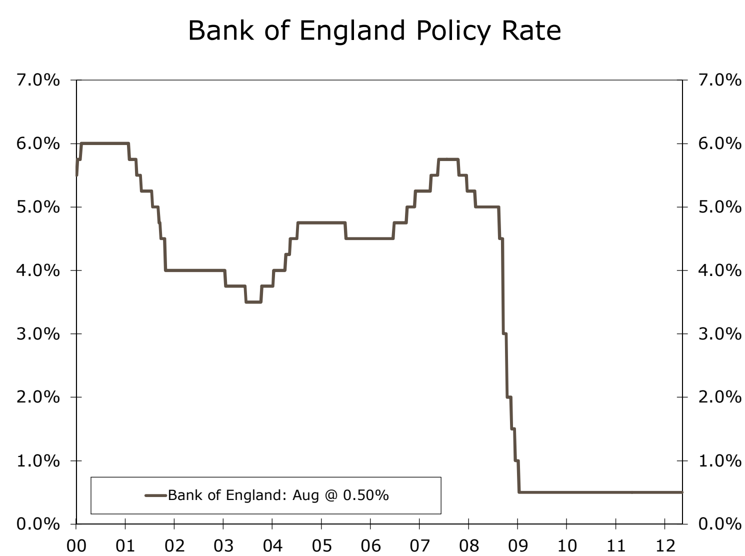
Bank of England Rate Decision • Thursday

Real GDP in the United Kingdom has contracted for three consecutive quarters. Fortunately, the year-over-year rate of CPI inflation has been below 3 percent since May. That gives the Bank of England room to continue to ease monetary policy in an attempt to spur economic growth. The Monetary Policy Committee (MPC) agreed at its July policy meeting to increase the size of its quantitative easing program to £375 billion from £325 billion.

However, we do not expect any further easing when the BOE announces its asset purchase target and lending rate on Thursday of next week.

Previous: 0.50% **Wells Fargo: 0.50%**

Consensus: 0.50%



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

Interest Rate Watch

Bernanke: The Fed Has Options

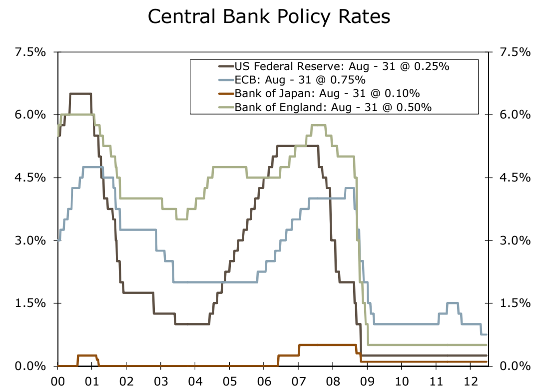
Chairman Bernanke's speech at the Jackson Hole conference suggests that the Federal Reserve has a number of policy options to provide further stimulus, including another round of asset purchases, but there was no immediate announcement of any policy action. Our view, which is an extension of the interest rate guidance through 2015 but no QE3 at the Sept. 12-13 Federal Open Market Committee meeting, may be influenced by a weak jobs report. A weak jobs number may draw more substantial action at the September meeting.

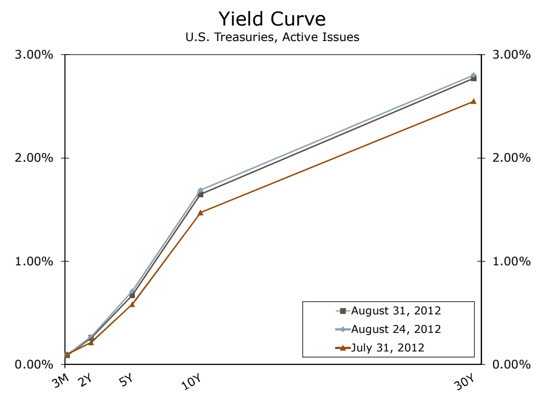
Why No Announcement Today?

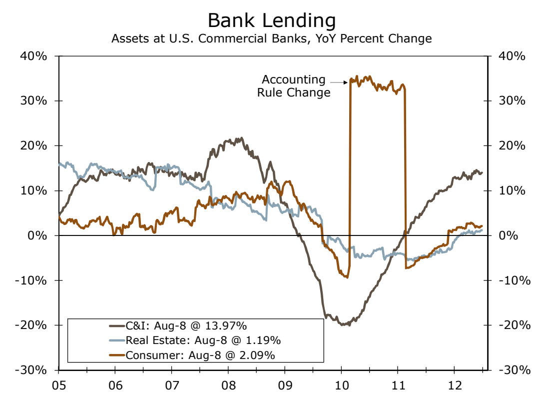
Three reasons present themselves. First, the next FOMC meeting is just two weeks away and the chairman did not wish to preempt the discussions at that meeting as the case for unanimous action to further ease is, in our view, unlikely at this time. The September meeting also will include a discussion of the Fed's overall outlook for growth, inflation and credit, and thereby would provide intellectual support for any action. Finally, given recent comments and our reading of the August FOMC meeting minutes, there was not a firm consensus about further easing that would not have drawn several dissents. Given the political season and the differing outlook among the FOMC members, we suspect the chairman sought to avoid the appearance of any dissention at this important time.

If Not Now, then When?

Anytime would be our reply. The pace of current and expected future growth will be the driving factor in any future easing as inflation is not an issue at this time. However, even more important will be the perception by members of the FOMC of whether an 8-percent-plus unemployment rate represents a sustainable state of the economy consistent with the Fed's dual mandate. It is clear from the chairman's speech today that the labor market remains a primary concern, and the committee may be moved to further action by lack of sufficient progress in the labor market's recovery.







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

Credit Market Insights

Consumer Deleveraging: Debt Repayment versus Charge-offs

One of the primary reasons consumer spending has been relatively weak in this recovery is that consumers have significantly decreased debt relative to income. Consumer and mortgage debt as a percent of income—the leverage ratio—has fallen from a peak of 123 percent in 2007 to 104 percent in the first quarter of 2012. Over the past year, consumer debt, such as credit cards, auto loans and student loans, has risen, leaving lower mortgage debt as the current source of the reduction in total household debt. Yet, how much of the decline is due to repayments versus charge-offs in the wake of the housing crisis?

Data from the Federal Reserve Bank of New York has revealed that an increasingly large share of the decline in mortgage debt since 2008 is due to households paying down their loans. According to data from the Household Debt and Credit Report, charge-offs and pay-downs totaled $273 billion in 2008, the first year the leverage ratio began to decline. Charge-offs accounted for 86 percent of that total, but have slipped as a share of the source of debt reduction. As of 2011, charge-offs only comprised 56 percent of debt reduction, with the remainder accounted for by households paying down their mortgage. Household leverage has also moved lower due to a 7 percent rise in income from 2008 to 2011, putting households in a slightly better financial position than when the past recession started.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.59%	3.66%	3.55%	4.22%
15-Yr Fixed	2.86%	2.89%	2.83%	3.39%
5/1 ARM	2.78%	2.80%	2.75%	2.96%
1-Yr ARM	2.63%	2.66%	2.70%	2.89%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,464.3	-4.34%	11.58%	13.35%
Revolving Home Equity	$532.8	-8.01%	-5.43%	-4.48%
Residential Mortgages	$1,564.6	-33.90%	-4.51%	4.73%
Commerical Real Estate	$1,409.3	-4.69%	-3.07%	-1.47%
Consumer	$1,112.0	-3.06%	2.17%	2.17%

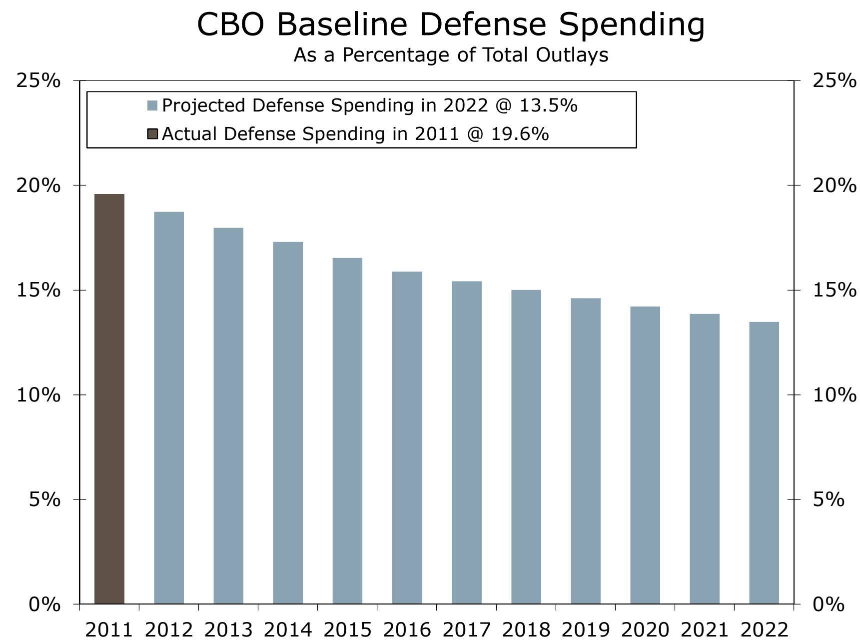
Source: Freddie Mac, Federal Reserve Board and Wells Fargo Securities, LLC

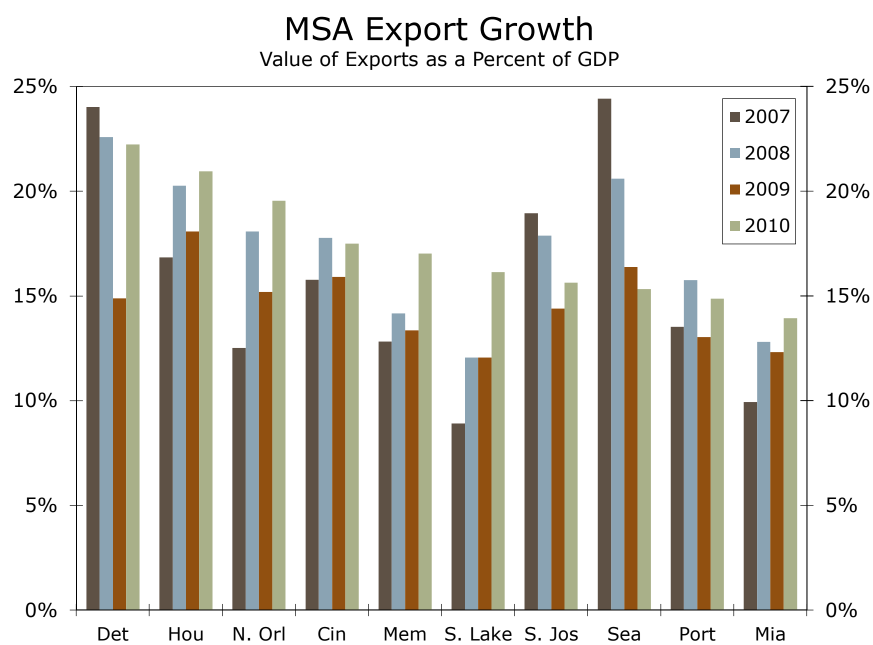
Topic of the Week

Key Metro Areas Face Risks from Federal Spending Cuts and Slowing Exports Growth

Over the next six months, metro areas around the country will face increasing risks to growth from impending federal spending cuts along with a slowing global economy. Under existing law, the federal government is set to reduce spending considerably over the next 10 years, primarily for contracts and grants. The potential exists that these policies could be implemented, sending the nation over the so-called "fiscal cliff." If this situation were to occur, there would obviously be severe effects on local-level governments. Many of the nation's major metropolitan areas are at risk of deep federal spending reductions. One clear trend that emerges from looking at the metro areas that face the greatest risk to federal spending reductions is that the areas most at risk of these cuts are related to defense department employment or contracts. Thus, defense cuts would likely hit a more wide-spread area of the country than other federal budget reductions. Given that defense spending is slated to decline as a share of the federal budget over the next few years, there are risks of at least some federal budget cuts affecting these regions, resulting in downside risks to growth.

Fourteen of the nation's 50 largest metropolitan areas depend on exports to provide more than 10 percent of the local economy. The metro areas most at risk from slowing export growth are highlighted in the graph to the right. A theme persists among many of these metropolitan areas—exports heavily weighted toward the manufacturing industry: transportation equipment, chemical, petroleum and coal products and other commodity manufacturing. In addition to the weight a global slowdown will bear on the value of exports, slowing demand will also endanger export-related employment. Therefore, metro areas reliant on trade need to be aware of the external environment and their downside risks.





Source: U.S. Department of Treasury and U.S. Department of Commerce

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/31/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.09	0.09	0.01
3-Month LIBOR	0.42	0.42	0.33
1-Year Treasury	0.17	0.17	0.11
2-Year Treasury	0.25	0.27	0.20
5-Year Treasury	0.67	0.71	0.96
10-Year Treasury	1.65	1.69	2.22
30-Year Treasury	2.77	2.80	3.60
Bond Buyer Index	3.72	3.76	4.14

Foreign Exchange Rates

	Friday 8/31/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.261	1.251	1.437
British Pound ($/₤)	1.586	1.581	1.625
British Pound (₤/€)	0.795	0.791	0.884
Japanese Yen (¥/$)	78.480	78.670	76.660
Canadian Dollar (C$/$)	0.990	0.992	0.978
Swiss Franc (CHF/$)	0.952	0.960	0.806
Australian Dollar (US$/A$	1.034	1.040	1.071
Mexican Peso (MXN/$)	13.303	13.173	12.333
Chinese Yuan (CNY/$)	6.349	6.355	6.378
Indian Rupee (INR/$)	55.528	55.495	46.095
Brazilian Real (BRL/$)	2.045	2.027	1.590
U.S. Dollar Index	81.213	81.593	74.117

Foreign Interest Rates

	Friday 8/31/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.17	0.18	1.48
3-Month Sterling LIBOR	0.68	0.69	0.89
3-Month Canadian LIBOR	1.29	1.29	1.15
3-Month Yen LIBOR	0.19	0.19	0.19
2-Year German	-0.01	-0.01	0.72
2-Year U.K.	0.11	0.12	0.60
2-Year Canadian	1.14	1.15	1.08
2-Year Japanese	0.10	0.10	0.14
10-Year German	1.39	1.36	2.22
10-Year U.K.	1.49	1.53	2.60
10-Year Canadian	1.79	1.83	2.49
10-Year Japanese	0.80	0.81	1.03

Commodity Prices

	Friday 8/31/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	95.35	96.15	88.81
Gold ($/Ounce)	1661.00	1670.55	1825.72
Hot-Rolled Steel ($/S.Ton)	640.00	645.00	665.00
Copper (¢/Pound)	346.00	348.35	418.70
Soybeans ($/Bushel)	17.79	17.39	14.47
Natural Gas ($/MMBTU)	2.75	2.70	4.05
Nickel ($/Metric Ton)	15,920	16,023	21,864
CRB Spot Inds.	516.92	517.38	569.68

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	3	4	5	6	7
U.S. Data		**ISM Manufacturing** July 49.8 Aug 50.3 (W) **Construction Spending** June 0.4% July 0.3% (W)	**Nonfarm Productivity** 2Q S 1.6% 2Q F 1.8% (W) **Unit Labor Costs** 2Q S 1.7% 2Q F 1.6% (W)	**ISM Non-Manf. Index** July 52.6 Aug 52.9 (W)	**Nonfarm Payrolls** July 163K Aug 75K (W) **Unemployment Rate** July 8.3% Aug 8.3% (W)
Global Data	**Eurozone** **PMI Manufacturing** Previous (Aug) 45.1		**Canada** **Bank of Canda Rate** Previous 1.0% **Eurozone** **Retail Sales** Previous (June) -1.2%	**Eurozone** **ECB Rate Decision** Previous 0.75% **U.K.** **B.O.E Rate Decision** Previous 0.5%	**U.K.** **Industrial Production** Previous (June) -4.3% **Germany** **Industrial Production** Previous (June) -0.3%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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