September 07, 2012

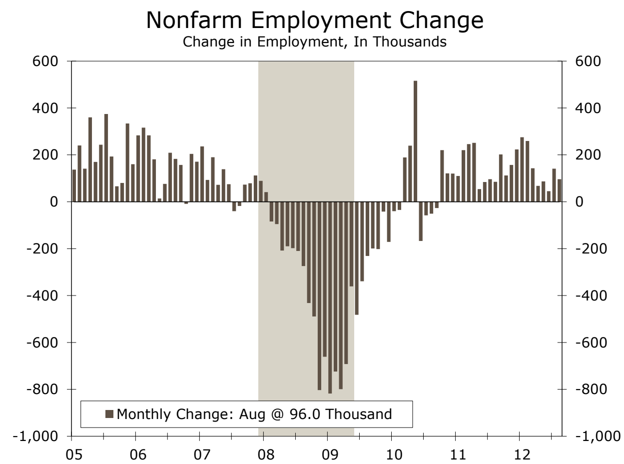
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

A Second-Half Downshift Underway

- Nonfarm payrolls rose a meager 96,000 in August while the unemployment rate edged down to 8.1 percent. Job losses were concentrated in the manufacturing and government sectors.
- The ISM manufacturing index posted its weakest reading since 2009 for the month of August as the employment, new orders and production components posted declines.
- The ISM non-manufacturing index rose in August, but the key new orders and business activity components fell on the month, suggesting some weakness ahead.



Global Review

Can Mario Draghi and China Deliver?

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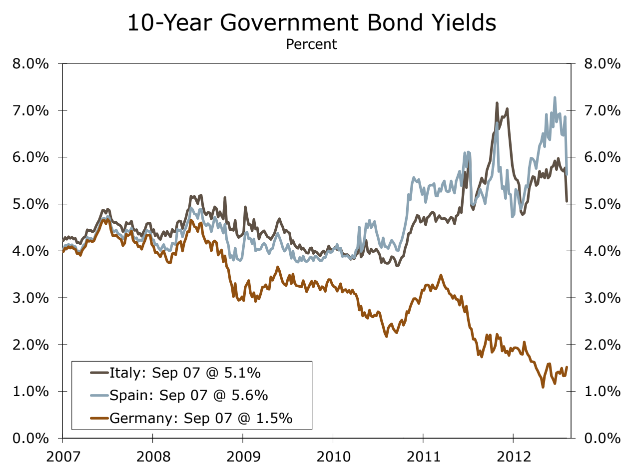


Wells Fargo U.S. Economic Forecast

	Forecast								Actual		Forecast		
	2012				2013				2010	2011	2012	2013	2014
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	2.0	1.7	1.6	1.6	2.0	2.0	2.2	2.3	2.4	1.8	2.2	1.6	2.1
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	1.3
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	1.9
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	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	3.8
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	7.0
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	79.8
Unemployment Rate	8.3	8.2	8.2	8.1	8.0	7.9	7.7	7.5	9.6	9.0	8.2	8.2	7.8
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	0.98
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	3.95	3.68	3.62	3.50	0.00	0.00	0.00	0.00	4.69	4.46	3.69	3.60	0.00
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	2.28

Forecast as of: September 7, 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

U.S. Review

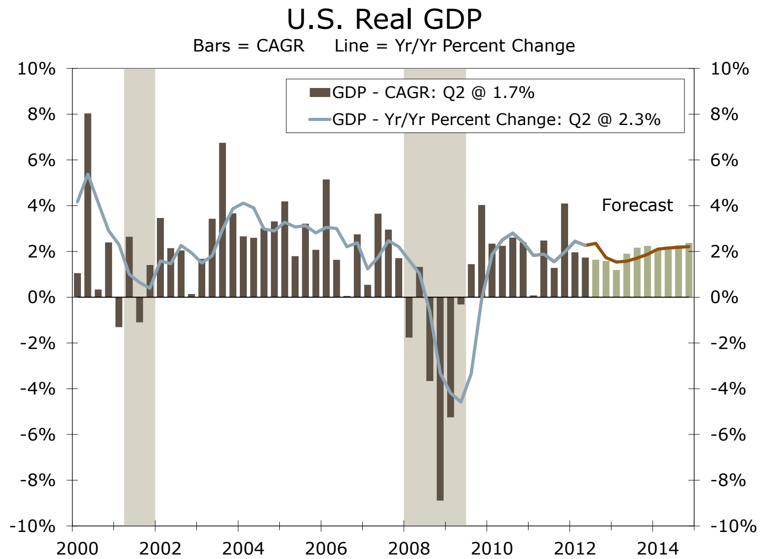
A Second-Half Downshift Underway

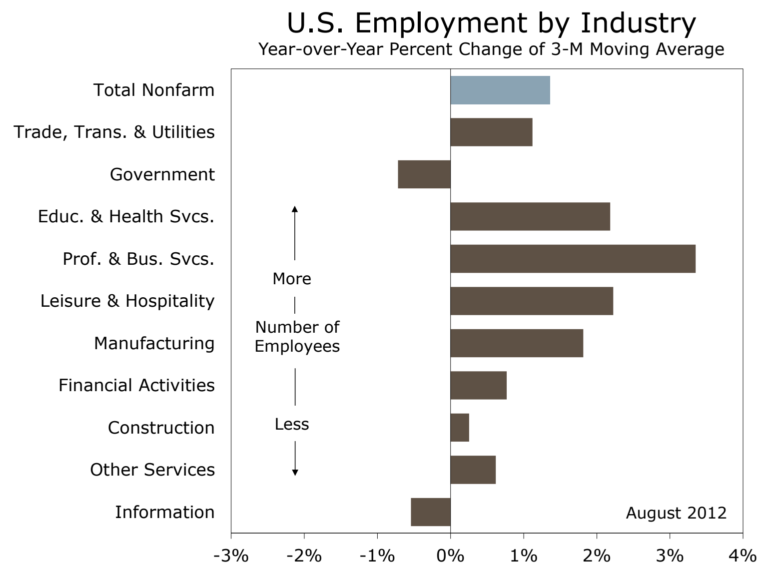
This week, economic data were largely disappointing as the ISM manufacturing index, construction spending and employment reports all posted results below consensus expectations. The manufacturing sector appears to be slowing due to sluggish domestic and export demand. The service sector remains in positive, but slow growth, territory. The sluggish pace of demand for both manufacturing and services kept employment growth at a meager 96,000 for the month of August. This week's data support our contention that economic growth will remain sluggish during the second half of the year. Uncertainty surrounding domestic fiscal policy and the European financial crisis continues to cloud hiring and investment decisions. Our forecast calls for real GDP to grow at a 1.6 percent annual rate in both the second and third quarters.

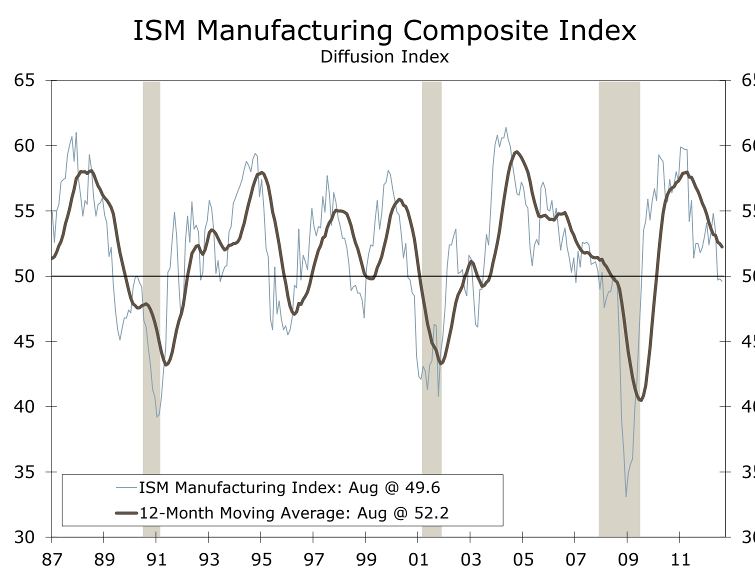
The big economic news this week was the disappointing August employment report that indicated only a slight increase of 96,000 in nonfarm payrolls for the month. The unemployment rate declined to 8.1 percent in August, but this can be attributed to a fall in the labor force participation rate. Going into Friday's report, we had suspected a somewhat disappointing headline number given the softer downward trend in initial jobless claims. Jobless claims have appeared to level off at around the 365,000-370,000 level, suggesting that the slower pace of job growth may linger for a while. The number of hours worked by employees fell 0.1 percent in August as demand for goods and services slowed for the month. The major sectors continuing to add to job growth included professional & business services, education & healthcare, and leisure & hospitality. The government sector continued to shed jobs with total government employment declining by 7,000, reflecting ongoing reductions by state and local governments. The biggest surprise was the pullback in manufacturing employment, the first such decline since September of last year.

The ISM manufacturing index hit its lowest level since 2009 this week, setting up a slowdown in industrial production during the second half of the year. The forward-looking new orders component fell to 47.1 in August from 48.0. Other major components also fell, including the employment and production components. The employment component slide was reflected in Friday's employment release, with manufacturing payrolls declining 15,000 in August. In a sign that manufacturers are beginning to feel the pressure from higher commodity prices, the prices paid component rose significantly.

The ISM non-manufacturing index, a key metric of the service sector, remained in expansion territory in August, but the report's underlying details were less than stellar. The business activity index fell for the month, and the forward looking new orders component dropped to 53.7 from July's 54.3, signaling a slower pace of business activity in the service sector in coming months. The employment component climbed back into expansion territory for the month, which coincided with a rise in service sector employment.







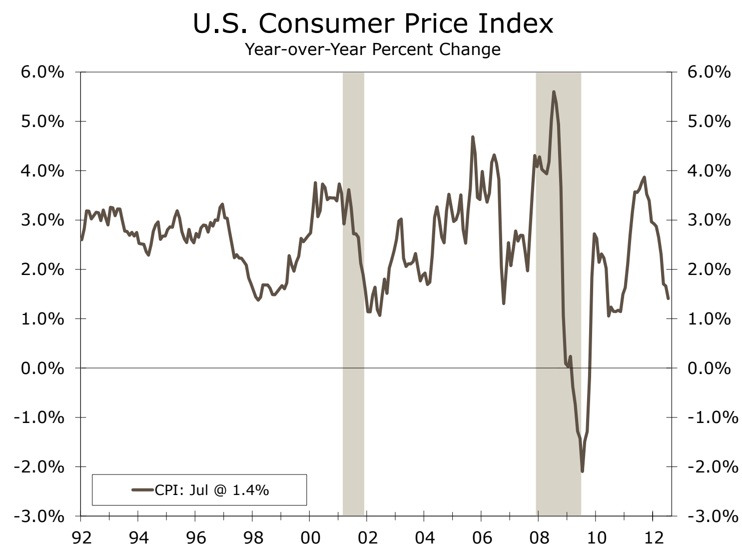
Source: U.S. Department of Commerce, U.S. Department of Labor, ISM and Wells Fargo Securities, LLC

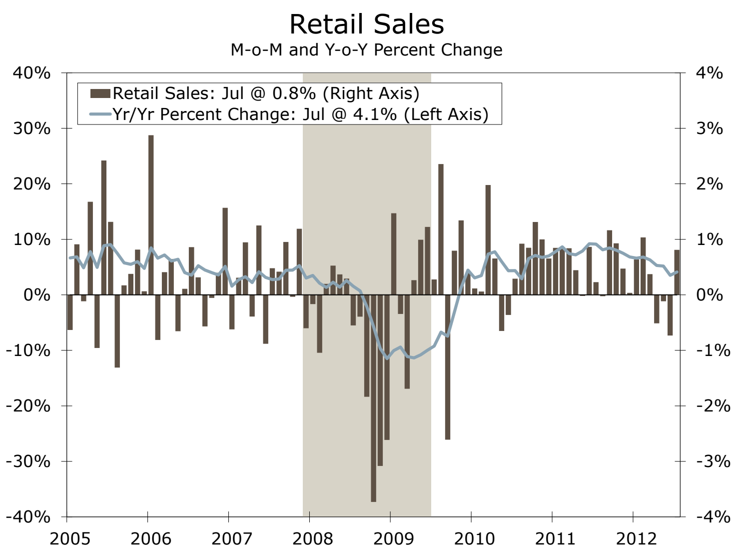
Consumer Price Index • Friday

Inflation for consumer goods has slowed considerably since the start of the year. The year-over-year rate of headline inflation, as measured by the CPI, fell to 1.4 percent in July from 2.9 percent in January. However, the downward trend in the rate of consumer price inflation may finally be over. After two months of flat readings, the CPI is expected to have edged higher in August. The reprieve from rising gas prices earlier in the summer expired in July, and the average retail price for a gallon of gas rose 8.7 percent in August. Moreover, the effects from the drought in the Midwest will likely begin to affect food at the retail level after a sizeable jump in finished wholesale food prices in July. We expect to see the overall CPI jump 0.6 percent in August. However, we look for "core" prices to rise a more moderate 0.2 percent. This would keep the year-over-year rate of inflation tame for both headline and core CPI, and well within the FOMC's comfort zone.

Previous: 0.0% **Wells Fargo: 0.6%**

Consensus: 0.5% (Month over Month)





Retail Sales • Friday

After three months of declines, retail sales bounced back in July. Sales rose a solid 0.8 percent during the month, with broad-based gains across categories. Sales of motor vehicles and parts matched the headline gain, rising 0.8 percent, while sales of furniture, building materials, personal care and non-store items (such as goods sold online) rose 1 percent or more. We expect retail sales continued to rise in August, but by a slightly smaller amount than in July. Sales for July likely reflected some pent-up demand for items after consumers were particularly cautious in the preceding months as well as a pickup in gas prices. August sales likely will get a further lift from higher gas prices, but weak income gains over the past few months and low confidence will limit consumers' willingness to spend. With the bulk of back-to-school shopping taking place in August, next week's report will also provide some early insight into how holiday sales may shape up this winter.

Previous: 0.8% **Wells Fargo: 0.7%**

Consensus: 0.6% (Month over Month)

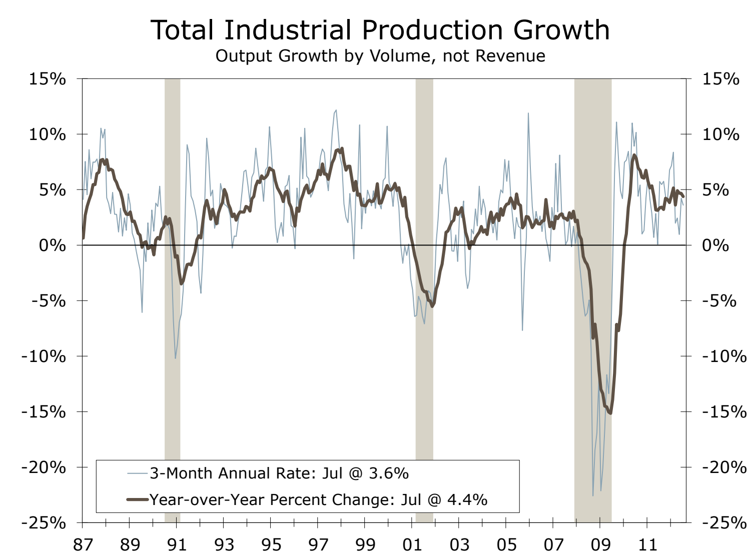
Industrial Production • Friday

Industrial production expanded 0.6 percent in July after back-to-back gains of 0.1 percent in May and June. The pick-up was due in large part to strength in the motor vehicles sector, where production picked up 3.3 percent. Utilities and mining output increased 1.3 percent and 1.2 percent, respectively. Excluding autos, utilities and mining, production rose a feebler 0.2 percent, however.

Industrial production growth likely was more tepid in August. The strength in July's auto production may wane as auto manufacturers return to their normal seasonal schedule following fewer shutdowns in July. Utilities output also likely slowed in August after a record hot July. Moreover, the majority of the regional purchasing managers' surveys and the national ISM manufacturing index remained in negative territory in August, suggesting no near-term immediate resurgence in the manufacturing sector.

Previous: 0.6% **Wells Fargo: 0.0%**

Consensus: 0.1% (Month over Month)



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

Global Review

Can Mario Draghi and China Deliver?

While the U.S. markets wait for Fed Chairman Ben Bernanke to possibly deliver another round of quantitative easing (QE3) soon, the rest of the world's markets are waiting for Mario Draghi, the president of the European Central Bank (ECB) to deliver on his promise to save the euro and the Eurozone. After disappointing several weeks ago, Draghi seems to have formulated a new plan for bond buying that would help solve the economic issues in the battered common currency region (see our Topic of the Week section in this report for more plan details).

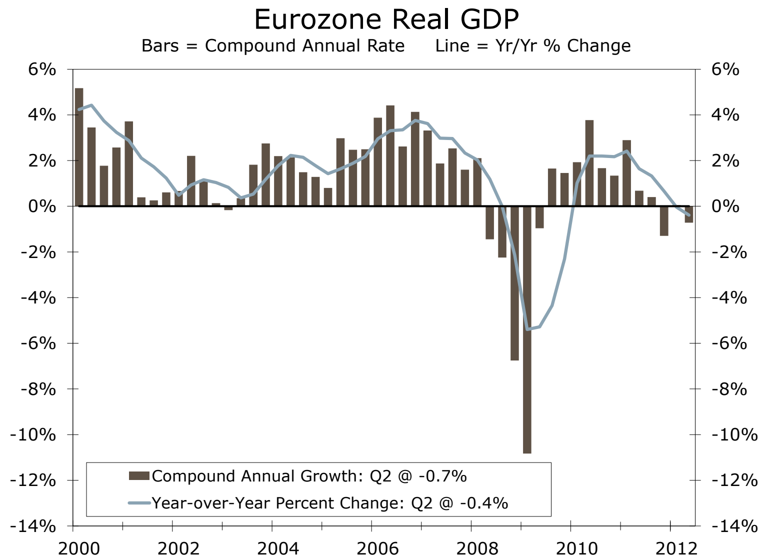
Meanwhile, China seems to be waiting on the sidelines to see if this plan will be enough to solve Europe's problems and thus kick-start demand for its products—recall that Europe is the largest export market for China's production—or if the Chinese government will need to offer more help targeting domestic consumption, as it did during the Great Recession, to cover the slack from external demand.

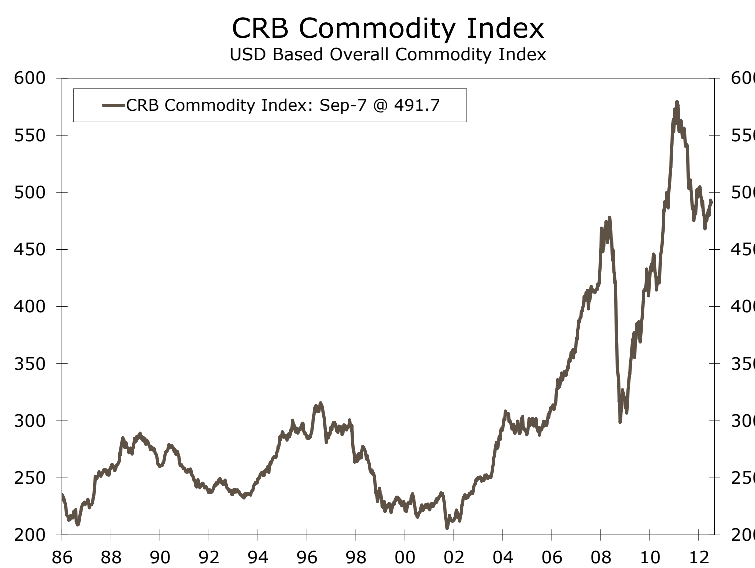
For now, the Chinese government seems to be content with the current slowdown in economic activity as it will enable some of the imbalances affecting the economy to correct. However, that slowdown has a limit and many say the limit, that is, the floor in terms of economic growth, is approximately 5 percent per year. We expect the Chinese economy to grow 7.7 percent in 2012 and 8.0 percent in 2013. Although slow compared to recent economic performance standards for the Chinese economy, it is still above the 5 percent floor limit markets believe the government has.

For the rest of the world's economy, but especially for the emerging markets that depend on commodity prices and commodity exports, more clarity on these two issues is at the root of their own growth prospects. Once more clarity is available, we should expect emerging market growth to start brightening a bit. However, we do not expect strong growth to resume anytime soon, although we anticipate improving expectations about emerging growth prospects for the future.

We do not want to minimize the seriousness of the issues faced by the Eurozone countries because we believe this aspect alone will continue to linger and limit world economic growth for many years. However, any sign that shows some light at the end of the tunnel for the Eurozone will be welcomed by the markets and could set the stage for better economic prospects for the future.

If the new ECB plan is the first step to solving the mounting Eurozone problems, it could lay the foundation for a slow but sustained recovery of the region and set a floor for world economic growth. If this is the case, the central banks across the world will have to revisit their stance in terms of monetary accommodation as we may start to see the return of some inflationary pressures. We think any sustained inflationary pressures will be determined by stronger economic growth across the world and that will also take time. For now, at least, central bankers still have plenty of time to maintain their respective accommodative stances.





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

Chinese Industrial Production • Monday

Chinese real GDP growth slowed to a 7.6 percent year-over-year rate in the second quarter. Not only is that the sixth consecutive quarter in which the overall rate of economic growth has slowed, it marks the weakest rate for the world's second-largest economy since the global recession in 2009.

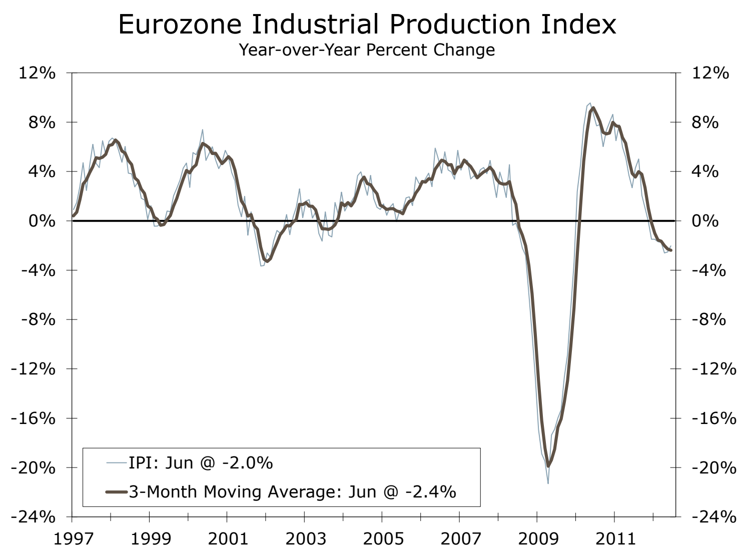
Mirroring the slowdown in the broader economy, Chinese industrial production has slowed to a single digit annual growth rate since April, coming in at just 9.2 percent on a year-over-year basis through July.

The manufacturing PMI in China slipped to 49.2 in August, which is the first reading below 50 since February 2009.

On Monday, Sept. 10, we will learn how industrial production shaped up in August. The consensus is looking for a modest decline in output.

Previous: 9.2%

Consensus: 9.0% (Year over Year)



Eurozone Industrial Production • Wed.

Financial market reactions were mixed in response to ECB President Draghi's announcement that the ECB would engage in a program of buying government bonds in the secondary market. For more on this ECB action, see our Topic of the Week on page 7.

Of course, an optimal solution for the problems in Europe would be for economic growth to pick up. Although the Eurozone economy has avoided consecutive quarters of falling GDP, we think the euro area is experiencing a mild recession. The Eurozone's industrial production has been negative on a year-over-year basis since December 2011. July's industrial production report is due out on Wednesday, and we do not hold much hope for a significant turnaround with the PMI still in contraction territory.

Previous: -2.2%

Consensus: -3.6% (Year over Year)

Brazilian Retail Sales • Thursday

The Brazilian economy grew at a 1.6 percent annualized rate in the second quarter, the fastest pace of growth in a year. That said, the gain was boosted in part by a jump in agricultural output related to a spike in corn prices. This boost may prove to be temporary. As we described in our Aug. 5 special report, *Brazilian Economy Slows Down; Better Times Ahead*, Brazil is struggling to grow. The country's economy faces headwinds from diminished exports to Europe and the lagged effects of previous monetary tightening.

One area of hope for Brazil is the continued evolution and growth in domestic demand. Family consumption was up 2.4 percent, year over year, in the second quarter. We will get our first look at how the Brazilian consumer is faring in the third quarter when July's retail sales figures hit the wire on Thursday. Sales increased 1.5 percent in the month of June. The consensus looks for a gain of roughly the same magnitude in July.

Previous: 1.5%

Consensus: 1.3% (Month over Month)

Source: IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

Fed Rhetoric Suggests QE3

Economic fundamentals suggest continued subpar economic growth, an above 8 percent unemployment rate and a below 2 percent inflation rate for the second half of this year and extending into the first part of 2013. In addition, there is the downside risk of a fiscal cliff hitting the economy early next year. All of this has not changed over recent months.

What has changed, however, has been the Fed's rhetoric on this outlook. The perception by members of the FOMC is that sub-2 percent growth and an 8-percent-plus unemployment rate do not represent a sustainable state of the economy consistent with the Fed's dual mandate. It is clear from Chairman Bernanke's comments that the labor market remains a primary concern and that the FOMC will likely be moved to further action by lack of sufficient progress in the labor market's recovery.

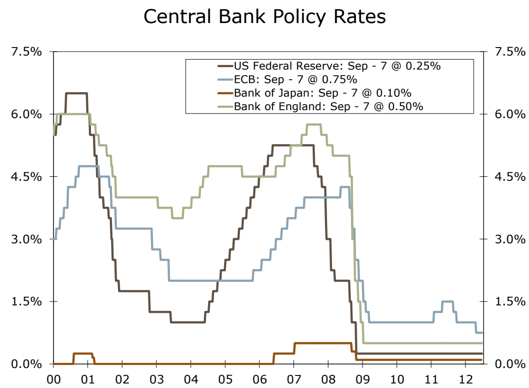
Interest Rate Outlook

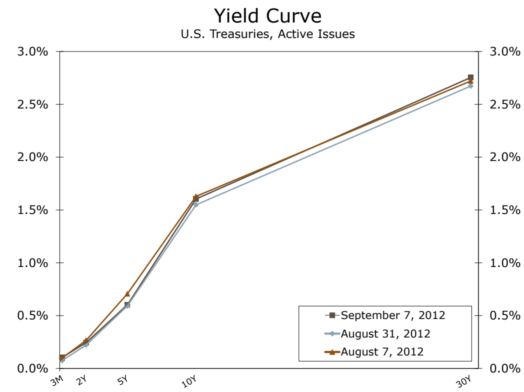
The FOMC's move to further ease policy by large-scale asset purchases as well as extending that policy beyond 2014 suggests that short-term benchmark Treasury rates will remain low for a longer period of time. Meanwhile, any increase in long-term interest rates will also likely be very limited going forward.

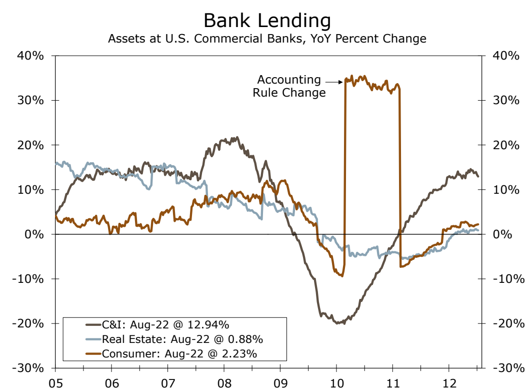
Private credit market rates will also remain lower than otherwise. Buyers of credit will continue to search for yield given continued low Treasury rates. Sellers of credit will continue to offer credit at what are perceived to be continued historically low interest rates in a growing, even if just modest, economic environment.

Mortgage rates are also likely to remain low for a longer period of time, which will further support the improving housing market.

Low interest rates have become the standard for the U.S. economy, given the fundamentals of below-trend growth and low inflation. Until those fundamentals turn, the FOMC appears to be geared toward continuing its accommodative policy. While these low rates may appear to be unusually uncomfortable for now, they are feeling more permanent than many had expected.







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

Consumer Credit Insights

Credit Managers' a Bit More Optimistic

According to the National Association of Credit Managers', the Credit Manager's Index (CMI) shows professionals in this sector are a bit more optimistic than purchasing managers for the manufacturing and nonmanufacturing sectors. Indeed, the CMI increased 2.4 percentage points in August to 55.8, the highest level since March.

The CMI is a diffusion index that surveys trade credit managers from the manufacturing and service sectors. Participants are asked whether they are seeing improvement, deterioration or no change for various favorable and unfavorable factors. Favorable components include sales, new credit applications, dollar collections and amount of credit extended. Unfavorable factors are items such as rejections of credit applications, accounts placed for collection and disputes, etc. A reading above 50 suggests growth, while anything below 50 is contractionary.

Favorable factors increased to 60.0 on the month with sales making the largest contribution. Solid sales for both the manufacturing and nonmanufacturing sectors imply stronger growth ahead. Gains in the favorable component were nearly broad-based with the exception of new credit applications—although the level is still above the line of demarcation. Unfavorable factors also increased and now sit at 53.1 following a dip into contraction territory in June.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.55%	3.59%	3.59%	4.12%
15-Yr Fixed	2.86%	2.86%	2.84%	3.33%
5/1 ARM	2.75%	2.78%	2.77%	2.96%
1-Yr ARM	2.61%	2.63%	2.65%	2.84%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,462.6	-6.03%	10.23%	12.94%
Revolving Home Equity	$532.5	-4.11%	-4.04%	-4.47%
Residential Mortgages	$1,570.4	-7.38%	1.28%	5.07%
Commerical Real Estate	$1,409.2	-1.52%	-2.59%	-1.42%
Consumer	$1,110.0	-9.31%	0.79%	2.23%

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

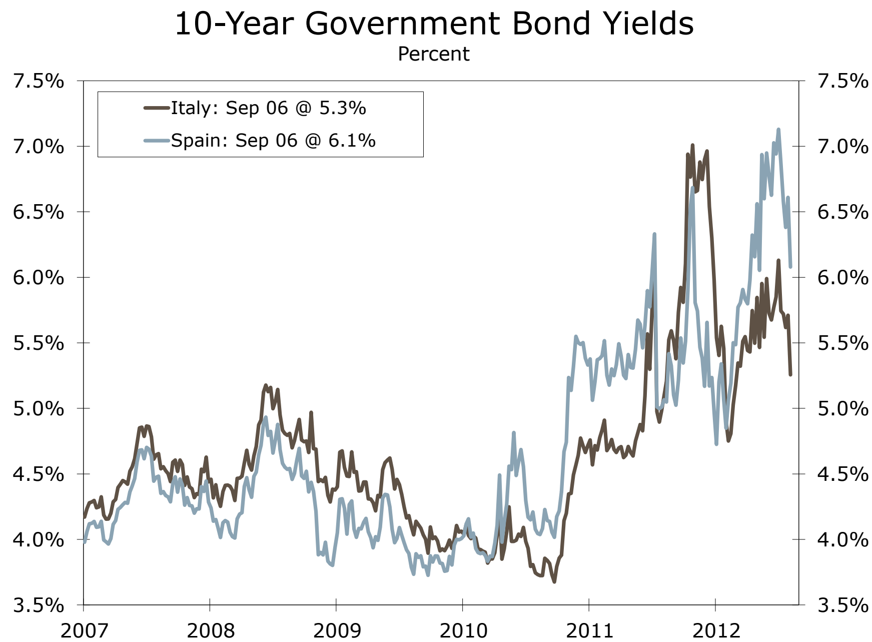
Topic of the Week

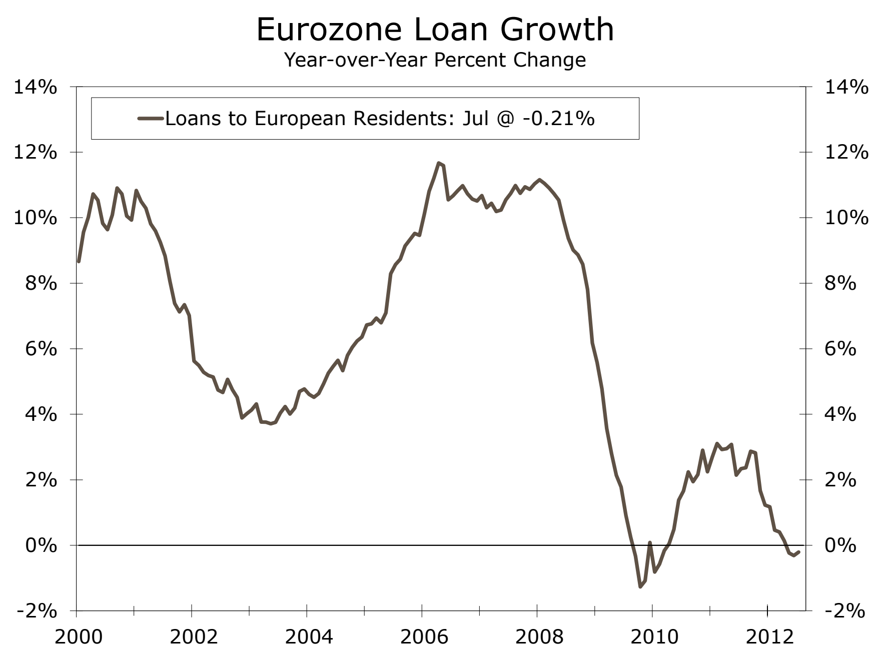
***Quid Pro Quo* for ECB Help**

At the widely anticipated ECB policy meeting this week, the Governing Council announced that the ECB stands ready to purchase, in unlimited quantities if necessary, the government bonds of Eurozone member countries. Although the Governing Council did not specifically mention them by name, the announcement had particular relevance to the governments of Italy and Spain, which have experienced a marked rise in their borrowing costs over the past two years.

The ECB, however, made it clear that it is not prepared to offer a conditions-free "bailout" for wayward governments. Rather, as a condition for ECB bond purchases, which are seen as a mechanism that will help to stabilize financial markets, governments must seek assistance from the formal "bailout" funds (i.e., the EFSF and the ESM) that have been established and enter into fiscal consolidation programs and undertake structural economic reforms. The carrot for governments is potential ECB assistance in reducing borrowing costs. The stick is the painful adjustment programs that need to be undertaken in order to tap the ECB's checkbook.

In our view, this week's announcement is an important step on the road to bringing the 3-year sovereign debt crisis to a conclusion. It puts force behind the comments made a few weeks ago by ECB President Draghi that the ECB is prepared to do "whatever it takes" to preserve the euro. And markets reacted positively to the development with yields on Spanish and Italian government bonds dropping to their lowest levels in months. We would caution, however, that the crisis is not necessarily "over" yet. Governments that have come under market scrutiny must first seek assistance from the ESFS/ESM and undertake painful economic adjustments, both of which can entail significant domestic political costs. For political reasons governments could balk at entering into these agreements. Therefore, instability could return if governments do not do "the right thing."





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 9/7/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.10	0.07	0.02
3-Month LIBOR	0.41	0.42	0.34
1-Year Treasury	0.18	0.17	0.14
2-Year Treasury	0.24	0.22	0.20
5-Year Treasury	0.60	0.59	0.91
10-Year Treasury	1.60	1.55	2.04
30-Year Treasury	2.75	2.67	3.37
Bond Buyer Index	3.73	3.72	4.05

Foreign Exchange Rates

	Friday 9/7/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.279	1.258	1.410
British Pound ($/£)	1.602	1.587	1.599
British Pound (£/€)	0.798	0.793	0.882
Japanese Yen (¥/$)	78.230	78.390	77.260
Canadian Dollar (C$/$)	0.978	0.986	0.983
Swiss Franc (CHF/$)	0.945	0.955	0.858
Australian Dollar (US$/A$	1.039	1.032	1.066
Mexican Peso (MXN/$)	12.996	13.191	12.464
Chinese Yuan (CNY/$)	6.343	6.349	6.395
Indian Rupee (INR/$)	55.395	55.528	46.168
Brazilian Real (BRL/$)	2.029	2.048	1.657
U.S. Dollar Index	80.258	81.208	75.467

Foreign Interest Rates

	Friday 9/7/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.16	0.17	1.48
3-Month Sterling LIBOR	0.68	0.68	0.90
3-Month Canadian LIBOR	1.28	1.29	1.16
3-Month Yen LIBOR	0.19	0.19	0.19
2-Year German	0.03	-0.04	0.49
2-Year U.K.	0.12	0.08	0.58
2-Year Canadian	1.15	1.14	0.91
2-Year Japanese	0.11	0.10	0.15
10-Year German	1.51	1.33	1.91
10-Year U.K.	1.69	1.46	2.34
10-Year Canadian	1.80	1.77	2.27
10-Year Japanese	0.82	0.80	1.01

Commodity Prices

	Friday 9/7/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	94.81	94.62	89.34
Gold ($/Ounce)	1736.33	1692.01	1817.47
Hot-Rolled Steel ($/S.Ton)	640.00	640.00	695.00
Copper (¢/Pound)	362.35	344.05	411.55
Soybeans ($/Bushel)	17.50	17.79	13.88
Natural Gas ($/MMBTU)	2.70	2.75	3.94
Nickel ($/Metric Ton)	16,002	15,920	20,635
CRB Spot Inds.	519.94	516.92	571.19

Next Week's Economic Calendar

	Monday 10	Tuesday 11	Wednesday 12	Thursday 13	Friday 14
U.S. Data	**Consumer Credit** June $6.459B July $9.100B (C)	**Trade Balance** June -$42.9B July -$42.0B (W)	**Import Price Index** July -0.6% August 1.2% (W) **Wholesale Inventories** June -0.2% July 0.3% (C)	**PPI (MoM)** July 0.3% August 1.2% (W) **Core PPI (MoM)** July 0.4% August 0.2% (W) **Budget Statement** July -$134.1B August -$155.0B (C)	**CPI (MoM)** July 0.0% August 0.6% (W) **Advance Retail Sales** July 0.8% August 0.7% (W) **Industrial Prod.** July 0.6% August 0.0% (W)
Global Data	**China** **Trade Balance (USD)** Previous (Jul) $25.15B **China** **Industrial Prod. (YoY)** Previous (Jul) 9.2%	**Mexico** **Industrial Prod. (YoY)** Previous (Jun) 3.7% **Japan** **Machine Tool Orders** Previous (Jul) -6.7%	**Eurozone** **Industrial Prod. (YoY)** Previous (Jun) -2.2% **U.K.** **ILO Unemp. Rate** Previous (Jun) 8.0%	**Brazil** **Retail Sales (MoM)** Previous (Jun) 1.5%	**Eurozone** **CPI (YoY)** Previous (Jul) 2.4%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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