September 09, 2011

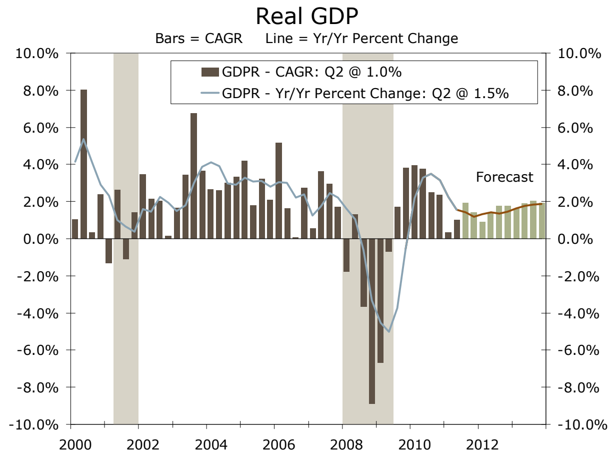
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

The Economy Still Faces Core Issues

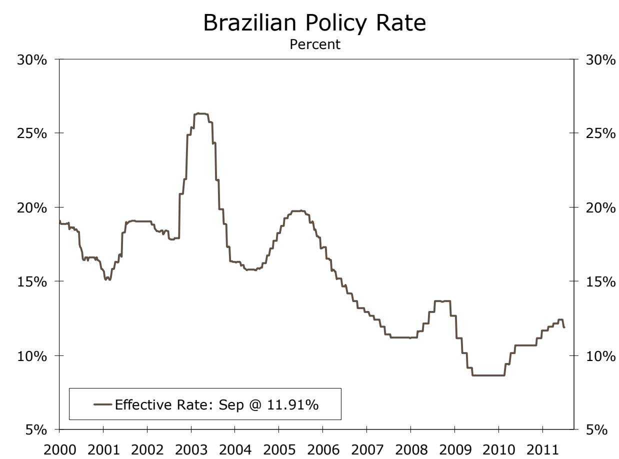
- While it was a fairly light week for economic data, speeches by President Barack Obama and Fed Chairman Ben Bernanke dominated headlines. The president outlined a plan that calls for payroll tax cuts and spending initiatives. Although the proposal could boost growth somewhat, we do not believe it fully addresses the core issues of weak consumer demand and structural unemployment.
- Fed Chairman Ben Bernanke's speech offered no new surprises, which puts greater weight on the two-day FOMC meeting scheduled in September.



Global Review

First Mover's Advantage?

- The Brazilian central bank seems to have moved ahead of the crowd in the race to reverse the course of monetary tightening that it started back in April 2010 as the country's rate of inflation was increasing and threatening to get out of the central bank's target range of 4.5 percent (plus or minus two percentage points).
- Now, there is speculation that other central banks in the Latin America region will follow the decision of the Brazilian central bank and cut rates as well. The argument is that world economic growth is a bigger concern than domestic inflation.



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]	0.4	1.0	2.0	1.4	0.9	1.3	1.7	1.8	-3.6	3.0	1.6	1.4	1.8
Personal Consumption	2.1	0.4	2.0	1.4	1.3	1.3	1.4	1.4	-2.0	2.0	2.1	1.4	1.3
Inflation Indicators [2]													
"Core" PCE Deflator	1.1	1.3	1.6	2.0	2.1	2.0	1.9	1.8	1.5	1.4	1.5	1.9	1.7
Consumer Price Index	2.2	3.3	3.5	3.5	2.8	2.3	2.3	2.3	-0.3	1.6	3.1	2.4	2.4
Industrial Production [1]	4.8	1.0	5.7	1.4	2.2	3.1	4.0	4.1	-11.1	5.3	4.0	2.9	3.9
Corporate Profits Before Taxes [2]	8.8	8.3	6.5	6.4	6.2	6.0	6.4	6.6	7.9	32.2	7.5	6.3	7.1
Trade Weighted Dollar Index [3]	70.6	69.4	68.5	69.5	70.5	71.5	72.5	73.0	77.7	75.6	69.5	71.9	74.9
Unemployment Rate	8.9	9.1	9.1	9.4	9.5	9.5	9.5	9.4	9.3	9.6	9.1	9.5	9.2
Housing Starts [4]	0.58	0.57	0.58	0.55	0.57	0.62	0.67	0.70	0.55	0.58	0.57	0.64	0.86
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	3.90	3.80	3.80	4.00	4.20	4.40	5.04	4.69	4.26	4.10	4.95
10 Year Note	3.47	3.18	1.75	1.75	2.00	2.20	2.30	2.40	3.26	3.22	2.54	2.23	2.65

Forecast as of: September 9, 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

The Economy Continues to Grow at Stall Speed

While it was a fairly light week for economic data, speeches by President Barack Obama and Fed Chairman Ben Bernanke dominated headlines. With economic growth projected to remain very sluggish in the second half of the year and the Fed left with very few tools in its kit, many are looking for additional guidance on how to keep the U.S. economy from double dipping. While we continue to believe the U.S. economy will avoid another downturn, the slow pace of growth leaves the U.S. economy vulnerable. On Thursday, President Obama unveiled a $447 billion proposal to revive the ailing economy.

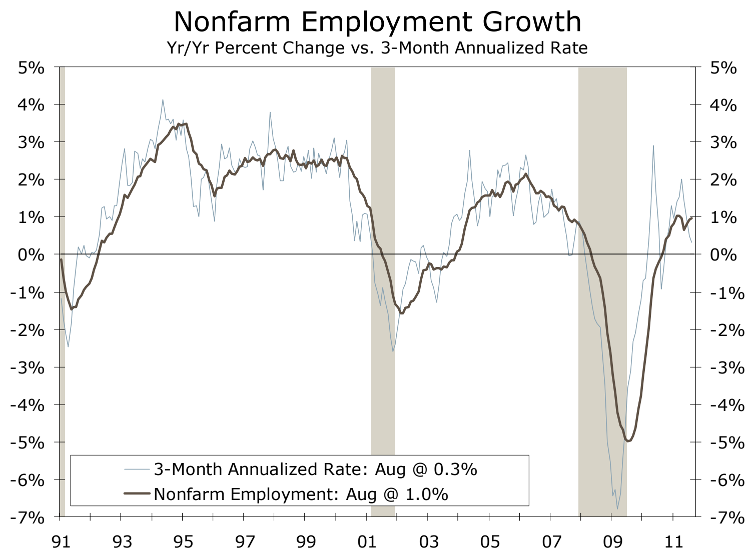
The president called for payroll tax cuts, which accounted for more than half of the plan, extension of emergency unemployment compensation, infrastructure spending, aid to state and local governments, programs to subside the issue of long-term unemployment and mortgage-refinancing assistance. The $447 billion package is equivalent to nearly 3 percent of GDP, and it could provide a boost to economic growth next year. However, the proposal still needs to be passed by Congress, so it is unclear how much new spending will actually take place.

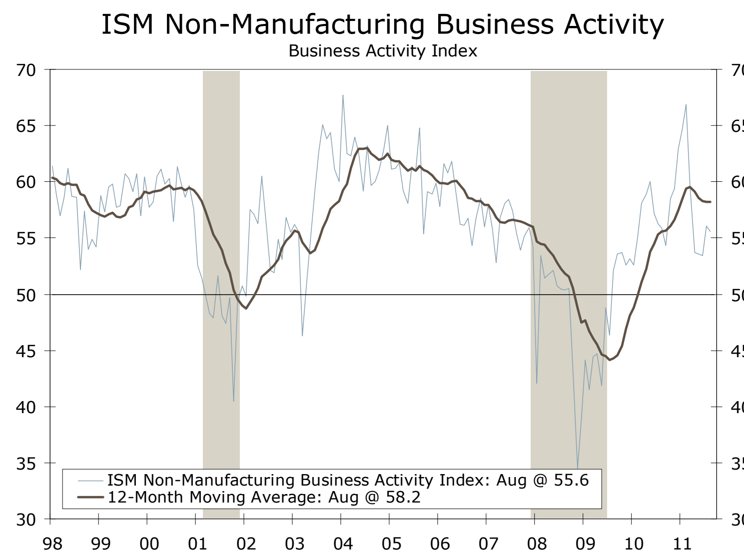
Weak consumer demand and structural unemployment remain the largest obstacles for solid economic growth. Consumers continue to be extremely cautious and confidence remains at very depressed levels. With employment growth likely to remain very weak for the foreseeable future, we continue to expect consumer spending to grow at a slow pace. Moreover, the mismatch of job openings and the skills of many unemployed workers is a long-term issue that will likely not be fixed with short-term stimulus.

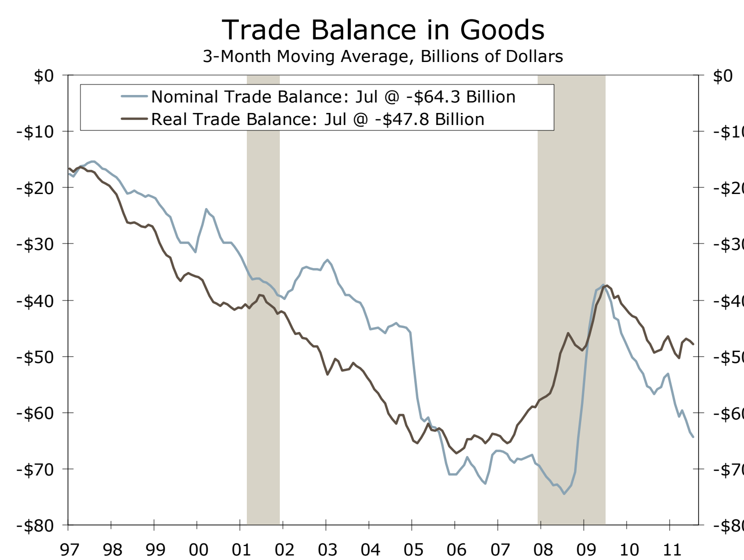
Another option market watchers are hoping to come to fruition is another round of quantitative easing. With speculation of Operation Twist still fervent, whereby the Fed sells short-term securities and buys longer-term securities, many are reading the tea leaves to garner clues. In a speech to the Economic Club of Minnesota this week, Fed Chairman Ben Bernanke offered no new surprises, which puts greater weight on the two-day FOMC meeting scheduled in September.

Economic data released during the week came in better than expected. The ISM non-manufacturing survey rose to a 53.1 in August from 52.7 in July. While the underlying components that make up the headline were mixed, the forward-looking new orders component rose to 52.8 suggesting further growth in the service sector in the coming months.

Driven by a surge in exports, the trade deficit narrowed sharply in July, falling from $51.5 billion in June to $44.8 billion. Exports rose 3.6 percent, while imports fell 0.2 percent. In real terms, if the trade balance remains unchanged at July's level, net exports could add 0.7 percentage points to real GDP in the third quarter. On the other hand, while some economists are raising their third-quarter estimates, the pullback in imports could show up as lower inventory accumulation, which may offset any gains. We continue to look for real GDP to increase at a 2.0 percent annual pace in the third quarter.





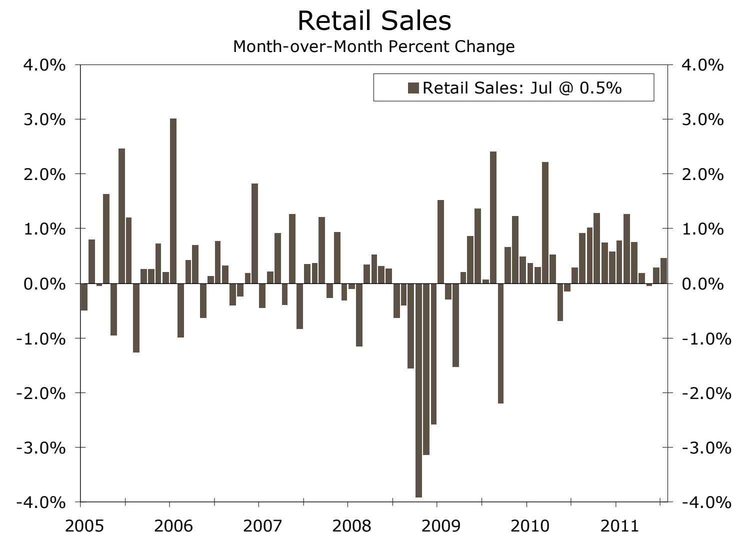


Retail Sales • Wednesday

Despite the tumult emanating out of Washington amid the debt ceiling standoff and the resulting loss of confidence, consumers continued to spend in July. Retail sales rose 0.5 percent, the best showing in four months, and were up 8.5 percent from a year ago. Sales at gasoline stations rose 1.6 percent and contributed 0.2 percentage points to total sales growth. Still, sales excluding gasoline rose 0.3 percent and were up 6.8 percent from a year ago, the strongest growth since February. Outside of gasoline, electronics led the way with 1.4 percent growth followed by 0.9 percent at non-store retailers. Vehicle sales rose for a second month following three months of declines. Slightly better hourly earnings growth in July aided sales. However, flat payrolls in August and the first monthly decline in hourly earnings since December, along with unstable financial markets and a further drop in confidence, point to weaker retail sales for August.

Previous: 0.5% **Wells Fargo: 0.1%**

Consensus: 0.2% (Month-over-Month)

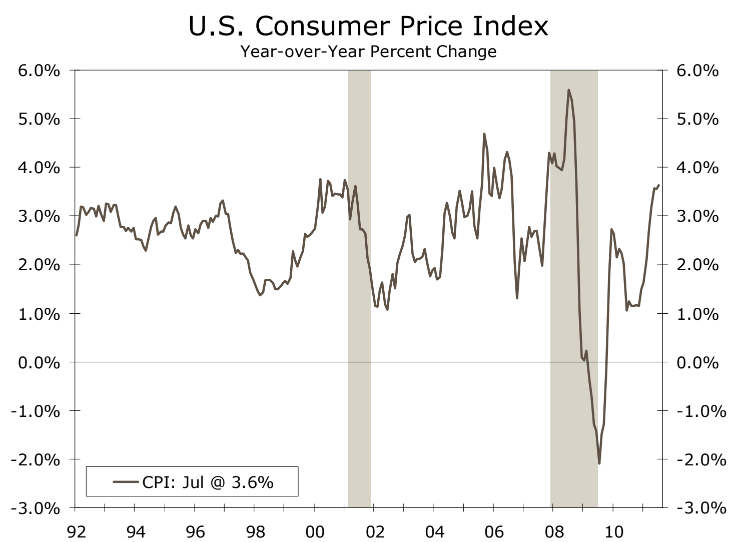


Consumer Price Index • Thursday

Consumer prices rose 0.5 percent in July, more than twice the 0.2 percent consensus forecast. Leading the increase was a 4.7 percent jump in gasoline prices following two months of declines. Owners' equivalent rent, which accounts for about a quarter of the CPI, rose 0.3 percent, the most since June 2008, as rents have risen amid the ongoing foreclosure crisis. Excluding food and energy, the core index rose 0.2 percent and was up 1.8 percent from a year ago, the biggest annual increase since December 2009 and double the 0.9 percent rate of a year ago. Thus, it is clear that the jump in food and energy prices from earlier this year has filtered into core prices. Unfortunately, this comes at a time when the labor market and the overall economy are showing signs of renewed weakness. The recent rise in inflation may limit what the Fed can do to jumpstart an economy still struggling to gain a solid footing.

Previous: 0.5% **Wells Fargo: 0.2%**

Consensus: 0.2% (Month-over-Month)

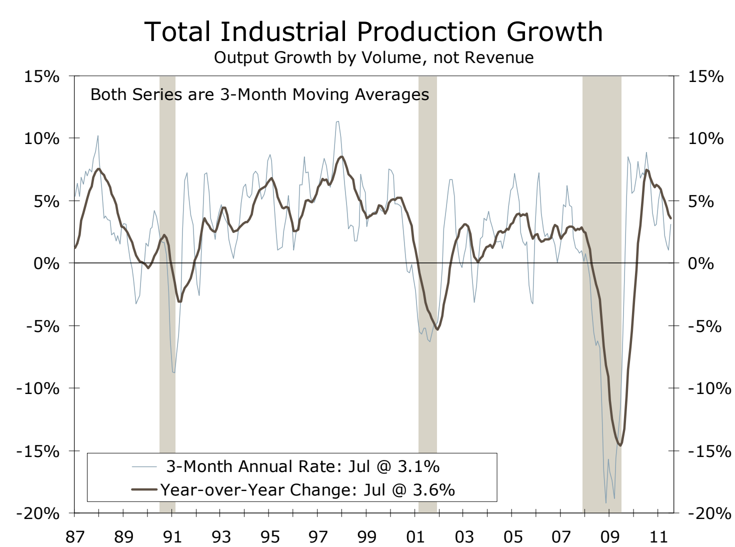


Industrial Production • Thursday

Industrial production jumped 0.9 percent in July, the most since December, and was up 3.6 percent from a year earlier. Helping to bolster a 0.6 percent increase in manufacturing was a 5.2 percent surge in production of motor vehicles and parts following three straight monthly declines amid the fallout from the Japan disasters. Utilities also saw a large 2.8 percent increase as air conditioners hummed across the country during a very hot and humid July. Mining also rose 1.0 percent as metals prices marched higher during the month. Capacity utilization rose to 77.5 percent, the highest in almost three years. However, the pace of production growth continues to slow, as July's year-over-year increase was less than half the pace of a year ago. Regional manufacturing reports for August suggest industrial production likely moderated during the month as financial turbulence and falling consumer confidence led to a pullback in new orders and production.

Previous: 0.9% **Wells Fargo: 0.1%**

Consensus: 0.1% (Month-over-Month)



Global Review

First Mover's Advantage?

The Brazilian central bank seems to have moved ahead of the crowd in the race to reverse the course of monetary tightening that it started back in April 2010 as the country's rate of inflation was increasing and threatening to get out of the central bank's target range of 4.5 percent (plus or minus two percentage points). The Brazilian Selic benchmark interest rate went from a low of 8.75 percent in April 2010, a rate the institution had maintained since August 2009, to a high of 12.50 percent in July of this year. The bank decided, during its August monetary policy meeting, to lower that rate to 12.00 percent.

This was a surprise move by a central bank that had argued for the need to increase the Selic rate from 12.25 percent to 12.50 percent during its July monetary policy meeting. Furthermore, while the increase in the rate during the July meeting was unanimous, the decision to decrease the rate from 12.50 percent to 12.00 percent had two dissenters. Interestingly, there were two dissenters during the monetary policy meeting back in April of this year when the central bank decided to increase the Selic rate from 11.75 percent to 12.00 percent. The two dissenting members of the committee wanted to increase the rate by 50 bps rather than by 25 bps.

Many argue that the political pressures to achieve a higher growth rate and reduce the strong appreciation of the Brazilian currency may have played an important role in the monetary policy reversal. The Brazilian economy grew at a year-over-year rate of 3.1 percent during the second quarter of the year compared to a 4.2 percent rate during the first quarter.

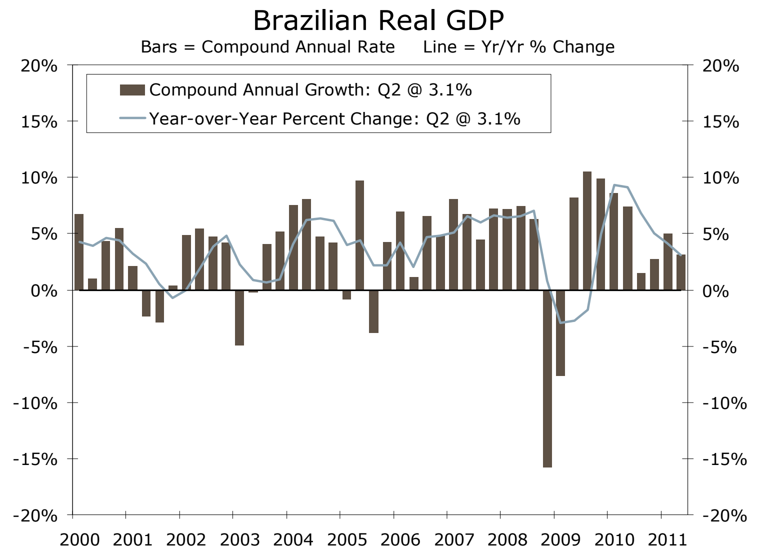
The most interesting thing about the Brazilian central bank's move to reduce interest rates was that it was done at a time where inflation in the country is outside of the central bank's target range and still increasing on a year-over-year basis.

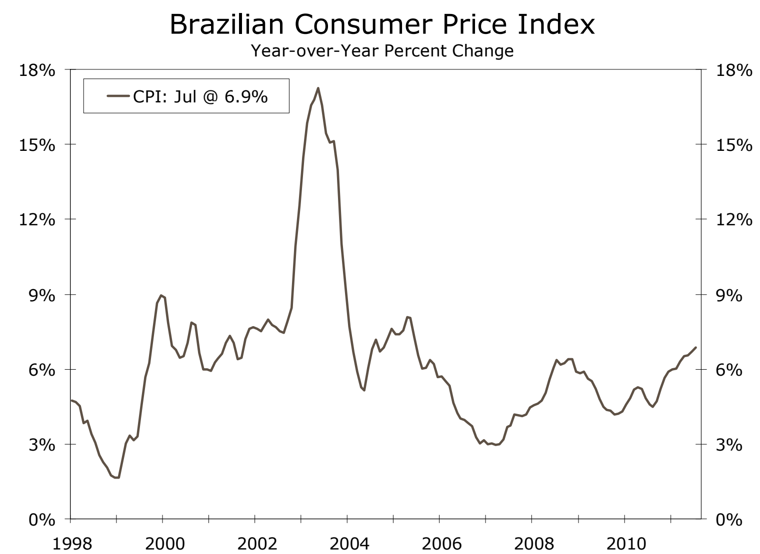
Blame It on the Rest of the World

Now, there is speculation that other central banks in the Latin America region will follow the decision of the Brazilian central bank and cut rates as well. The argument, which is the same argument made by the Brazilian central bank, is that the risks coming from the rest of the world are more important, today, than any concern regarding inflation.

Furthermore, other Latin American countries do not have the problems that Brazil is facing. In Chile, inflation is low and stable and the economy is growing at a reasonable pace. In Mexico, inflation is very close to the central bank's target and it is expected to approach the target by the end of this year. In Peru, inflation is also contained and low.

However, what is unsettling for central banks in the Latin America region is that economic growth is slowing down. With lower economic growth comes lower risks of inflation and lower inflation rates means more freedom for central banks to lower interest rates. The Brazilian real weakened after the rate cut, and other central banks in the region may be tempted to follow suit to prevent appreciation of their currencies.





Mexican Industrial Production • Monday

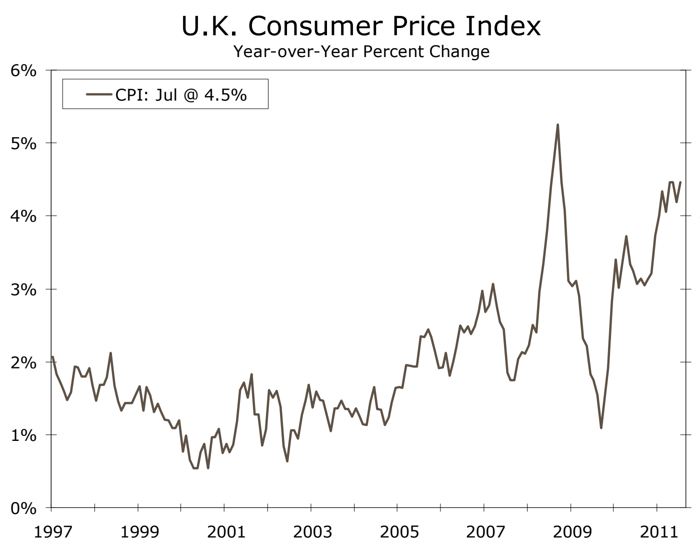
Factory output in Mexico is roughly back to the level it was before the global recession. That said, the annual pace of growth has been slowing on trend since the beginning of 2010.

We will get a sense of how Mexican factory activity is holding up in the third quarter when industrial production data for July hits the wire on Monday.

A continuation of the trend and a slower pace for output growth in July might put pressure on the Bank of Mexico to follow the lead of the Brazilian central bank and reduce the target lending rate to boost domestic consumption and business spending.

Previous: 3.7% **Wells Fargo: 3.2%**

Consensus: 3.3% (Year-over-Year)



U.K. Consumer Price Index • Tuesday

Economic growth in the United Kingdom slowed to an annualized pace of 0.7 percent in the second quarter. There is little data yet with which to evaluate how the third quarter is shaping up, but what little we do have is not encouraging. Industrial production slowed in July and the manufacturing PMI, after slipping into contraction territory in July, slumped further in August. Retail spending increased a modest 0.2 percent in July, but consumer confidence fell in July and slipped even further in August.

Consumer inflation for July came in at 4.4 percent, which is above the Bank of England's (BoE) target. Monetary Policy Committee members believe that inflation numbers are being boosted by temporary factors and will come down as slower economic growth pulls prices lower. The BoE left rates unchanged this week. We will get August inflation data on Tuesday.

Previous: 4.4% **Wells Fargo: 4.5%**

Consensus: 4.5% (Year-over-Year)

Eurozone Industrial Production • Wed.

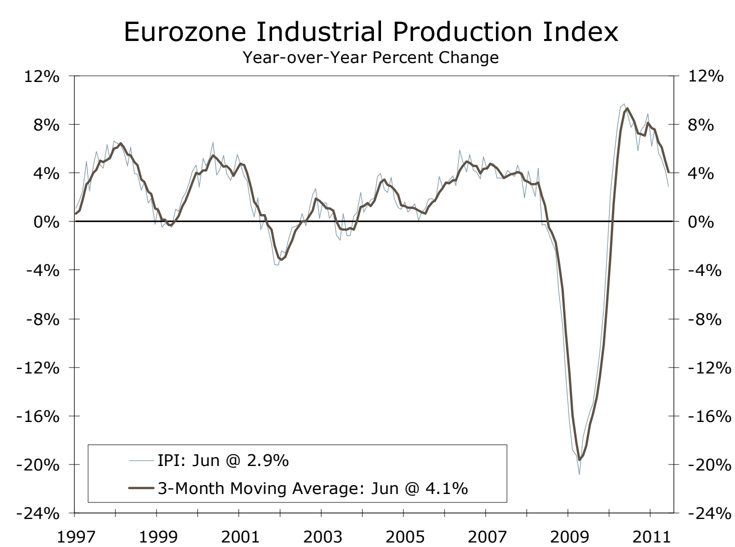
Despite the ongoing problems posed by the sovereign debt situation, industrial production in the Eurozone has remained rather healthy, until recently. After increasing in seven of the eight preceding months, output dipped 0.7 percent in June. The measure was still positive on a year-to-year basis.

Measures of sentiment offer little hope that things are poised to turn around in any substantive way. The manufacturing PMI for the Eurozone slipped to 49.0—the first reading in contraction territory since 2009. The ZEW survey in Germany plunged to -40.0, the lowest reading since 2008.

July industrial production data for the Eurozone will be released on Wednesday.

Previous: 2.7%

Consensus: 4.6% (Year-over-Year)



Interest Rate Watch

Fed on Track to September Ease

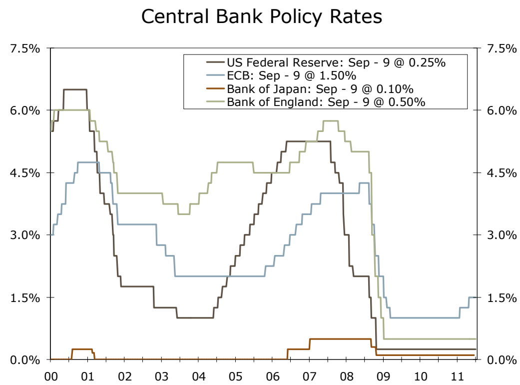
Our expectations are that the Federal Open Market Committee (FOMC) will pursue modest easing steps in September. Chairman Bernanke's presentation this week in Minnesota reinforced our impressions of the policy outlook he first outlined at Jackson Hole.

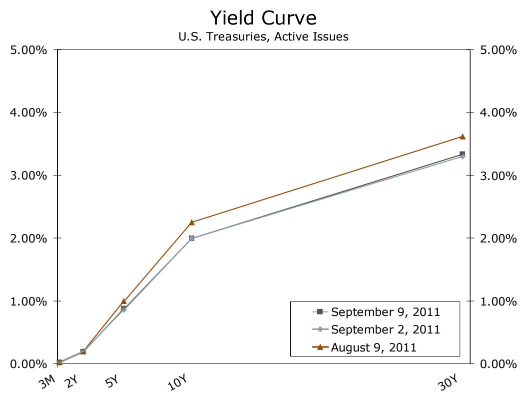
What is the economic framework of policy? From the chairman's viewpoint, economic growth is disappointing; that is, the recovery has been "much less robust than we had hoped." Here, we anticipate that real growth will be just below 2 percent in the second half of this year, and then just over 2 percent next year—both periods below what we would view as trend growth, and thereby there will be little progress in reducing unemployment. Meanwhile, "inflation is expected to moderate in the coming quarters" according to the FOMC. Here, we differ as we suspect that core PCE deflator readings will come in at or slightly above the perceived 2 percent Fed target over the next four quarters.

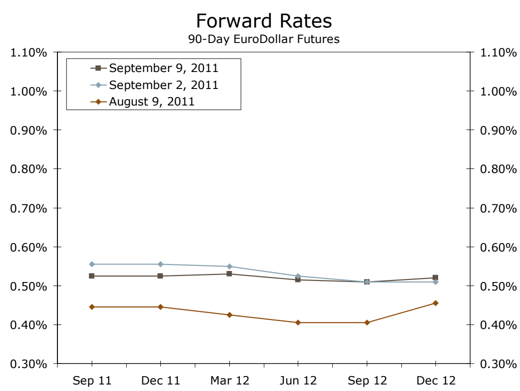
Policy Given This Framework

Given the FOMC's view, we expect that the September meeting will result in an easing of policy. This easing will lower long-term benchmark Treasury rates from five to ten years out, therefore offering some support for lower mortgage and high-grade bond rates as well. The FOMC is likely to move forward with selling shorter-dated paper and thereby may raise short-term interest rates a touch, thus giving rise to the term Operation Twist where the FOMC's actions would flatten the yield curve as short rates rise (we expect very little rise) and long rates come down (we expect very little).

Market interest rates are a function of many forces—especially expectations. Short-term market rates reflect the expectations that the Fed is unlikely to raise rates until early 2013. We believe that is a fair bet so we suspect that operation twist will have a very limited effect on the short end, especially since the amount of Fed buying is small relative to the depth of the market. As for long rates, the dollar and foreign buying sentiment remains more important.







Credit Market Insights

Consumer Credit Expansion

The Federal Reserve this week released its update on consumer credit for July. The report indicated that total outstanding consumer credit rose at a 6.0 percent annualized pace. Nonrevolving credit, which includes car and student loans, rose 11.2 percent in July. The strong nonrevolving credit increase is not all that surprising given the increased automobile sales that took place in July. More notably, revolving credit, which includes credit cards, contracted in July, reversing the positive growth observed in the last few months. The pullback in revolving credit outstanding likely reflects the slow pace of wage and salary growth combined with the ongoing process of consumer deleveraging. The ratio of revolving credit as a percentage of personal income continues its decline, falling to 6.06 percent from 6.13 percent in June, highlighting the consumer deleveraging trend. In the absence of further revolving credit issuance to c0nsumers, there may be a negative effect on consumer spending in the second half of the year. While higher prices supported July's retail sales numbers, our forecast signals a slower pace of consumer spending through the end of this year and through 2012. With slow employment gains along with nearly flat personal income growth, financial institutions are becoming increasingly hesitant to issue further credit. Thus, the credit market is not likely to support economic growth anytime soon.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.12%	4.22%	4.32%	5.08%
15-Yr Fixed	3.33%	3.39%	3.50%	4.39%
5/1 ARM	2.96%	2.96%	3.13%	4.10%
1-Yr ARM	2.84%	2.89%	2.89%	4.05%
MBA Applications				
Composite	601.0	631.7	688.0	880.0
Purchase	159.6	159.3	184.2	184.5
Refinance	3,169.4	3,381.7	3,625.7	4,926.5

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

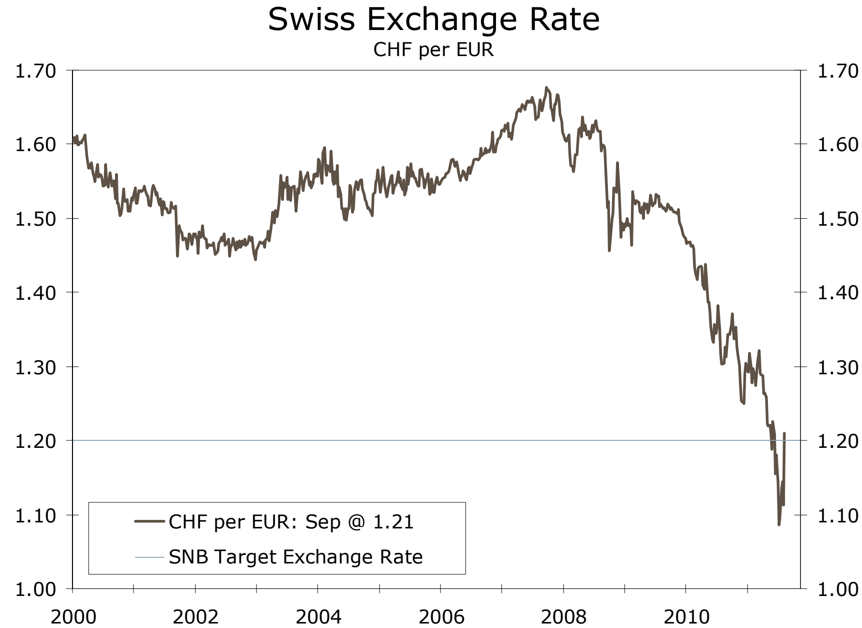
Topic of the Week

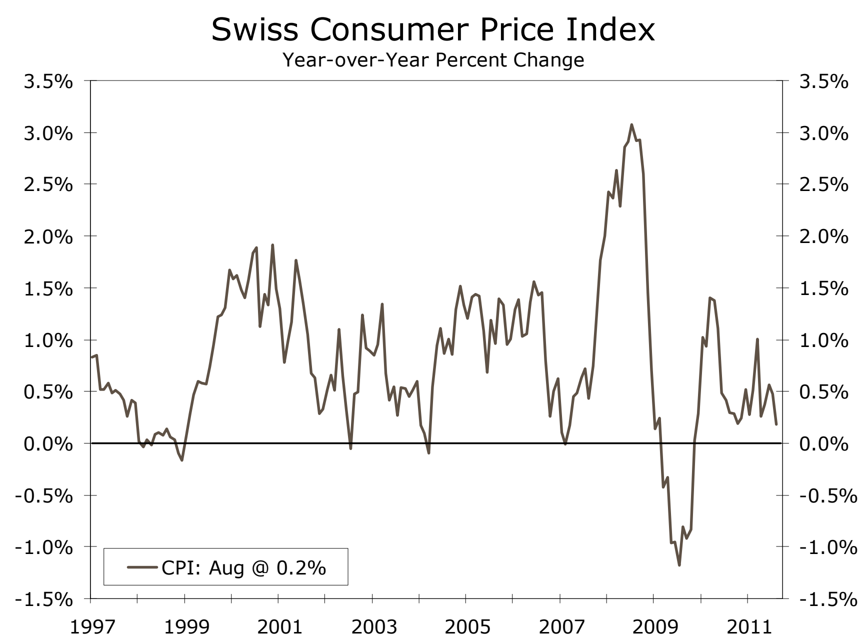
Swiss Intervene to Stem Further Appreciation

The Swiss National Bank (SNB) recently announced its intention to prevent the exchange value of the Swiss franc from falling below 1.20 francs per euro. The aggressive move follows an 11 percent appreciation of the franc against the euro so far this year, which has hurt Swiss exports to its largest market. Demand for francs as a safe haven has accelerated in the face of the lingering Eurozone sovereign debt saga as well as mounting global recession fears.

To keep the exchange rate from falling below 1.20, the SNB would potentially need to purchase unlimited quantities of euros by selling Swiss francs. As with any monetary intervention, the SNB's action carries with it certain risks. The most notable risk is the potential for inflation if the SNB is forced to defend its target and expand the supply of francs in circulation. At present, the CPI inflation rate in Switzerland stands at just 0.2 percent, which is well below its implicit target of 2.0 percent. Core inflation is even lower, 0.0 percent, which places the Swiss economy on the edge of deflation. A negative shock to the Swiss economy, such as a sharp contraction in exports due to an over-appreciated currency, could place the slowing economy into deflationary territory.

So far the franc remains above the SNB's target of 1.20. If the SNB's credibility holds, it may avoid having to make any significant purchases of euros; however, the market may decide to test the SNB's commitment. Given Switzerland's dangerously low inflation rate and its strong reliance on exports, the SNB's target will likely be tenable in the short run. Expanding the money supply, creating inflation and boosting exports all dovetail well with the SNB's explicit and implicit goals. However, if inflation were to rise above 2 percent, the SNB's flexibility would become more limited. For more information on the Swiss economy, please see our recent special report "*Strength of Currency Weighs on Swiss GDP Growth.*"





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 9/9/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.01	0.02	0.13
3-Month LIBOR	0.34	0.33	0.29
1-Year Treasury	0.11	0.12	0.24
2-Year Treasury	0.18	0.20	0.57
5-Year Treasury	0.84	0.86	1.56
10-Year Treasury	1.96	1.99	2.76
30-Year Treasury	3.32	3.30	3.84
Bond Buyer Index	4.05	4.14	3.92

Foreign Exchange Rates

	Friday 9/9/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.372	1.421	1.270
British Pound ($/£)	1.590	1.622	1.543
British Pound (£/€)	0.863	0.876	0.823
Japanese Yen (¥/$)	77.620	76.800	83.780
Canadian Dollar (C$/$)	0.996	0.985	1.034
Swiss Franc (CHF/$)	0.883	0.788	1.015
Australian Dollar (US$/A$)	1.047	1.065	0.923
Mexican Peso (MXN/$)	12.606	12.408	13.013
Chinese Yuan (CNY/$)	6.388	6.382	6.783
Indian Rupee (INR/$)	46.565	45.788	46.479
Brazilian Real (BRL/$)	1.674	1.641	1.720
U.S. Dollar Index	76.973	74.756	82.674

Foreign Interest Rates

	Friday 9/9/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.48	1.48	0.83
3-Month Sterling LIBOR	0.90	0.89	0.73
3-Month Canadian LIBOR	1.16	1.16	1.19
3-Month Yen LIBOR	0.19	0.19	0.23
2-Year German	0.40	0.52	0.70
2-Year U.K.	0.55	0.55	0.69
2-Year Canadian	0.83	1.00	1.47
2-Year Japanese	0.14	0.15	0.14
10-Year German	1.80	2.01	2.34
10-Year U.K.	2.30	2.44	3.05
10-Year Canadian	2.17	2.39	2.97
10-Year Japanese	1.01	1.03	1.13

Commodity Prices

	Friday 9/9/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	84.30	88.93	74.25
Gold ($/Ounce)	1851.33	1882.88	1243.65
Hot-Rolled Steel ($/S.Ton)	695.00	695.00	595.00
Copper (¢/Pound)	402.50	414.25	343.35
Soybeans ($/Bushel)	13.78	14.30	10.24
Natural Gas ($/MMBTU)	3.94	4.05	3.77
Nickel ($/Metric Ton)	22,058	21,708	22,891
CRB Spot Inds.	575.48	571.63	512.52

Next Week's Economic Calendar

	Monday 12	Tuesday 13	Wednesday 14	Thursday 15	Friday 16
U.S. Data		**Import Prices** July 0.3% August -1.1% (W)	**PPI** July 0.2% August 0.0% (W) **Retail Sales** July 0.5% August 0.1% (W) **Business Inventories** June 0.3% July 0.3% (W)	**CPI** July 0.5% August 0.2% (W) **Industrial Prod.** July 0.9% August 0.1% (W) **Current Account** Q1 -$119.3B Q2 -$128.0B (W)	**TIC** June -$29.5B
Global Data	**Mexico** **IP (YoY)** Previous (Jun) 3.7% **Mexico** **Fixed Investment** Previous (May) 9.1%	**U.K.** **CPI (YoY)** Previous (Jul) 4.4% **Brazil** **Retail Sales (MoM)** Previous (Jun) 0.2%	**Eurozone** **IP (YoY)** Previous (Jun) 2.7%	**Eurozone** **CPI (YoY)** Previous (Jul) 2.5% **U.K.** **Retail Sales (MoM)** Previous (Jun) 0.2%	

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

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