September 16, 2011

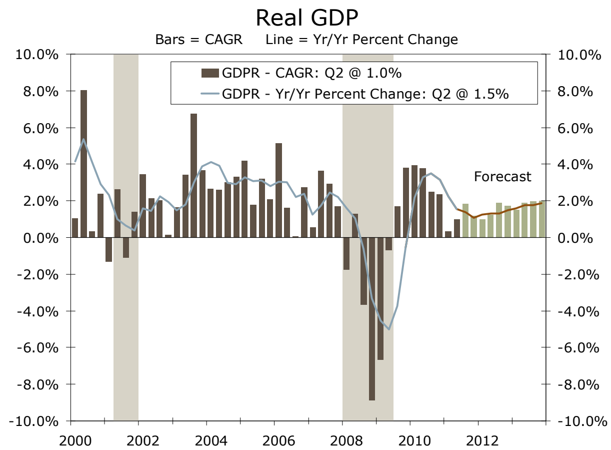
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Retail Sales Flat, Manufacturing Back?

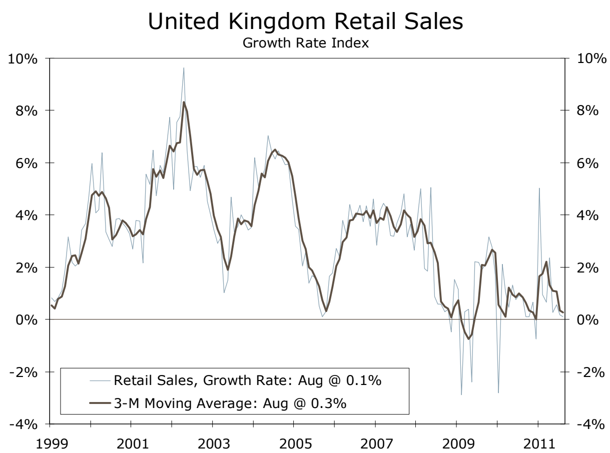
- Retail sales posted a disappointing flat reading for the month of August, with weaker-than-expected sales figures for several categories, including clothing and autos.
- Inflation measures continue to point to somewhat higher prices, with core measures rising for both the consumer and producer price indices.
- In light of this week's information, we believe that GDP growth is tracking at around a 1.8 percent annual pace for the third quarter.



Global Review

British Economy Remains in a Funk

- Recent economic indicators show that growth in the British economy remains anemic. Growth in retail spending has been sluggish recently, and exports have flattened. Official GDP data for Q3, which will be released at the end of next month, likely will show that growth in overall economic activity remains weak.
- U.K. inflation remains elevated, but the Bank of England's official forecast projects that inflation will recede over the next two years. We expect the Bank to keep its main policy rate at 0.50 percent through the end of 2012.



Wells Fargo U.S. Economic Forecast

	Actual 2011 1Q	Actual 2011 2Q	Forecast 2011 3Q	Forecast 2011 4Q	Forecast 2012 1Q	Forecast 2012 2Q	Forecast 2012 3Q	Forecast 2012 4Q	Actual 2009	Actual 2010	Forecast 2011	Forecast 2012	Forecast 2013
Real Gross Domestic Product [1]	0.4	1.0	1.8	1.2	1.0	1.2	1.9	1.7	-3.6	3.0	1.6	1.3	1.7
Personal Consumption	2.1	0.4	1.8	1.2	1.3	1.3	1.4	1.4	-2.0	2.0	2.1	1.3	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	3.7	3.9	3.2	2.8	2.6	2.3	-0.3	1.6	3.3	2.7	2.4
Industrial Production [1]	4.8	0.5	4.9	1.5	2.3	3.2	3.7	3.7	-11.1	5.3	3.8	2.8	3.8
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 16, 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

Together we'll go far

U.S. Review

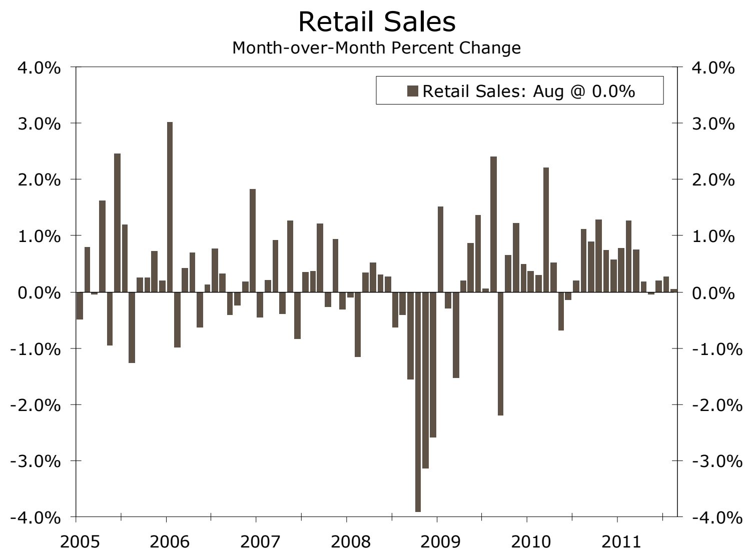
Retail Sales Flat, Manufacturing Back?

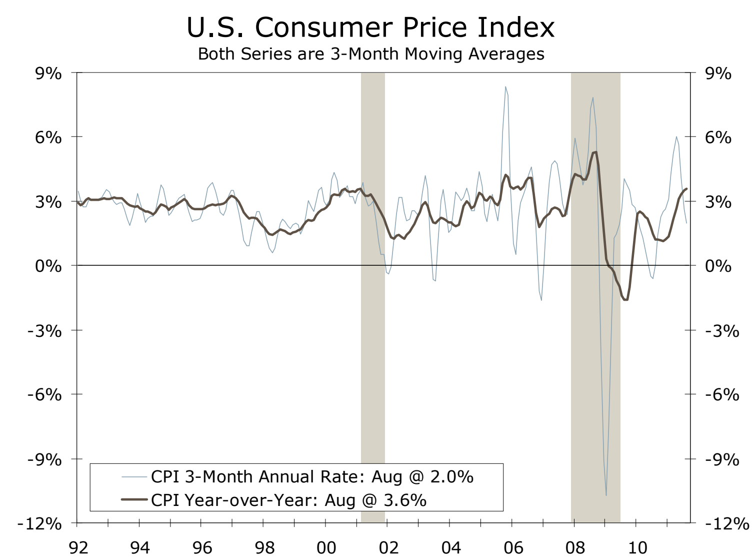
Economic data this week provided insight into three aspects of the domestic economy: the consumer picture, inflation measures and the manufacturing sector. We discovered that consumer retail spending remained flat in August; inflation, particularly core inflation, continued to trend higher; and the manufacturing sector posted a moderate increase in activity counter to what some of the regional Fed surveys reported. In light of this week's information, we believe that GDP growth is tracking at around a 1.8 percent annual pace for the third quarter.

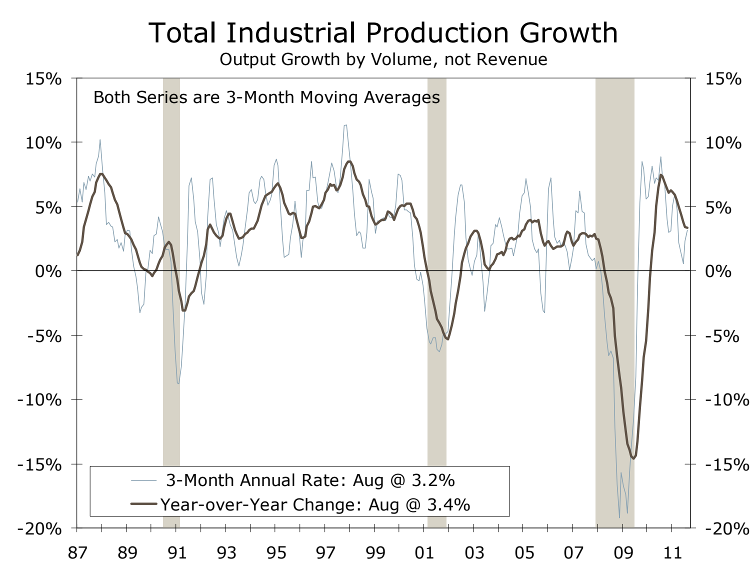
Retail sales posted a disappointing flat reading for August and a downward revision to July's reading. The weaker-than-expected sales figures were a product of weakness in several categories, including clothing and autos. Auto sales declined 0.3 percent in August after jumping 6 percent in July, likely reflecting the lower level of consumer sentiment. In general, this week's retail sales report reinforced our view that consumer spending will remain constrained through the end of this year, hovering at around a 1.5 percent growth pace.

On the inflation front, consumer prices for the month of August came in higher than we expected, jumping 0.4 percent. The higher consumer prices were observed in several categories, including food and energy. Core inflation, which excludes food and energy prices, was pushed higher again due to increasing rents amid strong demand for rental properties—a trend we expect will continue. Meanwhile, producer prices remained flat, as lower energy costs were offset by higher food prices. The core measure of PPI continued its upward trajectory, but at a slower pace. Our inflation outlook continues to call for inflation leveling off over the next few months. At this time, we do not anticipate a deflationary environment to return anytime soon.

This week's data on the manufacturing sector indicated that output was not as weak as some of the sentiment indices suggested for the month of August. Industrial production came in stronger than expected, posting a 0.2 percent increase for the month. The boost in output was attributed to a jump in manufacturing production, specifically automobile production. Our first look at September manufacturing conditions from the New York and Philadelphia Fed surveys did not provide much reassurance that manufacturing output is maintaining its current pace. The New York Fed indicated that local manufacturing activity weakened further, while the Philadelphia Fed reported that manufacturing activity remained in contractionary territory in September. It should be noted that the Fed surveys are sentiment indices, whereas industrial production measures are a gauge of actual activity. Over the past couple of months there has been a clear separation between the two measures leaving us to wonder if the ongoing slow growth environment is causing survey respondents to overstate the slowdown in production activity. Nevertheless, the new orders components of these indices have shown to be reliable predictors of actual order activity, and their negative readings continue to support our view of sluggish manufacturing activity through the end of the year.





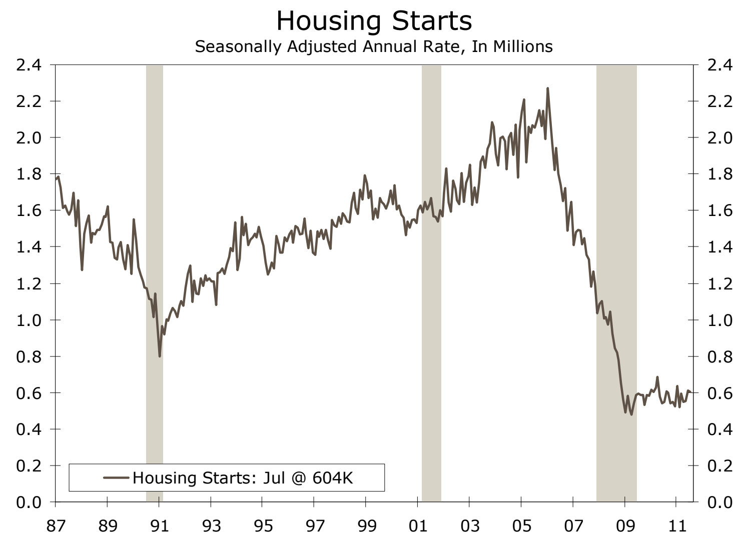


Housing Starts • Tuesday

Housing starts slowed to a 604,000-unit annualized rate in July from 613,000 in June. However, while single-family starts slipped 4.9 percent, construction of multifamily homes rose 7.8 percent, the second straight increase. Building permits also fell to 597,000 units. But while single-family permits edged up 0.5 percent, multifamily permits plunged 10.2 percent. In addition, the number of homes under construction fell to 413,000, the lowest on record dating back to 1970. With consumer confidence declining amid the political wrangling in Washington and S&P's credit rating downgrade, no job growth in August and volatile financial markets, we expect to see weaker housing starts for August. The decline in permits in July also portends weaker building activity. With so many cheap foreclosures on the market and lending standards still tight, there is currently little demand for new homes. The lack of building activity is a major reason unemployment remains high.

Previous: 604K **Wells Fargo: 585K**

Consensus: 590K

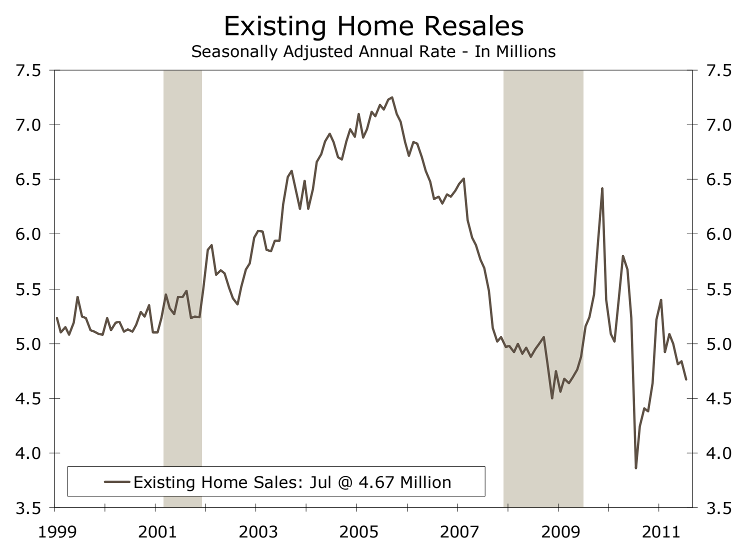


Existing Home Sales • Wednesday

Existing home sales fell to a 4.67 million-unit annualized rate in July from 4.84 million in June, as single-family sales dropped 4.0 percent while sales of condos and co-ops were unchanged. Supply rose to 9.4 months from 9.2 months, but while supply fell from 9.0 months to 8.9 months for single-family homes, supply jumped from 10.7 months to 13.1 months for condos and co-ops. The median price was down 4.4 percent from a year ago, with single-family prices down 4.5 percent and prices for condos and co-ops down 4.0 percent. Despite mortgage rates averaging around 4.5 percent in July, sales still remained sluggish thanks to high unemployment, tight lending standards, widespread negative equity and a jump in purchase cancellations as appraisals are being kept on the conservative side. With so many headwinds facing the market, mortgage applications tumbled in August. We expect to see little change in home sales for August.

Previous: 4.67M **Wells Fargo: 4.70M**

Consensus: 4.75M

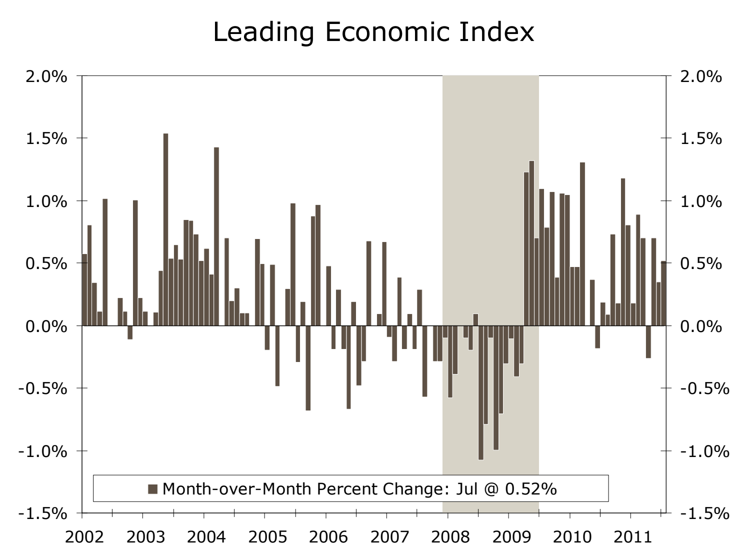


Leading Indicators • Thursday

The leading economic indicators index rose 0.5 percent in July, a bit better than the 0.3 percent increase in June. Money supply expansion contributed 0.71 percentage points to the increase, while the interest rate spread added another 0.31 percentage points. The pace of deliveries subtracted 0.42 percentage points and consumer expectations shaved off another 0.26 percentage points. We expect the big decline in the stock market and consumer expectations to result in a weaker reading for the leading economic indicators index for August. The increase in the money supply would normally signal stronger growth ahead. However, with the velocity of money at the lowest level in over 30 years, that may not necessarily ring true. In addition, even with the fed funds rate stuck near zero, the interest rate spread has been narrowing recently. None of the other eight indicators are showing much in the way of stronger growth either.

Previous: 0.5% **Wells Fargo: 0.0%**

Consensus: 0.1% (Month-over-Month)



Global Review

British Economy Remains in a Funk

The British economy has experienced a painfully slow recovery over the past two years following its very deep downturn. The economy contracted more than 6 percent between Q1-2008 and Q3-2009, and the level of real GDP remains nearly 4 percent below its prerecession peak. Indeed, real GDP was essentially flat on balance between Q3-2010 and Q2-2011. Therefore, recent signs suggesting that growth remains anemic (discussed below) are discouraging.

For starters, growth in consumer spending has been very weak lately. Real retail spending in the first two months of the third quarter was up only 0.2 percent relative to the second quarter. Moreover, real spending is essentially flat on a year-ago basis (see chart on front page). The economy is not getting much help from the rest of the world either. The value of British exports, which rose about 20 percent between mid-2009 and the end of last year, has been essentially flat on balance since the beginning of 2011.

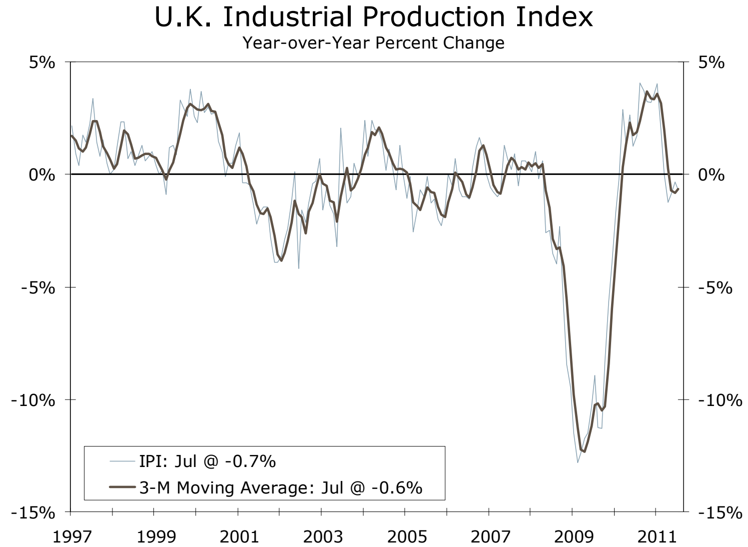
Weak growth in retail spending in conjunction with stagnant exports means growth in industrial production has flattened over the past few months (top chart). Moreover, the sharp decline in the PMI in August suggests that the service sector has weakened as well (middle chart). A research institute that makes an unofficial estimate of overall economic activity on a monthly basis recently announced that real GDP appears to have risen only 0.2 percent (not annualized) between May and August. It appears that the official GDP growth rate for the third quarter, which will be released at the end of next month, will be very weak indeed.

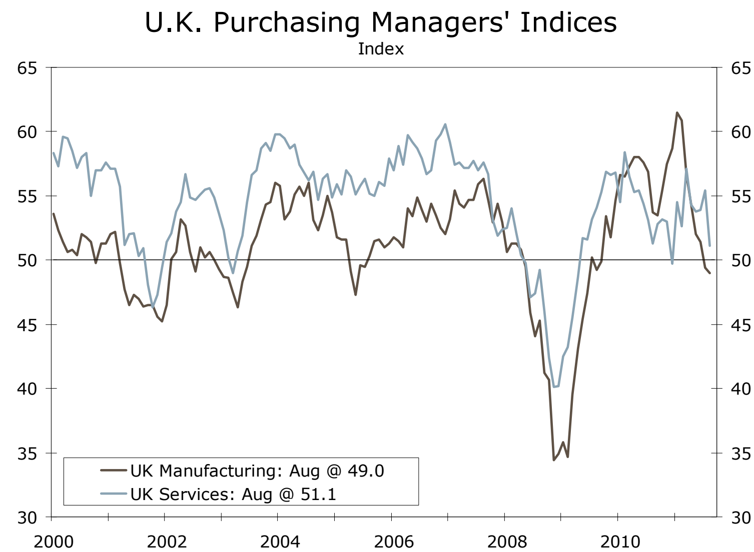
Sluggish economic growth means weak labor market conditions. In that regard, the unemployment rate has been hovering around 8 percent, the highest rate since the mid-1990s, for two years. There is little wonder then that indices of British consumer confidence remain depressed. Some commentators list weak labor market conditions as a factor that helped to fuel the riots that rocked some of the country's major cities in August.

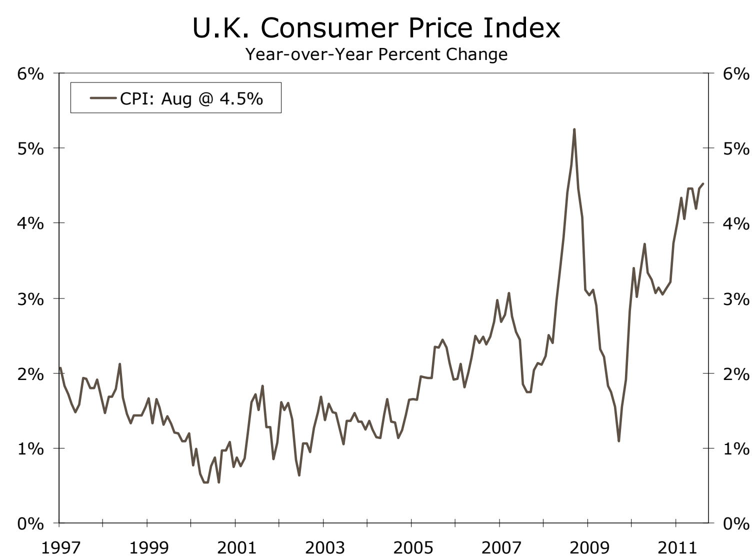
Inflation Remains Uncomfortably Elevated

Despite the sluggish pace of economic growth, CPI inflation in the United Kingdom remains elevated (bottom chart). According to the Bank of England's latest *Inflation Report*, inflation has been pushed higher by some temporary factors, such as an increase in the value-added tax and the lagged effects of past currency depreciation. The Bank's official forecast projects that the CPI inflation rate will fall back to the 2 percent target over the next two years, a target that the Monetary Policy Committee (MPC) is mandated by law to achieve in "the medium term."

The MPC has maintained its main policy rate at only 0.50 percent since March 2009, and it has engaged in quantitative easing (QE) over the past two years. However, the MPC has not raised the amount of QE, which currently is £200 billion, since last November. At a minimum, we expect the MPC to keep its main policy rate at 0.50 percent through the end of 2o12. And if the economy remains stagnant, the MPC could eventually increase the size of its QE.







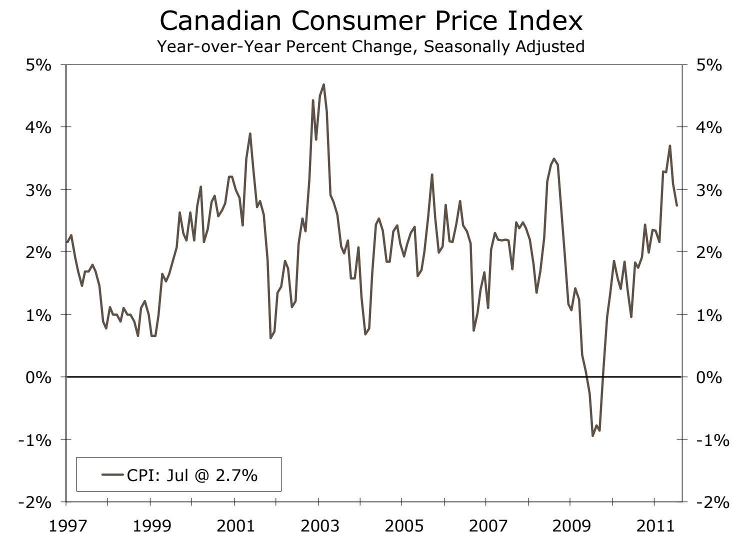
Canadian CPI • Tuesday

The Canadian consumer price index will be released on Tuesday. The consensus forecast anticipates that the overall CPI rose 0.1 percent in August, compared a 0.2 percent increase during the previous month. If realized, the monthly increase would translate into a year-over-year rise of 2.9 percent in August, up from 2.7 percent for the 12 months ending in July.

Meanwhile, core consumer prices are also expected to increase by only 0.1 percent during August and to remain stable at 1.6 percent on a year-earlier basis. The Bank of Canada has indicated that it expects inflation to decline the in coming months, as higher food and energy prices unwind. Therefore, the Bank likely will be on hold for the foreseeable future. However, higher-than-expected prints on CPI inflation could prevent the Bank from easing policy, should that prove necessary in the months ahead.

Previous: 2.7% **Wells Fargo: 2.8%**

Consensus: 2.9% (Year-over-Year)



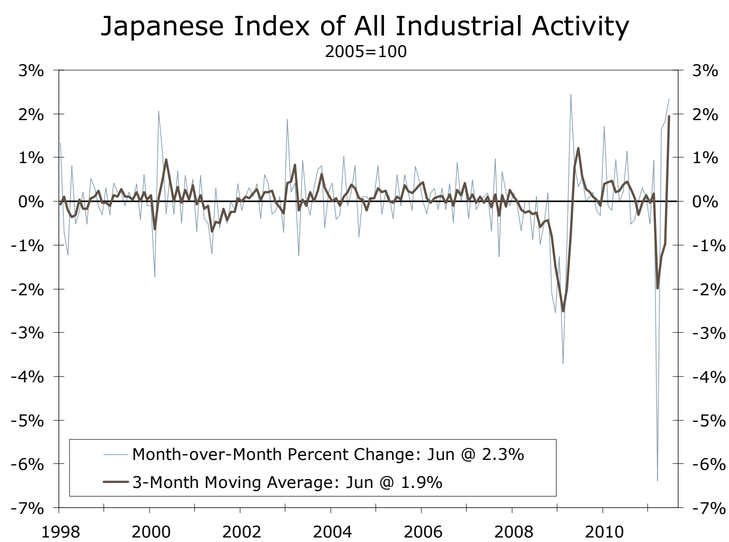
Japan Industrial Activity • Wednesday

The all industry activity index in Japan bounced 2.3 percent in June, but the index is expected to increase only 0.5 percent in July. This expected rate of weak growth is consistent with the sluggish economic environment currently affecting the Japanese economy. Moreover, the slowdown also reflects the effects of a pullback in economic activity across the world.

However, this increase in the all industry index is good news for the third quarter, even if the growth is not very strong. Japanese real GDP fell at an annualized rate of 2.1 percent in Q2, but we project that growth turned positive again in Q3. A stronger-than-expected number next week could lead to some upward revisions for Japanese GDP growth. However, expectations on the performance of the Japanese economy have been lowered so much that any improvement is coming off of a very low base.

Previous: 2.3%

Consensus: 0.5% (Month-over-Month)



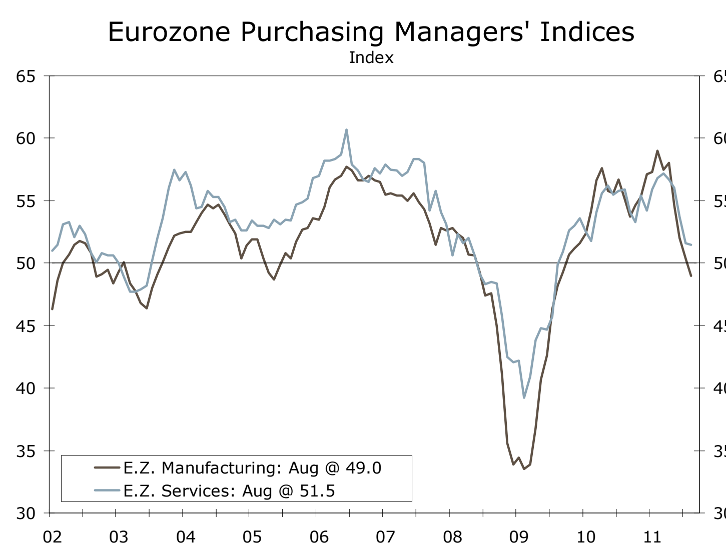
Eurozone PMIs • Thursday

On Thursday, we get the release of the Eurozone PMIs, and the expectation is for the indices to show a very weak economic environment. Markets expect the manufacturing PMI to come in at 48.5, a level that is only slightly below August's print and something that in this environment would be considered a good development as it shows that the sector is not deteriorating further. For the service PMI, the markets are expecting a slight deterioration, but the index is expected to remain just above the expansion-contraction level of 50. The expectation is for the index to have gone from 51.5 in August to 51.0 in September.

These numbers are nothing to celebrate about, but at least they will point to a weak but stabilizing economic environment. Of course, if the German PMI comes in stronger, then we may see some upward surprise on the index. However, we should not count on this.

Previous: 50.7

Consensus: 49.8 (Composite Index)



Interest Rate Watch

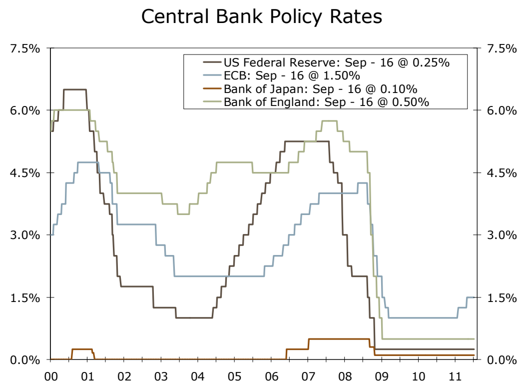
Inflation: Is the FOMC Spooked?

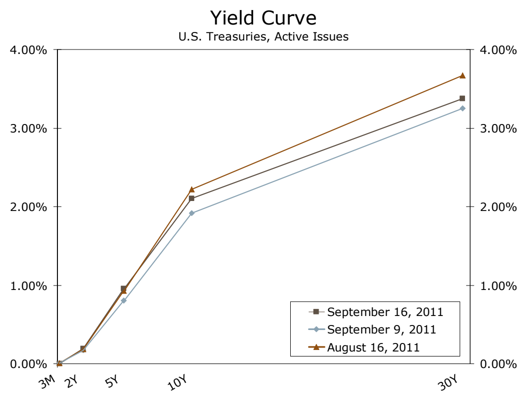
With the Consumer Price Index (CPI) coming in this week slightly hotter than expected, many observers have questioned whether this might restrain the FOMC from easing monetary policy further at its two-day meeting next week. Our view is that this week's inflation numbers will not prevent the Fed from taking further action.

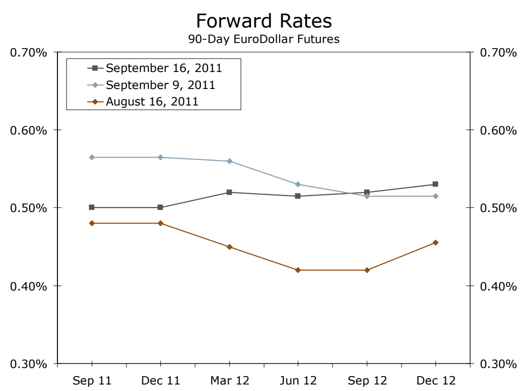
The headline CPI came in 0.2 percentage points higher than expected, rising 0.4 percent month over month in August. However, the core CPI, which excludes food and energy prices, came in right in line with market expectations, rising 0.2 percent on the month. Moreover, the Producer Price Index, which was released on Wednesday, showed prices falling at the production level, with the intermediate goods index falling 0.5 percent in August. Longer-term inflation expectations have also come down in recent months—the Cleveland Fed's five-year expected inflation index has fallen 0.24 percentage points over the past three months, and, on a year-over-year basis, this index is still showing expected inflation running below the Fed's implicit lower inflation bound of 2 percent.

With an unemployment rate still above 9 percent and the European sovereign debt crisis intensifying in recent weeks, the Fed will likely push the gas pedal further to the floor. Our view is that the FOMC will opt to change the maturity profile of its U.S. Treasury holdings, shifting out of shorter-dated securities and into longer-dated securities. Fed officials hope that by pushing down longer-term Treasury yields, more homeowners and consumers will take advantage of lower borrowing rates for mortgages and consumer credit, thereby boosting spending.

The bond market is anticipating a move in this direction. Longer-term Treasury yields are already at historically low levels—and even near negative in real terms. So far, however, the drop in rates has produced modest benefits. Mortgage refinancing activity remains weak and consumer credit growth continues to sputter. Monetary policy works with a lag, however, and we may see a more significant impact once the storm clouds from Europe clear.







Credit Market Insights

Corporate Bond Spreads Widening

Corporate bond spreads have widened recently, but at this point, we are a long way away from the panic seen in 2007-2008. Corporate Baa spreads have widened to 331 basis points over 10-year Treasury yields as of September 9, a far cry from the 612 basis point spread in December 2008. However, it is not as though demand has waned for corporate bonds. As a matter of fact, the Baa yield has actually dropped 58 basis points since the beginning of May, implying that prices have been rising. But the spread has widened, because 10-year Treasury yields have declined a much larger 131 basis points, as investors have sought the safest of assets amid slowing global growth and sovereign debt concerns. One reason corporate bonds may still be in favor despite slowing growth is that the real yield on the 10-year Treasury (10yr - CPI) has been negative for the past four months, giving investors incentive to look for more yield elsewhere. In addition, although corporate profit growth has slowed, corporate profit levels are still robust, meaning the chance for default is very slim even in a slowing economy. With the stock market volatile and real 10-year yields negative, U.S. corporate bonds have been a viable alternative for investors. Thus, while widening spreads may indicate a weakening economy, or at least a more risk averse environment, a closer look reveals that investors are still showing confidence in U.S. corporate debt, which is helping to support business fixed investment.

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

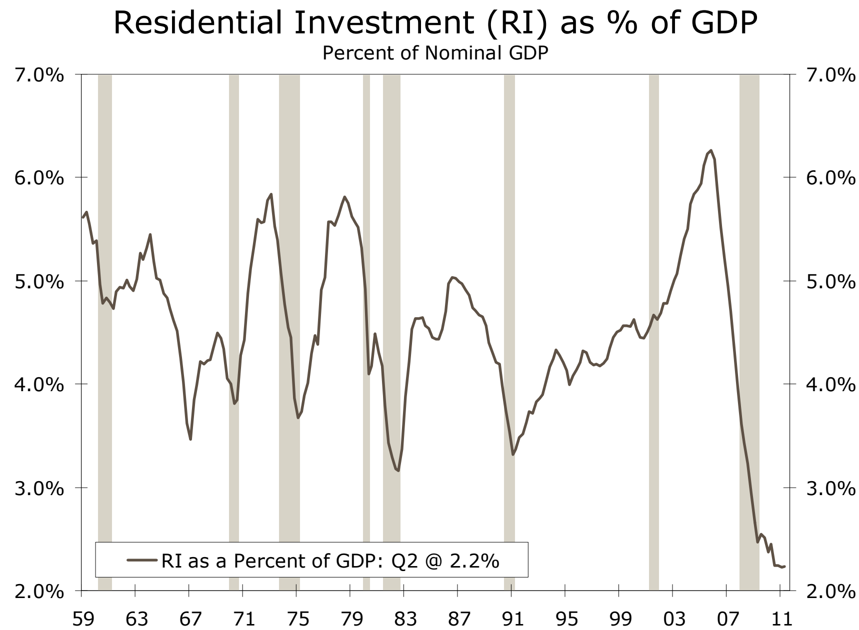
Topic of the Week

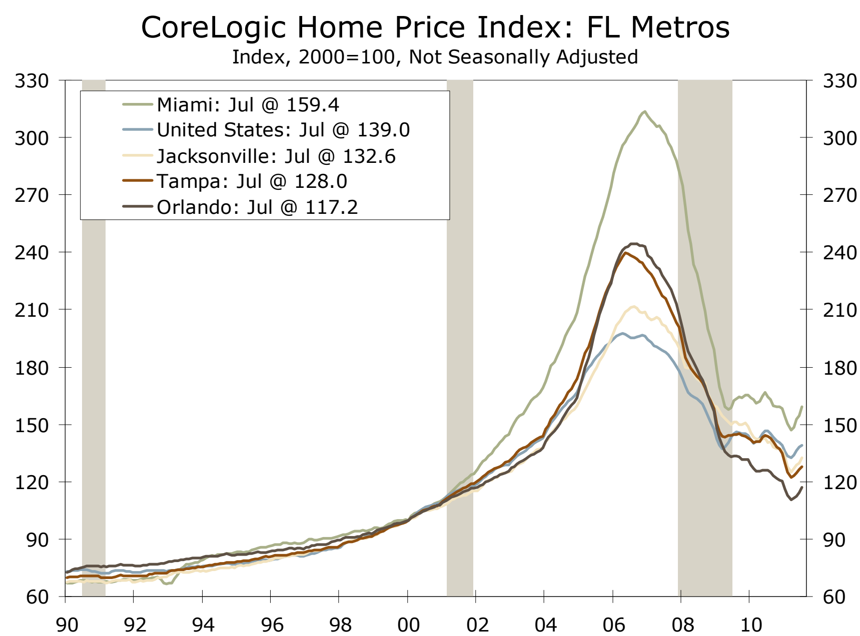
Florida: Beaches, Suntans and....Cheap Homes?

A common catchphrase we like to use is, "With housing still dead in the water, it is unlikely that the economy will grow faster than a 1.5 percent to 2.0 percent pace." The reason for this claim is because, historically, residential investment has been a huge driver of economic growth during the early stages of a recovery (top chart). So when residential investment as a share of GDP continued to fall even after the recession technically ended, it was quite obvious that the recovery was going to be sluggish.

We recently published a report on Florida's economy, which served as the epicenter of last decade's colossal housing boom and bust. (See *Florida Economic Outlook: September 2011*.) Not surprisingly, Florida's economy continues to struggle with a hangover from the boom years. Most of Florida's larger metro areas experienced home price bubbles that were considerably larger than the bubble at the national level, with prices in Miami deviating the furthest from trend (bottom chart). So when the bubble burst, home prices in Florida fell much further than did prices in most other states, pushing nearly half of all homeowners with a mortgage in the Sunshine State into a negative equity position.

However, some tentative signs suggesting that Florida's housing market is close to a bottom are finally emerging. International buyers have provided a boost to sales in a number of metro areas recently, taking advantage of their stronger currencies to scoop up homes at value prices—South American and Canadian buyers have been the most active. In the near term, foreign buying activity helps to reduce Florida's enormous stock of vacant homes. In addition, the presence of international buyers in Florida's housing market may provide domestic buyers with the confidence that prices are in fact reaching a bottom, as buying activity is often dictated by group sentiment. Either way, Florida's recovery remains crucial to the U.S. recovery, and construction activity in Florida—as well as in other boom-bust states—needs to grow again for the broader economy to gain traction.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 9/16/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.00	0.01	0.15
3-Month LIBOR	0.35	0.34	0.29
1-Year Treasury	0.11	0.11	0.26
2-Year Treasury	0.19	0.17	0.47
5-Year Treasury	0.95	0.80	1.46
10-Year Treasury	2.10	1.92	2.76
30-Year Treasury	3.37	3.25	3.92
Bond Buyer Index	4.07	4.05	3.89

Foreign Exchange Rates

	Friday 9/16/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.379	1.366	1.308
British Pound ($/₤)	1.580	1.588	1.563
British Pound (₤/€)	0.873	0.860	0.837
Japanese Yen (¥/$)	76.730	77.610	85.780
Canadian Dollar (C$/$)	0.985	0.997	1.027
Swiss Franc (CHF/$)	0.875	0.884	1.016
Australian Dollar (US$/A$)	1.036	1.047	0.937
Mexican Peso (MXN/$)	12.958	12.692	12.793
Chinese Yuan (CNY/$)	6.384	6.388	6.725
Indian Rupee (INR/$)	47.268	46.565	46.155
Brazilian Real (BRL/$)	1.714	1.674	1.712
U.S. Dollar Index	76.653	77.192	81.241

Foreign Interest Rates

	Friday 9/16/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.48	1.48	0.83
3-Month Sterling LIBOR	0.92	0.90	0.73
3-Month Canadian LIBOR	1.18	1.16	1.23
3-Month Yen LIBOR	0.19	0.19	0.23
2-Year German	0.59	0.39	0.81
2-Year U.K.	0.55	0.53	0.73
2-Year Canadian	1.05	0.79	1.52
2-Year Japanese	0.14	0.14	0.14
10-Year German	1.92	1.77	2.48
10-Year U.K.	2.52	2.26	3.14
10-Year Canadian	2.30	2.11	2.98
10-Year Japanese	1.01	1.01	1.05

Commodity Prices

	Friday 9/16/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	84.30	87.24	74.57
Gold ($/Ounce)	1787.68	1855.70	1275.25
Hot-Rolled Steel ($/S.Ton)	695.00	695.00	590.00
Copper (¢/Pound)	397.15	398.75	348.30
Soybeans ($/Bushel)	13.19	13.78	10.18
Natural Gas ($/MMBTU)	3.85	3.92	4.06
Nickel ($/Metric Ton)	21,785	22,058	23,210
CRB Spot Inds.	568.53	575.48	514.92

Next Week's Economic Calendar

	Monday 19	Tuesday 20	Wednesday 21	Thursday 22	Friday 23
U.S. Data		**Housing Starts** July 604K August 585K (W) **Building Permits** July 601K August 590K (C)	**Existing Home Sales** July 4.67M August 4.70M (W) **FOMC Rate Decision** Previous 0.25% Expected 0.25% (W)	**LEI** July 0.9% August 0.0% (W)	
Global Data		**Germany** **Producer Prices (MoM)** Previous (Jul) 0.7%	**Canada** **CPI (MoM)** Previous (Jul) 0.2% **Japan** **Ind. Activity (MoM)** Previous (Jun) 2.3%	**Canada** **Retail Sales (MoM)** Previous (Jun) 0.7% **Eurozone** **PMI Composite** Previous (Aug) 50.7	**Mexico** **Unemployment Rate** Previous (Jul) 5.62%

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

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