November 18, 2011

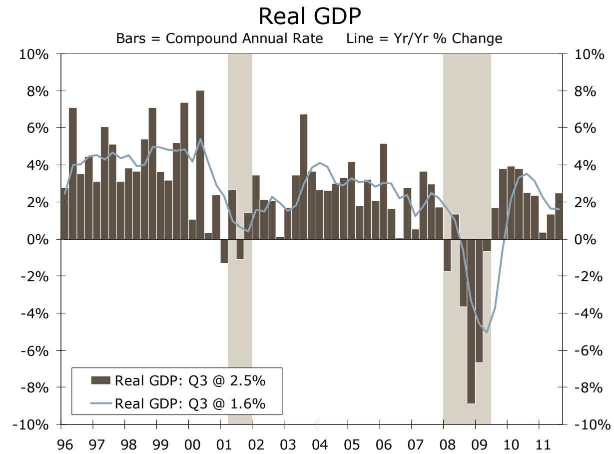
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Some Economic News to Be Thankful For

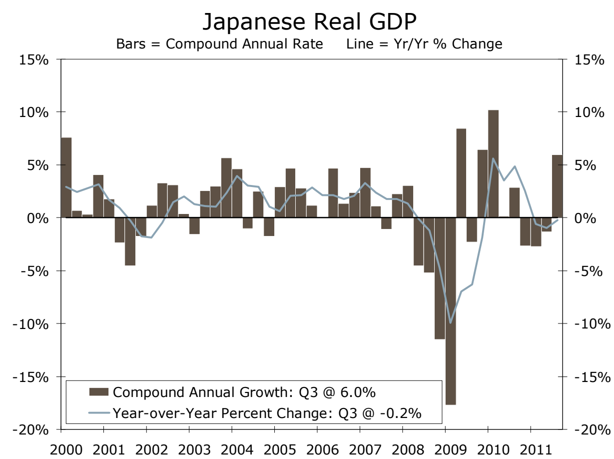
- Economic growth in the fourth quarter appears to be off to a good start. Retail sales rose 0.5 percent in October with nearly broad-based gains. Core retail sales, which exclude autos, food, gasoline and building materials, rose 0.6 percent and are up 5.7 percent on a three-month annualized basis.
- Inflation data provided a glimmer of hope for the economy with consumer and producer prices both pulling back. We expect prices to decelerate further throughout next year, which would continue to give the Fed the green light for additional quantitative easing.



Global Review

Fourth-Quarter GDP Likely to Worsen

- Several countries released third-quarter GDP data this past week. As expected, growth in the Eurozone slowed. Data were sporadic, but there were some pockets of strength. Japan's economic growth improved as exports recovered from the tsunami and earthquake. Strong consumer spending and investment supported improvement in Russia.
- Yet, there are signs that the fourth quarter may not be as rosy. Industrial production has weakened in Europe and Russia, while unemployment has jumped in the United Kingdom. A strong yen could hinder Japanese exports.



Wells Fargo U.S. Economic Forecast

	Actual			Forecast					Actual		Forecast		
	2011				2012				2009	2010	2011	2012	2013
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	0.4	1.3	2.5	2.6	1.7	1.8	2.0	2.1	-3.6	3.0	1.8	2.0	1.8
Personal Consumption	2.1	0.7	2.4	2.6	1.3	1.4	1.5	1.4	-2.0	2.0	2.3	1.6	1.3
Inflation Indicators [2]													
"Core" PCE Deflator	1.1	1.3	1.6	1.8	1.8	1.6	1.5	1.6	1.5	1.4	1.5	1.6	1.6
Consumer Price Index	2.2	3.3	3.8	3.5	2.6	2.0	1.7	1.8	-0.3	1.6	3.2	2.0	2.0
Industrial Production [1]	4.8	0.6	5.2	3.2	1.9	2.6	2.8	2.8	-11.1	5.3	4.0	2.8	2.0
Corporate Profits Before Taxes [2]	8.8	8.5	6.5	6.4	6.2	6.0	6.4	6.6	7.9	32.2	7.5	6.3	7.0
Trade Weighted Dollar Index [3]	70.6	69.4	72.8	74.0	75.0	76.0	76.5	77.0	77.7	75.6	71.7	76.1	78.6
Unemployment Rate	8.9	9.1	9.1	9.1	9.3	9.4	9.4	9.4	9.3	9.6	9.1	9.4	9.2
Housing Starts [4]	0.58	0.57	0.61	0.58	0.57	0.60	0.63	0.65	0.55	0.58	0.59	0.61	0.74
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	4.11	4.10	4.10	4.10	4.10	4.10	5.04	4.69	4.39	4.10	4.40
10 Year Note	3.47	3.18	1.92	2.20	2.30	2.40	2.40	2.50	3.26	3.22	2.69	2.40	2.70

Forecast as of: November 18, 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

Modest Recovery Is Still Under Way

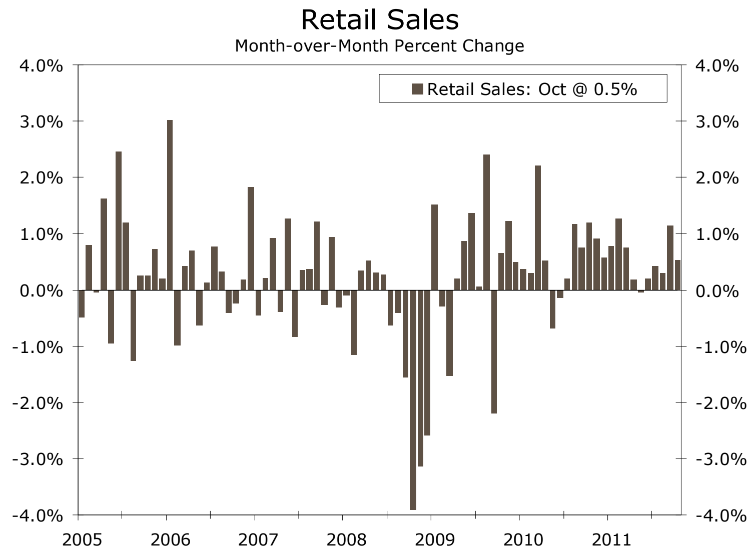
This week's full plate of economic indicators came in largely better than expected and continued to show the resilience of the recovery. That said, economic growth in the fourth quarter appears to be off to a good start. Indeed, retail sales rose 0.5 percent in October and while the increase is a deceleration relative to the 1.1 percent gain in September, the reading was stronger than the 0.3 percent consensus estimate. While gains were nearly broad-based, the headline was pulled lower by declines in furniture, gasoline and clothing sales. Sales of electronics, however, jumped 3.7 percent reflecting strong iPhone and tablet computer sales. Core retail sales, which exclude autos, food, gasoline and building materials, rose 0.6 percent and are up 5.7 percent on a three-month annualized basis.

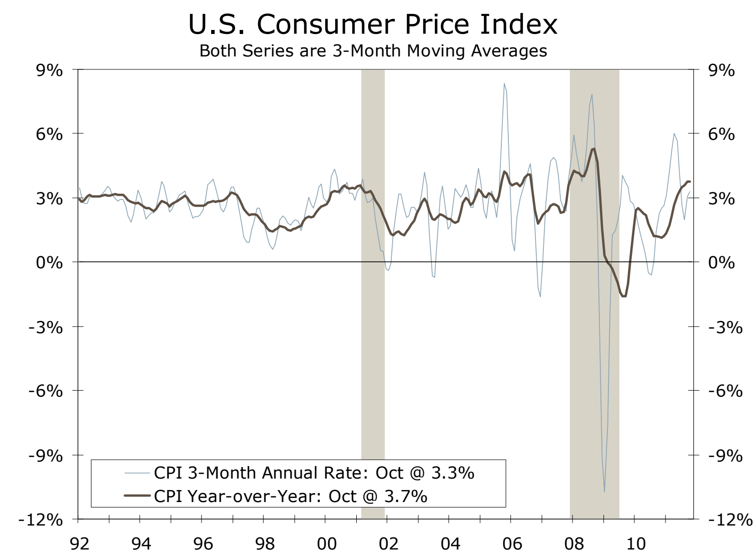
The retail sales data offer some encouragement going into the holiday season. We now suspect holiday sales will likely increase around 5.0 percent on a year-ago basis. The apparent obstacle to even stronger sales is weak real disposable income, which was up only 0.4 percent year-over-year in the third quarter. With anemic real disposable income, many consumers are reducing their saving rate. Consumers may finally catch a break later in the year, however, as inflation begins to subside.

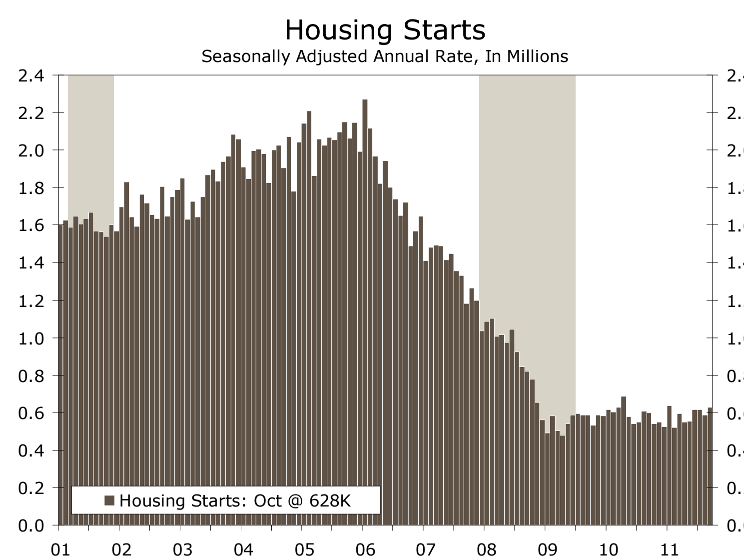
Speaking of inflation, producer and consumer prices were also released this week. Wholesale prices dropped 0.3 percent in October following a 0.8 percent increase in September. Much of the decline can be attributed to a 1.4 percent drop in energy prices. Core producer prices, which exclude energy and food, were flat on the month and were held back by a 0.8 percent drop in auto prices. Vehicle prices have now been down for three straight months and could be payback for the spike in prices in the wake of supply chain disruptions due to the Japanese earthquake. This would suggest the recent downward trend in auto prices may not be sustainable.

Headline consumer prices slipped 0.1 percent in October with the decline concentrated in retail gasoline prices. Softness was also seen in food and beverage prices, which has shown solid increases throughout the year. With GDP growth expected to perform at a subpar pace over the next year, it appears that we may have peaked on headline inflation. Year-over-year headline CPI pulled back from September's recent cycle peak and is now up 3.5 percent. Recent declines in commodities are supportive, and with consumer demand still weak, consumer prices should decelerate on a year-ago basis throughout next year. With consumer prices expected to remain below the Fed's implicit inflation target, the Fed will continue to have the green light to pursue another round of quantitative easing if necessary.

Housing remains stuck in slow growth, however. Housing starts fell 0.3 percent to a 628,000-unit pace in October, with the volatile multifamily component accounting for the decline. Multifamily starts fell 8.3 percent, but single-family starts rose 3.9 percent. While the increase in single-family starts is encouraging, it likely reflects the seasonal adjustment process.







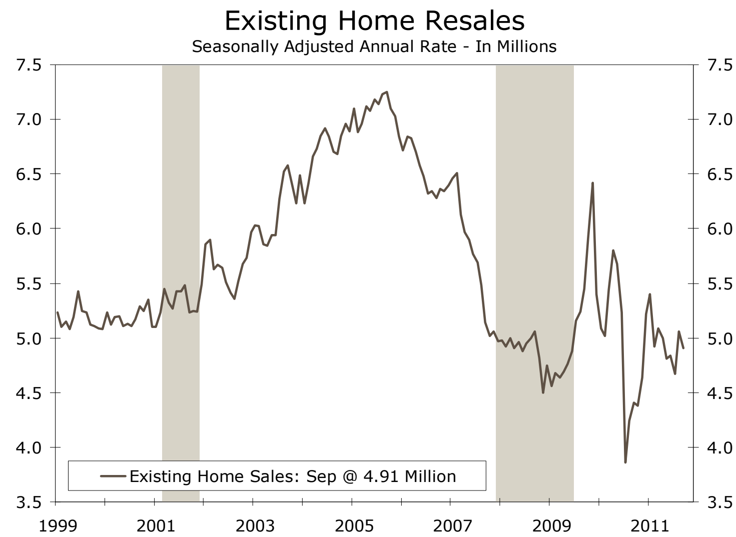
Existing Home Sales • Monday

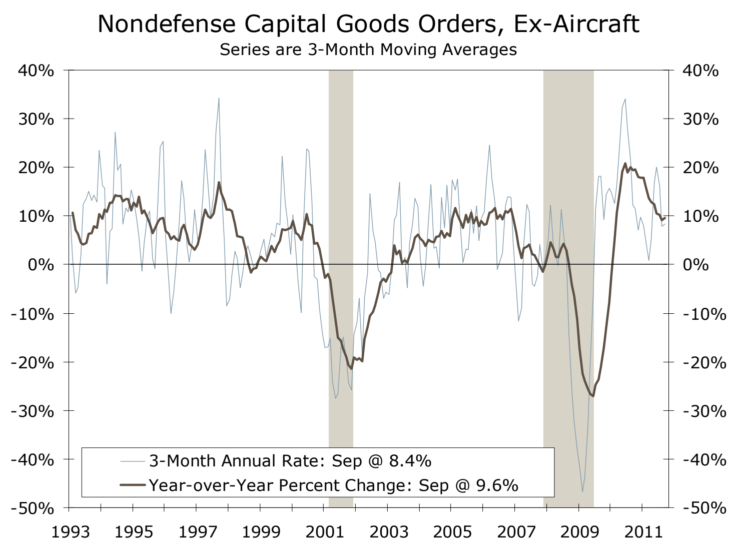
Existing home sales fell in September to a rate of less than 5 million per year. Contract cancellations continue to stymie sales, with 18 percent of NAR members reporting a contract that failed to close in both September and August. Properties in foreclosure and short sales still constitute 30 percent of all closings—an uncomfortably high share of overall sales.

On Monday, we will get a sense of how the existing home market fared in October. With slow job growth and weak consumer confidence, it is tough to imagine what might be the catalyst for a rebound in housing in the near future. On that basis, we do not expect much of a change in the sale of existing homes in October.

Previous: 4.91M **Wells Fargo: 4.78M**

Consensus: 4.80M





Durable Goods Orders • Wednesday

Total U.S. factory orders (both durable and non-durable) are closing in on the prerecession peak, off just 6.5 percent from the high-water mark in June 2008. The larger nondurable component has fared better than durables. Orders for durable goods are presently 18 percent smaller than they were at their height in December 2007.

But the key measure of business spending in this report is non defense capital goods orders, ex aircraft. It is the shipments of this series that go into GDP calculations, so trends in orders give a sense of what future business spending would look like in the GDP report. Orders for this key series are back above prerecession levels. We will get a better sense of how business investment is holding up when October durable goods data hit the wire on Wednesday.

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

Consensus: -1.1%

Personal Spending • Wednesday

Personal income eked out a gain of just 0.1 percent in September and climbed at just a 0.9 percent annual rate during the third quarter. Wages and salaries held up somewhat better, growing at a 2.0 percent pace.

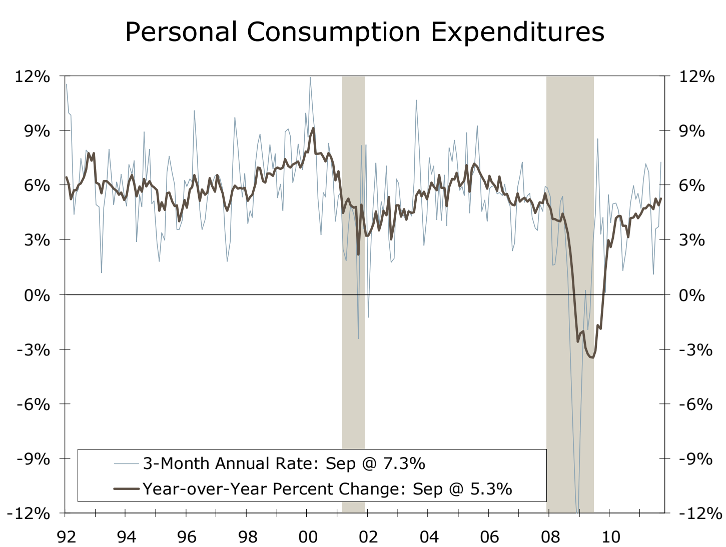
Unfortunately, higher inflation and taxes offset all the growth in personal income and then some. Inflation, as measured by the personal consumption deflator, rose at a 2.4 percent pace during the third quarter, while tax payments increased at a 3.6 percent pace.

Despite the modest income gain, spending increased 0.6 percent as consumers, saved less and spent more.

An October report for personal income and spending is to come out next Wednesday. A stronger-than-expected retail sales report lifts expectations for spending somewhat.

Previous: 0.6% **Wells Fargo: 0.3%**

Consensus: 0.3%



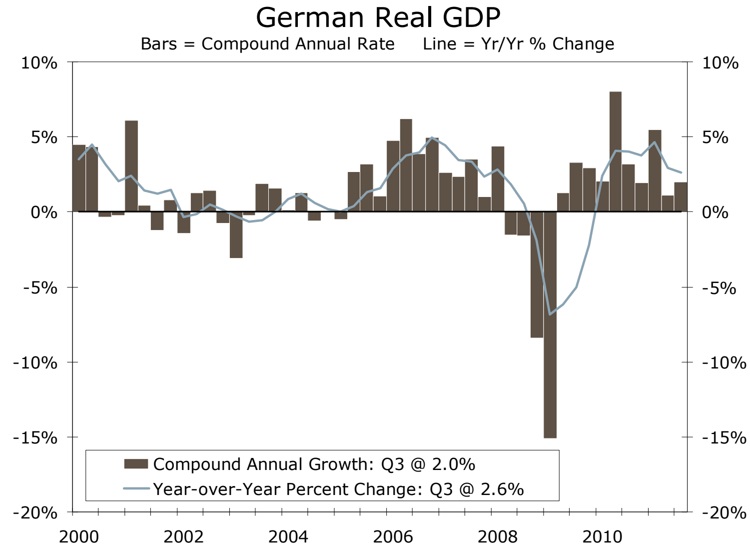
Global Review

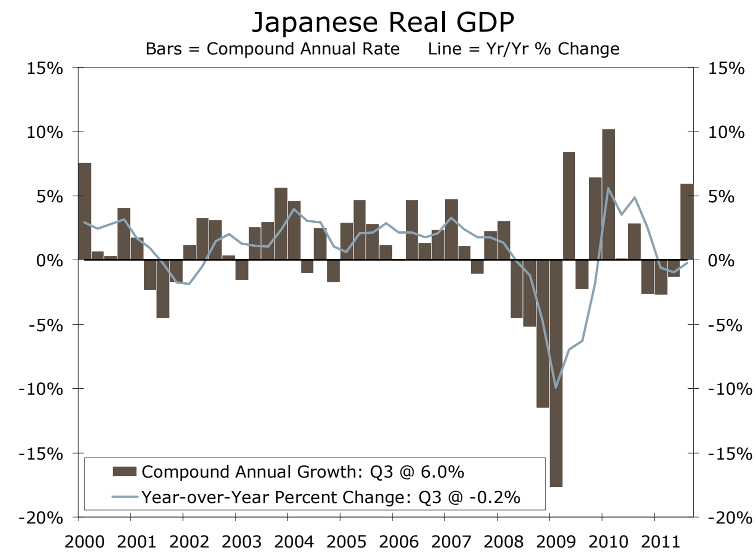
The Good and Bad in Third-Quarter Global GDP

Several countries released third-quarter GDP data this past week. The Eurozone economy as a whole grew 0.2 percent from the prior quarter, the same as in the second quarter. However, year-over-year growth slid to 1.4 percent, the second consecutive slowdown. Stronger consumer spending propelled improvement in quarterly GDP growth in Germany to 0.5 percent from 0.3 percent and in France to 0.4 percent from -0.1 percent. However, on a year-ago basis, German growth slowed from the second quarter, while French growth held steady. As for the heavily indebted countries, the data were sporadic. On a quarterly basis, Spain was unchanged, while Portugal's contraction worsened to -0.4 percent from -0.1 percent. Quarterly data were not available for Ireland, Greece and Italy. On a year-ago basis, contraction in Greece slowed to -5.2 percent from -7.4 percent, Spain held steady at 0.8 percent and Portugal's contraction worsened to -1.7 percent from -1.0 percent. Year-over-year growth data were not available for Ireland and Italy. Outside of Europe, Japan's economy rebounded, growing 1.5 percent on a quarterly basis following three quarters of contraction, as consumer spending and capital investment improved while exports recovered from the earthquake and tsunami. But GDP was still down 0.2 percent from the prior year. In Russia, a surge in fixed capital investment, stronger consumer spending and a widening of the trade surplus helped third-quarter economic growth to improve to 4.8 percent year over year compared to 3.4 percent in the second quarter.

The Fourth Quarter Is Looking Less Optimistic

Despite some pockets of strength in the third quarter, the fourth quarter isn't looking quite as rosy. The Eurozone debt crisis intensified toward the end of the third quarter, and late third quarter data are showing ominous signs. Eurozone industrial production fell 2.0 percent in September from the prior month, the largest decline since Feb. 2009. The biggest drop was in Estonia at -10.9 percent. But more worrisome were significant declines in Germany and France. Heavy declines were also seen in the troubled countries of Italy, Portugal, Spain and Ireland, while Greece saw a slight improvement. In addition, German investor confidence plunged in November to -55.2, a three-year low. Another point of concern was an increase in the U.K.'s unemployment rate in the third quarter to 8.3 percent. While this is generally a lagging indicator, the fact that it reached a 15-year high is not a good sign. Furthermore, the number of unemployed people in the U.K. is at a 17-year high. Outside of Europe, the Eurozone debt crisis poses significant headwinds. This, along with a yen near post-World War II highs, has Japan bracing for a sharp slowdown in exports and overall economic growth in the fourth quarter. Russia's industrial production rose just 3.9 percent from a year ago in September, the slowest pace since October 2009. In addition, slowing European growth dampens oil exports, which accounts for the vast majority of Russian exports and nearly 40 percent of budget revenues.





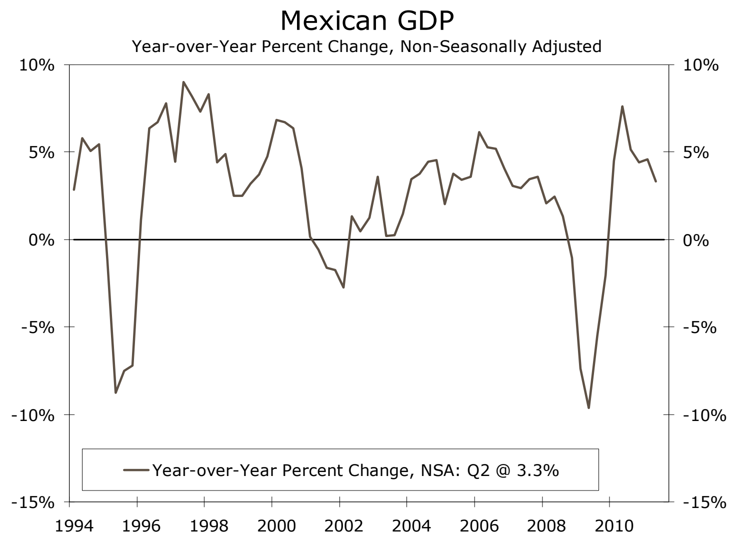
Mexican GDP Growth • Tuesday

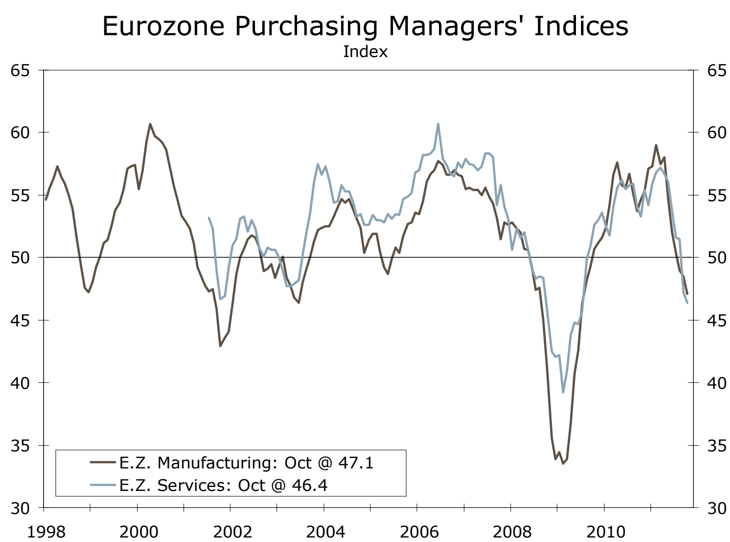
Mexico is to release its GDP data for the third quarter on Tuesday. The country has experienced a slowdown in its year-over-year rate of growth that mirrors the deceleration in its most important trading partner (i.e., the United States). However, we suspect that the rate of GDP growth south of the border strengthened somewhat in the third quarter. Not only have low interest rates helped to boost consumption expenditures—new car registrations rose 21 percent on a year-ago basis in the third quarter—but it appears that growth in business fixed investment spending was also strong during the quarter.

An insight into the state of the Mexican economy in the fourth quarter will be provided by the release on Thursday of October trade data. Bi-weekly price data, which are also on the docket on Thursday, should show that CPI inflation remains largely in check thus far in November.

Previous: 3.3% **Wells Fargo: 3.6%**

Consensus: 3.9% (Year-over-Year)





Eurozone PMIs • Wednesday

The purchasing managers' indices (PMIs) for the Eurozone have slipped below the demarcation line separating expansion from contraction in recent months. If these PMIs are indicative of the state of economic activity, then it appears that the overall euro area is slipping back into recession. Indeed, we are forecasting a modest downturn in the Eurozone over the next few quarters. The "flash" estimates for November, which are slated for release on Wednesday, will be important in determining whether the pace of contraction has become more or less intense in recent weeks.

The Ifo index of German business sentiment, which is on the docket on Thursday, will also be examined closely for what it says about the current state of the German economy. The index has been declining over the past few months, which would be consistent with a slowing pace of German economic activity.

Current Manufacturing PMI: 47.1

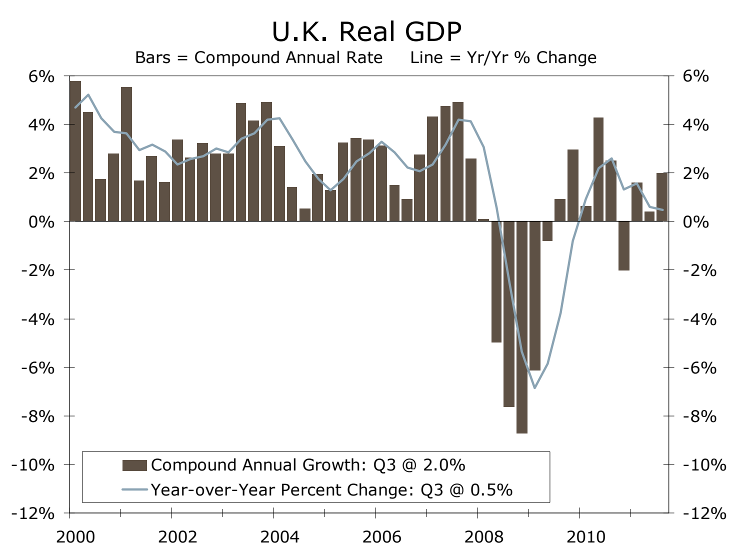
Current Services PMI: 46.4

U.K. GDP Growth • Thursday

The initial estimate of British GDP growth in the third quarter, which was released a few weeks ago, showed that the economy expanded at an annualized pace of 2.0 percent. The second estimate, which is slated to print on Thursday, likely won't be revised much. However, this estimate will also contain a breakdown of the GDP data into its underlying demand components, which will help to determine the near-term path of the British economy. A large inventory build in the third quarter would suggest, everything else equal, slower GDP growth in the fourth quarter as businesses pare back excessive stocks. On the other hand, however, a large stock drawdown last quarter would help to boost growth in the current quarter.

A widely followed survey of the industrial sector will also be released on Thursday. The information should shed some light on the state of British industry in November.

Previous: 2.0% **Wells Fargo: 2.0%**



Interest Rate Watch

Changing Frameworks and Nonlinear Interest Rate Move

This week's moves in Italian and Spanish bond rates reflect patterns that we have witnessed in the past where new information to the financial markets generates a nonlinear move for interest rates and a rash of unprepared investors who are on the wrong side of the market.

In the United States we have witnessed similar sharp moves in market rates, 1979-1982, 1984-85, 1994-95, and in each case the underlying factor was a change in the framework/model of the marketplace.

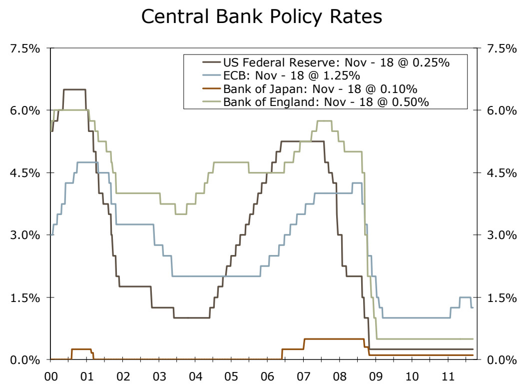
Classic Model

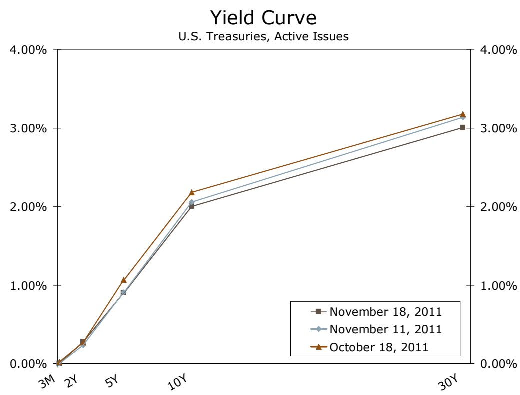
Typically, we would model the movements of interest rates in response to changes in expectations for economic growth, inflation, the dollar or Treasury financing. This process assumes a stable model where only the values of the independent variables (growth, inflation, etc.) change and not the relationships between the variables themselves. That is, a change in expected inflation would have the same impact on interest rates over time.

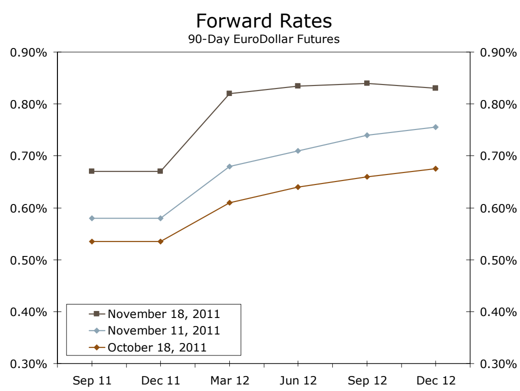
Today's Framework

Unfortunately, today this framework has been altered, because the size of the debt in Spain and Italy provides a new twist on the interest rate link. While stronger growth would suggest stronger private credit demand in a normal model, the lack of growth relative to the current level of interest rates adds another relationship between growth and rates. In this case, slower growth does not mean weaker credit demand and lower rates, but in fact, it suggests insufficient revenues at the governmental level such that questions arise about the sustainability of interest payments and the quality of the debt itself. Weaker growth suggests weaker credit quality and thereby higher interest rates in a regime where debt is very high relative to growth expectations.

As the framework changes so will the choices that are possible for policy makers. Large federal deficits limit the options for fiscal policy and, in fact, lead to calls for restraint even with subpar economic growth. The policy framework is upside-down.







Credit Market Insights

Commercial Paper Continues to Rise

The commercial paper market plays an important role in providing short term liquidity to businesses for use on current transactions. The benefit to the firm is that commercial paper is a lower-cost alternative to traditional bank notes. Commercial paper is used for such expenses as inventory investments, funding credit cards, and payrolls. Thus, it has earned the reputation for "greasing the wheels of an economy."

During the financial crisis, the commercial paper market collapsed, putting the breaks on short-term commercial lending. The effect was that many firms were unable to continue purchasing raw materials for production and in some cases had difficulty making their payroll payments. Given the importance of the commercial paper market, a recovery in the paper market is welcomed news. As business confidence improves, the need for commercial paper increases as firms begin purchasing more raw material inventories and marginally expanding payrolls.

Recent trends in the commercial paper market point towards increased business confidence. Outstanding commercial paper has increased in three of the past four weeks. The week ended November 16 outstanding paper increased $31.9 billion. If the upward trend continues, November would be the first monthly increase in outstanding paper since May, a positive sign of improving business confidence.

Mortgage Data

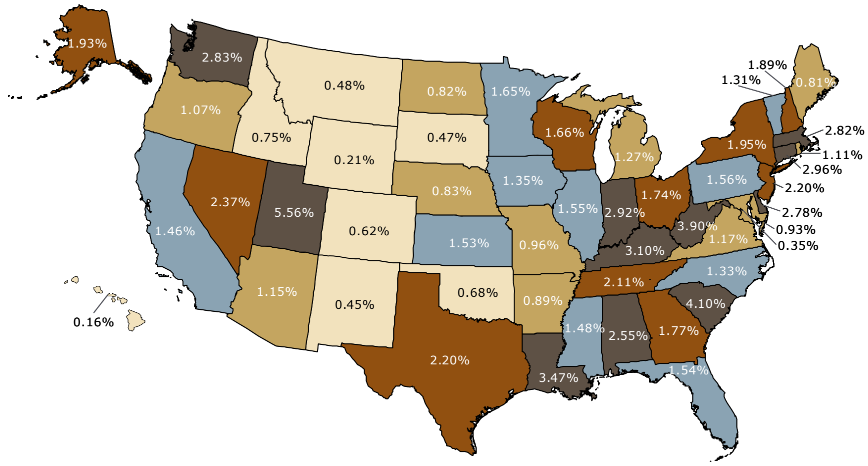
	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.00%	3.99%	4.11%	4.27%
15-Yr Fixed	3.31%	3.30%	3.38%	3.72%
5/1 ARM	2.97%	2.98%	3.01%	3.47%
1-Yr ARM	2.98%	2.95%	2.94%	3.40%
MBA Applications				
Composite	660.5	734.3	633.1	713.6
Purchase	178.9	183.1	161.4	179.2
Refinance	3,483.9	3,967.5	3,396.1	3,831.0

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

Topic of the Week

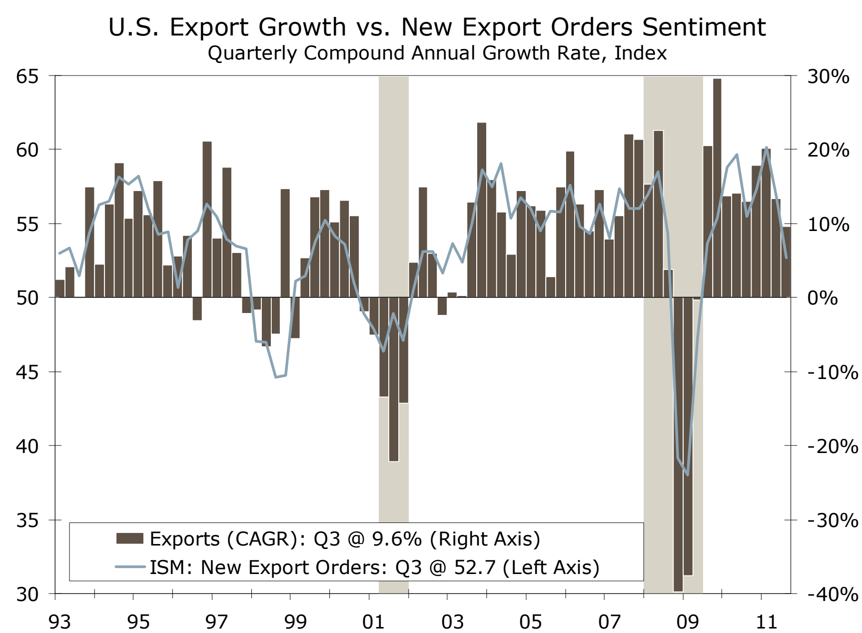
Regional Exposure to a European Recession

This week, we released a report detailing the U.S. states that were most at risk of being affected by a European recession. We began by breaking down the top trading partners for all 50 states. The map to the right shows each state's goods exports to Europe as a percentage of GDP. The darker shaded areas represent the states with the largest exposure to Europe. It should be noted that one shortcoming of this dataset is only exports of goods are represented in the map data.



Our findings suggest that while the effect on goods exports may not be significant, given that only 1.97 percent of U.S. GDP is dependent on European goods exports, the effect on a handful of states will be more severe. One noticeable trend is that there is not a specific geographical concentration of states with direct export exposure to Europe. Among the states with the highest exposure to Europe include Utah, South Carolina, West Virginia and Louisiana.

The common thread among many of the top states on the list is that many of these states are exporters of commodities. Utah's gold and silver exports account for the largest share of the state's total exports at 52 percent, much of which is exported to the United Kingdom. West Virginia is also among the states that will likely be affected due to commodities exports to Europe, particularly in coal production, with nearly 4 percent of the state's economic growth tied to Europe. Other areas likely to be affected by a European recession include states that export automobiles and automobile parts along with aircraft and aircraft parts. South Carolina and Alabama are among the auto producing states that have somewhat strong ties to Europe. With many states continuing to struggle with the effects of the sluggish U.S. economic recovery, the prospect of some additional challenges as the European Union slips back into a recession over the next couple of quarters represents another hurdle. The effects on these states would include a slowdown in new export orders, which would in turn reduce output and job growth.



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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 11/18/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.00	0.00	0.13
3-Month LIBOR	0.49	0.46	0.28
1-Year Treasury	0.12	0.10	0.19
2-Year Treasury	0.28	0.23	0.50
5-Year Treasury	0.92	0.91	1.50
10-Year Treasury	2.01	2.06	2.90
30-Year Treasury	3.01	3.13	4.28
Bond Buyer Index	4.09	4.02	4.72

Foreign Exchange Rates

	Friday 11/18/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.353	1.375	1.364
British Pound ($/£)	1.580	1.607	1.604
British Pound (£/€)	0.856	0.856	0.851
Japanese Yen (¥/$)	76.880	77.200	83.520
Canadian Dollar (C$/$)	1.026	1.010	1.019
Swiss Franc (CHF/$)	0.917	0.900	0.996
Australian Dollar (US$/A$)	1.004	1.028	0.990
Mexican Peso (MXN/$)	13.732	13.540	12.273
Chinese Yuan (CNY/$)	6.355	6.342	6.633
Indian Rupee (INR/$)	51.335	50.115	45.230
Brazilian Real (BRL/$)	1.784	1.744	1.712
U.S. Dollar Index	77.948	76.945	78.617

Foreign Interest Rates

	Friday 11/18/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.42	1.42	0.98
3-Month Sterling LIBOR	1.02	1.01	0.74
3-Month Canadian LIBOR	1.28	1.28	1.20
3-Month Yen LIBOR	0.20	0.20	0.20
2-Year German	0.47	0.40	1.11
2-Year U.K.	0.48	0.54	1.13
2-Year Canadian	0.92	0.92	1.64
2-Year Japanese	0.12	0.13	0.17
10-Year German	1.97	1.89	2.70
10-Year U.K.	2.25	2.29	3.40
10-Year Canadian	2.14	2.13	3.12
10-Year Japanese	0.95	0.97	1.12

Commodity Prices

	Friday 11/18/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	97.63	98.99	81.85
Gold ($/Ounce)	1725.53	1788.68	1353.07
Hot-Rolled Steel ($/S.Ton)	630.00	635.00	530.00
Copper (¢/Pound)	340.20	346.20	383.05
Soybeans ($/Bushel)	11.46	11.56	11.85
Natural Gas ($/MMBTU)	3.31	3.58	4.01
Nickel ($/Metric Ton)	18,184	18,140	21,485
CRB Spot Inds.	527.38	531.06	545.93

Next Week's Economic Calendar

	Monday 21	Tuesday 22	Wednesday 23	Thursday 24	Friday 25
U.S. Data	**Existing Home Sales** September 4.91M October 4.78M (W)	**GDP (Q/Q Annualized)** 3Q A 2.5% 3Q S 2.5% (W) **Personal Consumption** 3Q A 2.4% 3Q S 2.4% (c) **Core PCE (QoQ)** 3Q A 2.1% 3Q S 2.1% (c)	**Durable Goods Orders** September -0.6% October 0.0% (W) **Personal Income** September 0.1% October 0.3% (W) **Personal Spending** September 0.6% October 0.3% (W)	**Thanksgiving Day Holiday**	
Global Data		**Mexico** **GDP (YoY)** Previous (Q2) 3.3% **Canada** **Retail Sales (MoM)** Previous (Aug) 0.5%	**Eurozone** **PMI Manufacturing** Previous (Oct) 47.1 **Eurozone** **PMI Services** Previous (Oct) 46.4	**Germany** **IFO Business Climate** Previous (Oct) 106.4 **U.K.** **GDP (Annualized)** Previous (Q3) 2.0%	

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

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