December 16, 2011

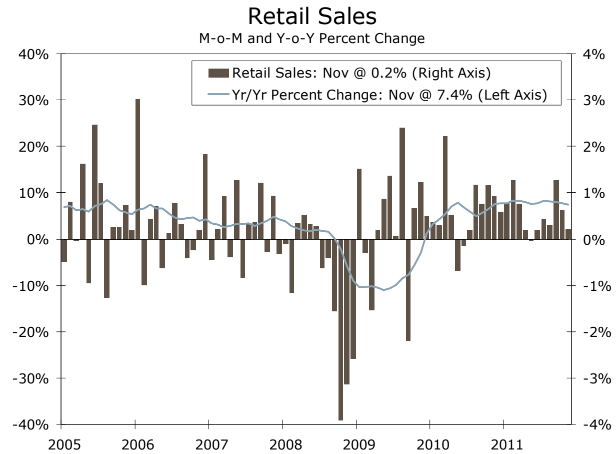
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Mixed Bag of Chips, but Reports Still Suggest Recovery

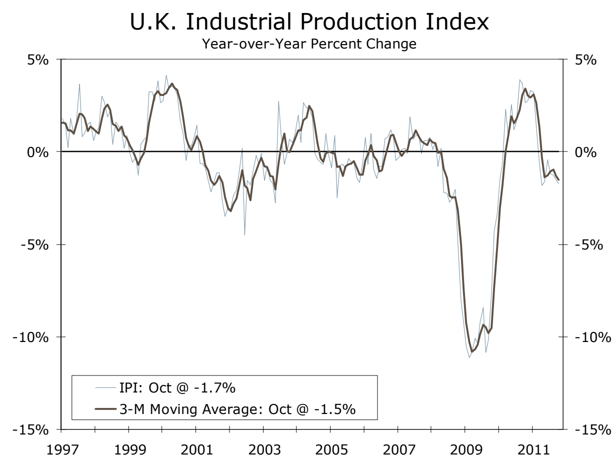
- Retail sales posted a disappointing increase of 0.2 percent in November, but categories typically associated with the holiday season saw solid gains. We believe the holiday sales projections will remain on track.
- Industrial production delivered an unexpected decline in November with the pullback concentrated in the manufacturing sector. However, regional surveys for December suggest further positive momentum.
- Regarding inflation, we continue to expect prices to moderate over the next year due to restrained domestic demand and slowing global growth.



Global Review

U.K. Economy May Be Contracting Slightly at Present

- Recent data suggest that the British economy may be contracting slightly. Industrial production fell in October, and growth in retail sales remains anemic. Weak economic growth and receding inflation should give the Bank of England scope to increase the size of its quantitative easing program further in the months ahead.
- Britain's relations with its European partners may be strained at present, but we believe a complete break with the EU, if it occurs at all, will be years in the future.



Wells Fargo U.S. Economic Forecast

	Actual 2011 1Q	2Q	3Q	4Q	Forecast 2012 1Q	2Q	3Q	4Q	Actual 2009	2010	Forecast 2011	2012	2013
Real Gross Domestic Product [1]	0.4	1.3	2.0	3.5	1.4	1.9	2.4	2.3	-3.6	3.0	1.8	2.1	1.8
Personal Consumption	2.1	0.7	2.3	3.5	1.4	1.5	1.7	1.7	-2.0	2.0	2.3	1.8	1.3
Inflation Indicators [2]													
"Core" PCE Deflator	1.1	1.3	1.6	1.7	1.7	1.5	1.4	1.6	1.5	1.4	1.4	1.6	1.6
Consumer Price Index	2.2	3.3	3.8	3.4	2.4	1.9	1.5	1.7	-0.3	1.6	3.2	1.9	2.0
Industrial Production [1]	4.8	0.7	6.1	2.7	2.8	3.6	3.0	2.2	-11.1	5.3	4.1	3.2	1.9
Corporate Profits Before Taxes [2]	8.8	8.5	7.9	6.4	6.2	6.0	6.4	6.6	7.9	32.2	7.9	6.3	7.0
Trade Weighted Dollar Index [3]	70.6	69.4	72.8	72.0	72.5	73.0	74.0	75.0	77.7	75.6	71.2	73.6	77.5
Unemployment Rate	8.9	9.1	9.1	8.8	9.0	9.1	9.0	8.9	9.3	9.6	9.0	9.0	8.9
Housing Starts [4]	0.58	0.57	0.61	0.62	0.61	0.64	0.67	0.68	0.55	0.58	0.60	0.65	0.75
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	4.20	4.20	4.20	4.30	5.04	4.69	4.39	4.23	4.50
10 Year Note	3.47	3.18	1.92	2.00	2.20	2.30	2.30	2.40	3.26	3.22	2.64	2.30	2.70

Forecast as of: December 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

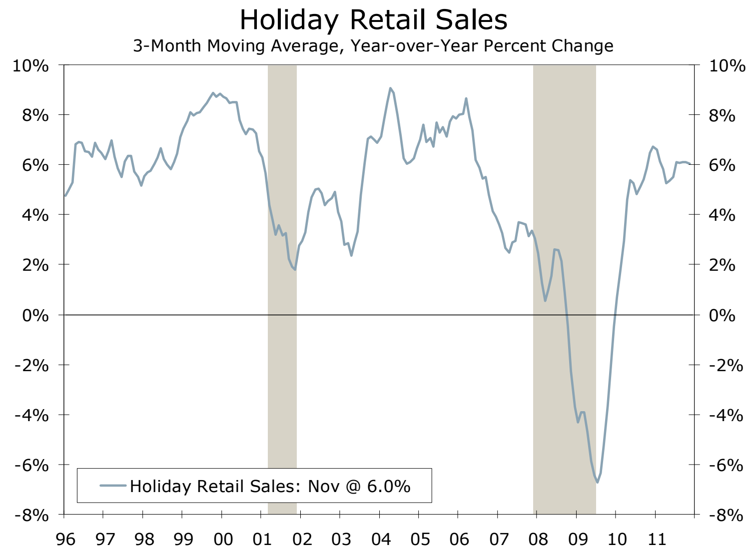
Economic Recovery Is Still on Pace

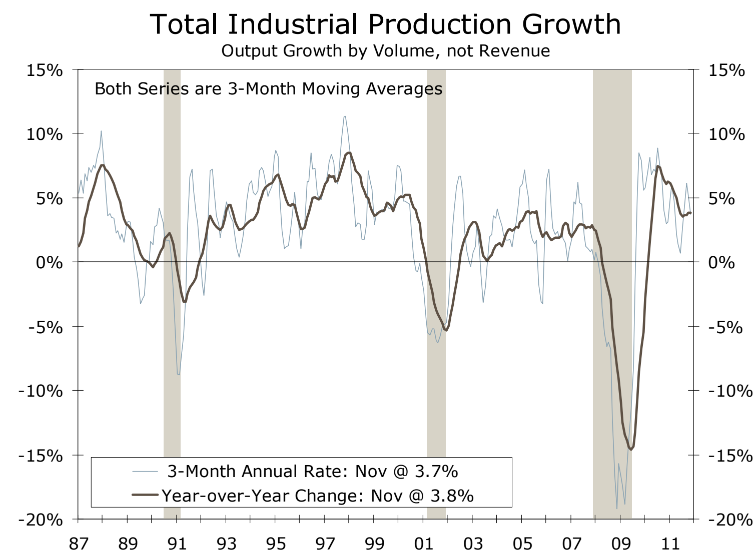
The busy week of economic releases continued to show an economy improving but at a moderate pace. Retail sales posted a disappointing increase of 0.2 percent in November following gains of 0.6 percent in October and 1.3 percent in September. However, spending rose across most categories typically associated with the holiday season. Electronics rose 2.1 percent in November likely reflecting sales of tablet computers and smart phones. Nonstore retail sales rose 1.5 percent and apparel sales rose 0.5 percent. Indeed, reports from retailers show aggressive Black Friday promotions and extended store hours likely helped drive sales over the weekend. In fact, the National Retail Federation estimates sales and traffic reached a record high.

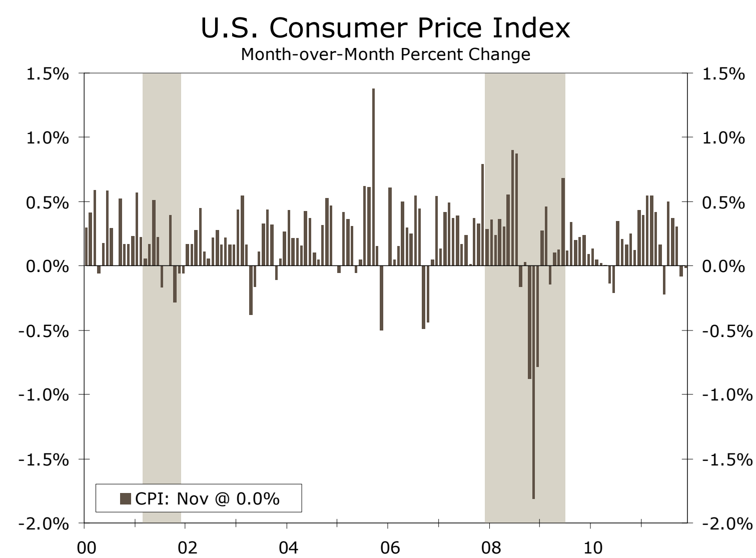
That said, despite November's lackluster increase, retail sales still look pretty solid and holiday sales projections remain on track. Anecdotal reports suggest most consumers have yet to complete their holiday wish list. Moreover, sales over the past three months are up 8.7 percent on an annualized basis and core retail sales, which exclude gasoline stations, building materials and motor vehicles, are up 6.6 percent. The strong gains suggest real personal consumption will at least match third quarter's 2.3 percent growth rate even if sales rise only modestly in December.

Industrial production was also released this week and delivered an unexpected decline of 0.2 percent. The decline was concentrated in manufacturing, which dropped 0.4 percent. Much of the pullback in factory output was due to a surprising decline of 3.4 percent in motor vehicle output, which wiped out the prior month's impressive gain. That said, the retracement in motor vehicle output seems suspicious and could be revised away, as unit sales to dealers from manufactures rose nearly 3.0 percent in November to a 13.59 million unit pace. Moreover, regional manufacturing reports including the Empire State Manufacturing Survey and the Philadelphia Fed index both saw solid gains in December suggesting further positive momentum in the factory sector. In fact, the Philadelphia Fed index jumped to 10.3, the highest reading since April.

Regarding the outlook for inflation, we continue to expect consumer and wholesale prices to moderate over the next year due to restrained domestic demand and slowing global growth. This week's consumer price and wholesale price reports continue to support this claim. Consumer prices were flat in November following a drop in October. Much of the pullback in headline consumer prices has been driven by pullback in energy prices. Energy prices fell 1.6 percent in November, the second consecutive decline. On the other hand, while wholesale prices rose 0.3 percent on the month, finished goods excluding food and energy, rose only 0.1 percent. Moreover, further back in the pipeline, intermediate and raw materials excluding food and energy, declined for the second straight month. Taken together with the November import price report, while not our call, the Fed still has the green light to consider additional accommodative policies.





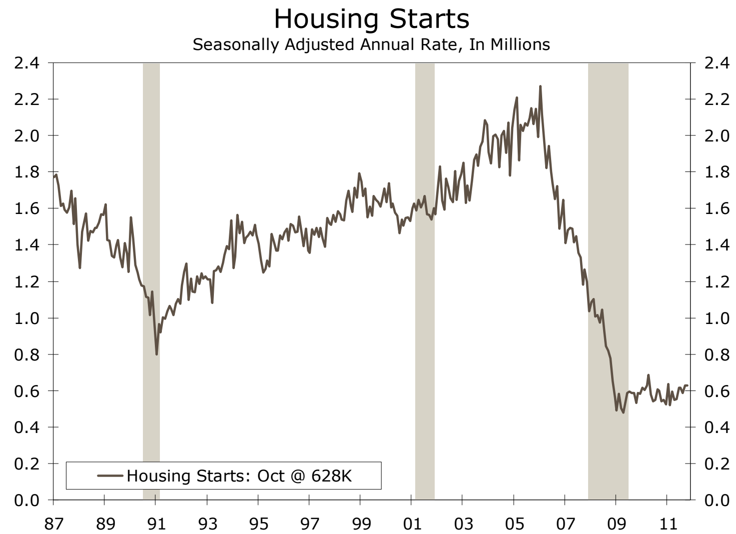


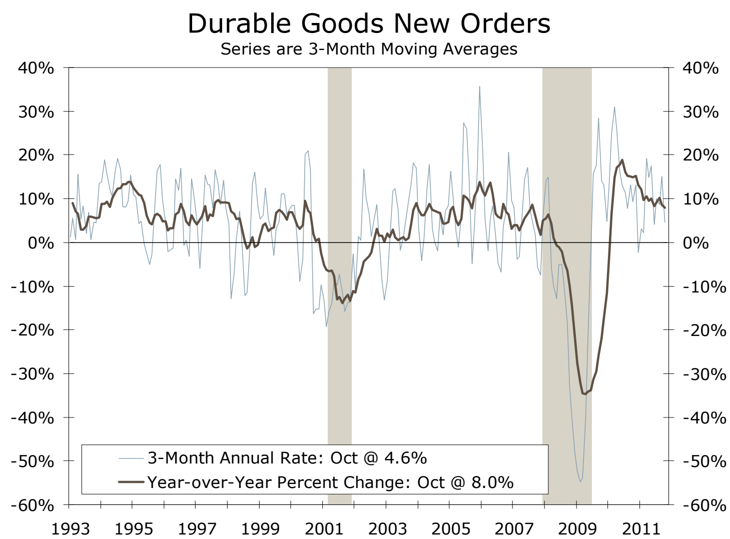
Housing Starts • Tuesday

Housing starts came in better than expected in October but fell for the month. The headline number was pulled down by the multi-family component, which fell 8.3 percent. The story is not likely to change much over the next few months, as existing home price declines continue to make new homes less competitive with existing inventory. New homebuilders have little incentive to build due to home price declines. The multi-family segment remains the bright spot in new home construction and should periodically boost the headline number over the next few months. We expect that new starts will fall to a 618,000 pace from October's 628,000 pace. Housing starts should come in around 590,000 for the year and should rise to around 650,000 next year. Most of the new building activity will remain on the multi-family side.

Previous: 628K **Wells Fargo: 618K**

Consensus: 634K





Durable Goods Orders • Thursday

October durable goods orders fell 0.5 percent, as a 16.4 percent decline in civilian aircraft orders pulled down the headline index. Excluding the volatile aircraft component, new durable goods orders rose a modest 0.7 percent for the month. The report also pointed to a weakening trend in nondefense capital goods orders ex-aircraft and more important shipments of these goods, which provides insight into equipment and software spending within the GDP accounts. While capital goods shipments have been softening they remain up 12.1 percent on a three-month annualized basis, which is consistent with our expectation for 6.3 percent growth in equipment and software spending in the fourth quarter. November should be a good month for durable goods orders, as orders for civilian aircraft should provide a boost to the headline number following the Dubai Air Show that took place early in the month. We expect that durable orders will post an increase of 1.3 percent.

Previous: -0.5% **Wells Fargo: 1.3%**

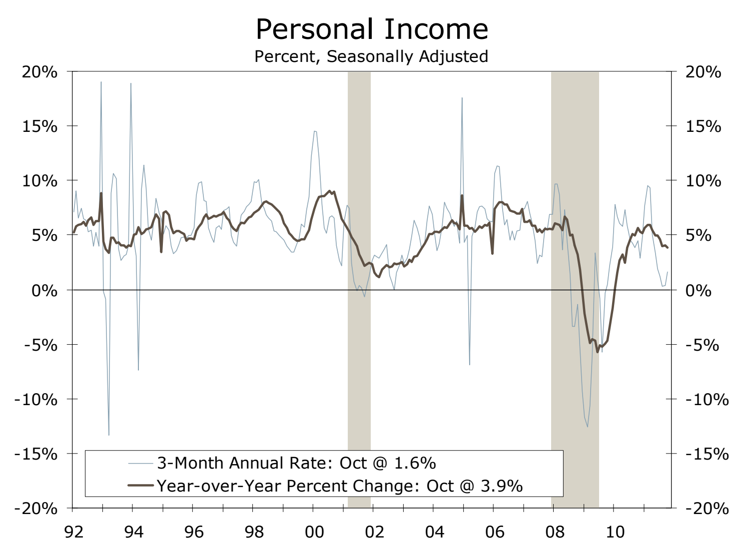
Consensus: 2.0% (Month-over-Month)

Personal Income • Friday

Personal income rose at a modest 0.4 percent pace in October after weak readings for most of the year. The increase was tied to a 0.5 percent increase in wages and salaries, which posted a second consecutive monthly increase. We expect that personal incomes continued to rise in November, improving 0.2 percent. Going forward, we expect that government transfer payments including social security and unemployment benefits will begin to wind down in the months ahead, as the federal government implements policies to reduce the deficit. Transfer payments have played a significant role in helping support personal incomes over the past year. The pullback in transfer payments will put downward pressure on personal incomes if wage and salary growth does not begin to pick up. We also expect the savings rate will continue to climb, as consumers work to rebuild lost wealth, which should keep the consumer spending around 1.8 percent over the next year.

Previous: 0.4% **Wells Fargo: 0.2%**

Consensus: 0.2% (Month-over-Month)



Global Review

U.K. Economy May Be Contracting Slightly at Present

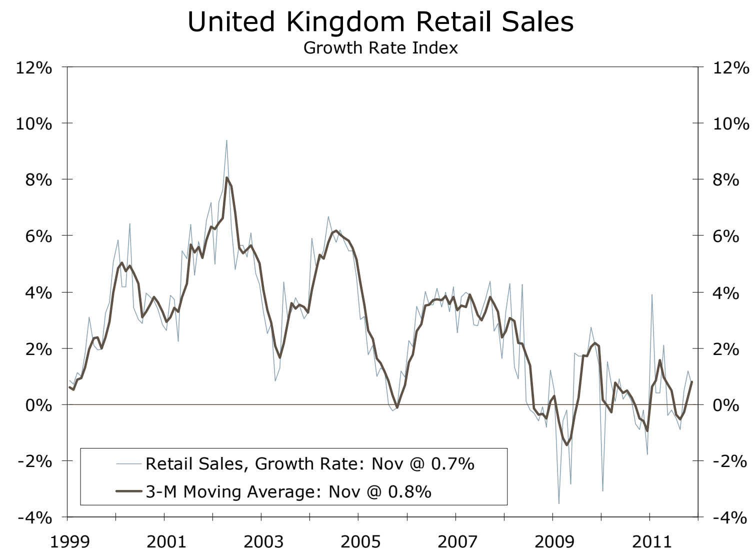
Prime Minister Cameron's veto of a fiscal pact at last week's European Union (EU) summit has given the United Kingdom a prominent place in the news recently. Recent economic news out of Great Britain has not been encouraging either. Indeed, it looks like real GDP, which has grown only 0.5 percent over the past four quarters, could be contracting modestly on a sequential basis in the current quarter. Although we do not have a "technical" recession, defined as two consecutive quarters of negative GDP growth in our official forecast, the British economy clearly is skating on thin ice at present. (See the Monthly Economic Outlook, which is posted on our website, for our U.K. macroeconomic forecasts.)

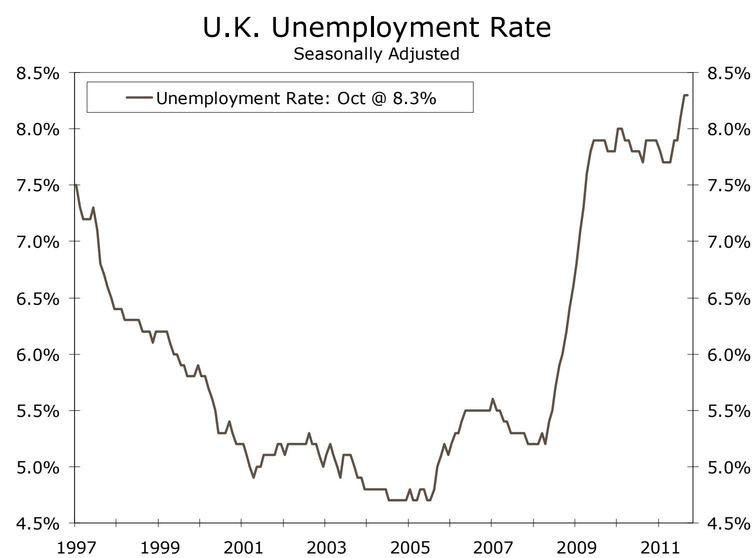
For starters, industrial production (IP) fell 0.7 percent in October. Growth in IP has been weakening, and October's outturn gets the fourth quarter off to a weak start (see the graph on page 1). Moreover, the manufacturing PMI in November remained below the demarcation line separating expansion from contraction, suggesting that IP likely declined further last month.

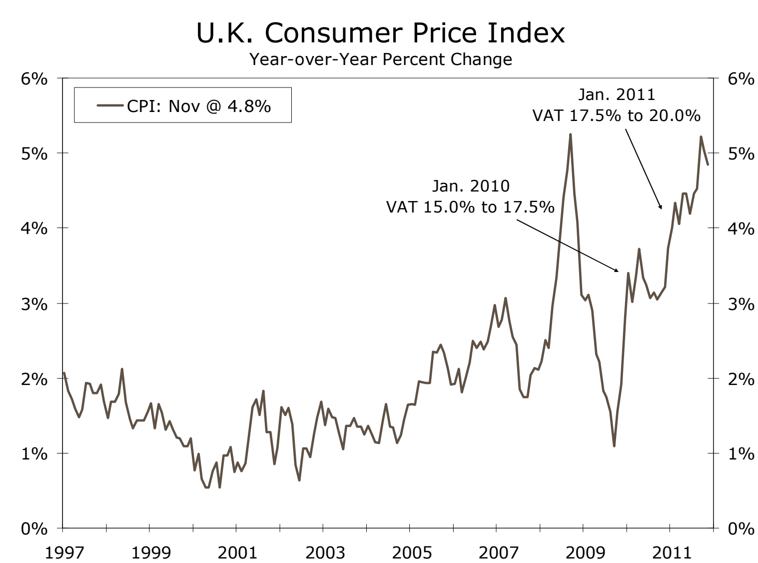
In addition, growth in retail spending remains anemic (top chart). The volume of retail sales fell 0.4 percent in November relative to the previous month, which translates into a year-over-year growth rate of only 0.7 percent. Average weekly earnings are up only 2 percent, while CPI inflation has been running at 5 percent. Little wonder that growth in retail spending has been anemic with real incomes getting squeezed. The good news is that the unemployment rate remained unchanged at 8.3 percent in October. The bad news, however, is that it remained unchanged at the highest rate in more than 15 years (middle chart).

Fortunately, CPI inflation, which has been well above the Bank of England's two percent target for roughly two years, is showing signs of receding. The overall rate of CPI inflation fell to 4.8 percent in November from 5.0 percent in October, and we look for a sharp decline over the course of the next few months as one-off factors like the increase in the value-added tax last year drop out of the year-over-year calculations. In our view, the weakness of the economy and the projected decline in inflation in coming months will lead the Bank of England to announce further quantitative easing (QE). The size of the Bank's QE program is currently £275 billion, and we look for the Monetary Policy Committee to announce further asset purchases in the months ahead.

As noted above, Prime Minister Cameron's veto at the EU summit last week has garnered significant media attention. Some commentators have speculated that the United Kingdom will ultimately leave the EU. We think such speculation is premature. The United Kingdom has been a member of the EU for nearly 40 years, and a decision to leave the organization, which would entail significant economic and political implications, would not be taken lightly. Britain's relations with its European partners may be strained at present, but we believe a complete break with the EU, if it occurs at all, will be years in the future.



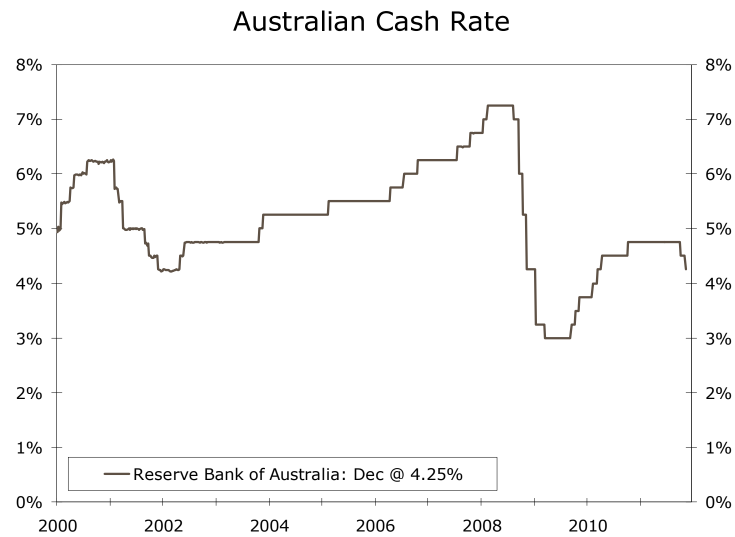




Reserve Bank of Australia Minutes • Tues.

For the first time since the financial crisis in 2009, the Reserve Bank of Australia (RBA) has cut its key lending rate, the cash rate, at back-to-back meetings. The official rate in Australia, now at 4.25 percent, is still the highest rate among the world's developed economies, but the recent easing recognizes vulnerability in Australia due to the deterioration in the outlook for global growth, particularly the threat of a worsening situation in the Eurozone.

In the press release that accompanied the Dec. 5 rate cut announcement, the RBA cautioned that the threat of further deterioration in the sovereign debt crisis in Europe could be disrupting to the Aussie economy. We will get a better sense of the future bias in RBA policy when the minutes from that meeting are released next week.



German Ifo Index • Tuesday

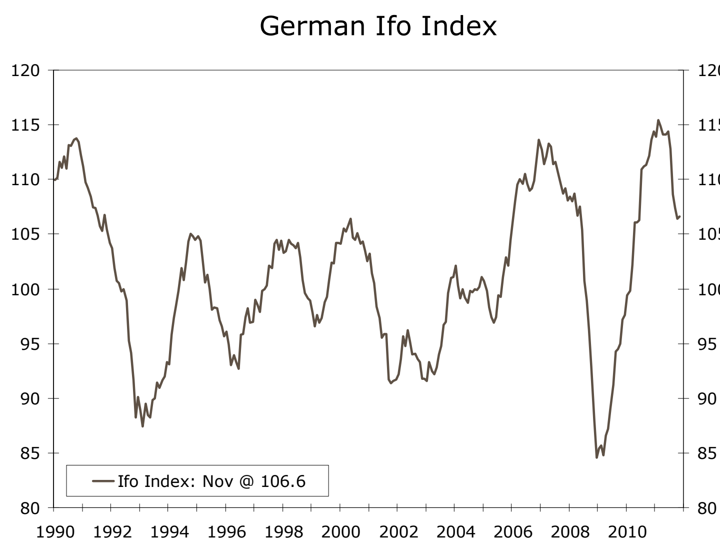
So far the sovereign debt situation in Europe has not been enough to stop the German economy from growing, but it certainly has manifested itself in the form of deteriorating sentiment in Germany.

The German manufacturing purchasing managers index (PMI) slipped into contraction territory in October and has remained below 50 since, including a 48.1 reading for December. The non-manufacturing or services PMI in Germany has fared somewhat better, coming in at a better-than-expected 52.7 in December.

Another key measure of German business sentiment is due out on Tuesday of next week. The Ifo index has fallen to 106.6 in November from 115 just a few months ago. Given the variability with other sentiment measures, the consensus forecast is for little change.

Previous: 106.6

Consensus: 106.0

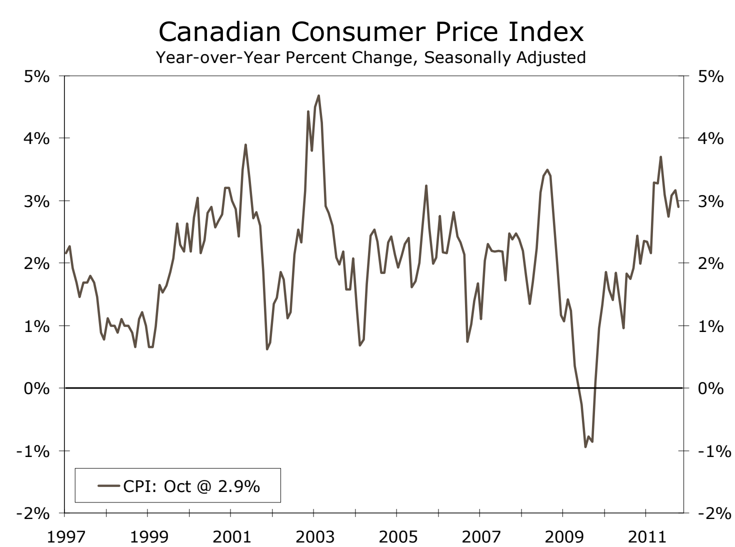


Canadian CPI • Tuesday

The headline rate of inflation, presently at 2.9 percent, is narrowly within the bounds of the Bank of Canada's (BoC) target range. The core rate of inflation, however, is more subdued at just 1.5 percent on a year-over-year basis. On Tuesday of next week, the consumer price index for November will give us a more current look at inflation. We expect to see price growth of 2.8 percent on a year-over-year basis. This somewhat benign rate of inflation combined with tepid economic growth likely means that the BoC will likely remain on hold throughout 2012.

If world leaders are able to successfully deal with the sovereign debt crisis in Europe, we think that the Canadian expansion will eventually pick up speed and the BoC might begin tightening again in 2013.

Previous: 2.9% (Year-over-Year) Wells Fargo: 2.8%



Interest Rate Watch

FOMC Provides 2012 Outlook

This week's Federal Open Market Committee (FOMC) policy announcement emphasized an economy that is "expanding moderately accompanied by inflation that has "moderated since earlier this year." As a result, the FOMC decided to keep the target range at 0 percent to 0.25 percent and that economic conditions are likely to warrant exceptionally low levels for the federal funds rates at least through mid-2013.

Risks

This outlook is consistent with the outlook in our annual report. Unfortunately, so are the risks.

In our annual, we emphasized a more global approach to the economic outlook going forward. For the FOMC, strains in global financial markets continue to pose significant downside risks to the economic outlook. For starters, we are already expecting global growth at a below-average pace and a mild recession in the Eurozone through early 2012.

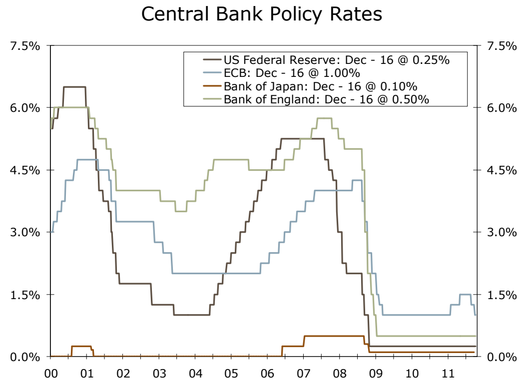
Interest rates have risen in Italy and Spain to unsustainable levels. What makes these levels unsustainable? There is a delicate balance between the level of interest rates and the pace of nominal economic growth in any country. The growth in the interest on the debt, represented by the interest rate, cannot exceed the growth of the tax base (nominal GDP) to pay that debt.

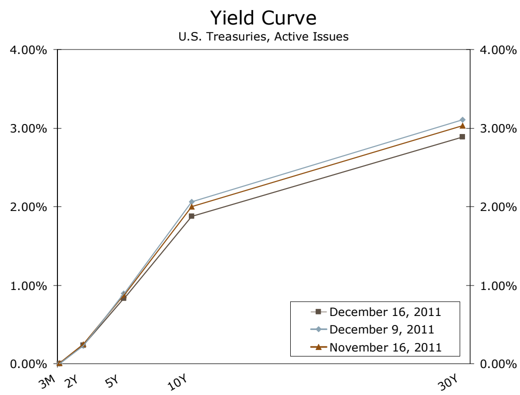
The issue is not just European. If U.S. interest rates, which are currently low, were to rise to a more normal level, the U.S. debt situation would also quickly take on a European tone—not a good situation.

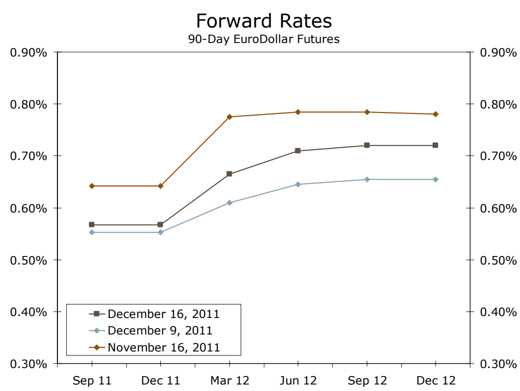
Structural Headwinds to a Full Recovery

The FOMC highlighted two areas where structural problems represent a headwind to recovery "Unemployment rate remains elevated;" "... the housing sector remains depressed".

What is significant here is that the linkage from interest rates and housing has been seriously impaired such that low interest rates do not generate strength in the housing sector nor in employment.







Credit Market Insights

Little Solace in Rising Mortgage Apps

Mortgage applications rose 4.1 percent over the past week. Despite a decline in the 30-year fixed mortgage rate to 4.12 percent, which is the lowest this year, purchase applications dropped 8.2 percent from the prior week. However, the low mortgage rate helped lift refinancing applications by 9.3 percent. While the purchase index is up 21 percent since mid-August, it is still lower than a year ago and far below the peak in 2004. Still, the jump in mortgage purchase applications in November suggests that home sales will likely see a bit of strength over the next month or two, depending on the lag time between applications and purchases, which averages about six weeks. Unfortunately, due to the high levels of distressed properties and cash transactions, home prices remain below year-ago levels despite the modest improvement in home sales over the past three months.

According to the Federal Reserve's Flow of Funds report, although nearly all of the decline in household net worth in the third quarter was due to falling financial asset values, real estate values also fell slightly and have declined for six straight quarters. Furthermore, while financial assets were up $912 billion from a year ago, real estate assets were still down $587 billion from a year ago and owners' equity in real estate was just 38.7 percent compared to 56.9 percent in 2006. Thus, despite the strength in purchase applications over the past few months, there is little to be excited about in housing.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	3.94%	3.99%	4.00%	4.27%
15-Yr Fixed	3.21%	3.27%	3.31%	3.72%
5/1 ARM	2.86%	2.93%	2.97%	3.47%
1-Yr ARM	2.81%	2.80%	2.98%	3.40%
MBA Applications				
Composite	677.0	650.4	660.5	589.7
Purchase	190.9	208.0	178.9	200.3
Refinance	3,573.7	3,268.7	3,483.9	2,910.9

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

Topic of the Week

Uncertainty Rises in Russia

For 12 years, Russia has endured the policies of Vladimir Putin, whether as prime minister or president. By all accounts, regardless of what position he is in, Putin remains the most powerful man in Russia. After four years as president, Dmitry Medvedev agreed in September to basically swap positions with Putin, with Medvedev becoming prime minister and Putin returning to the presidency in 2012. This, along with reports of fraud in the Dec. 4 parliamentary elections, brought Russians out into the streets in the biggest protests of the post-Soviet era. An even bigger protest, some say as large as half a million people, is scheduled for Dec. 24.

Putin's United Russia party has lost support as Russians have become increasingly discontent with stagnant wages and rampant corruption. Despite the rebound in oil prices, economic growth and real wages have been growing at a much slower rate over the past two years compared to before the financial crisis. Corruption is also a real problem. Transparency International's 2011 Corruption Perceptions Index ranks Russia 143rd out of 182 countries, right between Nigeria and Timor-Leste. This is likely a major factor in the sharp 40 percent drop in foreign direct investment from 2008-2010, as heightened risk aversion kept investors and businesses away. Combine these factors with an underdeveloped financial system, weak property rights, a lack of law enforcement, little freedom of expression and a crony political system, and it is no wonder Russians are clamoring for change.

Despite the claims of election fraud and Russians' subsequent outrage, there may be a silver lining. The government was expected to step up social spending leading up to the elections. Now that Putin's return to the presidency is less certain, social spending may rise even more to placate the masses. It still may not be enough though. Many Russians have made it clear they are completely fed up with Putin. Please see our report *Russia: Black Gold and Political Stranglehold* for more.

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 12/16/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.00	0.00	0.12
3-Month LIBOR	0.56	0.54	0.30
1-Year Treasury	0.10	0.08	0.30
2-Year Treasury	0.23	0.22	0.64
5-Year Treasury	0.83	0.89	2.02
10-Year Treasury	1.89	2.06	3.42
30-Year Treasury	2.90	3.11	4.53
Bond Buyer Index	3.92	3.93	5.15

Foreign Exchange Rates

	Friday 12/16/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.303	1.339	1.324
British Pound ($/£)	1.551	1.567	1.563
British Pound (£/€)	0.840	0.854	0.847
Japanese Yen (¥/$)	77.850	77.650	83.910
Canadian Dollar (C$/$)	1.037	1.017	1.006
Swiss Franc (CHF/$)	0.938	0.923	0.965
Australian Dollar (US$/A$)	0.997	1.022	0.990
Mexican Peso (MXN/$)	13.822	13.574	12.411
Chinese Yuan (CNY/$)	6.351	6.364	6.665
Indian Rupee (INR/$)	52.745	52.043	45.355
Brazilian Real (BRL/$)	1.848	1.798	1.703
U.S. Dollar Index	80.172	78.632	80.181

Foreign Interest Rates

	Friday 12/16/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.35	1.37	0.95
3-Month Sterling LIBOR	1.06	1.05	0.75
3-Month Canadian LIBOR	1.34	1.34	1.23
3-Month Yen LIBOR	0.20	0.20	0.18
2-Year German	0.22	0.32	1.08
2-Year U.K.	0.34	0.39	1.24
2-Year Canadian	0.85	0.91	1.69
2-Year Japanese	0.14	0.14	0.23
10-Year German	1.89	2.15	3.07
10-Year U.K.	2.09	2.16	3.63
10-Year Canadian	1.90	2.06	3.27
10-Year Japanese	0.99	1.02	1.28

Commodity Prices

	Friday 12/16/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	93.89	99.41	87.70
Gold ($/Ounce)	1588.08	1711.60	1370.28
Hot-Rolled Steel ($/S.Ton)	685.00	675.00	596.00
Copper (¢/Pound)	333.50	354.70	411.05
Soybeans ($/Bushel)	11.01	11.14	12.58
Natural Gas ($/MMBTU)	3.13	3.32	4.05
Nickel ($/Metric Ton)	17,906	18,285	24,496
CRB Spot Inds.	513.76	526.68	573.94

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	19	20	21	22	23
U.S. Data		**Housing Starts** October 628K November 618K (W) **Building Permits** October 644K November 635K (c)	**Existing Home Sales** October 4.97M November 5.10M (c)	**GDP (Q/Q Annualized)** 3Q S 2.0% 3Q T 2.0% (W) **Personal Consumption** 3Q S 2.3% 3Q T 2.3% (c) **LEI** October 0.9% November 0.3% (W)	**Durable Goods Orders** October -0.5% November 1.3% (W) **New Home Sales** October 307K November 316K (W) **Personal Income** October 0.4% November 0.2% (W)
Global Data	**Australia** **RBA Minutes**	**Germany** **IFO-Business Climate** Previous (Nov) 106.6 **Canada** **CPI (YoY)** Previous (Oct) 2.9%		**U.K.** **Q3 GDP (YoY)** Previous (Q3 S) 0.5%	**Canada** **Nov. GDP (YoY)** Previous (Sep) 3.0%

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

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