November 16, 2012

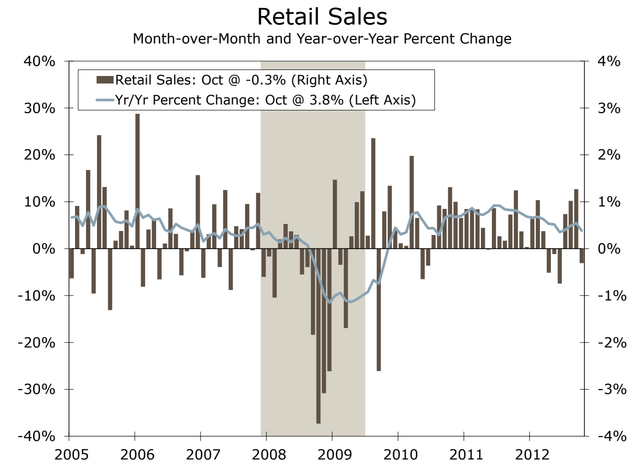
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Tapping the Brakes

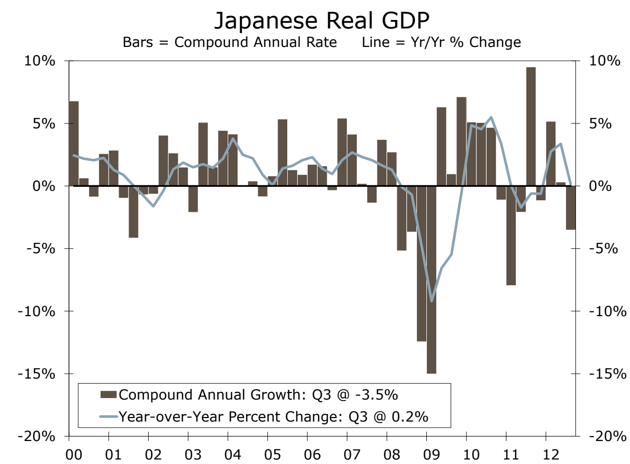
- Retail sales fell slightly more than expected in October, declining 0.3 percent. Sales were dragged down by a 1.5 percent decline in auto sales, but even when stripping out this sector, sales disappointed with a flat reading.
- The latest PPI and CPI reports show that inflation continues to present little challenge to Fed policy. Lower gas prices pushed down the pace of CPI growth, while the PPI fell 0.2 percent in October. On a year-over-year basis, consumer prices have risen 2.2 percent and producer prices have increased 2.3 percent. Additional Fed asset purchases are likely on the way.



Global Review

Japanese Economy Shrinks

- Japanese real GDP posted its fastest pace of contraction since the earthquake and tsunami took major factors of production offline in early 2011.
- In this week's global review section, we look at the various components of Japanese GDP and consider what this week's disappointing print means for monetary and fiscal policy.



Wells Fargo U.S. Economic Forecast

	Actual 2012			Forecast 2012	Forecast 2013				Actual		Forecast		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2010	2011	2012	2013	2014
Real Gross Domestic Product [1]	2.0	1.3	2.0	1.4	1.0	2.1	2.2	2.2	2.4	1.8	2.1	1.6	2.2
Personal Consumption	2.4	1.5	2.0	2.4	0.6	1.2	1.4	1.3	1.8	2.5	1.9	1.4	1.3
Inflation Indicators [2]													
PCE Deflator	2.4	1.6	1.5	1.8	1.5	1.7	1.6	1.5	1.9	2.4	1.8	1.6	1.9
Consumer Price Index	2.8	1.9	1.7	2.3	2.2	2.7	2.7	2.3	1.6	3.1	2.2	2.5	2.2
Industrial Production [1]	5.9	2.6	-0.4	0.5	0.7	3.5	4.1	4.1	5.4	4.1	3.6	1.8	3.8
Corporate Profits Before Taxes [2]	10.3	6.7	5.7	5.3	4.8	5.2	5.7	6.3	26.8	7.3	6.9	5.5	7.0
Trade Weighted Dollar Index [3]	72.7	74.5	72.7	73.0	74.0	75.0	76.0	77.0	75.4	70.9	73.2	75.5	74.5
Unemployment Rate	8.3	8.2	8.1	7.8	7.7	7.8	7.9	7.9	9.6	9.0	8.1	7.8	7.7
Housing Starts [4]	0.71	0.74	0.79	0.84	0.90	0.96	1.02	1.08	0.59	0.61	0.77	0.99	1.17
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Conventional Mortgage Rate	3.95	3.68	3.50	3.40	3.40	3.40	3.45	3.50	4.69	4.46	3.63	3.44	3.80
10 Year Note	2.23	1.67	1.65	1.70	1.70	1.80	1.85	1.90	3.22	2.78	1.81	1.81	2.15

Forecast as of: November 8, 2012
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units
[5] Annual Numbers Represent Averages

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

Inside

U.S. Review

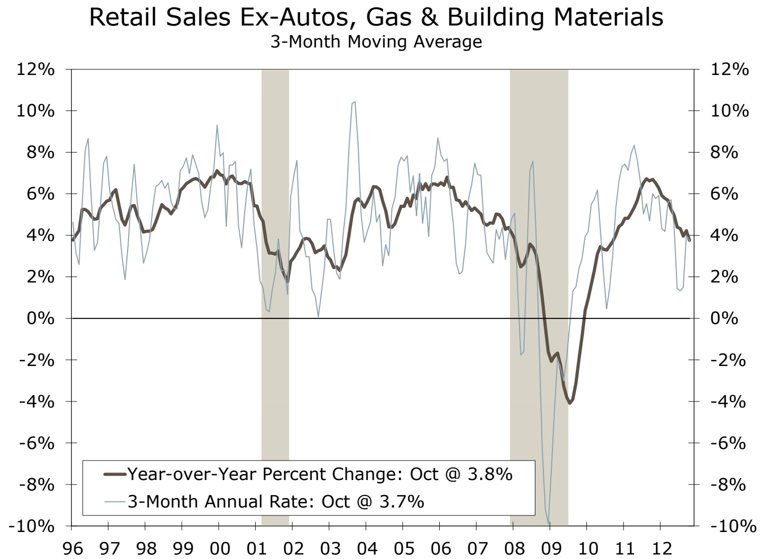
Weathering Noisy Data

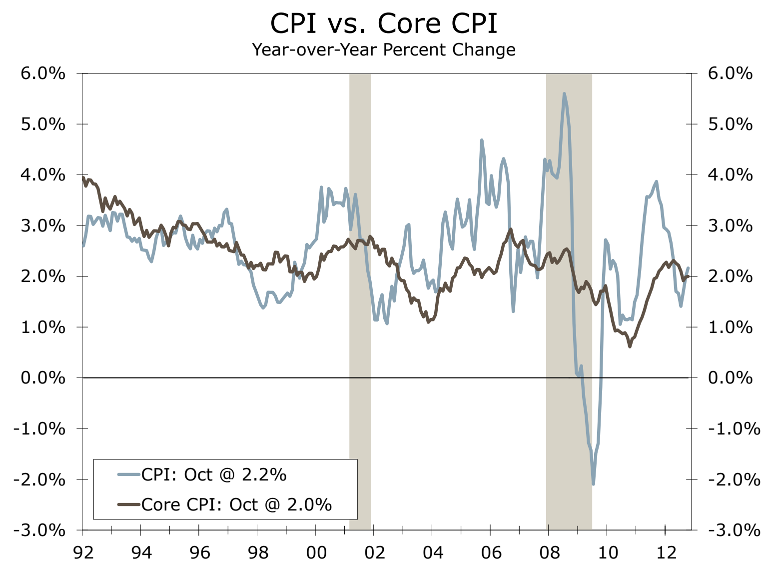
As October data roll in, the current pace of growth remains stuck in low gear. Complicating much of the data is a lack of clarity over how Hurricane Sandy has affected production and sales and how the fiscal cliff is affecting business spending. Retail sales fell 0.3 percent in October after an upwardly revised 1.3 percent gain in September. Auto sales fell 1.5 percent, with some dealers in the northeast noting that fewer selling days hurt sales for October. Building materials also fell over the month, even though stores in the storm-hit region likely saw a small boost in sales the few days before Sandy made landfall. Core retail sales, which excludes autos, gas and building materials, fell 0.1 percent in October. If the slowdown is due to Hurricane Sandy, sales will likely rebound in November and December, but if it is due to consumers pulling back on spending ahead of the fiscal cliff, the slowdown may weigh more heavily on consumer spending in the fourth quarter.

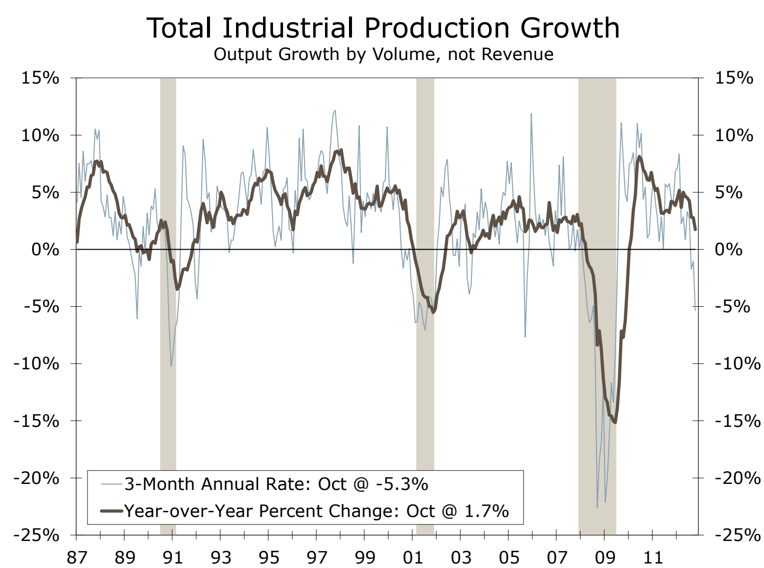
Inflation pressures abated in October, largely due to lower energy prices. The Producer Price Index fell 0.2 percent after monthly increases of more than one percent in August and September. Declining gasoline prices more than offset gains in electricity and natural gas bringing energy prices down 0.5 percent. Food prices, however, climbed for the fifth straight month as the effects of the summer drought have moved through the pipeline. Excluding food and energy, producer prices fell 0.2 percent in October. The drop largely stemmed from annual quality adjustments on 2013 model vehicles and therefore does not suggest a widespread decline in total prices.

For consumers, price pressures eased in October thanks to lower gas prices. Food prices, however, continue to creep upward and eat into any savings at the pump. Core inflation picked up slightly in October, rising 0.2 percent versus 0.1 percent the previous three months, but stands at a comfortable 2.0 percent on a year-over-year basis. Although we expect headline inflation to pick up over the coming quarters, price growth should remain modest enough for the Fed to continue its accommodative policy stance. The minutes from the FOMC's October meeting showed that additional monthly asset purchases are likely when Operation Twist ends in December.

The manufacturing sector remains on shaky ground. Industrial production fell 0.4 percent in October, with the factory sector seeing a 0.9 percent decline, its largest since May 2009. However, here too, Hurricane Sandy has complicated the data. The Fed noted that the storm cut production by nearly a percentage point, leaving output little changed outside of these effects. The latest PMI surveys do not suggest a turnaround is in store for the fourth quarter. The Empire State and Philly Fed PMIs posted negative readings in November. Both surveys noted production disruptions from Hurricane Sandy, which lowered readings over the month, but the Philly Fed survey reported that respondents noted weaker activity outside of Sandy. We will get a clearer look at November manufacturing activity next week with the preliminary reading of the Markit PMI.







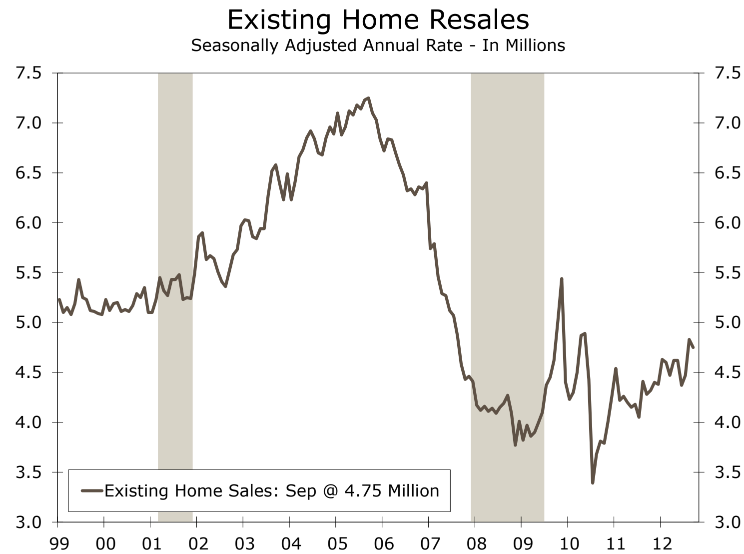
Source: U.S. Department of Commerce, U.S. Department of Labor, Federal Reserve Board and Wells Fargo Securities, LLC

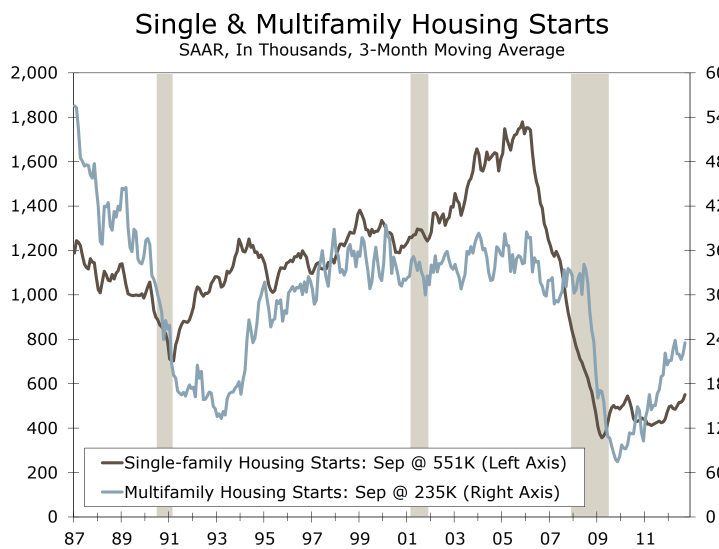
Existing Home Sales • Monday

Existing home sales retreated in September after climbing through the summer months. Total sales recorded a 4.75 million-unit annual pace in the month. The drop in sales was partly due to a lack in total inventory, as housing inventory fell 3.3 percent to 2.32 million, marking the lowest level since March. Due to limited supply (listed inventory is 20 percent below year-ago levels), 32 percent of homes sold in September were on the market for less than a month. The housing market is experiencing a genuine recovery, with ample demand helped by mortgage rates at historical lows. According to Freddie Mac, the 30-year fixed rate on conventional mortgages recorded a new low in October, declining to 3.38 percent from 3.47 percent in September. This time last year, mortgage rates were north of 4 percent. We expect existing home sales to remain steady at around a 4.75 million-unit pace in October.

Previous: 4.75M **Wells Fargo: 4.75M**

Consensus: 4.75M





Housing Starts • Tuesday

Housing starts surprised to the upside in September, jumping 15.0 percent to an 872,000-unit annual pace. Strength in single-family and multifamily starts has led total housing starts to rise to their highest level since July 2008. While the multifamily sector has been a driver of the recent housing recovery, the single-family sector has gained momentum over the past couple of months, posting positive growth in five of the past six months. Furthermore, building permits have gained steam. Single-family permits are running at a 545,000-unit pace, marking the highest level since July 2008. However, the level of single-family permits is still running below the level of starts, suggesting new construction may level off in the usually slow fall and winter months. Given the sizeable jump in starts in September, we expect a slight pullback in October and forecast housing starts to slow to an 836,000-unit pace.

Previous: 872,000 **Wells Fargo: 836,000**

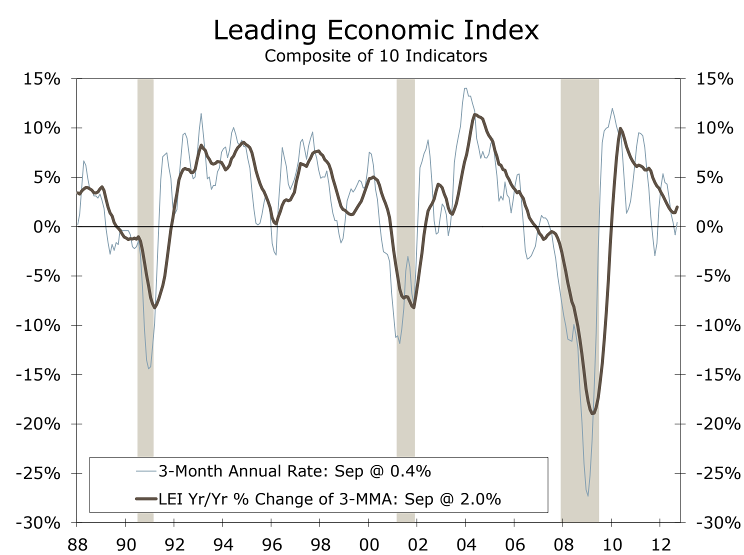
Consensus: 840,000

Leading Indicators • Wednesday

The Leading Economic Indicators (LEI) Index climbed 0.6 percent in September to 95.9. The 11.6 percent month-over-month boost in building permits was the primary driver of the improvement in the index; however, general gains in the stock market and the Fed's renewed efforts to keep the cost of consumer financing low provided additional support. We expect the LEI index to continue to rise in October, up 0.2 percent. Gains will be driven by a steepening yield spread and continued declines in initial jobless claims. In addition, the ISM new orders index has moved further into expansion territory after spending three months in contraction over the summer. However, not all of the leading indicators have fared so well. The S&P 500 index retraced much of September's gains in October, and continues to sell off, sitting at levels last seen in August. In addition, as noted above, we expect a payback in building permits as September's outsized gain is not sustainable.

Previous: 0.6% **Wells Fargo: 0.2%**

Consensus: 0.1%



Source: National Association of Realtors, U.S. Department of Commerce, The Conference Board, and Wells Fargo Securities, LLC

Global Review

Japanese Economy Shrinks More Than Expected

We learned this week that the Japanese economy contracted at an annualized pace of 3.5 percent in third quarter. The outturn was a larger decline than we had forecasted and worse than consensus expectations. The only major components that boosted growth during the quarter were government spending and a slower pace of inventory depletion, which resulted in a boost from the inventory component. In other words, this was a dismal report.

Slower Private Sector Domestic Demand

Consumer spending contracted at a 1.8 percent annualized rate in the third quarter, resulting in a 1.1 percentage point drag on overall GDP growth. That was not a complete surprise, given the weakness we have seen in higher frequency indicators in recent months. Retail sales, for example, fell in two out of the three months in the third quarter. The 3.5 percent drop in September sales was mostly attributable to the expiration of a government subsidy for fuel efficient autos. Auto sales plunged 13.9 percent in September. What remains to be seen is the extent to which the incentive program pulled forward other sales and how long the absence of the program will cast a shadow on sales overall.

Business fixed investment spending fell at a 3.7 percent annualized rate in the third quarter, as businesses scaled back on capital outlays. The declines here were enough to exert a 0.9 percent drag on GDP. Industrial production slowed in all three months of the quarter, and given the weakness in recent orders data in Japan, there is little to suggest a near-term turnaround for the Japanese business sector.

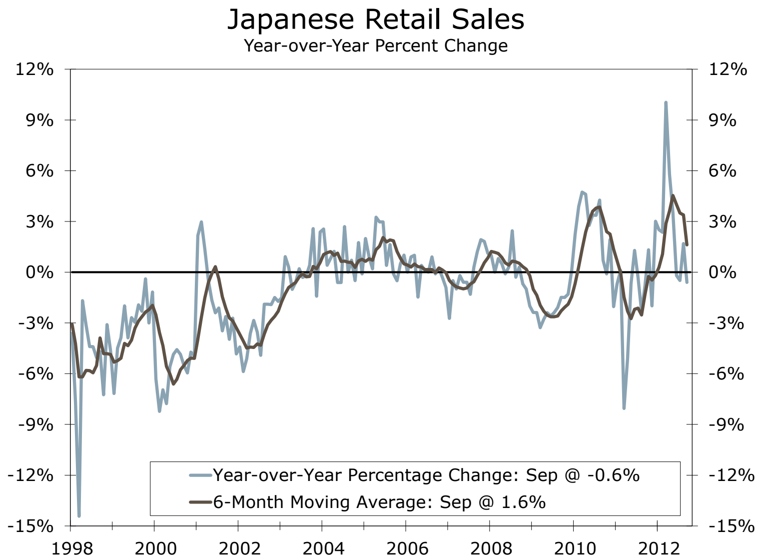
Weaker Trade

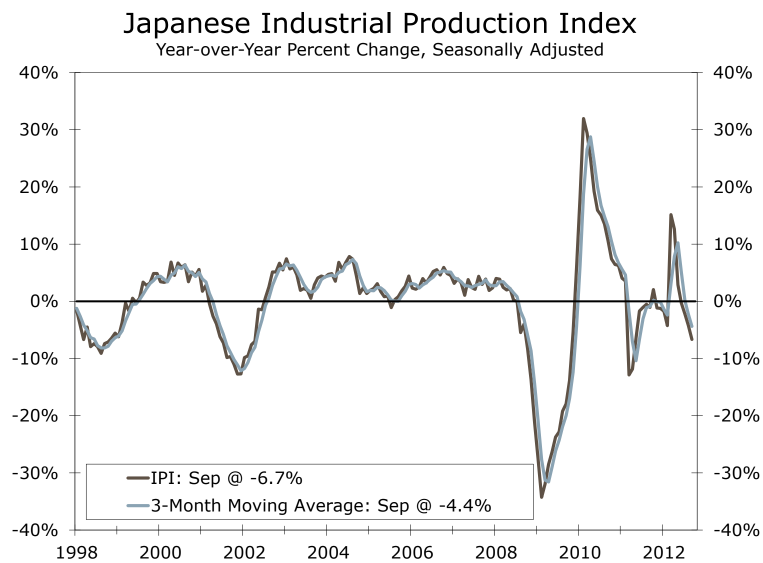
Given the weakness in domestic demand it probably comes as little surprise that imports slowed at a 1.7 percent pace in the third quarter. Unfortunately, exports slowed at an 18.7 percent annualized rate. The much faster pace of falling exports resulted in a 3.1 percentage point drag from trade on GDP for the quarter.

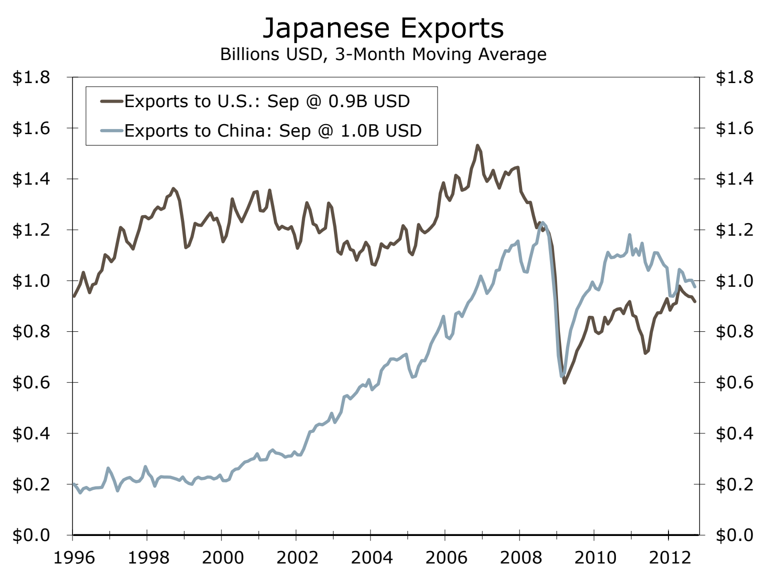
Exports to China and the United States have slowed in recent months. Sino-Japanese tensions regarding disputed claims to the Senkaku islands may be dampening demand for Japanese-made goods in China. Anti-Japanese protests raged in cities across China in September. Three major Japanese auto-makers have revised down their sales figures for the Chinese market because of declining demand there.

Implications for Fiscal and Monetary Policy

In its ongoing effort to maintain an accommodative monetary policy, the Bank of Japan (BoJ) has kept rates at 0.10 percent since the end of 2008. Like other central banks, the BoJ has turned to asset purchase programs to provide an additional boost when the economy needs it. In October, the BoJ expanded its program by ¥11 trillion, to ¥91 trillion. After this disappointing GDP report, additional expansions seem likely. While it is too early to tell, the Japanese government may also need to reconsider the timing of implementing its sales tax increase planned for April 2014.





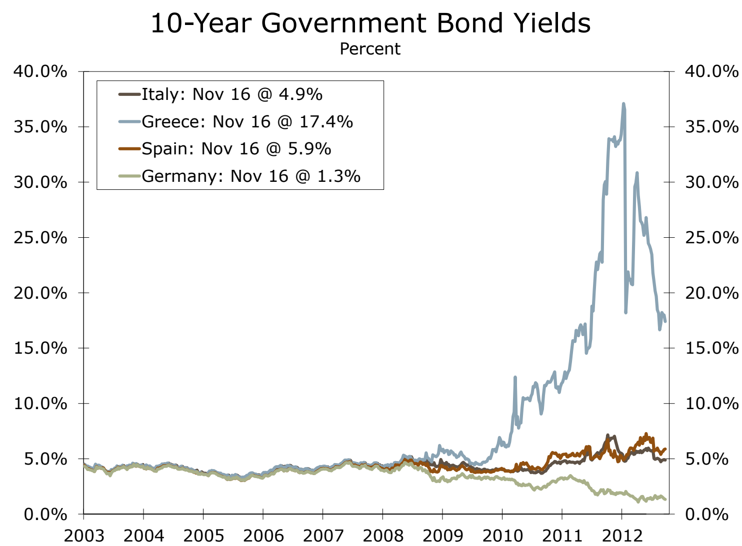


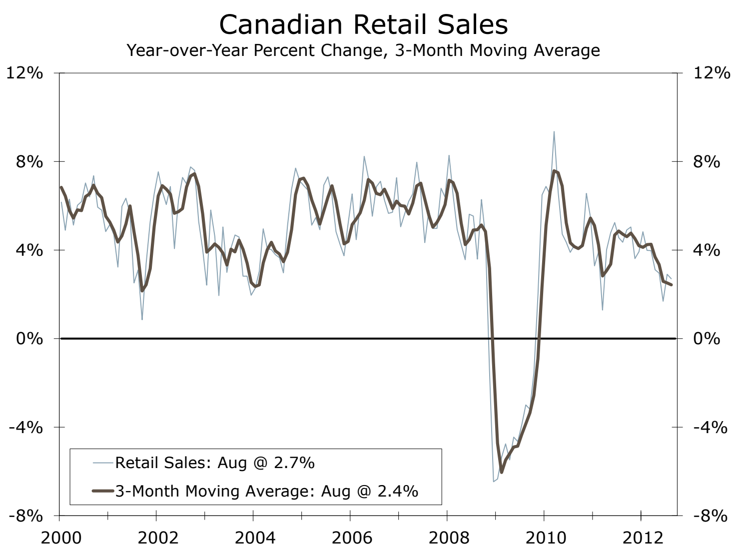
Source: IHS Global Insight and Wells Fargo Securities, LLC

EU Finance Ministers' Meeting • Tuesday

Finance Ministers from the 17 countries that comprise the Eurozone gather on Tuesday in Brussels. The main item on the docket is the consideration of Greece's request to extend its fiscal adjustment period by two years. Specifically, Greece has requested that the date to bring its debt-to-GDP ratio back down to 120 percent be extended to 2022 rather than 2020 as originally stipulated. The request has generated headlines in the past week or so, as some EU officials are sympathetic to Greece's pleas, while the IMF has opposed the request.

Tensions in European financial markets have died down significantly over the past few months, as European leaders have taken some steps to "fix" the ailing currency union. Indeed, government bond yields in the indebted countries have declined significantly. However, tensions could rise anew if finance ministers cannot agree on terms.





Canadian Retail Sales • Thursday

Strong growth in consumer spending helped lift the Canadian economy out of recession in 2009, but retail spending has decelerated this year, as has the pace of overall GDP growth. Data on retail sales in September will print on Thursday, which will allow analysts to update their estimates of GDP growth in the third quarter. (Data on Q3 GDP will be released on November 30.)

Consumer price data for October are on the docket for Friday. The government has tasked the Bank of Canada to keep CPI inflation within a 1 percent to 3 percent range. In that regard, the overall and rates of CPI inflation are currently running near 1 percent. In other words, there are few inflationary pressures in Canada at present. Although we do not forecast imminent monetary tightening by the Bank of Canada, we look for a few rate hikes next year as growth in Canada begins to pick up again.

Previous: 0.3% (Month-over-Month)

Consensus: 0.5

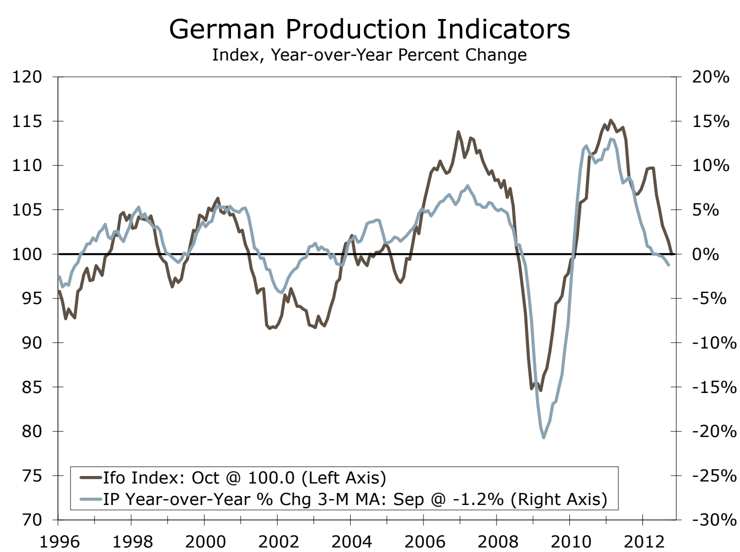
German Ifo Index • Friday

The Ifo index of German business sentiment is widely followed because it is correlated with growth in German industrial production (IP). Moreover, given the lag in reporting IP growth—"hard" data on IP are released almost two months after the Ifo index—the index is a good leading indicator of the state of German IP. The Ifo index has declined for six consecutive months, and a significant recovery does not seem likely anytime soon given the weakness in many other European economies.

Preliminary data released this week showed that German real GDP rose 0.2 percent (not annualized) on a sequential basis in the third quarter. A breakdown of the real GDP data into its underlying demand components will be released on Friday. This breakdown will help analysts determine how much underlying momentum the German economy had entering the fourth quarter.

Previous: 100.0

Consensus: 99.5



Source: IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

Credit Market Evolution

Changing growth and policy perceptions have altered the path for credit and equity markets, and yet, financing growth is still available and, in fact, plentiful, in many areas. Expectations have been modified but remain positive.

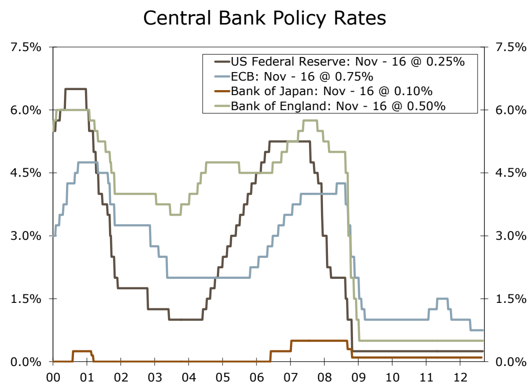
Since the election, equity markets have sold off sharply, especially coal and financials, as perceptions on tax and regulatory policy have shifted to a less optimistic view. As a result, we can expect the cost of equity capital to rise subsequent to the rise in the marginal tax rate on dividends and capital gains. In contrast, the credit markets have been positive up until now, and we expect they will remain supportive going forward.

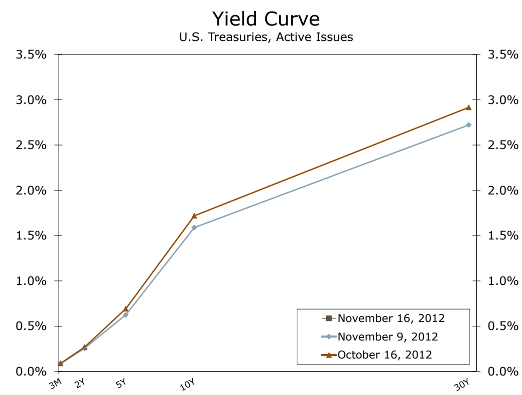
For example, the modest gains in small business sentiment have been accompanied by a rise in the net percent of banks reporting higher demand for C&I loans, according to the Fed's Senior Loan Officer Opinion Survey. Meanwhile, bank lending standards for C&I loans have been relatively unchanged for the past year. Leveraged loan issuance has also risen lately, thereby suggesting that credit is available and meeting the current demands of borrowers. Though, we note that some small business surveys have turned negative recently.

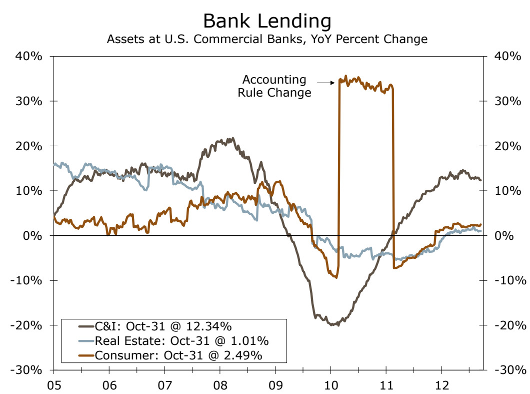
Asset-backed lending has improved in total issuance relative to the pace of issuance last year. Meanwhile, spreads on triple-A ABS have declined on credit cards, autos and home equity relative to their 52-week average. Meanwhile, Aaa and Baa corporate bond spreads over the 10-year Treasury note remain modest and have been accompanied by strength in issuance.

Outlook: Steady Rates Ahead

Our outlook remains that the Fed will continue with its easy monetary policy, and with continued modest economic growth, the outlook for Treasury interest rates remains for only a modest rise in rates over the next six months. These fundamentals will support investor interest in high grade and high yield bonds as well as in other credit products. For the economy, there is credit to go around for good ideas—the speculative phase of the credit cycle remains sometime away—but come it will.







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

Credit Market Insights

Mortgage Applications Rebound in Sandy Aftermath

Mortgage Bankers Association data for the week ending Nov. 9 showed a 12.6 percent increase in mortgage applications over the previous week. The pickup comes after five straight weeks of decline, and may, in part, be due to payback in the wake of Hurricane Sandy. We see large contributions to the rebound in applications from New Jersey, where volume more than doubled, as well as in New York and Connecticut, which increased more than 60 percent. Looking at the eight-week average, the application volume index has been hovering around its current reading, 190.4, for most of the year. However, the index had been experiencing growth for the past two months until stalling, as a result of Hurricane Sandy.

Mortgage activity continues to be supported by historically low rates at 3.52 percent, edging out the previous MBA survey low of 3.53 percent in September of this year. With mortgage rates hovering at record lows, strength in the housing market should persist. Low rates should support the housing market recovery and help bring traditional buyers back into the market.

According to the Fed's Senior Loan Officer Survey, lending standards have remained unchanged over the past three months. Lending restrictions make it difficult for new buyers to enter the market, as they have to meet elevated standards. Future growth in demand for residential mortgages may not be met without loosening of lending standards.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.34%	3.40%	3.37%	4.00%
15-Yr Fixed	2.65%	2.69%	2.66%	3.31%
5/1 ARM	2.74%	2.73%	2.75%	2.97%
1-Yr ARM	2.55%	2.59%	2.60%	2.98%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,484.1	25.80%	11.27%	12.34%
Revolving Home Equity	$521.7	-10.05%	-9.35%	-5.41%
Residential Mortgages	$1,592.8	1.16%	-1.64%	4.54%
Commerical Real Estate	$1,416.8	15.53%	1.98%	-0.28%
Consumer	$1,116.9	23.33%	3.37%	2.49%

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

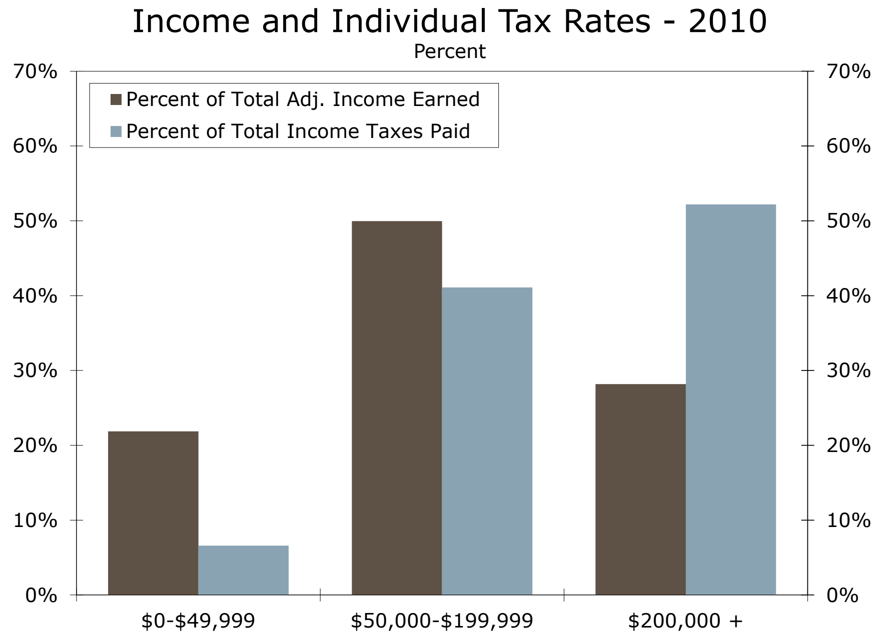
Topic of the Week

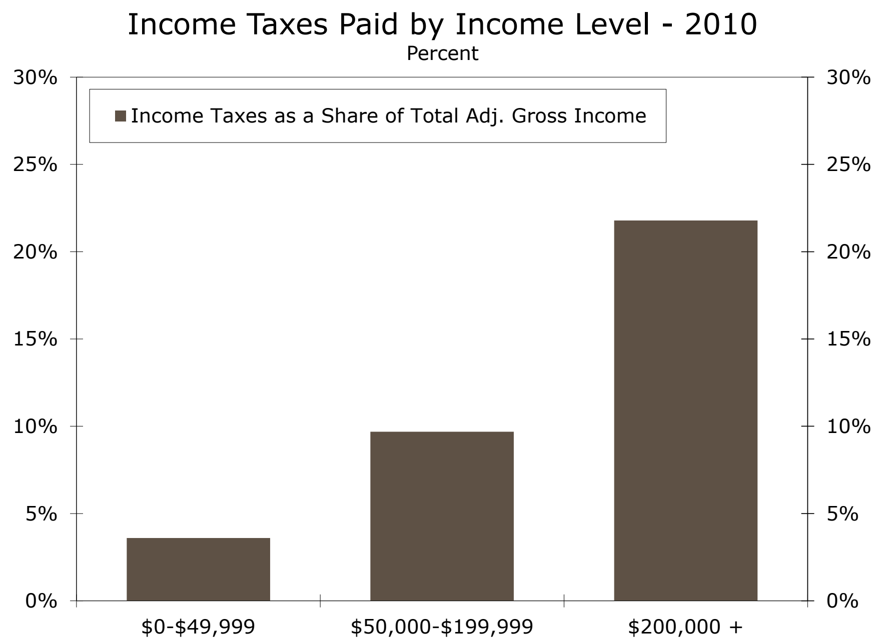
Income Tax Analysis: Who Pays?

Individual tax collections are an essential component of the functioning of the federal government. Of all the revenues collected by the federal government, individual income taxes make up the largest share at 47 percent of total federal government revenues. The most reliable source of tax collections data is the IRS's annual tax statistics data. We will look at the 2010 tax data in two ways to gauge which income brackets pay more in income taxes. Looking at the percent of total income taxes paid, we can clearly see that those earning $200,000 or more a year pay 52.2 percent of all income taxes, but only earn 28.2 percent of the total adjusted income produced in the country. In contrast, those individuals making between $50,000 and $200,000 per year in adjusted gross income make up 50 percent of the nation's total income, but only pay 41.1 percent of all the individual income taxes collected. The bottom income group ($0-$49,999) earns 22 percent of the nation's income and pays 6.6 percent of total income taxes.

Another way to look at the disparities in taxes paid across the income spectrum is to compare the aggregated total amount of taxes paid as a share of adjusted gross income by each income group. The greatest number of taxpayers is in the $50,000-$199,999 income bracket which in aggregate has paid 10 percent of their income in taxes. In contrast, the top income bracket in aggregate paid around 22 percent of their adjusted gross income in taxes, while the lowest income bracket paid 3.6 percent of their income in taxes.

The importance for tax policy can not be understated. While increased taxes on any group has negative economic effects, the reality of the current federal fiscal situation dictates a balanced approach. In other words, since we are all in this together, everyone must participate in funding federal government operations in some form, whether it includes a loss of some benefits at the lower end of the spectrum, or middle and upper income individuals having to pay higher tax rates. For more information, see our recent report, *Income Tax Analysis: Who Pays?*, available on our website.





Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 11/16/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.08	0.09	0.01
3-Month LIBOR	0.31	0.31	0.47
1-Year Treasury	0.18	0.13	0.10
2-Year Treasury	0.24	0.26	0.24
5-Year Treasury	0.62	0.64	0.87
10-Year Treasury	1.58	1.61	2.00
30-Year Treasury	2.72	2.74	3.03
Bond Buyer Index	3.41	3.55	4.09

Foreign Exchange Rates

	Friday 11/16/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.274	1.271	1.346
British Pound ($/₤)	1.587	1.590	1.573
British Pound (₤/€)	0.803	0.799	0.856
Japanese Yen (¥/$)	81.140	79.490	77.060
Canadian Dollar (C$/$)	1.001	1.002	1.025
Swiss Franc (CHF/$)	0.946	0.949	0.919
Australian Dollar (US$/A$)	1.032	1.039	1.008
Mexican Peso (MXN/$)	13.213	13.200	13.646
Chinese Yuan (CNY/$)	6.236	6.243	6.345
Indian Rupee (INR/$)	55.175	54.755	50.739
Brazilian Real (BRL/$)	2.073	2.046	1.770
U.S. Dollar Index	81.186	81.026	78.016

Foreign Interest Rates

	Friday 11/16/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.13	0.13	1.41
3-Month Sterling LIBOR	0.52	0.53	1.01
3-Month Canadian LIBOR	1.23	1.23	1.28
3-Month Yen LIBOR	0.19	0.19	0.20
2-Year German	-0.03	-0.03	0.40
2-Year U.K.	0.25	0.25	0.49
2-Year Canadian	1.07	1.08	0.89
2-Year Japanese	0.10	0.10	0.13
10-Year German	1.34	1.35	1.82
10-Year U.K.	1.74	1.74	2.16
10-Year Canadian	1.71	1.72	2.10
10-Year Japanese	0.73	0.74	0.95

Commodity Prices

	Friday 11/16/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	86.41	86.07	102.59
Gold ($/Ounce)	1715.62	1731.18	1763.38
Hot-Rolled Steel ($/S.Ton)	618.00	618.00	630.00
Copper (¢/Pound)	344.60	344.55	348.45
Soybeans ($/Bushel)	14.07	15.01	11.73
Natural Gas ($/MMBTU)	3.74	3.50	3.34
Nickel ($/Metric Ton)	15,858	16,115	17,544
CRB Spot Inds.	508.61	505.22	530.95

Next Week's Economic Calendar

	Monday 19	Tuesday 20	Wednesday 21	Thursday 22	Friday 23
U.S. Data	**Existing Home Sales** September 4.75M October 4.75M (W)	**Housing Starts** September 872K October 836K (W) **Building Permits** September 894K October 865K (C)	**LEI** September 0.6% October 0.2% (W)		
Global Data	**Japan** **Machine Tool Orders** Previous (Oct) -6.7% **Japan** **All Ind. Activity Index** Previous (Aug) 0.1%	**Eurozone** **Fin. Ministers' Meeting**		**Eurozone** **PMI Manufacturing** Previous (Oct) 45.4 **Canada** **Retail Sales (MoM)** Previous (Aug) 0.3%	**Canada** **CPI (YoY)** Previous (Sep) 1.2% **Germany** **Ifo Index** Previous (Oct) 100.0

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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