WELLS FARGO SECURITIES

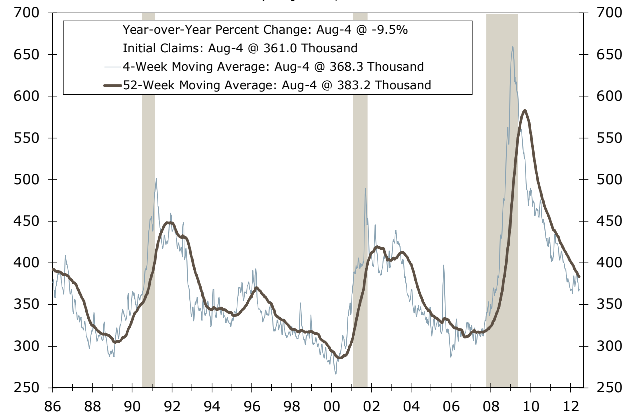
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Less Strength but More Resiliency

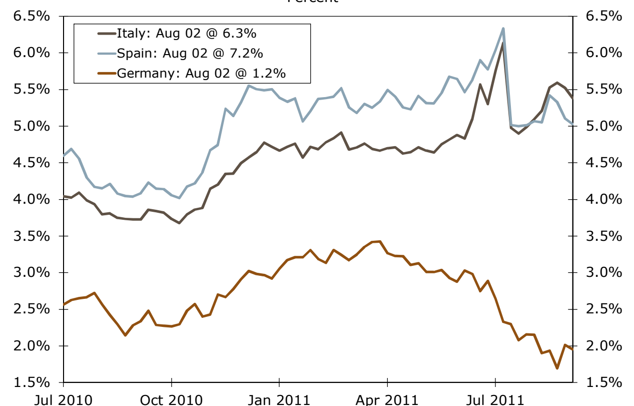
- This week's light compliment of economic reports shows the economy continuing to expand at a modest pace and further diminish the downside risks. The trade deficit was smaller than expected, hiring plans increased to their highest level since June 2008 and weekly unemployment claims declined.
- Nonfarm productivity grew at a 1.6 annual rate in Q2 but rose just 1.1 percent over the past year. With the labor force growing just 1.1 percent over that period and average weekly hours unchanged, the economy needs to grow only 2.2 percent in order to keep the unemployment rate from rising.
- Import prices fell 0.6 percent, with petroleum prices falling 1.6 percent. Excluding food and energy, prices fell 0.4 percent.



Global Review

Is This The Calm That Precedes The Tempest?

- Global markets have taken a breather during this week after a volatile environment during the previous week when "help-is-on-the-way" commentaries by European officials did not come to fruition. This calm does not seem real or based on an understanding that all is well now and that we should not be concerned with the potential effects of a worsening of the Eurozone crisis.
- During the 2008 and 2009 crisis, fear and a rush to prevent a total collapse of the world economy worked as catalysts to move governments to action across the world. Such distress does not exist today and thus, in its absence, policymaking will remain cautious.



Wells Fargo U.S. Economic Forecast

	Actual 2011				Forecast 2012				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2009	2010	2011	2012	2013
Real Gross Domestic Product [1]	0.1	2.5	1.3	4.1	2.0	1.5	1.7	1.1	-3.2	2.4	1.8	2.1	1.5
Personal Consumption	3.1	1.0	1.7	4.1	2.4	1.5	1.2	1.3	-2.0	1.8	2.5	1.8	1.1
Inflation Indicators [2]													
PCE Deflator	1.8	2.6	2.8	2.5	2.4	1.6	1.2	1.1	0.4	1.9	2.4	1.6	1.1
Consumer Price Index	2.1	3.3	3.8	3.3	2.8	1.9	1.3	1.4	-0.3	1.6	3.1	1.9	2.0
Industrial Production [1]	4.4	1.2	5.6	5.1	5.8	2.2	2.7	2.2	-11.3	5.4	4.1	4.1	2.4
Corporate Profits Before Taxes [2]	4.6	10.8	4.7	9.2	10.3	6.0	5.7	5.3	7.5	26.8	7.3	6.7	5.5
Trade Weighted Dollar Index [3]	70.6	69.4	72.8	73.3	72.7	74.5	72.5	74.0	77.7	75.6	70.9	73.4	76.5
Unemployment Rate	9.0	9.0	9.1	8.7	8.3	8.2	8.3	8.3	9.3	9.6	9.0	8.3	8.1
Housing Starts [4]	0.58	0.57	0.61	0.68	0.71	0.74	0.76	0.75	0.55	0.59	0.61	0.74	0.85
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	3.96	3.95	3.68	3.10	3.20	5.04	4.69	4.46	3.48	3.55
10 Year Note	3.47	3.18	1.92	1.89	2.23	1.67	1.60	1.60	3.26	3.22	2.78	1.78	1.85

Forecast as of: August 10, 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, Bloomberg LP and Wells Fargo Securities

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U.S. Review

Slow Growth Exceeds Low Expectations

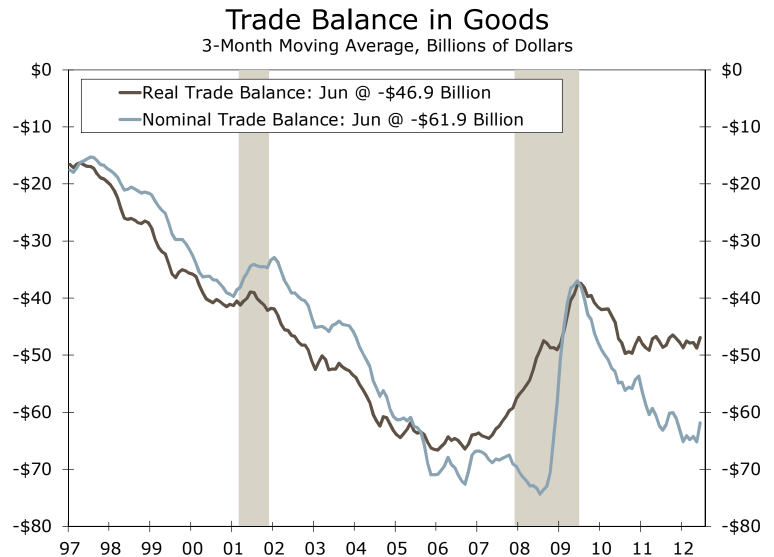
One way to sum up the current economic environment is, if you set your expectations low enough, you will not be disappointed. That seems to be what is behind the markets sanguine view of the generally sluggish U.S. and global economic numbers over the past few weeks. In addition to low expectations, the financial markets have also likely been relieved by a drop in the news flow, as most policymakers in Europe and the United States are on vacation. As a result, the world's attention is focused on the Olympic Games instead of the still simmering European financial crisis and approaching U.S. fiscal cliff. While watching Usain Bolt, Ally Raisman and Michael Phelps beats listening to Mario Draghi and U.S. congressional leaders, the Olympics is short and the problems facing Europe and the United States look so intractable that we may still be looking for another break from the bad economic news when the Olympic torch is lit in Rio in 2016.

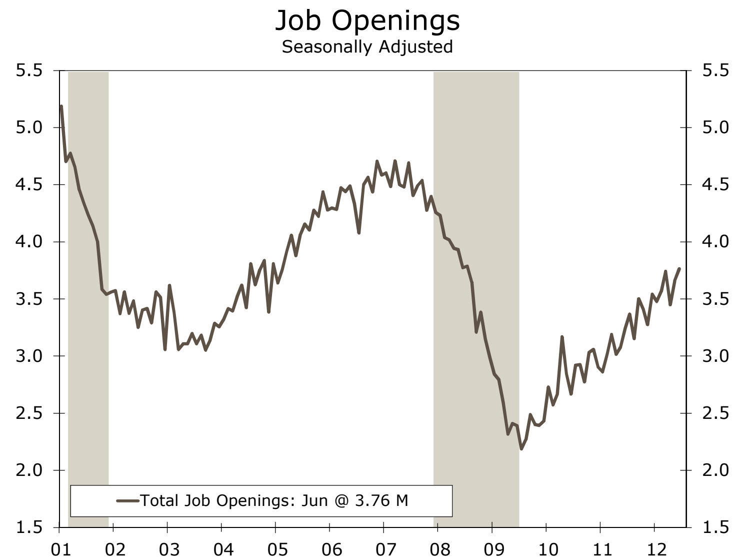
There was a short list of economic reports released this week, and only one, international trade, that would be considered a major report. The trade data did not disappoint, with exports rising 0.9 percent and imports falling 1.5 percent. The trade deficit narrowed by $5.12 billion to $42.9 billion in June. While much of this improvement reflects lower oil prices, the ex-petroleum deficit narrowed by $2.85 billon to $20.4 billion and the inflation adjusted trade gap narrowed by $3.5 billion to $44.2 billion.

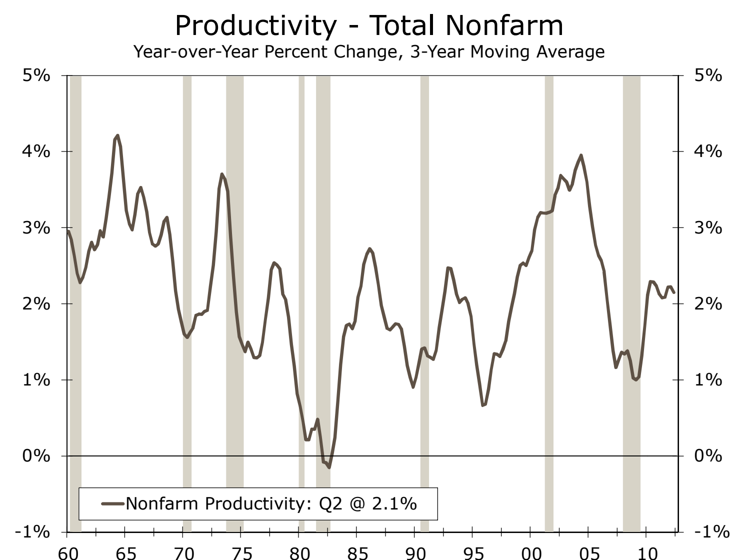
June's smaller trade deficit may lift second quarter GDP by about a tenth of a percentage point. Much of the improvement came from a decline in imports, which also resulted in an unexpectedly large decline in wholesale inventories. The real surprise is the resilience of exports. Export orders have slowed and corporate earnings reports for the second quarter clearly point to reduced demand in Europe, Asia and Latin America. We have raised our estimates for exports and reduced our estimate for imports in the current quarter but are looking for some payback later this year. The U.S. cannot buck the receding global tide much longer.

There was bit more good news on the labor front this week. The JOLTS survey for June reported a 105,000-job increase in job openings, which brought the number of job openings up to its highest level since July 2008. Improvement is evident across most of the private sector, with the largest increases occurring in the leisure and hospitality sector, healthcare and manufacturing. While the number of job openings increased, actual hiring slowed, suggesting that some industries may be experiencing difficulty finding the skilled workers they need.

Productivity growth also came in slightly ahead of expectations, rising at a 1.6 percent annual rate in Q2 and climbing 1.1 percent over the past year. The sluggish recent growth likely reflects the mix of job gains, which have been more heavily weighted toward lower productivity jobs. Business fixed investment has also been lagging, which may also be taking a toll on efficiency. The slowdown in productivity is noteworthy. Nonfarm productivity has averaged a 2.1 percent pace over the past three years compared to a 3.6 percent pace in the three years following the 2001 recession. The trend now looks more like it did during the productivity slowdown from 1973 to 1995 than it does during the great productivity revival during the late 1990s and early part of the last decade. Slower productivity growth means the economy's potential GDP has likely ratcheted down a few notches and also means the inflation outlook is less sanguine than widely thought.







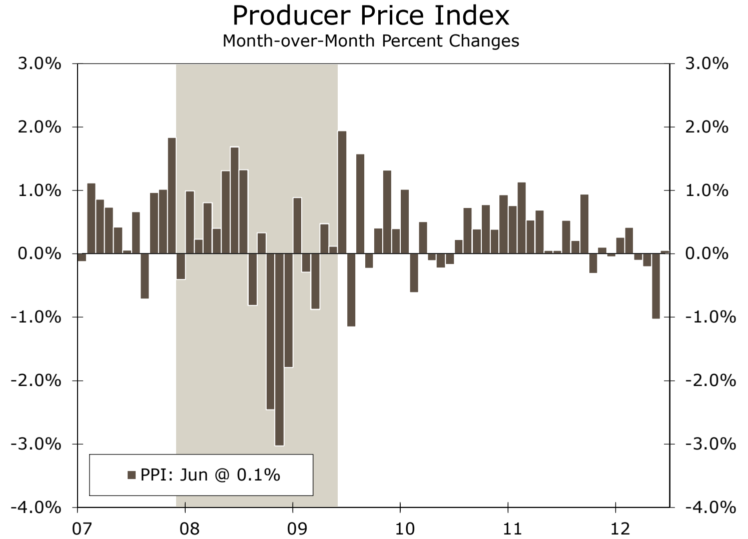
Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities

Producer Price Index • Tuesday

Producer prices rose 0.1 percent in June after declining 1.0 percent in May. Excluding volatile food and energy prices, producer prices rose 0.2 percent for the month. The slight upward trend in oil prices led to a 1.9 percent rise in gasoline prices. Finished consumer goods prices also rose in June, the largest monthly increase since November of last year. The global economic slowdown has put some downward pressure on commodity prices, helping to keep raw materials prices lower. There are some signs that this trend may be reversing, as the extreme drought in the mid-United States has damaged crops, which will likely lead to higher agricultural commodity prices in the months ahead. We expect producer prices will rise slightly again in July. Going forward, we continue to expect a slow but steady rise in the pace of producer prices, as the full effects of this summer's drought feeds through to crop prices. The upward pressure on prices will likely also filter through to consumer prices later in the year.

Previous: 0.1% **Wells Fargo: 0.2%**

Consensus: 0.2% (Month-over-month)

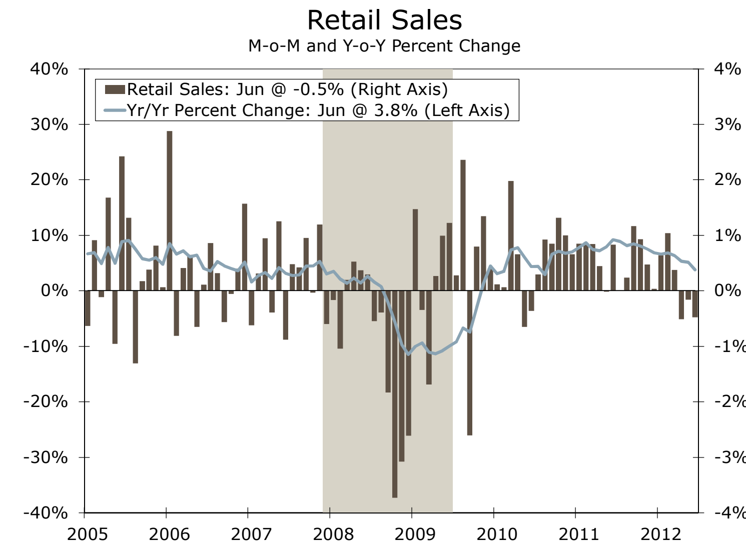


Retail Sales • Tuesday

Retail sales have consistently disappointed over the past three months as falling prices and a pullback in consumers' willingness to spend have put pressure on headline retail sales. June sales pulled back 0.5 percent, with broad-based declines in sales. Looking at core sales, which strip out gasoline, building materials and auto dealer sales, fell 0.1 percent after remaining flat in May. Given the slow pace of personal income growth, households remain under pressure to reign in spending. July begins the back-to-school shopping season. July's chain-store sales edged higher, with sales rising 4.6 percent excluding drug stores; apparel sales surged 9.2 percent. Given the stronger chain-store sales, we expect retail sales to bounce back slightly in August to a monthly increase of 0.2 percent. While sales are likely to look somewhat better in July, we do not expect the strength to continue. Our forecast for retail sales through the end of the year remains modest, consistent with our call for 1.2 to 1.3 percent personal consumption growth.

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

Consensus: 0.3%

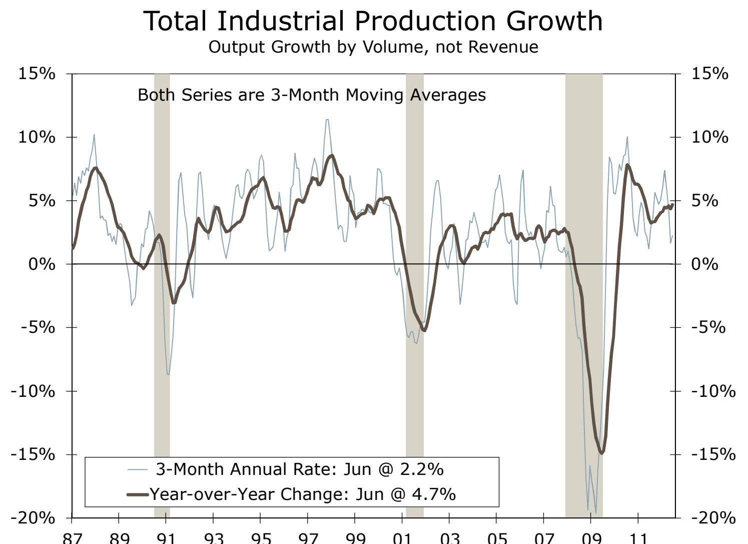


Industrial Production • Wednesday

Industrial production bounced back in July, rising 0.4 percent with manufacturing output posting a 0.7 percent increase for the month. The stronger pace of output in manufacturing was mostly tied to a 2.2 percent increase in automobile production. Other metrics of the manufacturing sector are not fairing so well. The August ISM-manufacturing survey remained in contractionary territory for the second month in a row. More disconcerting was the large slide in the new orders component that continued to signal further weakness in the months ahead. Our expectation is that industrial production will likely slow to 0.4 percent in August, as slowing global demand and increased domestic fiscal policy uncertainty begins to weigh on output growth. Through the end of the year, we continue to expect a downshift in the pace of industrial production to around 2.5 percent compared to the 4.0 percent average pace of output in the first half of the year.

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

Consensus: 0.5%



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

Global Review

Is This the Calm That Precedes the Tempest?

Global markets have taken a breather during this week after a volatile environment during the previous week when "help-is-on-the-way" commentaries by European officials did not come to fruition. This calm does not seem real or based on an understanding that all is well now and that we should not be concerned with the potential effects of a worsening of the Eurozone crisis. It seems that the lack of data coming out of the Eurozone during this week may have had something to do with how "calm" markets have been. However, this is likely going to change in the coming week when Euro zone GDP for the second quarter, as well as industrial production numbers for June, are released.

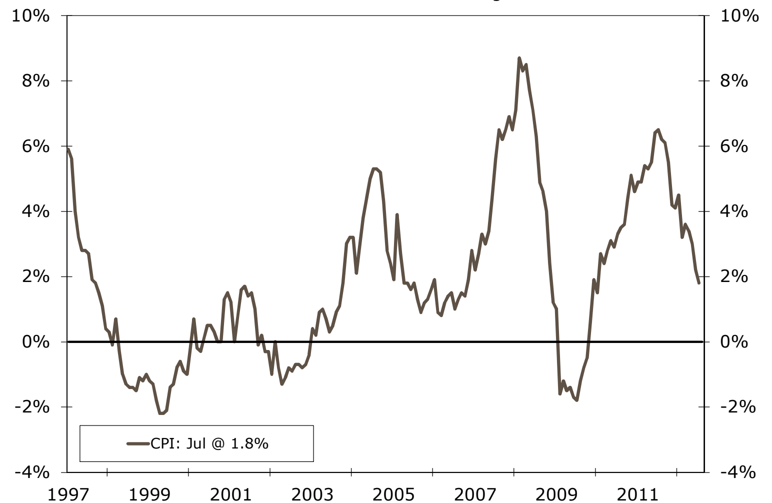
In this environment, it seems that the news that "made the news" included more evidence from China on a slowing economy, as reflected by easing inflationary pressures compared to 2011. Chinese consumer prices increased by 1.8 percent on a year-over-year basis in July from a 2.2 percent increase in June. Meanwhile, Chinese industrial production slowed to a 9.2 percent pace in July compared to a 9.5 percent pace in June, both year over year. This slowdown plus similar benign news on inflationary pressures from Japan and Korea as well as weak Indian industrial production has given markets some new grounds for speculation regarding further monetary easing "coming to a theater near you" in the near future.

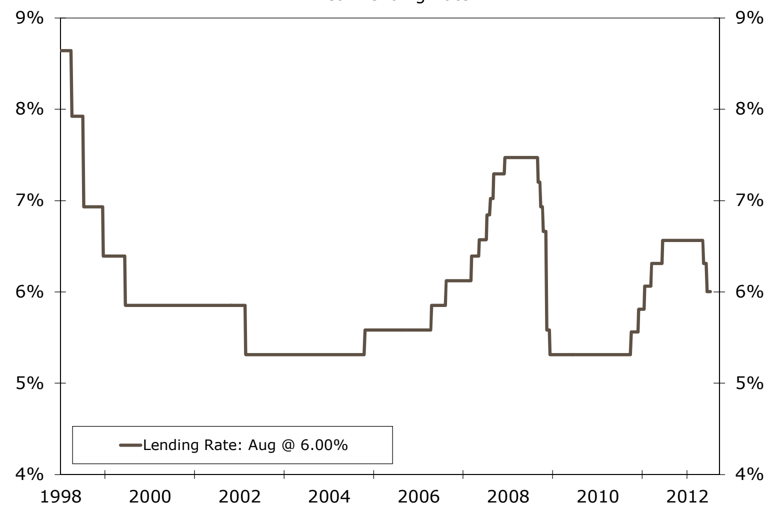
We agree the Chinese government may have to do a bit more to recreate stronger economic activity, but the size or degree of this effort is still uncertain. In principle, the current environment is not a repeat of the post-Lehman Brothers worldwide financial collapse, so any speculation that China may be injecting the kind of money it injected back in 2008 and 2009 is not reasonable.

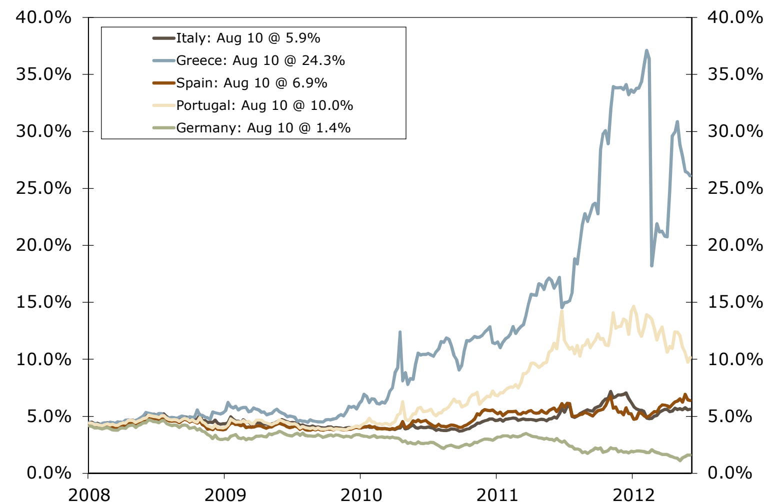
It is clear that Chinese authorities are not happy with the latest slowdown in economic activity, as they have taken some measures to reverse it during the past several months. However, it seems that they will take their time to judge whether what they have done so far is going to be enough or not. Furthermore, the effects of higher agriculture and food prices are still in the pipeline going forward, and acting on current price-level measures may not be the correct gauge central banks should be looking at when determining whether to further intervene.

The world economy has continued to slow down, and while there are some bright spots across the world, the overall condition of the world economy are not particularly encouraging. Furthermore, the potential, or more specifically, the possible effectiveness of further monetary policy reactivating economic growth across the world seems feeble at best. The only alternative, today, seems to be expansionary fiscal policy, but this is limited by already over-extended public sectors across the world.

During the 2008 and 2009 crisis, fear and a rush to prevent a total collapse of the world economy worked as catalysts to move governments to action across the world. Such distress does not exist today and thus, in its absence, policymaking will remain cautious. Furthermore, little has been done to solve the European sovereign debt crisis, so a relapse from the current calm cannot be ruled out. At the same time, a severe crisis triggered by events in the Eurozone could be the catalyst to change the current, "do not innovate" fiscal policy stance across the world.







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

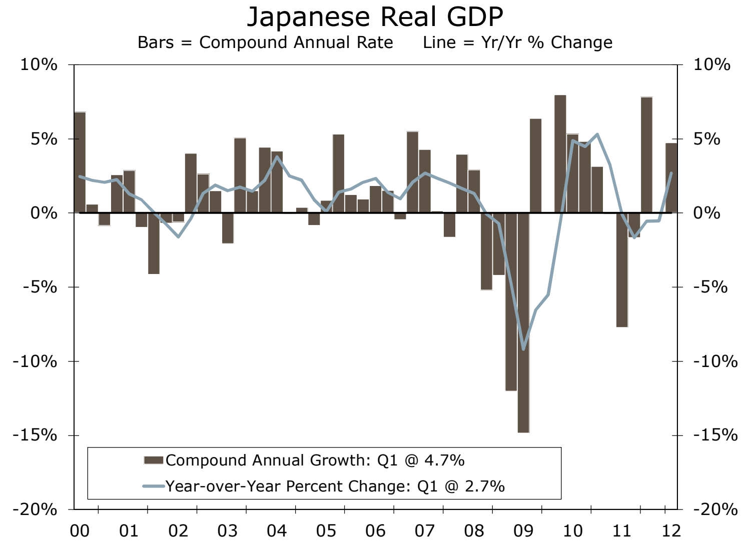
Japanese GDP • Monday

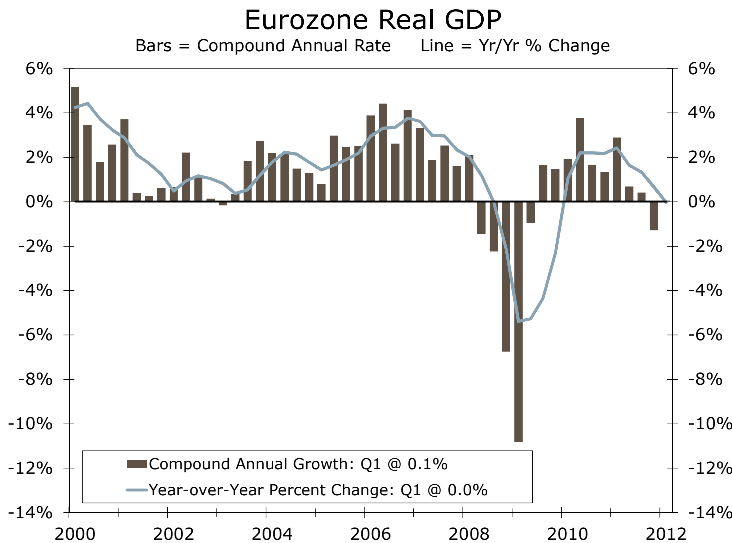
In the minutes from the Bank of Japan (BoJ) June meeting, policymakers reaffirmed that "it was necessary for the Bank to do its utmost to ensure the stability of Japan's financial system while paying particular attention to developments in global financial markets, where some nervousness persisted, reflecting the European debt problem."

Japan has seen some signs of recovery since the disruptions caused by last year's tsunami and nuclear disasters. Indeed, GDP grew at a 4.7 percent pace in the first quarter. That said, the economy is not without its share of trouble. Retail sales fell two out of three months in the second quarter, and industrial production fell in April and May before rebounding in June. We expect the pace of growth to slow to 2.2 percent in the second quarter. Japanese GDP hits the wire on Monday.

Previous: 4.7% (CAGR) **Wells Fargo: 2.2%**

Consensus: 2.3%





Eurozone GDP • Tuesday

The short end of the Spanish and Italian government bond curves have been coming down in recent weeks in reaction to comments from ECB President Draghi and gestures from German leadership that there might be less opposition from Germany to a more substantial monetary policy.

Keeping the Eurozone together and shoring up frenzied bond markets has become the central focus of European policymakers in recent months, but ultimately the best fix for Europe is to grow its economy. However, with the various PMIs all signaling trouble, it is unlikely the economy in Europe is going to come roaring back.

Growth was essentially flat in the first quarter and we suspect the economy will shrink at a 1.0 percent annualized rate in the second quarter. The official number will be released on Tuesday.

Previous: 0.1% (CAGR) **Wells Fargo: -1.0%**

Consensus: -0.9%

U.K. CPI • Tuesday

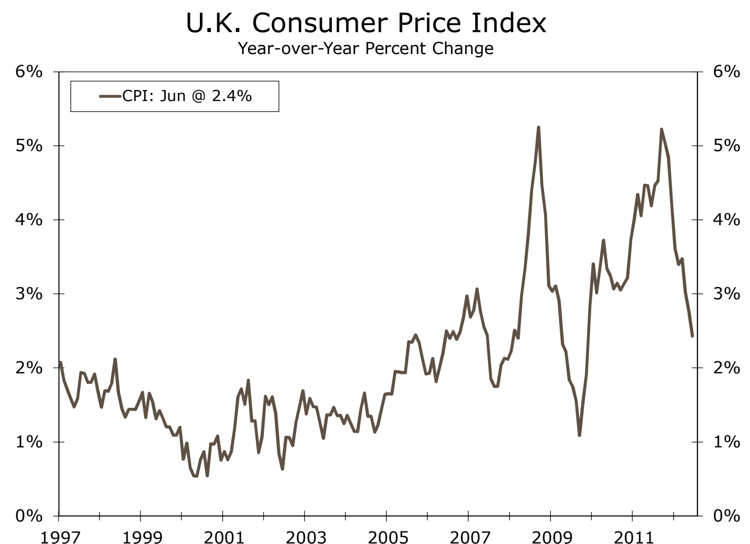
The 0.7 percent (not annualized) decline in second-quarter real GDP in the United Kingdom marked the third straight quarter in which the economy contracted.

Fortunately, the drop in CPI inflation over the past few months has given the Bank of England room to keep monetary policy accommodative. The consumer price index is due out on Tuesday of next week, and we expect to see that the year-over-year rate of consumer price growth slowed to 2.1 percent.

The Monetary Policy Committee (MPC) agreed at its July policy meeting to increase the size of its quantitative easing program to £375 billion from £325 billion.

Previous: 2.4% (Year-over-year) **Wells Fargo: 2.1%**

Consensus: 2.3%



Source: IHS Global Insight and Wells Fargo Securities

Interest Rate Watch

Fundamentals Dictate Steady Ahead

Our monthly outlook reaffirms our call for sub-2.0 percent economic growth and inflation below the Fed's 2.0 percent target. Given this backdrop, the consensus expects some form of additional policy stimulus at the September FOMC meeting. While we agree with this assessment, we do not expect QE3.

The Fundamentals: Growth and Inflation

Since we published our annual outlook for 2012 last December, our view has been that the U.S. economy would continue to underperform trend growth expectations; this was certainly true in the first half of this year, and we expect more of the same for the second half. Our expectation for real growth is for gains of 1.0 to 1.5 percent with positive but slower growth in consumer spending and business investment.

Meanwhile, our expectation for the personal consumption deflator measure of inflation is for a rise of 1.0 to 1.5 percent in the second half of this year. This will certainly fit below the 2.0 percent target set by the Federal Reserve.

Interest Rates: Little Change

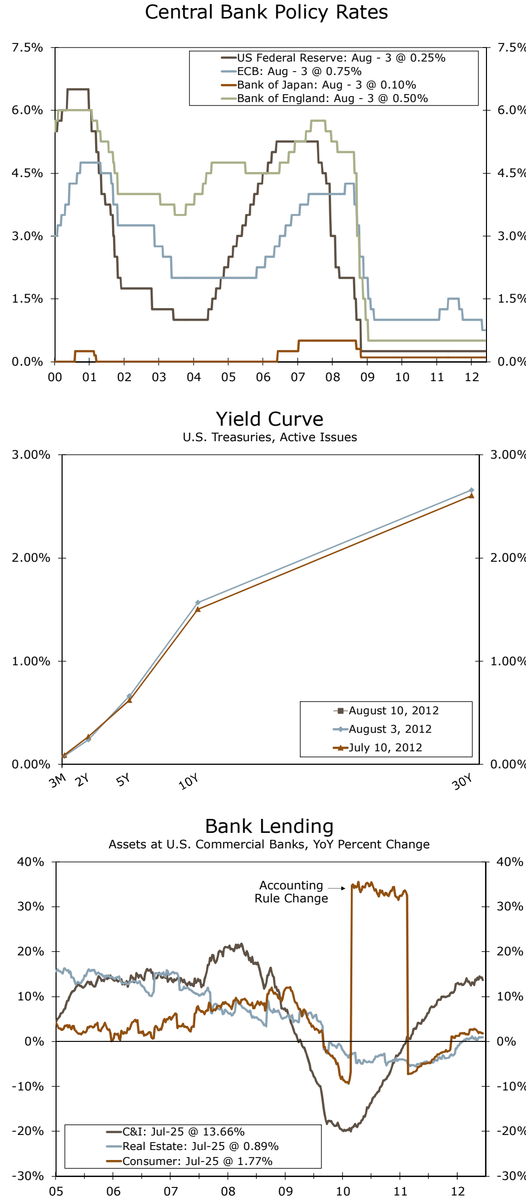
As a result of the fundamentals, we suspect the Fed will keep the funds rate low and will pursue its Operation Twist program, given the downside uncertainties cited in the Fed's mid-year economic outlook.

However, we do not believe the evidence in growth and inflation will be enough to pursue a QE3 move. Moreover, the efficacy of such a move appears to be limited. Interest rates are not the primary barrier to growth in the economy. Housing markets and small business lending both appear to be improving. Instead, the uncertain and low pace of final sales appears to be the real primary driver of limited credit in the economy. In addition, policy uncertainty on the fiscal cliff and regulatory actions in the financial and health care fields are also limiting growth.

Low Rates: Good Time to Borrow

For financially well-positioned households and businesses, the low nominal interest rates this year have been a plus for borrowing. Home sales are up and small business lending demand has also improved. High grade and high yield bond issuance has also benefitted from the current low rates.

For the outlook, interest rates do not appear to be a barrier to growth. Rather the lack of visibility on final sales and policy appear to be far more important.



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

Consumer Credit Insights

MBS Prepayment Speeds Pick Up

Reflecting lower Treasury bond yields, mortgage rates reached an unprecedented low of 1.5 percent in June, which continued to fuel prepayments due to refinancing. Indeed, refinancing activity has increased 33 percent since the beginning of the year and could increase in the coming months.

Some of the upswing in refinancing activity is being led by the widening of the Home Affordable Refinance Program (HARP). According to the Federal Housing Finance Agency, HARP volume jumped in June, representing 33 percent of total refinance volume, the highest percentage reported since the inception of HARP. Moreover, borrowers with loan-to-value-ratios greater than 105 percent accounted for 62 percent of that volume. States such as Nevada, Arizona and Florida all saw large increases in HARP refinancing, with underwater borrowers accounting for the lions' share. In Nevada alone, 91 percent of total HARP refinancing was due to underwater borrowers in June. This is good news for states hard hit by the housing downturn, as negative equity not only constrains refinancing, but also limits geographic mobility, drives foreclosures and constrains supply.

That said, the universe of HARP-eligible borrowers is winding down, which should give MBS investors some ease. While MBS prepayment speeds could continue to increase over the next two months for both traditional and HARP-related refinances, our Structured Products Group expects prepayments to stabilize and eventually decline modestly by the end of 2012.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.59%	3.55%	3.56%	4.32%
15-Yr Fixed	2.84%	2.83%	2.86%	3.50%
5/1 ARM	2.77%	2.75%	2.74%	3.13%
1-Yr ARM	2.65%	2.70%	2.69%	2.89%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,451.3	-0.03%	13.99%	13.66%
Revolving Home Equity	$534.3	-8.96%	-6.59%	-4.39%
Residential Mortgages	$1,569.2	-3.76%	2.32%	5.31%
Commerical Real Estate	$1,413.4	0.63%	-1.99%	-1.64%
Consumer	$1,109.3	-3.79%	-1.19%	1.77%

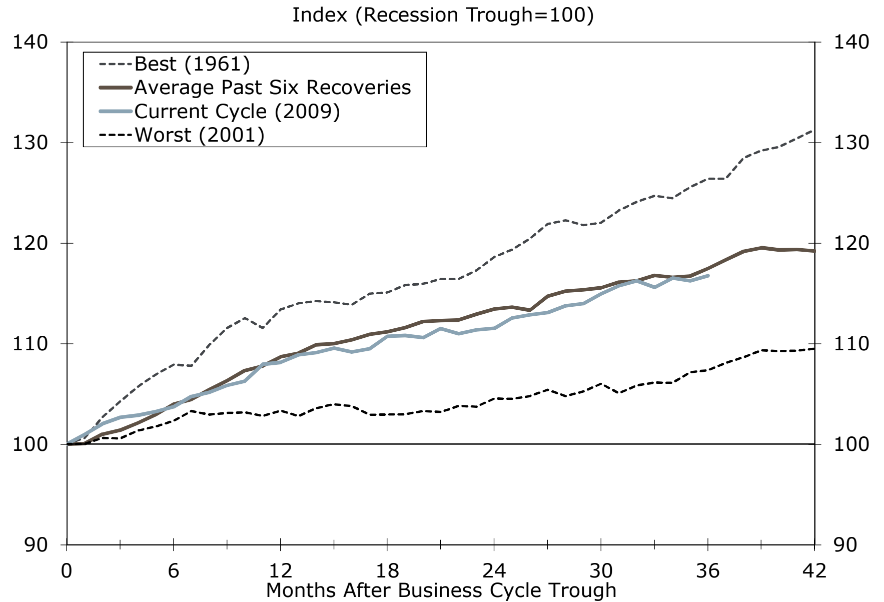
Source: Freddie Mac, Federal Reserve Board and Wells Fargo Securities, LLC

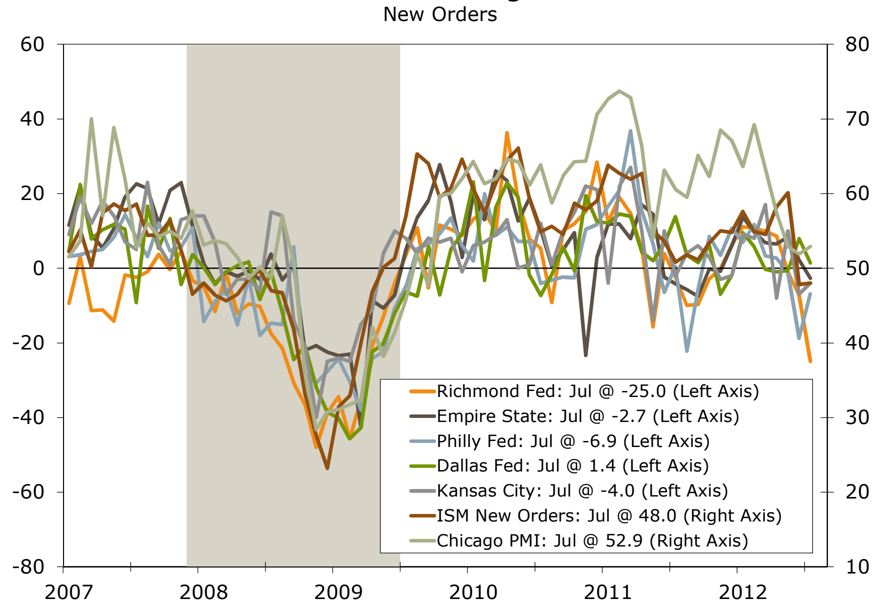
Topic of the Week

Orders & Production: No Time for Complacency

The pace of current economic growth is clearly losing momentum. Our mantra of “slow growth, no double-dip” has withstood similar summer soft patches before, but the recent run of weaker-than-expected data warrants a thoughtful look at where we are in the business cycle. The National Bureau of Economic Reserch (NBER) uses four coincident monthly indicators to determine whether the economy is in a recession: employment, real income growth, real wholesale sales and industrial production. When compared to prior recoveries that have lasted more than 36 months, employment and real income growth have been notably weak in this recovery. Real manufacturing and wholesale-retail trade sales have followed the average cyclical path, but are now losing ground. Industrial production has been the strongest—or at any rate the least weak—in this recovery and has almost perfectly retraced the recovery pattern in previous cycles (top chart). Given its relative strength, its outlook is critical to the outlook of the overall economy.

To get a sense of where industrial production is headed, we looked at the purchasing managers new orders index. Of seven major manufacturing surveys, five signaled a decline in new orders in July (bottom chart). The last time that many slipped into contraction territory was in February 2008, long before the NBER had confirmed a recession had begun in December 2007. While the number of purchasing managers’ indexes currently signaling a decline in new orders is concerning, it is important to note a simultaneous decline in these surveys has not always meant the onset of a recession. Our outlook of sluggish growth reflects the softness seen in orders in many of the major PMIs, but we do not believe the economy is currently in recession. However, in a world of uncertainty, it is important not to ignore the shots across the bow. Due to the critical role industrial production has played in this recovery, we cannot afford to ignore evidence that orders are falling. The unraveling in orders may lead to a broader weakening in the outlook for industrial production and overall economic growth. For our full analysis on this issue, please see “Orders and Production: No Time for Complacency.”





Source: Federal Reserve Board, Federal Reserve Banks of New York, Philadelphia, Richmond, Kansas City and Dallas, Institute for Supply Management, ISM Chicago and Wells Fargo Securities, LLC.

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/10/2012	1 Week Ago	1 Year Ago
3-Month T-Bill	0.10	0.08	0.01
3-Month LIBOR	0.44	0.44	0.28
1-Year Treasury	0.00	-0.03	0.12
2-Year Treasury	0.26	0.24	0.18
5-Year Treasury	0.70	0.66	0.92
10-Year Treasury	1.65	1.56	2.11
30-Year Treasury	2.74	2.64	3.51
Bond Buyer Index	3.75	3.66	3.97

Foreign Exchange Rates

	Friday 8/10/2012	1 Week Ago	1 Year Ago
Euro ($/€)	1.229	1.239	1.418
British Pound ($/£)	1.568	1.564	1.613
British Pound (£/€)	0.784	0.792	0.879
Japanese Yen (¥/$)	78.230	78.470	76.860
Canadian Dollar (C$/$)	0.992	1.001	0.995
Swiss Franc (CHF/$)	0.977	0.970	0.727
Australian Dollar (US$/A$	1.056	1.057	1.018
Mexican Peso (MXN/$)	13.109	13.135	12.554
Chinese Yuan (CNY/$)	6.360	6.373	6.418
Indian Rupee (INR/$)	55.285	55.755	45.254
Brazilian Real (BRL/$)	2.018	2.028	1.625
U.S. Dollar Index	82.555	82.375	74.636

Foreign Interest Rates

	Friday 8/10/2012	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.22	0.25	1.50
3-Month Sterling LIBOR	0.71	0.73	0.84
3-Month Canadian LIBOR	1.29	1.29	1.12
3-Month Yen LIBOR	0.20	0.20	0.19
2-Year German	-0.07	-0.02	0.57
2-Year U.K.	0.11	0.11	0.54
2-Year Canadian	1.13	1.12	0.86
2-Year Japanese	0.09	0.09	0.14
10-Year German	1.38	1.42	2.19
10-Year U.K.	1.54	1.56	2.48
10-Year Canadian	1.78	1.77	2.33
10-Year Japanese	0.80	0.74	1.04

Commodity Prices

	Friday 8/10/2012	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	92.79	91.40	82.89
Gold ($/Ounce)	1621.98	1603.48	1793.05
Hot-Rolled Steel ($/S.Ton)	641.00	640.00	670.00
Copper (¢/Pound)	338.65	336.75	388.85
Soybeans ($/Bushel)	16.93	16.58	12.95
Natural Gas ($/MMBTU)	2.79	2.88	4.00
Nickel ($/Metric Ton)	15,438	15,190	21,162
CRB Spot Inds.	510.90	494.80	571.18

Next Week's Economic Calendar

	Monday 13	Tuesday 14	Wednesday 15	Thursday 16	Friday 17
U.S. Data		**PPI (MoM)** June 0.1% July 0.2% (W) **Retail Sales (MoM)** June -0.5% July 0.2% (W) **Business Inventories** May 0.3% June -0.1% (W)	**CPI (MoM)** June 0.0% July 0.1% (W) **IP** June 0.4% July 0.4% (W) **Net TIC Flows** May $101.7B	**Housing Starts** June 760K July 748K (W) **Building Permits** June 760K July 765K (C)	**LEI** June -0.3% July 0.3% (W)
Global Data	**Japan** **GDP Annualized** Previous (1Q) 4.7%	**Eurozone** **GDP (QoQ)** Previous (1Q) 0.0% **U.K.** **CPI (YoY)** Previous (Jun) 2.4%	**U.K.** **ILO Unemployment Rate** Previous (May) 8.1%	**Eurozone** **CPI (YoY)** Previous (Jun) 2.8% **Mexico** **GDP (QoQ)** Previous (1Q) 1.3%	**Canada** **CPI (YoY)** Previous (Jun) 1.5%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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