September 07, 2011

Economics Group

WELLS FARGO SECURITIES

MONTHLY OUTLOOK

U.S. Overview	International Overview

Same Song—Just Another Verse

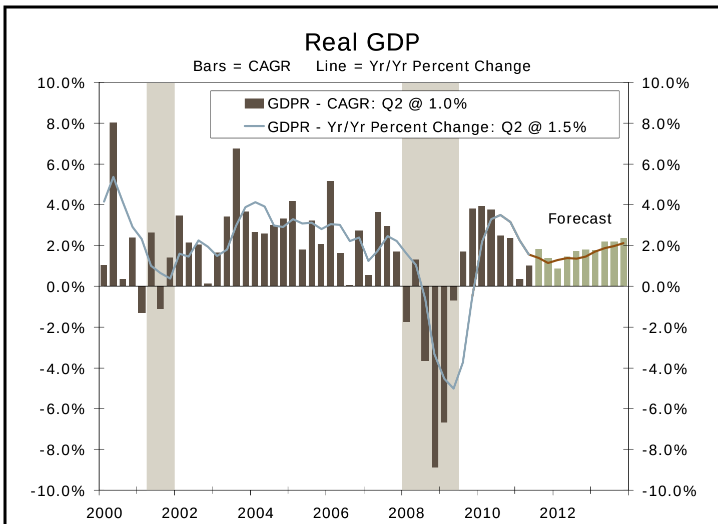
Neither recession nor boom, but a disappointing middling growth outlook demands that investors and decision makers choose economic policies carefully. Hiring will be cautious, orders will be slow. Profit growth will be constrained. Our outlook remains for moderate, subpar growth accompanied by modest inflation pressures and no change in the Federal Reserve policy on the federal funds rate. For the next six months we anticipate growth will reflect modest gains in consumer spending, equipment & software spending and modest improvement in commercial and residential construction (remodeling). There is no one driving factor—just a lot of little gains.

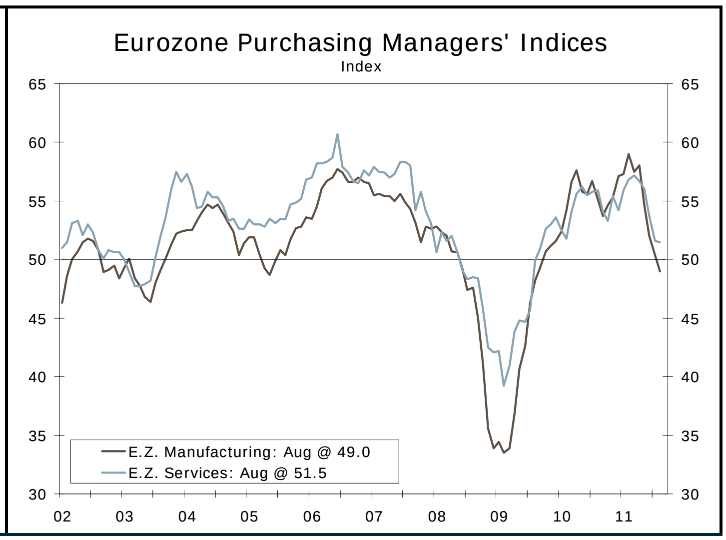
As suggested in our previous reports, the U.S. economy is surrounded and unable to break through enemy lines—debt downgrades, stalemates in fiscal policy, slow job growth, and the end, at least temporarily, of further monetary stimulus. Meanwhile, inflation, as measured by the core PCE deflator, is rising and will end this year just below the Fed's 2 percent implicit target. With modest growth and benign inflation, the Fed will not alter the federal funds rate at all this year—a view we had taken in our Annual Economic Outlook last December. The Fed will likely pursue modest policies to supply liquidity, but no QE3. Finally, corporate profit growth will moderate in the year ahead. Yet, the pace of profit growth will reflect globalization and the competitiveness of U.S. firms, especially in value-added manufacturing and consumer products.

Global Growth Positive, but Weak at Present

Recent data, including purchasing managers' indices, suggest that the global economy continues to expand. In the United States, which is the world's largest economy, growth appears to be positive, albeit sluggish, at present. The overall euro area is nearly as large as the U.S. economy, and growth rates in individual Eurozone countries, especially highly indebted ones, are very weak at present. Fortunately, Asia appears to be holding up a bit better, but intensive trade ties make many individual Asian economies susceptible to slowdowns in other areas of the global economy.

In a low growth environment, the global economy becomes vulnerable to economic and financial shocks. In that regard, the recent intensification of the European sovereign debt crisis is troubling, with Italy now clearly visible in the crosshairs of investor nervousness. Yields on government bonds in Italy have risen much less than comparable Greek bonds. Unlike Greece, however, Italy is essentially too big to bail out. If investors absolutely refuse to buy Italian government debt, that debt would need to be restructured. This would entail significant losses for investors, including some of Europe's largest banks, who own it. In a worst-case scenario, another global financial crisis could ensue. In that event, the global economy would plunge back into recession. Because committing more financial resources is politically unpopular in some European countries, we believe that the European sovereign debt crisis will continue to fester for some time.





Source: U.S. Department of Commerce, Bloomberg LP and Wells Fargo Securities, LLC

This report is available on wellsfargo.com/economics and on Bloomberg WFEC

To Repeat—Still Skating on Thin Ice

Over the past two plus years, many of our colleagues have asked our opinion on the economy, and our view is that we continue to skate on thin ice. Indeed, we continue to be on that path and we must recognize that there is no deus ex machina—either from monetary or fiscal policy. There has been no magic silver bullet. Instead, we are dealing with our old friend the Stockdale Paradox—we are in a fix and we need to deal with it—there is no quick rescue.

So what are we facing? First, we have slow, subpar growth that should come in at 1.5 percent for the second half of this year—a pace of growth that commands that economic decision makers be thoughtful about how they make economic decisions in such a treacherous environment.

Growth reflects the continued modest contributions of consumer spending, business investment in equipment & software, residential and commercial construction. For the consumer, nominal personal income growth benefits from gains in employment and wages, which we recognize are very modest at best, but will help improve consumer spending. Yet, we also recognize that inflation (CPI expected to rise 3.5 percent during the second half) will eat into gains so that growth in real disposable income, at 1 percent, will support only modest real consumer spending. Equipment & software spending is expected to contribute to growth based upon the improvement in capital goods orders, gains in corporate profits and the incentives for global competitiveness. Commercial and residential real estate investment is also expected to contribute to economic growth. On the downside, state and local governments will continue to cut spending and restructure their operations as rating downgrades add to the pressures of below-historical revenue growth trends.

While economic growth continues, the improvement in employment remains muted. Last Friday's employment report showed zero job gains and unemployment stubbornly above 9 percent, reinforcing the message that structural unemployment has taken on a greater share of the jobs issue today. For many workers, the skills and location issues are significant barriers to an easy transition to a new position.

Inflation, Interest Rates and Corporate Profits

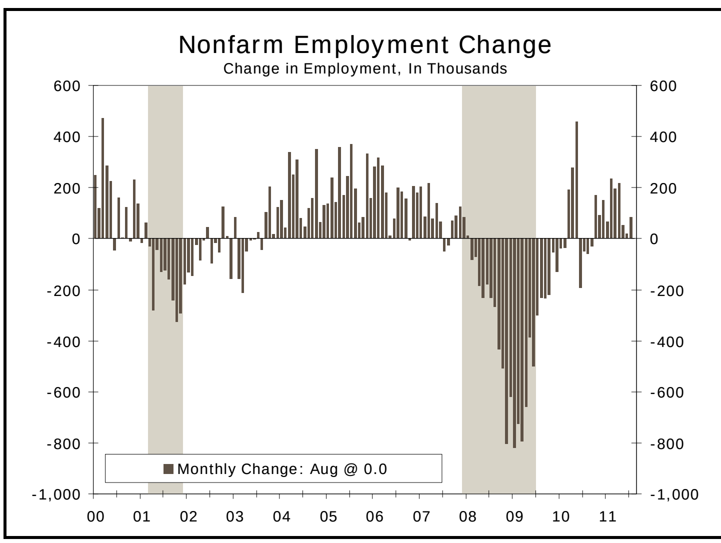
Meanwhile, inflation, while modest, continues to creep upward. Our call on the core personal consumption deflator, the Fed's implicit guidepost, will approach 2 percent by the end of this year. Rising core inflation reflects an upturn in a number of factors—not the product of any single component.

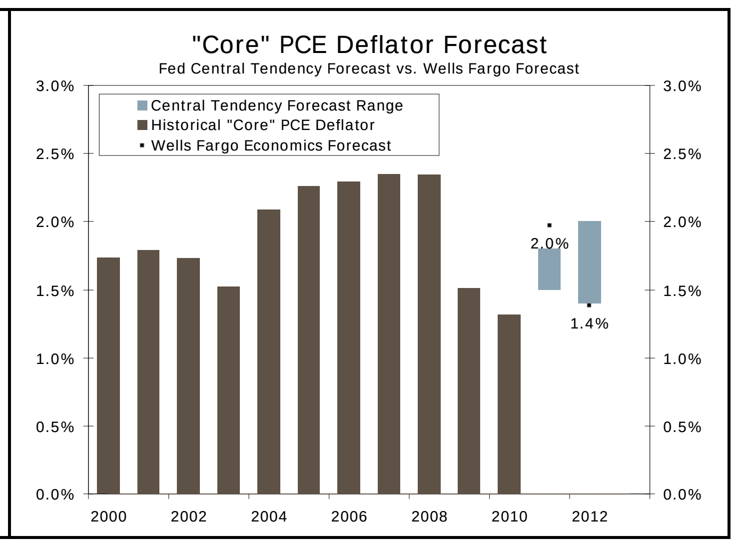
To repeat a theme we have held all year, we believe that modest economic growth and a sub-2 percent core deflator dictate that the Fed will not alter the federal funds rate at all this year. While short-term interest rates are anchored by the fed funds rate, long-term benchmark Treasury rates have fallen sharply in response to the turmoil in Europe as well as the significant downshift in economic growth expectations.

Finally, corporate profit growth is still expected to moderate in the year ahead. The pace of profit growth reflects the competitiveness of U.S. firms in a global environment, especially in value-added manufacturing, energy and consumer products.

Playing the Hand We Are Dealt

As decision makers, we need to deal with the challenges we face with the tools we have available. Blaming someone else for our problems does not solve our problems. We have a slow growth economy with creeping inflation and a restructuring of consumer, state, local and federal government finances. We must make do with what we have—not what we would like to have. There are opportunities out there that we must pursue, and those who complain will miss those opportunities. During every tough economic period, entrepreneurs have found a way to succeed.





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

Wells Fargo U.S. Economic Forecast

	Actual						Forecast										Actual		Forecast		
	2010				2011				2012				2013				2009	2010	2011	2012	2013
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product (a)	3.9	3.8	2.5	2.3	0.4	1.0	1.8	1.4	0.9	1.4	1.7	1.8	1.8	2.2	2.2	2.4	-3.6	3.0	1.6	1.4	1.9
Personal Consumption	2.7	2.9	2.6	3.6	2.1	0.4	2.0	1.3	1.3	1.3	1.4	1.4	1.3	1.5	1.5	1.9	-2.0	2.0	2.1	1.4	1.4
Business Fixed Investment	6.0	18.6	11.3	8.7	2.1	9.9	10.5	6.7	3.1	5.5	6.9	8.1	8.3	8.2	8.8	9.0	-18.0	4.4	8.2	6.3	8.0
Equipment and Software	21.7	23.2	14.1	8.1	8.7	7.9	4.6	7.4	2.9	6.0	7.6	9.1	8.9	8.3	8.8	9.0	-16.3	14.6	9.3	5.8	8.5
Structures	-24.7	7.5	4.2	10.5	-14.3	15.7	-3.5	4.0	4.0	4.0	4.5	4.5	6.0	8.0	9.0	9.0	-21.2	-15.8	1.5	3.8	6.3
Residential Construction	-15.3	22.8	-27.7	2.5	-2.5	3.4	-2.5	0.0	3.0	5.0	7.5	8.5	9.5	11.0	13.5	15.0	-22.3	-4.3	-2.6	3.0	9.9
Government Purchases	-1.2	3.7	1.0	-2.8	-5.9	-0.9	-1.7	-2.4	-2.1	-2.0	-1.0	-0.9	-1.0	-0.9	-0.7	-0.6	1.7	0.7	-2.2	-1.8	-1.0
Net Exports	-376.8	-437.4	-458.7	-414.2	-424.4	-421.3	-424.4	-420.0	-417.5	-412.7	-415.1	-423.1	-431.8	-442.0	-454.3	-468.6	-358.8	-421.8	-422.5	-417.1	-449.2
Pct. Point Contribution to GDP	-1.0	-1.9	-0.7	1.4	-0.3	0.1	-0.1	0.1	0.1	0.1	-0.1	-0.2	-0.3	-0.3	-0.4	-0.4	1.0	-0.5	0.0	0.0	-0.2
Inventory Change	39.9	64.6	92.3	38.3	49.1	40.6	37.5	40.5	34.8	34.8	38.0	41.0	45.0	58.0	65.5	70.0	-145.0	58.8	41.9	37.2	59.6
Pct. Point Contribution to GDP	3.1	0.8	0.9	-1.8	0.3	-0.2	-0.1	0.1	-0.2	0.0	0.1	0.1	0.1	0.4	0.2	0.1	-0.8	1.6	-0.1	0.0	0.2
Nominal GDP	5.5	5.4	3.9	4.2	3.1	3.5	4.0	3.5	2.9	3.5	3.7	3.8	3.9	4.4	4.4	4.6	-2.6	4.2	3.7	3.4	4.0
Real Final Sales	0.8	3.0	1.7	4.2	0.0	1.2	1.8	1.3	1.0	1.4	1.6	1.7	1.6	1.8	2.0	2.2	-2.8	1.4	1.7	1.4	1.8
Retail Sales (b)	5.3	6.9	5.6	7.7	8.2	7.8	7.8	5.6	3.7	3.4	3.6	3.8	4.2	4.4	4.3	4.5	-7.0	6.4	7.3	3.6	4.3
Inflation Indicators (b)																					
"Core" PCE Deflator	1.7	1.5	1.3	1.0	1.1	1.3	1.6	2.0	2.1	2.0	1.9	1.8	1.7	1.7	1.7	1.7	1.5	1.4	1.5	1.9	1.7
Consumer Price Index	2.4	1.8	1.2	1.2	2.2	3.3	3.5	3.5	2.8	2.3	2.3	2.3	2.2	2.3	2.4	2.5	-0.3	1.6	3.1	2.4	2.4
"Core" Consumer Price Index	1.3	1.0	0.9	0.6	1.1	1.5	1.9	2.4	2.3	2.1	1.8	1.6	1.7	1.8	1.9	2.0	1.7	1.0	1.7	2.0	1.9
Producer Price Index	5.1	4.3	3.7	3.8	5.0	6.9	6.8	5.8	3.4	2.2	2.7	2.8	3.3	3.1	3.1	2.9	-2.6	4.2	6.1	2.8	3.1
Employment Cost Index	1.7	1.9	1.9	2.0	2.0	2.2	2.1	2.0	2.2	2.0	2.0	2.1	2.3	2.1	2.2	2.2	1.7	1.3	2.1	2.1	2.2
Real Disposable Income (a)	4.9	5.6	2.3	1.5	1.2	1.0	0.8	0.9	1.0	1.0	1.4	1.9	-1.0	0.9	1.0	1.2	-2.1	1.8	1.6	1.1	0.7
Nominal Personal Income (b)	1.4	3.2	4.9	5.4	5.8	5.4	5.1	5.0	3.5	3.2	3.5	4.0	4.7	5.4	5.8	6.0	-4.0	3.7	5.4	3.5	5.5
Industrial Production (a)	8.1	7.1	6.7	3.1	4.8	1.0	5.7	1.4	2.2	3.1	4.0	4.1	3.8	3.7	4.1	4.3	-11.1	5.3	4.0	2.9	3.9
Capacity Utilization	72.3	74.0	75.5	76.1	76.8	76.7	77.5	77.3	77.2	77.4	77.5	77.7	78.0	78.3	78.6	79.0	69.2	74.5	77.1	77.4	78.5
Corporate Profits Before Taxes (b)	46.7	41.5	27.4	18.2	8.8	8.3	6.5	6.4	6.2	6.0	6.4	6.6	6.8	7.0	7.2	7.4	7.9	32.2	7.5	6.3	7.1
Corporate Profits After Taxes	36.0	36.2	23.3	17.4	10.6	9.2	6.1	7.2	7.5	7.2	7.5	7.5	7.7	7.9	8.2	8.4	14.2	27.5	8.2	7.4	8.1
Federal Budget Balance (c)	-328.9	-287.0	-290.2	-369.0	-460.5	-141.1	-345.5	-267.0	-355.0	-146.0	-201.0	-210.0	-170.0	-130.0	-185.0	-195.0	-1415.7	-1294.2	-1316.0	-969.0	-695.0
Current Account Balance (d)	-118.3	-120.3	-120.1	-112.2	-119.3	-130.0	-135.0	-140.0	-145.0	-155.0	-165.0	-175.0	-180.0	-185.0	-190.0	-195.0	-376.6	-470.9	-524.3	-640.0	-750.0
Trade Weighted Dollar Index (e)	76.1	78.8	73.6	73.2	70.6	69.4	68.5	69.5	70.5	71.5	72.5	73.0	73.5	74.5	75.5	76.0	77.7	75.6	69.5	71.9	74.9
Nonfarm Payroll Change (f)	39.3	181.0	-45.7	138.7	165.7	96.7	45.0	40.0	50.0	70.0	90.0	110.0	110.0	120.0	130.0	140.0	-421.9	78.3	86.8	80.0	125.0
Unemployment Rate	9.7	9.6	9.6	9.6	8.9	9.1	9.1	9.4	9.5	9.5	9.5	9.4	9.3	9.2	9.1	9.0	9.3	9.6	9.1	9.5	9.2
Housing Starts (g)	0.61	0.60	0.58	0.54	0.58	0.57	0.58	0.55	0.57	0.62	0.67	0.70	0.74	0.82	0.91	0.97	0.55	0.58	0.57	0.64	0.86
Light Vehicle Sales (h)	11.0	11.4	11.6	12.3	13.0	12.1	12.1	12.5	11.9	12.4	12.9	13.3	13.7	14.0	14.3	14.6	10.4	11.6	12.4	12.6	14.2
Crude Oil - WTI - Front Contract (i)	78.72	78.03	76.20	85.17	94.10	102.56	90.23	85.00	85.00	85.00	90.00	95.00	97.00	99.00	101.00	103.00	61.80	79.53	92.97	88.75	100.0
Quarter-End Interest Rates (j)																					
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	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3 Month LIBOR	0.29	0.53	0.29	0.30	0.30	0.25	0.30	0.30	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.69	0.34	0.29	0.33	0.35
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Conventional Mortgage Rate	4.97	4.74	4.35	4.71	4.84	4.51	3.75	3.65	3.80	4.00	4.10	4.20	4.30	4.30	4.40	4.40	5.04	4.69	4.19	4.03	4.35
3 Month Bill	0.16	0.18	0.16	0.12	0.09	0.03	0.02	0.05	0.05	0.10	0.10	0.15	0.20	0.25	0.30	0.40	0.15	0.14	0.05	0.10	0.29
2 Year Note	1.02	0.61	0.42	0.61	0.80	0.45	0.20	0.15	0.15	0.20	0.20	0.30	0.40	0.50	0.60	0.80	0.96	0.70	0.40	0.21	0.58
5 Year Note	2.55	1.79	1.27	2.01	2.24	1.76	0.80	0.80	0.90	1.00	1.20	1.30	1.50	1.60	1.70	1.70	2.20	1.93	1.40	1.10	1.63
10 Year Note	3.84	2.97	2.53	3.30	3.47	3.18	1.75	1.75	2.00	2.20	2.30	2.40	2.60	2.60	2.70	2.70	3.26	3.22	2.54	2.23	2.65
30 Year Bond	4.72	3.91	3.69	4.34	4.51	4.38	3.10	2.90	3.10	3.30	3.40	3.50	3.70	3.70	3.80	3.80	4.08	4.25	3.72	3.33	3.75

Forecast as of: September 7, 2011
Notes: (a) Compound Annual Growth Rate Quarter-over-Quarter
(b) Year-over-Year Percentage Change
(c) Quarterly Sum - Billions USD; Annual Data Represents Fiscal Yr.
(d) Quarterly Sum - Billions USD
(e) Federal Reserve Major Currency Index, 1973=100 - Quarter End

Pace of Global Economic Activity Appears To Be Weak

Recent economic data indicate that growth in global economic activity probably remains positive, but it is weak. The United States is the world's largest economy and recent data suggest that real GDP continues to expand, albeit at a sluggish pace. Measured at current exchange rates, the Eurozone is nearly as large as the U.S. economy. The bad news is that the manufacturing PMI in the Eurozone slipped below the demarcation line separating expansion from contraction in August (see graph on page 1). However, the comparable index for the service sector held steady at 51.5 last month. Taken together, the indices suggest that real GDP in the Eurozone probably is not growing much faster than the anemic 0.6 percent annualized rate that was registered in the second quarter.

Growth rates vary widely within the overall euro area. Greece clearly is struggling as real GDP tumbled 5.5 percent on a year-over-year basis in the second quarter. Since peaking in 2008, real GDP in Greece has declined about 11 percent and further contraction seems likely due, at least in part, to continued fiscal consolidation in the Hellenic Republic. In contrast, German GDP will probably regain its pre-downturn peak within the next quarter or two. However, the pace of growth within Germany has clearly slowed as well. After expanding 4.7 percent in the first three months of the year, which was the strongest year-over-year growth rate in the post-reunification era, real GDP growth downshifted to 2.7 percent in the second quarter, and it appears that growth slowed further in the third quarter. Germany is probably not in recession at present, but the sequential rate of growth is not very strong either.

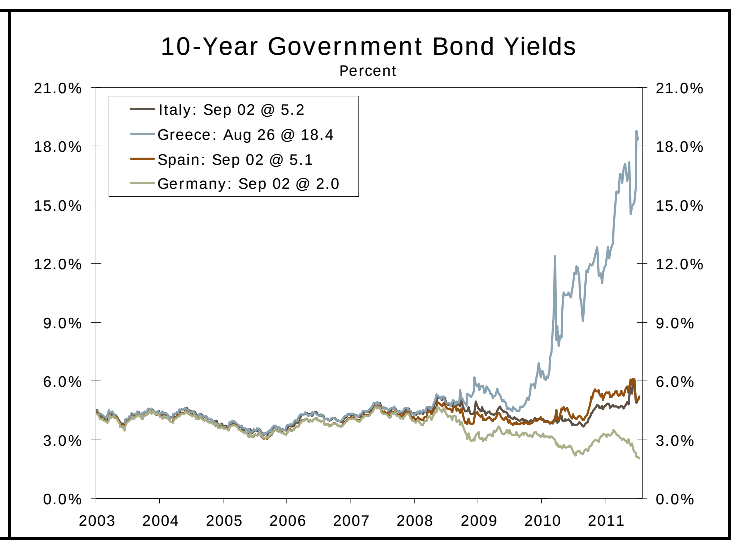
Fortunately, the pace of economic activity appears to be stronger in Asia. For example, industrial production in China, which is the world's second largest individual economy, is up nearly 14 percent on a year-ago basis at present (bottom left chart). Growth rates in other Asian economies appear to be positive as well. However, many Asian economies are sensitive to trends in global trade. Therefore, the slowdown that is painfully apparent in other countries has exerted headwinds on Asian economies. The bottom line is that global economic growth appears to be positive at present, but it clearly has weakened recently. In this slow growth environment, it would not take much of an economic or financial shock to cause some countries, if not the entire global economy, to slip back into recession.

European Sovereign Debt Crisis Continues to Fester

In that regard, the recent intensification of the European sovereign debt crisis is troubling, with Italy now clearly visible in the crosshairs of investor nervousness. The catalyst for the recent unease is bickering among Italian politicians over a deficit reduction package. This political news in conjunction with signs of slower growth in the Eurozone has caused yields on Italian government debt to rise (bottom right chart).

The rise in Italian government bond yields is miniscule relative to the blowout that has occurred in Greece. Unlike Greece, however, Italy is too big to bail out. If investors absolutely refuse to buy Italian government debt, that debt would need to be restructured. This would entail significant losses for investors, including some of Europe's largest banks, who own it. In a worst-case scenario, another global financial crisis could ensue. In that event, the global economy would plunge back into recession.

The European Central Bank (ECB) has been trying to stabilize markets by buying Italian (and Spanish) government bonds, but the ECB can not intervene indefinitely. In order to end the crisis, it may be necessary to increase the financial resources that are available to highly indebted countries. Extending more resources, however, is politically unpopular in some European countries. Therefore, we do not think that a solution to the European sovereign debt crisis is imminent, and we look for financial market volatility to continue for some time.



Source: IHS Global Insight and Wells Fargo Securities, LLC

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2011	2012	2013	2011	2012	2013
Global (PPP weights)	3.5%	3.4%	3.7%	5.4%	4.4%	4.2%
Global (Market Exchange Rates)	2.3%	2.2%	2.5%	n/a	n/a	n/a
Advanced Economies[1]	1.5%	1.6%	2.0%	2.8%	2.0%	1.9%
United States	1.6%	1.4%	1.9%	3.1%	2.4%	2.4%
Eurozone	1.6%	1.1%	1.7%	2.5%	1.7%	1.5%
United Kingdom	1.0%	1.4%	2.2%	4.4%	2.4%	2.0%
Japan	-0.5%	2.3%	1.5%	-0.1%	0.2%	0.2%
Korea	4.2%	4.0%	3.7%	4.5%	3.7%	3.2%
Canada	2.2%	2.2%	3.0%	2.7%	1.7%	2.1%
Developing Economies[1]	5.8%	5.4%	5.7%	8.3%	7.2%	6.8%
China	9.1%	8.4%	9.0%	5.6%	4.1%	3.6%
India	7.1%	7.5%	7.7%	8.7%	7.3%	6.8%
Mexico	3.2%	3.2%	3.4%	3.4%	4.0%	4.0%
Brazil	3.2%	3.6%	3.5%	6.3%	4.7%	4.2%
Russia	4.1%	3.4%	3.1%	8.9%	8.0%	7.7%

Forecast as of: September 7, 2011

[1]Aggregated Using PPP Weights

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond				
	2011		2012				2011		2012		
	Q3	Q4	Q1	Q2	Q3	Q4	Q3	Q4	Q1	Q2	Q3
U.S.	0.30%	0.30%	0.30%	0.30%	0.35%	0.35%	1.75%	1.75%	2.00%	2.20%	2.30%
Japan	0.20%	0.20%	0.20%	0.20%	0.20%	0.20%	1.07%	1.10%	1.14%	1.16%	1.18%
Euroland*	1.50%	1.50%	1.50%	1.50%	1.50%	1.70%	1.75%	2.00%	2.10%	2.20%	2.40%
U.K.	0.90%	0.70%	0.60%	0.60%	0.60%	0.70%	2.25%	2.50%	2.60%	2.70%	2.90%
Canada	1.15%	1.15%	1.15%	1.50%	1.75%	2.00%	2.20%	2.50%	2.60%	3.10%	3.25%

Forecast as of: September 7, 2011

*10-year German Government Bond Yield

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 715-0314	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economist	(704) 374-4407	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 715-0569	michael.a.brown@wellsfargo.com
Tyler B. Kruse	Economic Analyst	(704) 715-1030	tyler.kruse@wellsfargo.com
Joe Seydl	Economic Analyst	(704) 715-1488	joseph.seydl@wellsfargo.com
Sarah Watt	Economic Analyst	(704) 374-7142	sarah.watt@wellsfargo.com

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