March 08, 2013

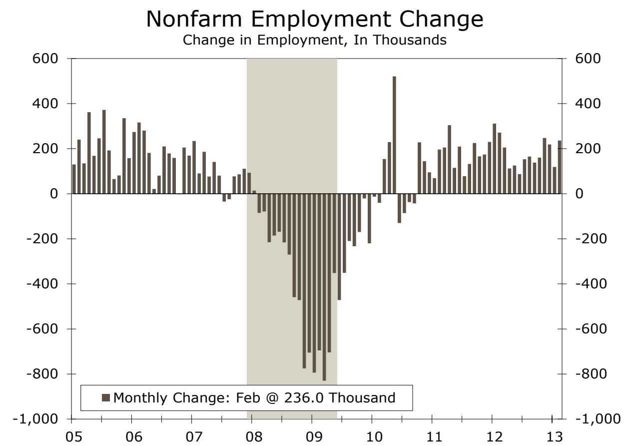
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Are Things Looking Up?

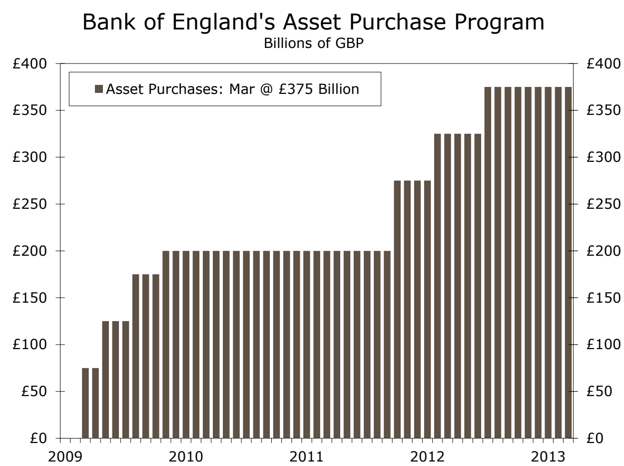
- Nonfarm payrolls increased by a stronger-than-expected 236,000 jobs in February. Average hours worked and earnings also rose, which bodes well for income growth.
- The unemployment rate fell to 7.7 percent from 7.9 percent on the back of an increase in household employment and a drop in the labor force.
- The ISM non-manufacturing index posted another solid reading in February. The index rose to 56 with gains across most categories.



Global Review

Bank of England and ECB Remain on Hold

- Both the Bank of England and the European Central Bank remained on hold this week. However, some analysts could argue that even further policy accommodation would be appropriate given continued weakness in both economies.
- The Chinese economy shows signs of strengthening. Although, the government recently raised a tax on second-home purchases, a wholesale tightening of policies in China does not seem likely until the global economy is stronger.



Wells Fargo U.S. Economic Forecast

	Actual 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	3.1	0.1	2.8	2.2	2.3	2.2	2.4	1.8	2.2	2.0	2.3
Personal Consumption	2.4	1.5	1.6	2.1	2.1	1.5	1.6	1.6	1.8	2.5	1.9	1.8	1.7
Inflation Indicators [2]													
PCE Deflator	2.4	1.6	1.5	1.6	1.0	1.2	1.2	1.3	1.9	2.4	1.8	1.2	1.9
Consumer Price Index	2.8	1.9	1.7	1.9	1.5	1.7	1.7	1.7	1.6	3.1	2.1	1.6	2.1
Industrial Production [1]	5.9	2.4	0.5	2.6	3.5	3.5	4.1	4.1	5.4	4.1	3.8	3.0	3.8
Corporate Profits Before Taxes [2]	10.3	6.7	7.5	5.0	4.8	5.2	5.3	5.7	26.8	7.3	7.3	5.3	6.4
Trade Weighted Dollar Index [3]	72.7	74.5	72.7	73.4	73.0	74.0	75.0	76.0	75.4	70.9	73.5	74.5	76.8
Unemployment Rate	8.3	8.2	8.0	7.8	7.8	7.6	7.5	7.4	9.6	8.9	8.1	7.6	7.2
Housing Starts [4]	0.71	0.74	0.77	0.90	0.90	0.96	1.02	1.08	0.59	0.61	0.78	0.97	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	3.35	3.50	3.60	3.70	3.80	4.69	4.46	3.66	3.65	4.20
10 Year Note	2.23	1.67	1.65	1.78	1.90	2.00	2.10	2.20	3.22	2.78	1.80	2.05	2.60

Forecast as of: March 1, 2013
[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. Dept. of Commerce, U.S. Dept. of Labor, Federal Reserve Board, Bloomberg LP, IHS Global Insight and Wells Fargo Securities, LLC

Inside

U.S. Review

Are Things Looking Up?

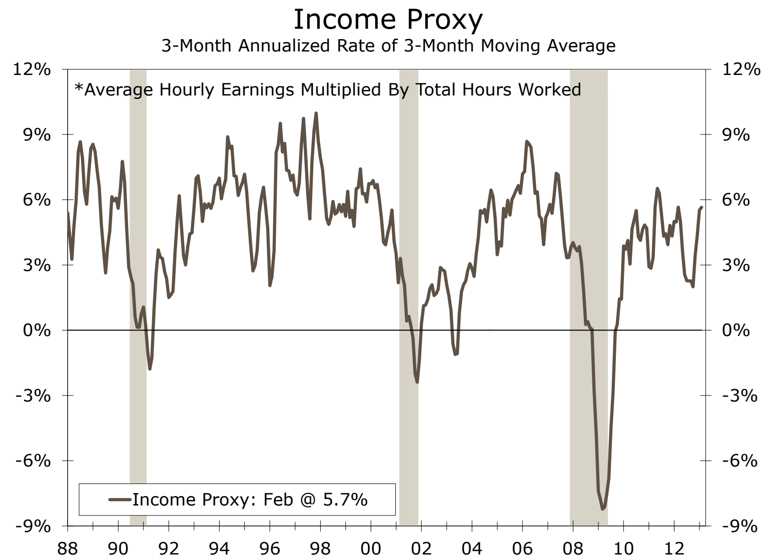
Data this week showed that the economy continues to gain momentum despite fears that the end of the payroll tax holiday and sequestration would slow growth early on in the year. Nonfarm payrolls rose more than expected in February. Employers added 236,000 jobs during the month, with widespread gains across the private sector. Government jobs, on the other hand, continued to decline, this month falling by 10,000. Federal budget pressures are evident in recent job cuts to federal employment, but the effects of the sequestration were not obvious in February's data as many agencies thought a last-minute deal would be reached. Non-postal service hiring fell by 4,200 jobs, but the decline was not dramatically different from losses over the previous four months, which averaged 2,900.

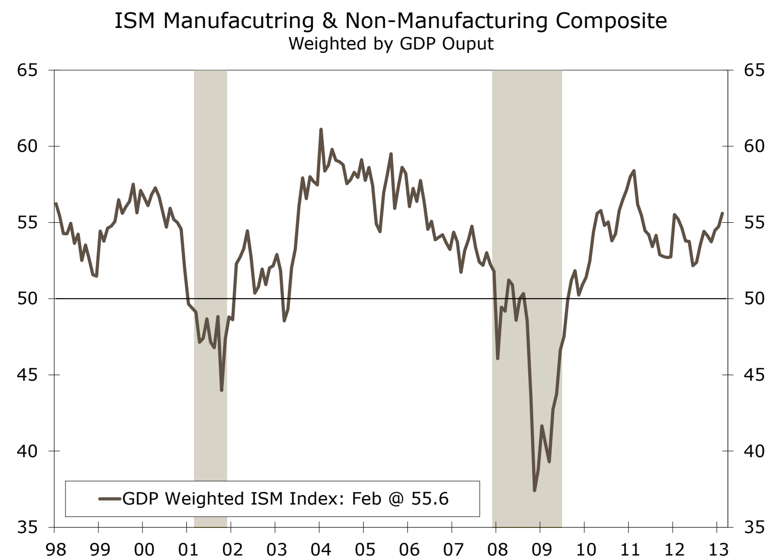
In addition to strong private sector hiring, today's report showed a pickup in average weekly hours and earnings. Average weekly hours ticked up to 34.5, and when combined with a 0.5 percent rise in earnings, suggest better income growth ahead. The unemployment rate fell to 7.7 percent from 7.9 percent in January. The improvement was driven by stronger household employment, but also a decline in the labor force. The labor force participation rate fell to 63.5 percent and will continue to be an issue in the discussion over what constitutes "full employment."

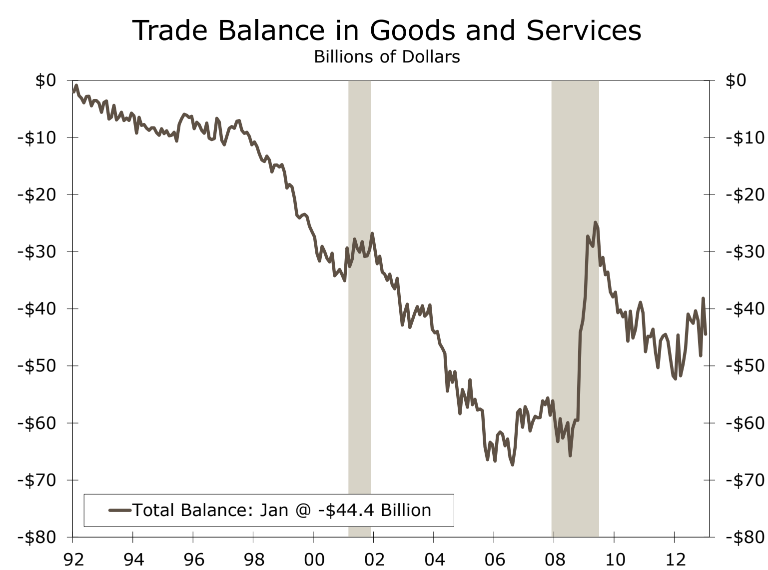
Elsewhere this week, the ISM non-manufacturing index showed that activity outside the factory sector continued to expand at a healthy clip. The composite index rose to 56.0, its highest reading in one year. The employment component edged slightly lower but, at 57.2, corroborates today's nonfarm payrolls report that hiring continues at a decent pace. Not surprising given the rise in energy prices in February, the prices paid component crept higher. Prices paid for both the ISM manufacturing and non-manufacturing indexes are now back above 60 and suggest some margin pressures if rising input costs cannot be passed on to end-users. On a GDP-weighted basis, a composite of the ISM manufacturing and non-manufacturing indexes shows business activity increasing at the fastest pace in two years, supporting our view of stronger GDP growth in the first quarter.

Factory orders for January looked better than expected. Durable goods orders declined a bit less than in the advanced report last week, with weakness concentrated in the volatile transportation sector. Nondurable goods were somewhat stronger. Orders and shipments for shorter-lasting goods each snapped a two-month string of declines and rose 0.6 percent. Shipments of durable goods fell 1.2 percent in January, but we believe equipment and software spending will gradually increase over the first quarter.

As expected, the trade deficit widened in January. The balance of goods and services fell to -$44.4 billion from -$38.1 billion. The wider gap stemmed from both a drop in exports and increase in imports. Petroleum products drove the rebound in imports, jumping $3.7 billion. Despite the first quarter getting off to a weak start, we believe net exports will provide a modest contribution to growth as the year moves on.







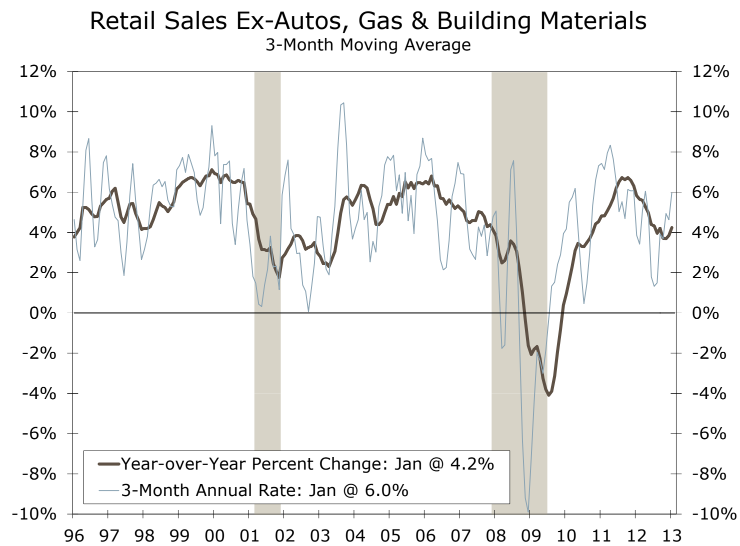
Source: U.S. Department of Labor, ISM, U.S. Department of Commerce and Wells Fargo Securities, LLC

Retail Sales • Wednesday

Retail sales edged modestly higher in January, but control group sales (excludes autos, gas and building materials) came in weaker than expected. Much of the weakness was due to a sizeable drop in miscellaneous sales which tumbled due to office supply sales. Control group sales are directly factored into consumer spending and, at first glance, suggest a weak start to the year. However, the drop in miscellaneous sales is likely an isolated occurrence. Department stores, electronics and non-store retailers all showed gains in January. In fact, non-store retailers are up a solid 17.5 percent over the past year. Online sales growth has now outpaced retail sales over the past few years due to increased smartphone and tablet penetration, investment in e-commerce and social networking. Outside of the control group, vehicle sales retreated, but building materials and gasoline station sales increased on the month. We suspect that retail sales will continue to show gains.

Previous: 0.1% (Month-over-Month) Wells Fargo: 0.6%

Consensus: 0.5%

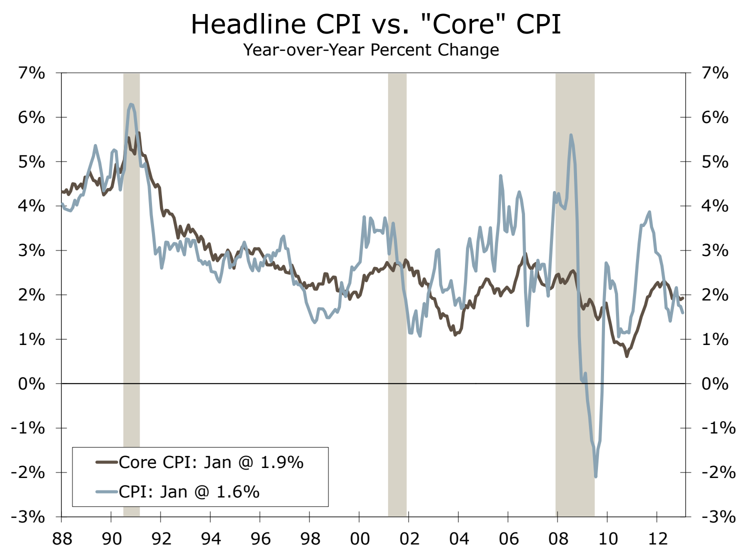


Consumer Price Index • Friday

Headline consumer prices have been flat over the past two months as the modest boost in services for items such as housing and apparel were offset by a retreat in commodity prices. Since the beginning of the year, retail gasoline prices have increased steadily which has somewhat crimped consumer purchasing power and constrained consumer spending. We expect this trend to continue, which means that headline consumer prices will continue to be heavily influenced by the energy sector. That said, core prices, which exclude food and energy, were stronger than expected in January and are now up nearly 2 percent over the past year. Airline fares, medical care, shelter and apparel showed the largest gains. While core prices are modestly increasing, we do not expect runaway inflation as some are purporting. Housing, which makes up about 40 percent of core consumer prices, still has many obstacles to overcome and inflation expectations remain stable.

Previous: 0.0% (Month-over-Month) Wells Fargo: 0.5%

Consensus: 0.5%

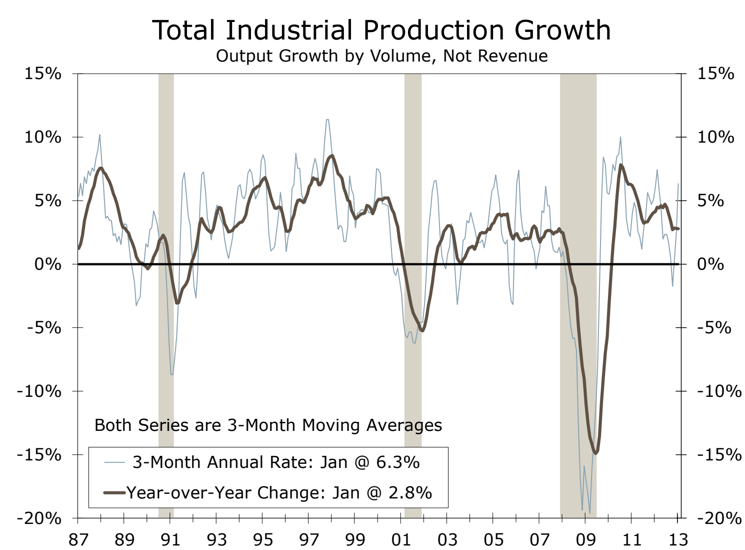


Industrial Production • Friday

Industrial production retreated in January with manufacturing and mining output tumbling on the month. However, utilities output jumped 3.5 percent as weather played a large role. Despite the decline in the headline, solid upward revisions to previous months' data suggest the trend in industrial production is a bit more promising. One bright spot was capacity utilization which increased to 79.1 percent. In fact, we expect capacity utilization to edge modestly higher in February to a reading of 79.3 percent. That said, headline industrial production should increase 0.3 percent in February with manufacturing output improving. Indeed, the ISM manufacturing index showed a solid gain in February and now sits firmly in positive territory at 54.2. Moreover, the forward-looking new orders component jumped 4.5 points to 57.8, the highest level since April 2011. Regional manufacturing reports also support the gain.

Previous: -0.1% (Month-over-Month) Wells Fargo: 0.3%

Consensus: 0.3%



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

Global Review

Bank of England and ECB Remain on Hold

As widely expected, the Bank of England kept its main policy rate unchanged this week at 0.50 percent, where it has been maintained for nearly four years. The Monetary Policy Committee (MPC) also decided to keep its amount of quantitative easing (QE) unchanged at £375 billion (see graph on front page). However, given the closeness of the vote in last month's policy meeting—two MPC members joined Governor King in voting for an increase in the amount of QE while 6 members did not support an increase—there were some analysts who had expected an increase in QE this week.

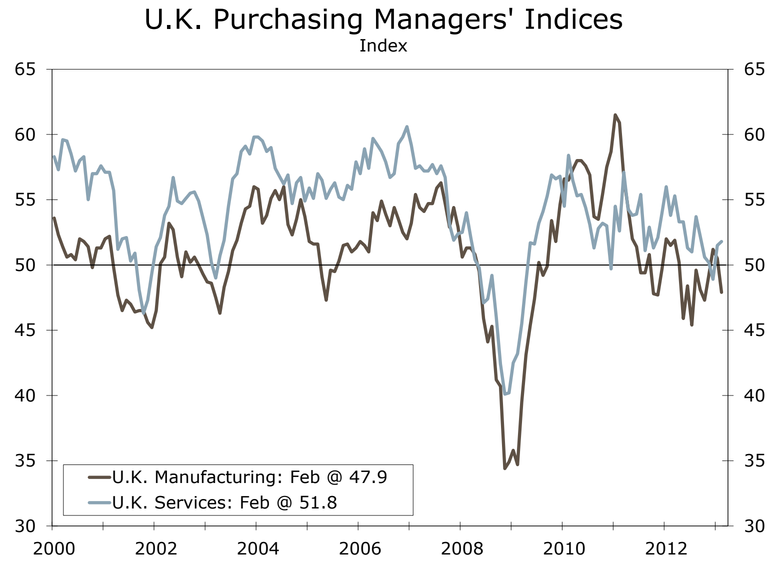
Supporting the case for further policy accommodation are signs of continued sluggish growth. For example, the manufacturing PMI slipped into contraction territory again in February, and the comparable index for the service sector continues to hover just above the demarcation line separating expansion from contraction (top chart). On the other hand, CPI inflation continues to run above the MPC's 2 percent target. (The year-over-year rate of CPI inflation in January was 2.7 percent.) The minutes of the policy meeting, which will be released in two weeks, will help investors determine how much support further easing commands on the MPC.

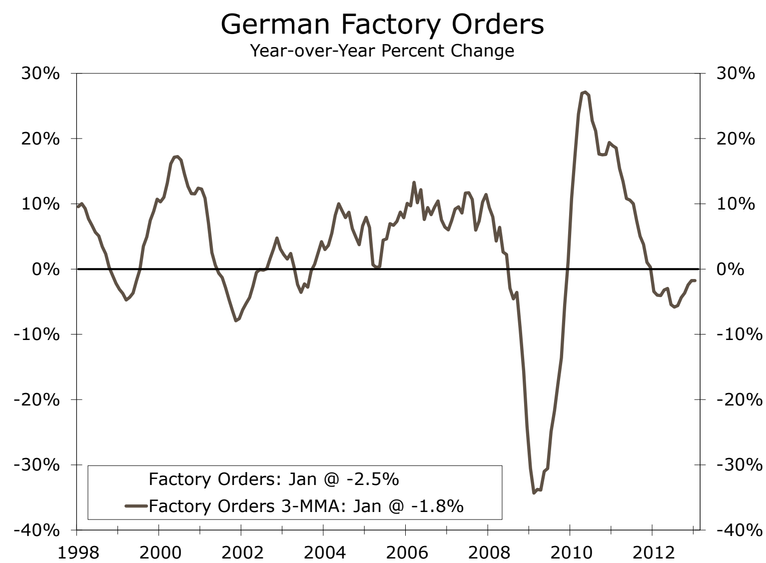
The ECB also decided to remain on hold this week, although recent indicators suggest that more accommodative policy could be considered appropriate in the Eurozone. For example, German factory orders declined 1.9 percent in January relative to the previous month, which was disappointing in light of the strength in German business sentiment indicators in recent months. German industrial production (IP) was flat in January, but it was boosted by an outsized increase in construction. Manufacturing production declined 0.2 percent in January, leaving it more than one percent below year-ago levels. Analysts do not expect the January IP data for other countries in the euro area that are slated for release over the next two weeks to be strong.

In his post-meeting news conference ECB President Draghi acknowledged the weak growth environment at present and said that it "will allow our monetary policy stance to remain accommodative." In other words, the ECB will not be tightening policy anytime soon. If the outlook darkens even further, the ECB could actually ease policy further.

Chinese Economy Continues to Perform Well

Fortunately, the Chinese economy appears to be picking up some steam early in 2013. Growth in industrial production has returned to the double-digit range, and the export data for February that were released this week were stronger than most analysts had expected (bottom chart). Indeed, signs that the property market is booming again has led the government to increase a tax on second-home purchases. That said, we do not look for a wholesale tightening of Chinese economic policies at the moment. As long as the outlook for the global economy remains somewhat clouded, Chinese policymakers likely will err on the side of accommodative economic policies.





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

China Industrial Production • Saturday

The week will start early, with several releases coming from China over the weekend. Saturday we will get the consumer price index for February, which is expected to come in at 3.0 percent year-over-year compared to a 2.0 percent reading for the 12 months ending in January. We will also get industrial production and retail sales on Saturday, and both are expected to have remained strong. Industrial production in Jan./Feb. is expected to increase 10.3 percent year-over-year, the same growth rate recorded in December, while retail sales in Jan./Feb. are expected to increase 15.2 percent year-over-year, which is also the same increase printed in December. Thus, if Chinese numbers come in according to plan, the week is going to be relatively uneventful. However, if Chinese numbers come in weaker than expected, we could see some increased nervousness from markets as they digest the potential consequences for worldwide economic growth.

Previous: 10.3% (Year-over-Year)

Consensus: 10.3%

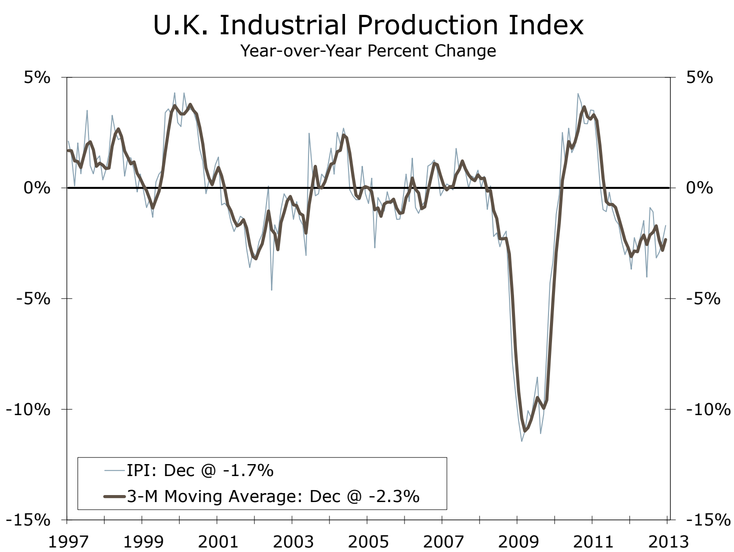
U.K. Industrial Production • Tuesday

U.K. industrial production was strong in December, surprising markets with a 1.1 percent increase versus November. Furthermore, markets are expecting January's number to have improved further, this time up 0.1 percent over December. Even though a 0.1 percent increase is a "small" number, the fact that it is expected to come after a 1.1 percent increase in the previous month makes that number stronger.

However, Germany's weak industrial production performance in January may be a signal that December's number was an exception rather than the rule. Germany's industrial production performance for December was revised up from an originally published 0.3 percent increase to a 0.6 percent increase. This upward revision put a larger threshold on January's result. In the case of the United Kingdom, industrial production will need to be very strong in January to post a positive number compared to December.

Previous: -1.7% (Year-over-Year)

Consensus: -1.1%



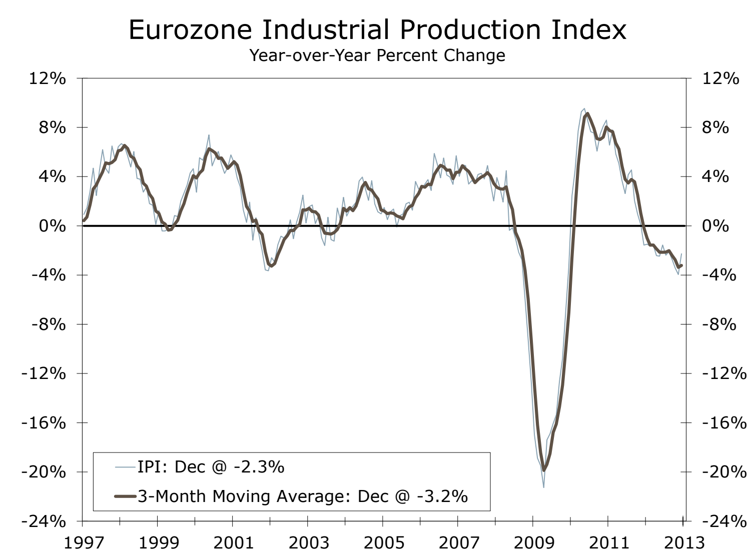
Eurozone Ind. Prod. • Wednesday

After the flat performance for Germany's industrial production in January, 0.0 percent versus the previous month and down 1.3 percent versus a year earlier, the expectation for Eurozone industrial production has suddenly dimmed. Before the release of the German result, consensus was looking for a flat performance over December. Now, the most likely scenario probably will be a slightly negative number for the entire region.

On a positive note, Germany's industrial production for December was bumped up from an originally reported increase of 0.3 percent to an increase of 0.6 percent. However, the recent performance has made the ECB change its view on economic growth for 2013. Now the ECB is estimating that the Eurozone economy will contract a little more than originally thought. The ECB has lowered its estimate for the region's economy to -0.5 percent.

Previous: -2.3% (Year-over-Year)

Consensus: -2.0%



Source: IHS Global Insight and Wells Fargo Securities, LLC

Interest Rate Watch

Fundamentals Frame Monetary Policy, But Rates Do Not

Dissonance is reflected in the split between the economic fundamentals and actual market interest rates on benchmark Treasury issues. This split presents a challenge to decision makers when making choices on financing and investment options.

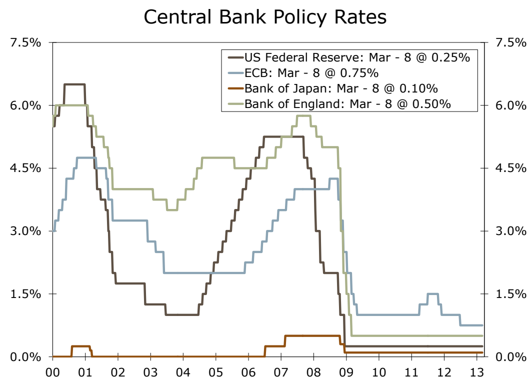
Fundamentals Driving Policy

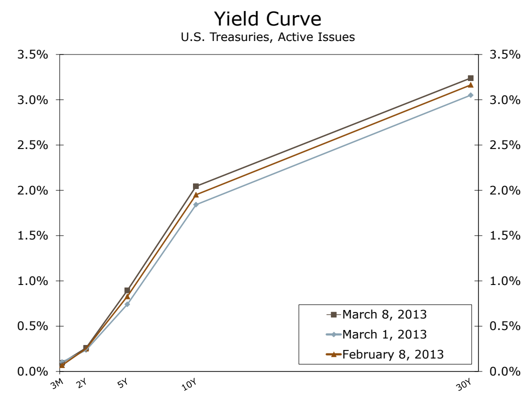
Chairman Bernanke makes clear that the economic fundamentals, as he views them, support the case for continued Fed easing. Economic growth remains subpar and the current unemployment rate of 7.7 percent is certainly far above the Fed's threshold of 6.5 percent for a revaluation of policy. Meanwhile, expected inflation and market measures of inflation expectations support the Fed's view that inflation, at present, is not an issue to halt the current easing policy. Given the fundamentals of subpar growth and low inflation/inflation expectations, we anticipate continued Fed asset purchases through the rest of this year and certainly no increase in the Federal funds rate.

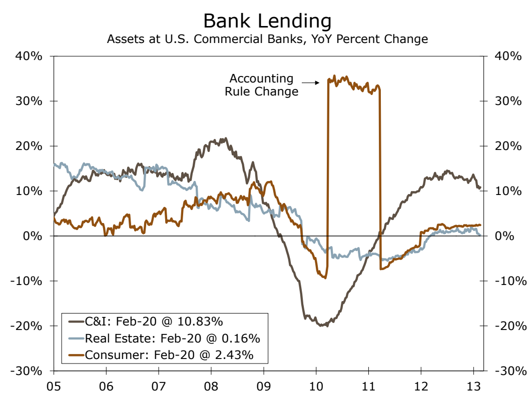
Market Pricing Disconnect

While we continue to expect that Fed policy will maintain the pattern of current low interest rates, there is a sharp disconnect with market pricing if there was not continued Fed easing. That disconnect will no doubt surprise investors and decision makers sometime in the future when markets reprice and Fed policy shifts.

Three problems are readily apparent. First, the consumer price inflation at a "low" rate of 1.7 percent year-over-year as of January and 5-year inflation expectations as of the University of Michigan Survey at 3 percent suggests that the current 5-year yield below one percent does not reflect a true market yield, but a yield driven by a policy decision that will reverse. Effectively, decision makers do not have a true "free market risk-free rate" to make informed judgments. Second, savers face even greater negative returns. Finally, there is the reinvestment risk for real estate and government finance when, as was true in 2006-2008, interest rates reset—as they always have.







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

Credit Market Insights

Households Continue Deleveraging

The Federal Reserve released the Q4 Flow of Funds report yesterday showing that household debt increased at a 2.5 percent annual rate. However, household debt as a percent of disposable income continues its steady decline, which started in Q2 2009, reaching just over 100 percent in Q4. This is the lowest reading since 2003. Household net worth is also growing at a steady pace and has risen to $66.1 trillion, just $1 trillion below the prerecession peak. As net worth continues to grow and household balance sheets continue to become less leveraged, consumers should be putting themselves in a more sustainable financial situation. As long as consumers taking on less debt does not greatly affect the degree of consumer spending this should be a positive sign for the economy all around.

Despite a continued decline in household debt as a percent of disposable income, the amount of household liabilities reported its first year-over-year growth since the recession, up 0.2 percent. Although this is a very small increase, it may suggest that consumers are slowly becoming more comfortable with their current financial situation, and are more apt to take on larger purchases that would previously have been unrealistic. With interest rates remaining at historically low levels, consumers may find that the time is now to start getting back into the market for larger purchases, as the *potential* for the Fed to raise interest rates continues to grow.

Credit Market Data

Mortgage Rates	Current	Week Ago	4 Weeks Ago	Year Ago
30-Yr Fixed	3.52%	3.51%	3.53%	3.88%
15-Yr Fixed	2.76%	2.76%	2.77%	3.13%
5/1 ARM	2.63%	2.61%	2.63%	2.81%
1-Yr ARM	2.63%	2.64%	2.53%	2.73%
Bank Lending	**Current Assets (Billions)**	**1-Week Change (SAAR)**	**4-Week Change (SAAR)**	**Year-Ago Change**
Commercial & Industrial	$1,522.1	6.41%	4.88%	10.83%
Revolving Home Equity	$505.3	-10.01%	-8.14%	-8.00%
Residential Mortgages	$1,616.5	-5.25%	0.84%	3.55%
Commerical Real Estate	$1,420.6	-12.58%	-5.32%	-0.41%
Consumer	$1,115.7	-1.96%	4.83%	2.43%

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

Topic of the Week

Government Spending: Three Faces of Change

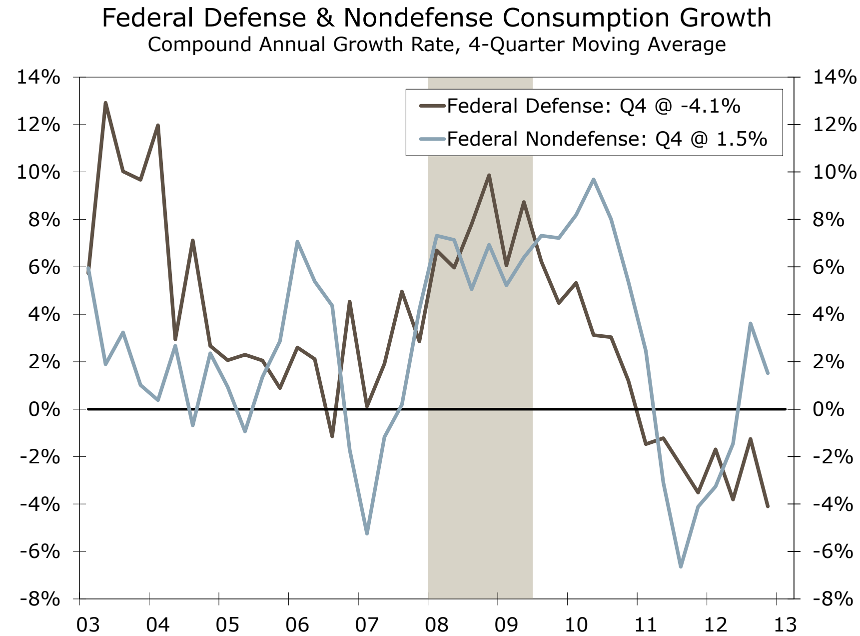
Overall government spending within the GDP accounts is divided into three parts and, of these three parts, the local governments have the strongest influence on government spending growth. Real GDP growth in the fourth quarter was flat, and the main culprit was a large pullback in federal spending, specifically federal defense spending. While the story of state and local government restructuring has been dominant for a while, the downturn in federal spending is just beginning. This has raised concerns by many of further dampening effects on overall GDP growth as federal budget cutting begins.

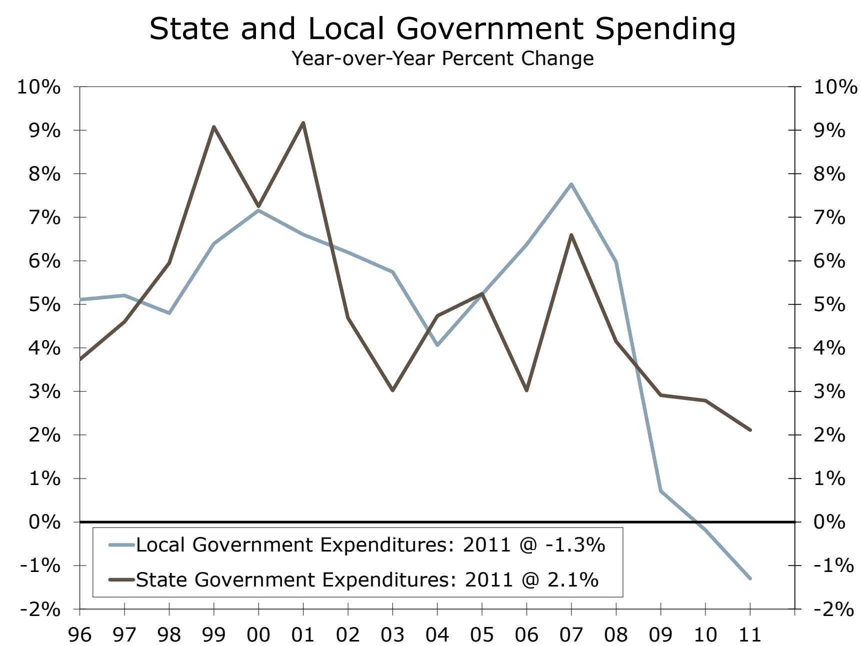
At the federal level, two distinct patterns of spending are illustrated in the top graph. On the one hand, federal defense spending growth has declined in recent years and, in fact, the pace of defense spending growth was actually declining prior to the onset of the Great Recession. In contrast, nondefense spending has a more volatile pattern as evidenced most recently by the rebound into positive spending territory.

In contrast, state and local spending exhibited modest growth prior to the recession and then dipped during the recession, then was temporarily boosted by the stimulus package but subsequently has sharply fallen off and remains in negative territory. Until recently, state and local governments have been a drag on economic growth. Beginning this year, we expect that state government spending will begin to come back slowly while local government spending will remain restrained.

This year should mark the fourth year of 2 percent growth in the U.S. economy. Reductions in government spending will likely continue to weigh on economic growth over the next couple of years. The reality of a new slower pace of revenue growth in a modest economic growth environment has set in for state and local governments but has yet to be realized by federal policymakers.

For further details see our report entitled *Government Spending: Three Faces of Change*.





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

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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 3/8/2013	1 Week Ago	1 Year Ago
3-Month T-Bill	0.09	0.10	0.08
3-Month LIBOR	0.28	0.28	0.47
1-Year Treasury	0.20	0.18	0.22
2-Year Treasury	0.26	0.23	0.31
5-Year Treasury	0.89	0.74	0.88
10-Year Treasury	2.05	1.84	2.01
30-Year Treasury	3.24	3.05	3.17
Bond Buyer Index	3.86	3.74	3.84

Foreign Exchange Rates

	Friday 3/8/2013	1 Week Ago	1 Year Ago
Euro ($/€)	1.299	1.302	1.328
British Pound ($/₤)	1.495	1.504	1.583
British Pound (₤/€)	0.869	0.866	0.839
Japanese Yen (¥/$)	95.990	93.590	81.560
Canadian Dollar (C$/$)	1.026	1.027	0.990
Swiss Franc (CHF/$)	0.952	0.943	0.908
Australian Dollar (US$/A$	1.024	1.020	1.064
Mexican Peso (MXN/$)	12.672	12.758	12.679
Chinese Yuan (CNY/$)	6.216	6.223	6.316
Indian Rupee (INR/$)	54.291	54.905	50.287
Brazilian Real (BRL/$)	1.951	1.980	1.761
U.S. Dollar Index	82.704	82.313	79.139

Foreign Interest Rates

	Friday 3/8/2013	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.13	0.13	0.81
3-Month Sterling LIBOR	0.51	0.51	1.04
3-Month Canadian LIBOR	1.19	1.19	1.38
3-Month Yen LIBOR	0.16	0.16	0.20
2-Year German	0.09	0.03	0.16
2-Year U.K.	0.25	0.20	0.44
2-Year Canadian	0.99	0.94	1.17
2-Year Japanese	0.05	0.05	0.12
10-Year German	1.52	1.41	1.80
10-Year U.K.	2.05	1.87	2.15
10-Year Canadian	1.93	1.80	2.01
10-Year Japanese	0.65	0.66	0.99

Commodity Prices

	Friday 3/8/2013	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	91.37	90.68	106.58
Gold ($/Ounce)	1579.57	1576.23	1699.77
Hot-Rolled Steel ($/S.Ton)	612.00	614.00	690.00
Copper (¢/Pound)	349.95	348.15	378.60
Soybeans ($/Bushel)	15.01	14.82	13.22
Natural Gas ($/MMBTU)	3.61	3.46	2.27
Nickel ($/Metric Ton)	16,586	16,539	18,808
CRB Spot Inds.	534.75	536.90	542.17

Next Week's Economic Calendar

	Monday 11	Tuesday 12	Wednesday 13	Thursday 14	Friday 15
U.S. Data		**Monthly Budget Stmt** January $2.883B February -$205.0B (W)	**Import Price Index** January 0.6% February 0.4% (W) **Retail Sales (MoM)** January 0.1% February 0.6% (W) **Business Inventories** December 0.1% January 0.1% (W)	**Current Acct Balance** 3Q -$107.5B 4Q -$110.0B (W) **PPI (MoM)** January 0.2% February 0.6% (W)	**CPI (MoM)** January 0.0% February 0.5% (W) **Industrial Production** January -0.1% February 0.3% (W) **Capacity Utilization** January 79.1% February 79.3% (W)
Global Data	**Japan** **Tertiary Ind. Index** Previous (Dec) 1.4%	**U.K.** **IP (YoY)** Previous (Dec) -1.7% **Mexico** **IP (YoY)** Previous (Dec) -1.1%	**Eurozone** **IP (YoY)** Previous (Dec) -2.3%	**Japan** **IP (YoY)** Previous (Jan) -5.1% **Brazil** **Retail Sales (YoY)** Previous (Dec) 5.0%	**Eurozone** **CPI (YoY)** Previous (Jan) 1.8%

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

Source: Bloomberg LP and Wells Fargo Securities, LLC

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