August 07, 2009

WELLS FARGO SECURITIES

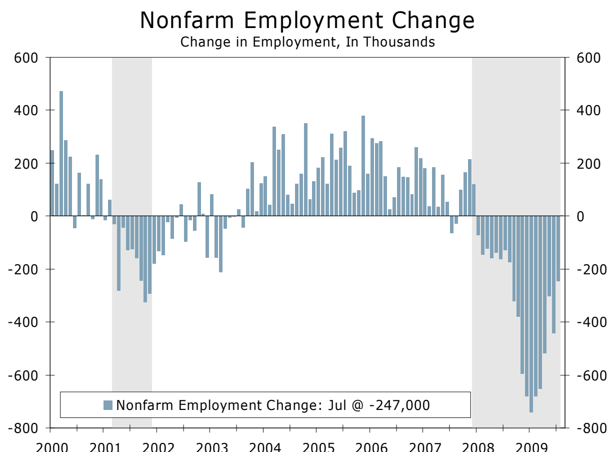
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

"Better News" but Still not Quite Good News

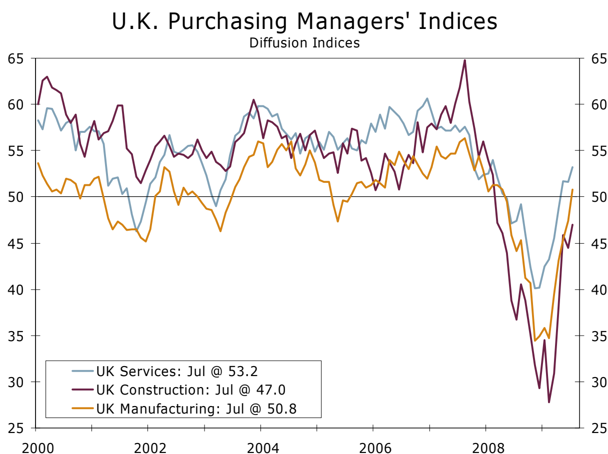
- July's drop in nonfarm payrolls, smaller than consensus expectations, and slight decline in the unemployment rate raises the probability the recession has ended.
- The re-opening of motor vehicle assembly plants has temporarily boosted the employment data and many other economic reports. We may see a payback in coming months.
- Final demand appears to have improved slightly in July but incomes remain under pressure.



Global Review

More Evidence that the U.K. Economy has Bottomed

- The current recession in Great Britain is roughly as severe as the deep downturn that occurred between 1979 and 1981. However, evidence continues to accumulate that the economy is bottoming.
- To help insure that the economy does not enter a renewed slide, the Bank of England decided this week to increase the size of its asset purchase program, an unconventional method to ease monetary policy. If, as we expect, the economy picks up some steam in the quarters ahead, the Bank will not need to ease policy further.



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Wells Fargo U.S. Economic Forecast

	Actual				Forecast				Actual				Forecast	
	2008				2009									
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2005	2006	2007	2008	2009	2010
Real Gross Domestic Product [1]	0.9	2.8	-0.5	-6.3	-5.5	-1.6	2.2	1.6	2.9	2.8	2.0	1.1	-2.4	1.7
Personal Consumption	0.9	1.2	-3.8	-4.3	1.4	-0.6	1.7	1.0	3.0	3.0	2.8	0.2	-0.7	1.3
Inflation Indicators [2]														
"Core" PCE Deflator	2.2	2.3	2.3	1.9	1.8	1.8	1.3	1.2	2.1	2.3	2.2	2.2	1.5	1.0
Consumer Price Index	4.2	4.3	5.2	1.5	-0.2	-1.2	-2.6	-0.2	3.4	3.2	2.9	3.8	-1.0	1.0
Industrial Production [1]	0.2	-4.6	-9.0	-13.0	-19.0	-14.3	3.1	2.9	3.3	2.3	1.5	-2.2	-11.1	1.3
Corporate Profits Before Taxes[2]	-1.5	-8.3	-9.2	-21.5	-17.6	-16.0	-12.0	-8.0	17.6	15.2	-1.6	-10.1	-13.7	5.8
Trade Weighted Dollar Index[3]	70.3	71.0	76.1	79.4	83.2	77.2	82.6	85.0	86.0	81.5	73.3	79.4	85.0	85.0
Unemployment Rate	4.9	5.4	6.1	6.9	8.1	9.3	9.8	10.2	5.1	4.6	4.6	5.8	9.3	10.3
Housing Starts[4]	1.06	1.02	0.87	0.66	0.53	0.49	0.52	0.55	2.07	1.81	1.34	0.90	0.52	0.70
Quarter-End Interest Rates														
Federal Funds Target Rate	2.25	2.00	2.00	0.25	0.25	0.25	0.25	0.25	4.25	5.25	4.25	0.25	0.25	0.50
Conventional Mortgage Rate	5.97	6.32	6.04	5.33	5.00	5.42	5.10	5.20	6.27	6.14	6.10	5.33	5.20	5.60
10 Year Note	3.45	3.99	3.85	2.25	2.71	3.53	3.50	3.60	4.39	4.71	4.04	2.25	3.60	4.00

Forecast as of: July 8, 2009
[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

Together we'll go far

U.S. Review

Better News but Less than Meets the Eye

This morning's report that job losses slowed substantially during the month of July and unemployment rate dipped slightly to 9.4 percent is encouraging. Numerous employment surveys and anecdotal reports from businesses suggest the bulk of major layoffs are now behind us. The extent of the improvement and implications for the recovery may be exaggerated, however. What appears to have happened is that businesses slashed output much more dramatically than sales declined, producing a huge drop in business inventories. Nowhere was this more dramatic than in the motor vehicle sector, where the swing in output was amplified by bankruptcies at Chrysler and General Motors. Moreover, the early success of the cash for clunkers program will boost sales through Labor Day and allow vehicle production to bounce back a little further and for a longer period of time.

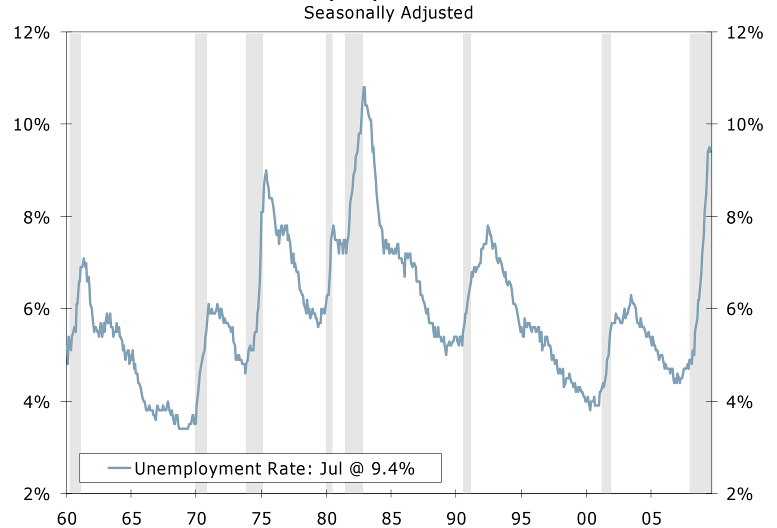
Nonfarm employment fell by 247,000 jobs in July, which is still a pretty hefty drop. Employment losses continue to be exceptionally broad based, with 76,000 jobs lost in construction and 119,000 jobs lost in service-providing industries. One notable area of weakness is retailing, which saw job losses essentially double in July to 44,000. Layoffs also picked up in wholesale trade and distribution. On the plus side, layoffs slowed a bit in the financial sector and temporary staffing companies shed just 10,000 jobs, which is far fewer than seen earlier in the year. Manufacturers shed only 52,000 jobs in July, which was the smallest drop since July of last year.

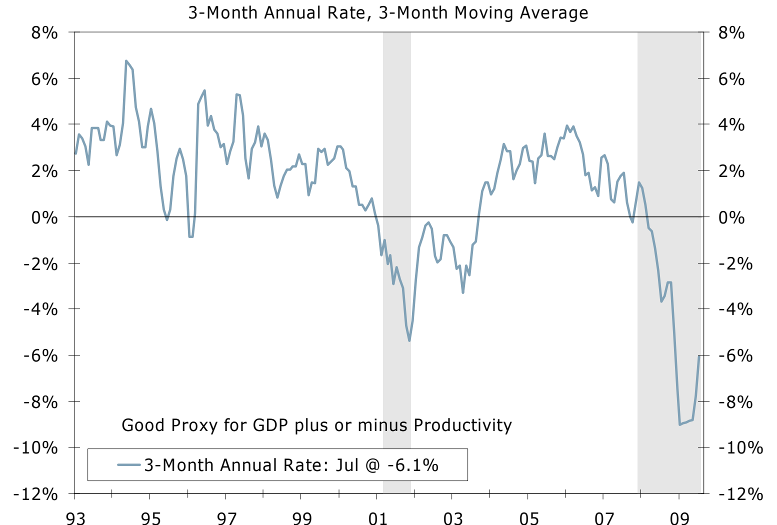
The improvement in the factory sector was mostly due to a rebound in employment in motor vehicles and parts, which added 28,200 jobs. That rebound likely boosted employment in several other sectors as well and was also likely largely responsible for the 0.4 percent rise in aggregate hours worked in the factory sector. Aggregate hours worked in the automotive sector soared at a 12.0 percent annual rate in July. With manufacturing hours up, aggregate hours worked were unchanged in July, which is the first time hours were unchanged since August of last year.

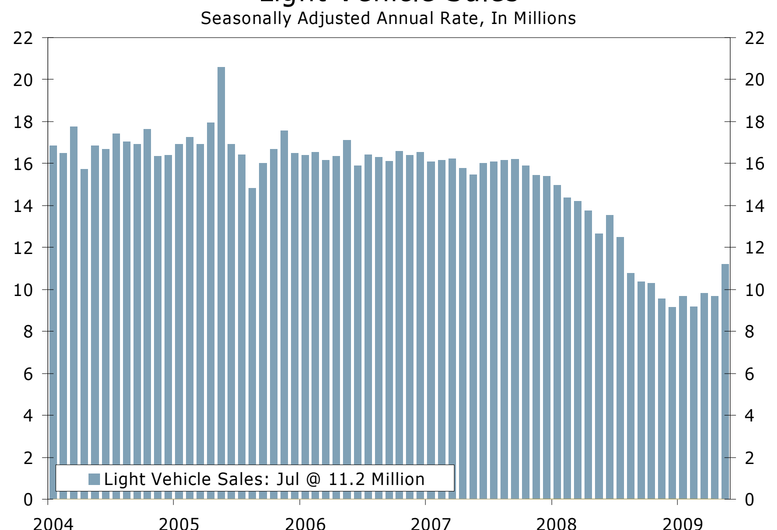
The smaller drop in nonfarm employment and leveling off in hours worked is consistent with the growing consensus that real GDP will grow solidly in the third quarter. We will release our forecast next week and our early read calls for a rise in real GDP at between a 2. 5 percent and a 3.5 percent annual rate.

One factor that will play a big role in driving GDP growth in the current quarter is the improvement in motor vehicle sales. Sales rose to an 11.2 million unit pace in July, a full 1.0 million units above market expectations. The better showing was largely brought about by the cash for clunkers program. Sales will likely rise even further in August. The latest chain store sales also offer some encouragement. While the year-to-year numbers remain off by around five percent, sales rose solidly from June to July.

There were a few other signs that final demand is showing signs of improving. Pending home sales rose solidly in June, climbing 3.6 percent, and factory orders came in much better than expected, rising 0.4 percent in June.





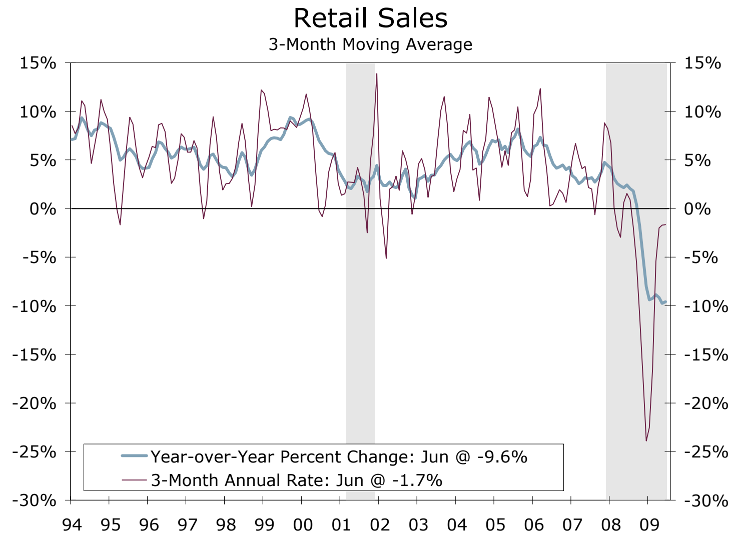


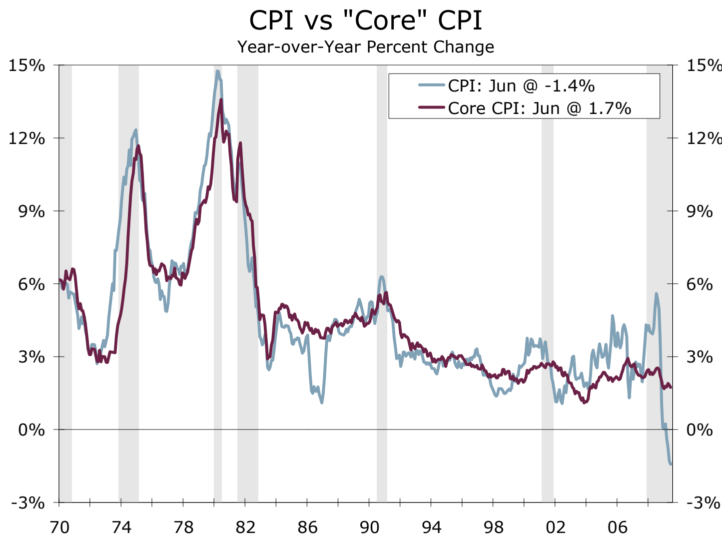
Retail Sales • Thursday

Advance retail sales in July likely rose 0.8 percent, the third consecutive increase. Much of the increase will come from motor vehicles due to the cash-for-clunkers program, which helped to boost manufacturer auto sales to an 11.2 million unit annual rate. The spike in motor vehicle sales, however, will likely be unsustainable once the program expires, which means we could see the gains retraced in coming months. Retail sales excluding autos should increase 0.3 percent. While same store sales, a key indicator of retail sales, fell 5.0 percent from a year ago, the month-over-month figures rose roughly 2.3 percent, which should help to boost retail sales in July. Department and luxury stores, however, continue to be hardest hit as consumers remain cost conscious. We expect consumers will continue to prioritize spending towards essential items until the labor market begins to improve.

Previous: 0.6% **Wells Fargo: 0.8%**

Consensus: 0.4%





Consumer Price Index • Friday

The Consumer Price Index (CPI) likely fell 0.2 percent in July following two consecutive increases in May and June. CPI surged 0.7 percent in June, but the increase was mostly due to soaring gasoline prices. Gasoline prices jumped 17.3 percent during June, accounting for 80 percent of the rise in the overall CPI. Energy prices have moderated considerably over the past month. Oil prices fell by about four dollars a barrel in July to around $66 a barrel. Gasoline prices fell 5.3 percent in July to an average of $2.65 per gallon. Housing, roughly 43 percent of the index, should remain unchanged. Housing remains in oversupply across much of the country and rents on leases nearing expiration are much higher than current rates. As those leases roll over, we should see substantial further moderation in the key rental components over the next year or so, which means the core CPI should continue to moderate well into next year.

Previous: 0.7% **Wells Fargo: -0.2%**

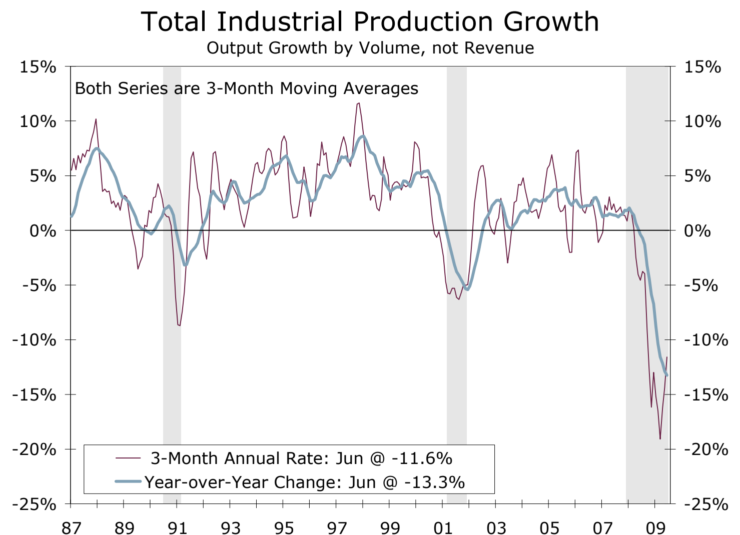
Consensus: 0.0%

Industrial Production • Friday

Industrial production likely rose 0.1 percent, the first increase in nine months. The Chicago Business Barometer and the ISM manufacturing index saw substantial increases in July, but still remain below the expansion/contraction threshold of 50. The headline ISM manufacturing index rose to 48.9 with new orders jumping 6.1 points to 55.3. New orders are typically a leading indicator for industrial production and support the expected gain. Much of the increase, however, will come from motor vehicle and parts output due to the cash-for-clunkers trade-in program. The spike in motor vehicle production, however, will not be sustainable once the program expires. Capacity utilization, which peaked in 2006 at 81.2 percent, will likely increase to 68.2 percent, but remains at historic lows. The abundance of production capacity means pricing power will remain minimal.

Previous: 0.4% **Wells Fargo: 0.1%**

Consensus: 0.1%



Global Review

Has the Recession in the United Kingdom Ended?

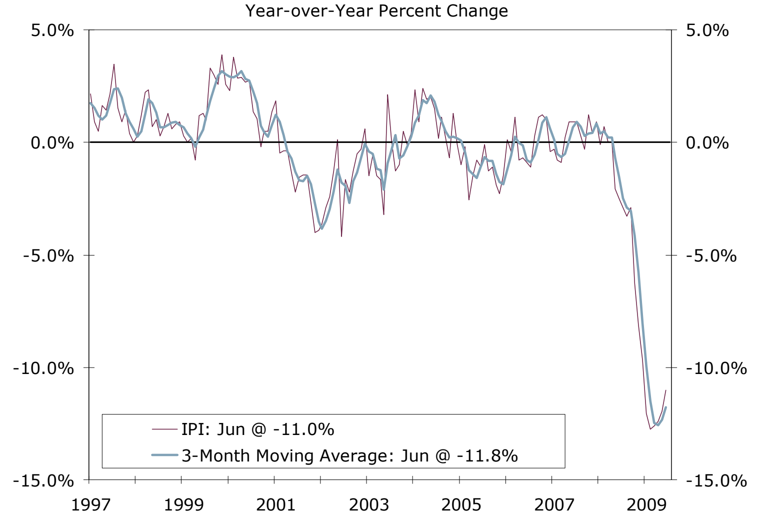
Data released two weeks ago showed that British real GDP fell 0.8 percent (not annualized) in the second quarter relative to the previous quarter, which was much weaker than most investors had expected. From its peak in the first quarter of 2008, the U.K. economy has contracted nearly six percent, equivalent to the deep downturn that occurred between 1979 and 1981.

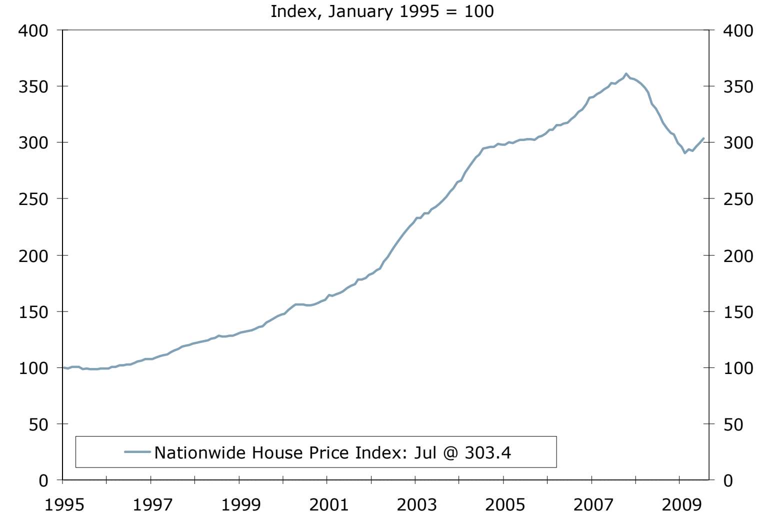
However, anecdotal evidence is starting to suggest that the economy is close to bottoming. As shown on the front page, the purchasing managers' indices for both the manufacturing and service sectors have recently crossed the demarcation line that separates expansion from contraction, the first time both indices have been in positive territory since the spring of 2008. "Hard" data generally confirm the message from the survey evidence. Industrial production rose 0.5 percent in June relative to May, the largest monthly increase since October 2007. June's rise notwithstanding, the level of industrial production remains depressed relative to a year ago (top chart).

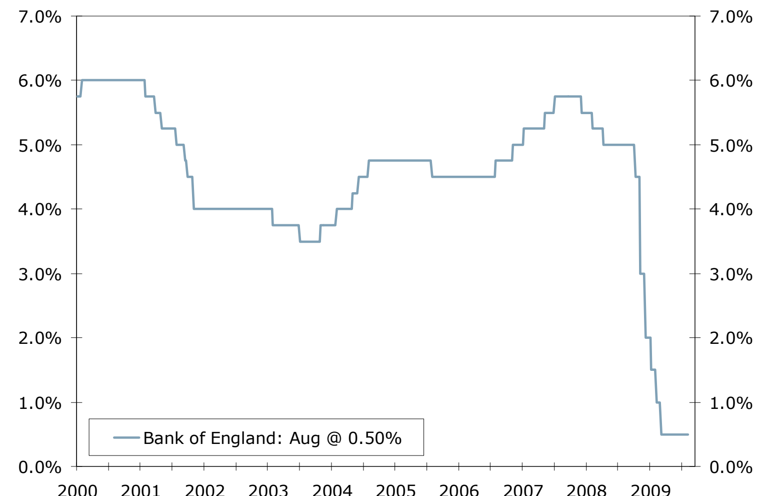
The news on the housing front has also turned positive. A widely followed index of house prices rose 1.3 percent in July, the third month in the past four that house prices have increased. The index is down 15 percent from its peak, but the stabilization in recent months is encouraging (middle chart). Indeed, a respected trade association predicted that house prices will generally be higher at the end of 2009 than they were at the end of last year.

What accounts for the apparent stabilization in the U.K. economy? First, Great Britain is clearly not immune to developments in the rest of the world, and the collapse in U.K. exports that occurred late last year and earlier this year seems to be coming to an end. In addition, policy steps by British authorities also appear to be working. Car sales have jumped recently due in part to the British version of a "cash for clunkers" program, and the cut in the value-added tax may be helping to shore up growth in retail spending. Aggressive policy easing by the Bank of England has also helped to stabilize the economy.

Speaking of the Bank of England, the Monetary Policy Committee (MPC) decided this week to ease policy further despite signs that the economy is stabilizing. No, the MPC did not reduce its main policy rate from 0.50 percent, where it has been maintained since March (bottom chart). However, the MPC announced that it would increase its purchases of assets (i.e., government bonds and private sector fixed income securities) by £50 billion to a total amount of £175 billion. These unconventional policy steps have pumped the banking system full of liquidity, and have helped to prevent a marked increase in longer-term interest rates. In announcing its decision to increase the size of its asset purchase program the MPC noted that "the recession appears to have been deeper than previously thought." By easing further, the MPC hopes to insure that a renewed slide in the economy does not develop. If, as we expect, the economy picks up some steam in the quarters ahead, the MPC will not need to take out additional insurance.







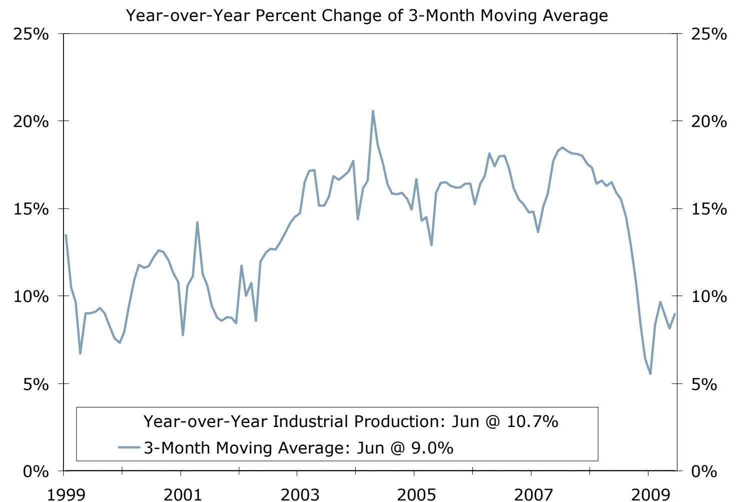
Chinese Industrial Production •Wednesday

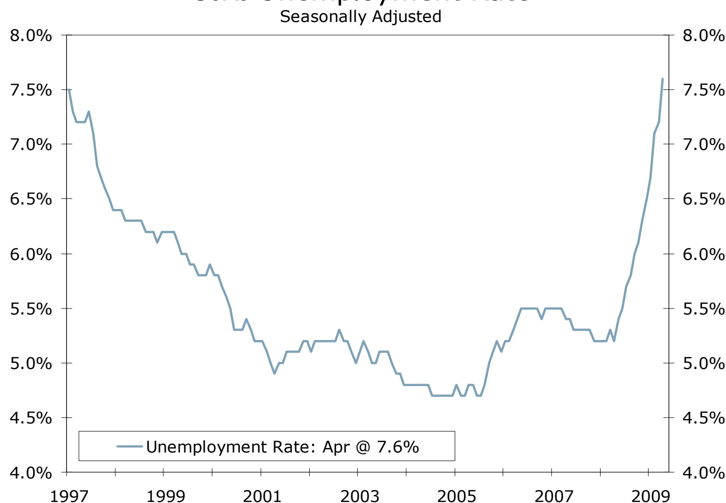
Economic growth in China has clearly rebounded this year, and a slew of data that are slated for release next week will give investors some insights into the strength of the economy at the beginning of the third quarter. The consensus forecast anticipates that growth in industrial production strengthened last month. Do stronger exports account for any of the expected acceleration in IP? Trade data for July that will print on Tuesday will shed some light on that question.

Strong growth in credit, which has been encouraged by the government, is probably the most important reason for the current upturn. In that regard, money supply data will show how strong credit growth remained last month. Data on CPI inflation, which will be released on Monday, should show that there are no inflationary pressures in the economy at present.

Previous: 10.7% (year-over-year growth rate)

Consensus:12.0%





U.K. Unemployment Rate • Wednesday

As discussed in the international section of this report, there are increasing signs that the U.K. economy is bottoming. Given its lagging nature, however, the unemployment rate likely will rise further in the months ahead. Indeed, the consensus forecast anticipates that the unemployment rate edged higher in June. Rising unemployment should put downward pressure on wage inflation, and the consensus looks for further slowing in the rate of wage growth in June.

The Bank of England's quarterly *Inflation Report* will be released on Wednesday. The forecasts for GDP growth and CPI inflation that are contained in the report may shed some light on the Bank's rationale to increase the size of its asset purchase program this week.

Previous: 7.6%

Consensus: 7.7%

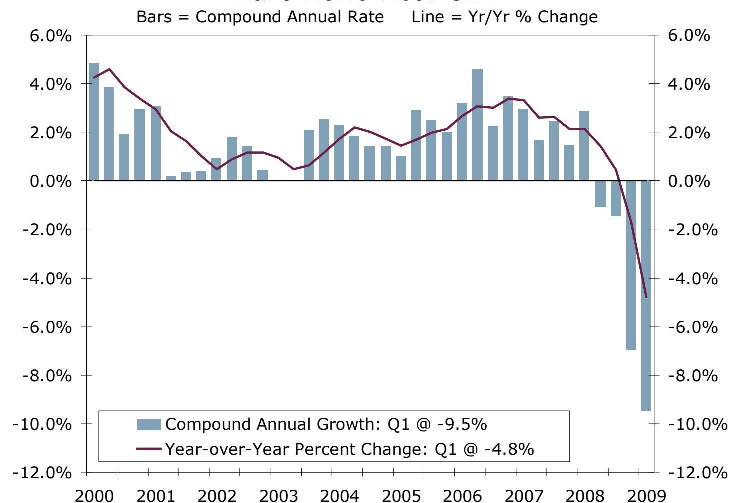
Euro-zone GDP Growth • Thursday

Real GDP in the Euro-zone tumbled nearly 10 percent at an annualized rate in the first quarter, the sharpest sequential rate of contraction since the series began in 1995. So far, the economy has shrunk nearly five percent since peaking in the first quarter of 2008 and, unfortunately, it appears that real GDP contracted further in the second quarter. That said, the rate of decline looks like it moderated significantly in the second quarter.

Some individual countries, including France and Germany, report their GDP data on Thursday as well, so investors will be able to see how widespread economic weakness in the Euro-zone is. Italy reported this morning that real GDP declined 0.5 percent (not annualized) in the second quarter relative to the previous quarter.

Previous: -2.5% (sequential growth, not annualized)

Consensus:-0.4%



Interest Rate Watch

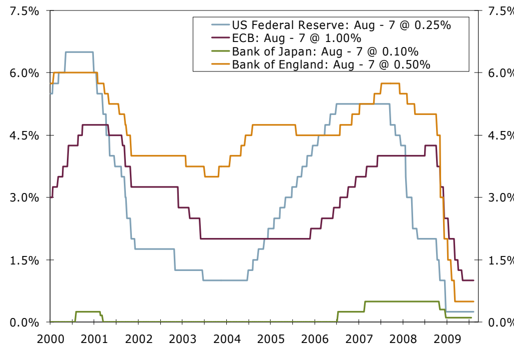
Will Anybody Hike Rates Soon?

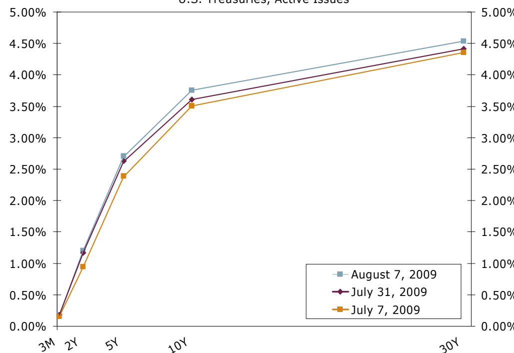
Although the U.S. economy appears to be nearing a bottom, few investors expect the Fed to tighten policy soon. If, as we expect, growth remains sluggish and inflation stays benign, then the Fed likely will remain on hold well into next year. Will any other major central banks tighten soon?

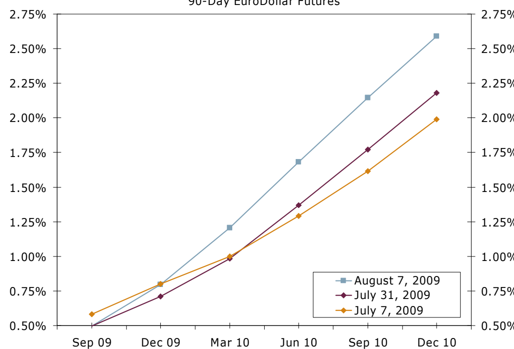
As discussed in the international section of the report, the Bank of England actually eased policy this week to ensure that the economy does not enter a renewed slide. Therefore, it sure does not seem likely that the folks on Threadneedle Street will be hiking rates anytime soon. Across the English Channel in Frankfurt, the European Central Bank kept its main policy rate unchanged this week at 1.00 percent, where it has been maintained since May. Real GDP in the Euro-zone very likely declined again in the second quarter, and overall consumer prices are declining modestly on a year-over-year basis. The ECB will unlikely raise rates in that environment. Indeed, we do not believe the Bank of England or the ECB will begin to hike rates until the second half of next year.

If there is an area of the world in which monetary policy could conceivably be tightened, it would be Asia. Most Asian countries avoided the over-lending binge that characterized many western economies over the past few years, and recoveries are already underway. Most central banks in Asia, however, probably will keep policy rates unchanged for the foreseeable future. The Reserve Bank of Australia has been on hold for the past few months with an implied "bias" to ease further. It removed that "bias" this week, but did not signal that tightening is imminent. Chinese officials have indicated that monetary policy will remain accommodative for the foreseeable future.

The collapse in global economic activity that occurred after the Lehman Brothers bankruptcy is coming to an end. However, most central bankers probably need to be convinced that recoveries are sustainable before they begin to tighten policy. It likely will not be until sometime next year before they know for sure whether the recovery is sustainable or not.







Consumer Credit Insights

Mortgages, Housing & the Fed

For the first time in several weeks we have seen some relief, albeit minor, in mortgage rates. The thirty year conventional mortgage rate dropped to 5.22 percent, and we saw similar improvements in other major mortgage products. Still rates are well above the sub-five percent level that prevailed from late March until mid-May.

While Fed intervention in both the agency as well as the Treasury market has helped push down mortgage rates from the highs seen during the worst of the credit crisis, that help may have largely run its course at this point. We will be waiting for the FOMC statement, out next Wednesday, for clues on the committee's intention to modify or stay the course on the current asset purchase programs. We do not currently expect major changes from the Fed next week.

With mortgage rates increasing off of their lows, housing affordability has taken a minor hit. Still, sales activity seems to have stabilized over the past few months, and purchase application data from the MBA support this view as well. The index has moved largely sideways for several months. If sales activity is able to gain further traction we would expect a corresponding increase in originations. Refinancing activity has retreated sharply with the return of higher rates, as would be expected for the more rate-sensitive sector. Look for borrowers to take advantage of lower rates opportunistically on the refinancing side.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	5.22%	5.25%	5.20%	6.52%
15-Yr Fixed	4.63%	4.69%	4.69%	6.10%
5/1 ARM	4.73%	4.75%	4.82%	6.05%
1-Yr ARM	4.78%	4.80%	4.82%	5.22%
MBA Applications				
Composite	517.3	495.4	493.1	432.6
Purchase	264.4	262.0	285.6	315.2
Refinance	1,996.7	1,862.1	1,707.7	1,121.8

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

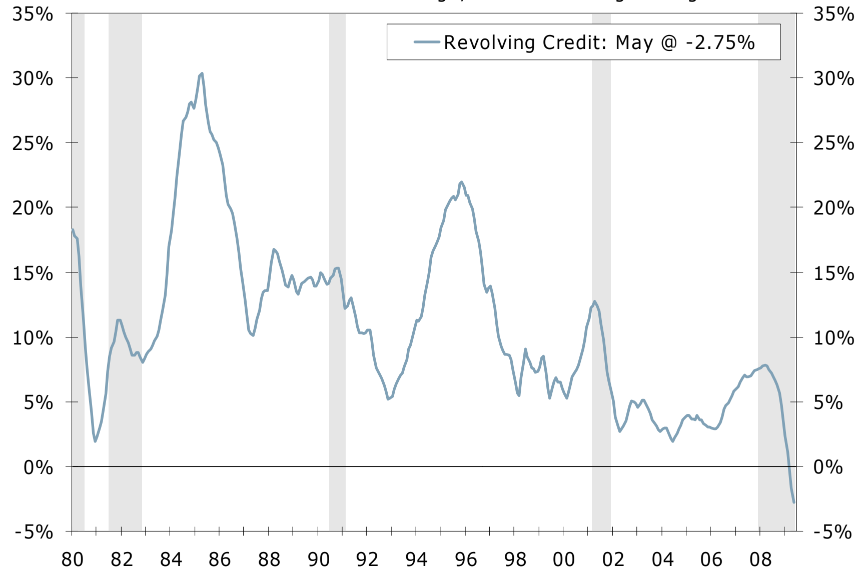
Topic of the Week

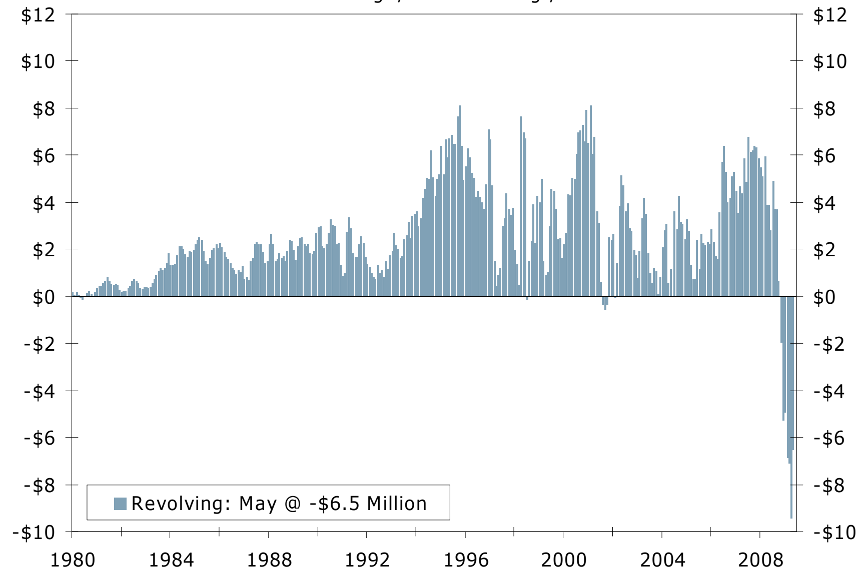
Downshift in Revolving Consumer Credit

The current recession marks the first decline in revolving consumer credit since the Federal Reserve began tracking the series in 1968. Revolving consumer credit, which typically refers to credit cards, dropped $48.7 billion from its peak of $977 billion in September of last year, a five percent decline. Revolving credit at the beginning of the recession played a big role in giving consumers the ability to extend their purchasing power when lending standards began tightening, limiting mortgage equity withdrawals which reached record levels during the housing boom. Today, consumers are spending far less as job losses continue to mount, consumer confidence remains low and the outlook for employment and income remains dismal. As consumers continue to restructure their balance sheets and delever, credit card usage has become increasingly unpopular as consumers shy away from high finance charges. Consumers are being more conservative and are shifting to debit cards and cash.

The Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009 signed in May aims to protect consumers from predatory lending, but has also encouraged lenders to tighten standards for credit cards further. Lenders have been switching to variable rate credit cards, increasing annual fees and requiring more information before approving credit card applications. As lenders will not be able to raise rates and impose fees as flexibly as they have been, they are getting cautious about those to whom they lend. As lenders profit from finance charges and fees, there will be fewer incentives for them to get into the credit card business. Thus in the near future, the extension of revolving credit will likely not be as robust as it once was.

This downshift in revolving consumer credit is encouraging consumers to live within their means which is putting further downward pressure on discretionary expenditures. Consumer spending will likely remain subdued for some time and will not likely grow at rates seen in past expansions.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/7/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.17	0.18	1.67
3-Month LIBOR	0.46	0.48	2.80
1-Year Treasury	0.58	0.57	2.25
2-Year Treasury	1.29	1.11	2.42
5-Year Treasury	2.81	2.51	3.15
10-Year Treasury	3.82	3.48	3.92
30-Year Treasury	4.57	4.30	4.56
Bond Buyer Index	4.65	4.69	4.75

Foreign Exchange Rates

	Friday 8/7/2009	1 Week Ago	1 Year Ago
Euro ($/€)	1.426	1.426	1.532
British Pound ($/£)	1.673	1.671	1.944
British Pound (£/€)	0.852	0.853	0.788
Japanese Yen (¥/$)	96.840	94.683	109.440
Canadian Dollar (C$/$)	1.086	1.078	1.053
Swiss Franc (CHF/$)	1.074	1.068	1.063
Australian Dollar (US$/A$)	0.837	0.836	0.907
Mexican Peso (MXN/$)	12.933	13.192	10.014
Chinese Yuan (CNY/$)	6.832	6.832	6.864
Indian Rupee (INR/$)	47.835	47.935	42.074
Brazilian Real (BRL/$)	1.828	1.865	1.597
U.S. Dollar Index	78.442	78.347	74.547

Foreign Interest Rates

	Friday 8/7/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.84	0.86	4.96
3-Month Sterling LIBOR	0.86	0.89	5.78
3-Month Canadian LIBOR	0.60	0.60	3.34
3-Month Yen LIBOR	0.41	0.41	0.90
2-Year German	1.54	1.26	4.09
2-Year U.K.	1.28	1.23	4.64
2-Year Canadian	1.46	1.47	2.77
2-Year Japanese	0.27	0.29	0.73
10-Year German	3.45	3.30	4.26
10-Year U.K.	3.78	3.80	4.68
10-Year Canadian	3.59	3.56	3.65
10-Year Japanese	1.44	1.42	1.53

Commodity Prices

	Friday 8/7/2009	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	72.27	69.45	120.02
Gold ($/Ounce)	955.48	954.00	873.05
Hot-Rolled Steel ($/S.Ton)	465.00	455.00	1125.00
Copper (¢/Pound)	278.60	261.65	345.80
Soybeans ($/Bushel)	11.70	11.23	12.20
Natural Gas ($/MMBTU)	3.84	3.65	8.57
Nickel ($/Metric Ton)	19,537	17,164	17,678
CRB Spot Inds.	443.82	426.70	480.66

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	10	**11**	**12**	**13**	**14**
U.S. Data		**Nonfarm Productivity** 1Q 1.6% 2Q 5.1% (W) **Unit Labor Costs** 1Q 3.0% 2Q -4.5% (W)	**Trade Balance** May -$26.0B June -$27.0B (W) **FOMC Rate Decision** Previous 0.25% Expected 0.25% (W)	**Retail Sales** June 0.6% July 0.8% (W) **Import Price Index** June 3.2% July 1.9% (W) **Business Inventories** May -1.0% June -0.8% (W)	**CPI** June 0.7% July -0.2% (W) **Industrial Production** June -0.4% July 0.1% (W) **Capacity Utilization** June 68.0% July 68.2% (W)
Global Data	**Japan** **Machine Orders (MoM)** Previous (May) -3.0%	**China** **Trade Balance (USD)** Previous (Jun) $8.25B	**UK** **Unemployment Rate** Previous (May) 7.6% **China** **Indus. Production (YoY)** Previous (Jun) 10.7%	**Euro-zone** **GDP (QoQ)** Previous (1Q) -2.5%	**Canada** **Manufacturing** Previous (May) -6.0%

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

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