August 14, 2009

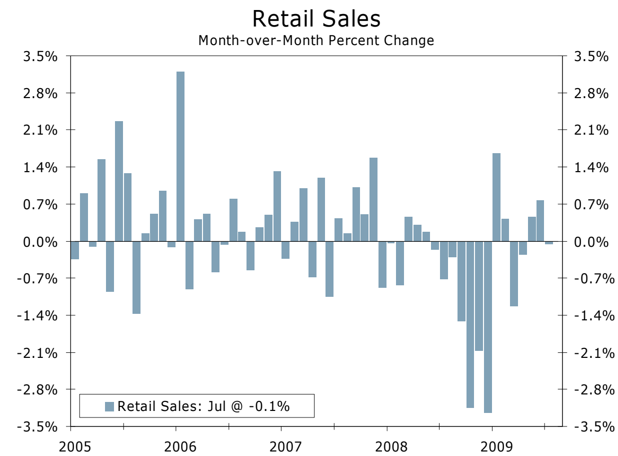
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

The Recovery May be as Challenging as the Recession

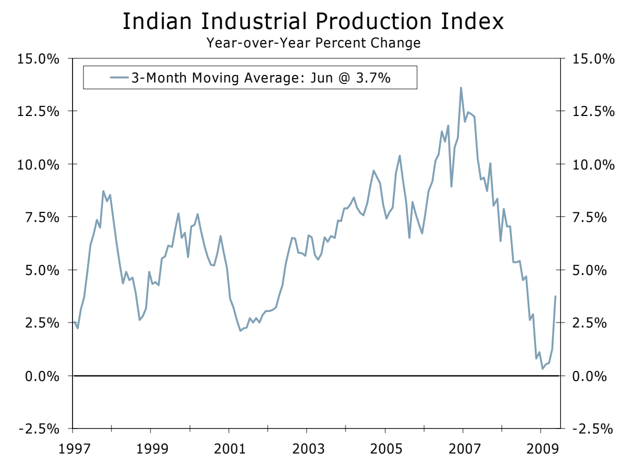
- This week's economic numbers were generally disappointing, particularly given the growing consensus that the recession ended around mid-year.
- The cash-for-clunkers trade-in program boosted retail sales but overall sales still declined as consumers cut back on just about everything else.
- Productivity growth surged and inventories dropped sharply, confirming anecdotal reports that businesses cut costs every way they could earlier this year. Cost cutting should remain in place for the next year or so.



Global Review

Indian Economy Shows Signs of Acceleration

- Like many of its Asian neighbors, the Indian economy is showing signs of acceleration. Although exports remain depressed at present, strong auto sales suggest that Indian consumer spending is alive and well.
- However, the Indian economy is not completely out of the woods yet. The potential for a monsoon that does not bring enough rain is one of the biggest downside risks that the economy faces at present. The agricultural sector accounts for more than 15 percent of GDP, and a downturn in agricultural output that a bad monsoon could cause would slow overall economic growth again.



Inside

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]	-0.7	1.5	-2.7	-5.4	-6.4	-1.0	3.4	2.6	3.1	2.7	2.1	0.4	-2.5	2.1
Personal Consumption	-0.6	0.1	-3.5	-3.1	0.6	-1.2	2.0	1.6	3.4	2.9	2.7	-0.2	-0.8	1.1
Inflation Indicators [2]														
"Core" PCE Deflator	2.4	2.5	2.6	2.0	1.7	1.6	1.3	1.2	2.3	2.3	2.4	2.4	1.5	1.2
Consumer Price Index	4.2	4.3	5.2	1.5	-0.2	-0.9	-1.8	0.5	3.4	3.2	2.9	3.8	-0.6	1.4
Industrial Production [1]	0.2	-4.6	-9.0	-13.0	-19.1	-11.6	5.3	2.9	3.3	2.3	1.5	-2.2	-10.3	1.8
Corporate Profits Before Taxes[2]	-4.9	-12.0	-5.4	-25.1	-19.0	-14.0	-11.0	2.0	16.8	10.5	-4.1	-11.8	-11.2	7.0
Trade Weighted Dollar Index[3]	70.3	71.0	76.1	79.4	83.2	77.7	78.5	80.9	86.0	81.5	73.3	79.4	80.9	81.4
Unemployment Rate	4.9	5.4	6.1	6.9	8.1	9.3	9.6	10.0	5.1	4.6	4.6	5.8	9.2	10.1
Housing Starts[4]	1.06	1.02	0.87	0.66	0.53	0.54	0.59	0.64	2.07	1.81	1.34	0.90	0.58	0.79
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	0.75
Conventional Mortgage Rate	5.97	6.32	6.04	5.33	5.00	5.42	5.50	5.40	6.27	6.14	6.10	5.33	5.40	5.80
10 Year Note	3.45	3.99	3.85	2.25	2.71	3.53	3.80	3.80	4.39	4.71	4.04	2.25	3.80	4.20

Forecast as of: August 12, 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

U.S. Review

Two Steps Forward and One Step Back

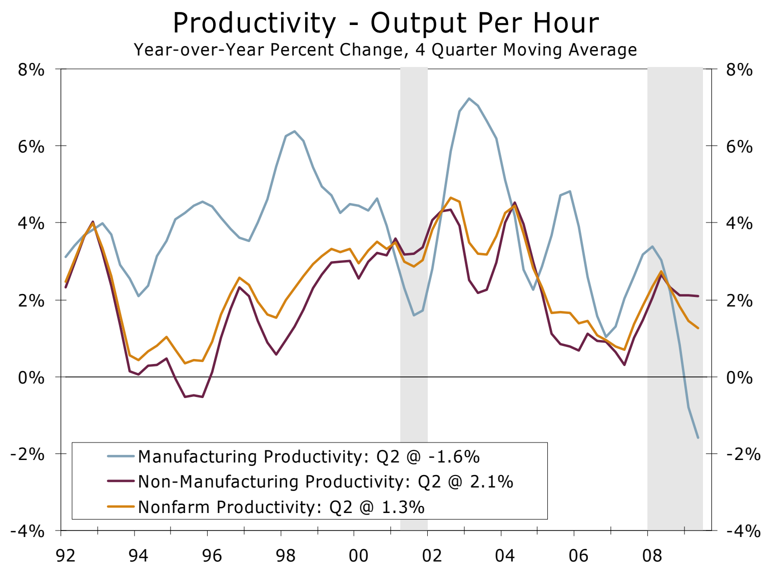
We believe the recession ended around the middle of this year. The ending of the recession is more significant to economists and statisticians than it is to ordinary citizens, however, most of whom will see little difference in their day-to-day lives. Unemployment remains high, incomes are basically stagnant, and consumers and businesses remain very reluctant to spend and invest. The end of the recession simply means that things are no longer getting worse and may in fact be starting to get slightly better. In layman's terms, we have gone from taking two steps back for every one step the economy took forward to taking one step back for every two steps the economy moves forward.

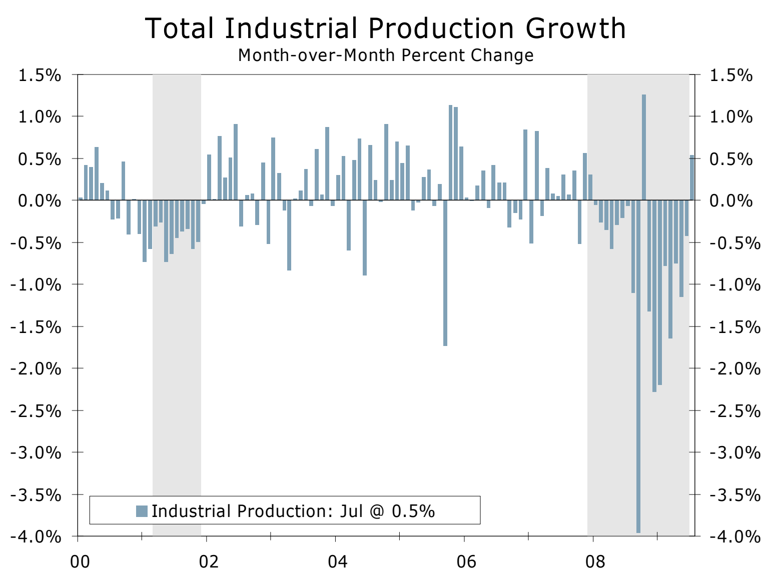
This past week's economic reports came in slightly below expectations but remain consistent with what you would expect to see near the end of a recession. Nonfarm productivity surged at a 6.4 percent annual rate during the second quarter as businesses slashed hours worked much more than they slashed production. Hours worked tumbled at a 7.6 percent pace during the quarter, while nonfarm output declined at just a 1.7 percent pace.

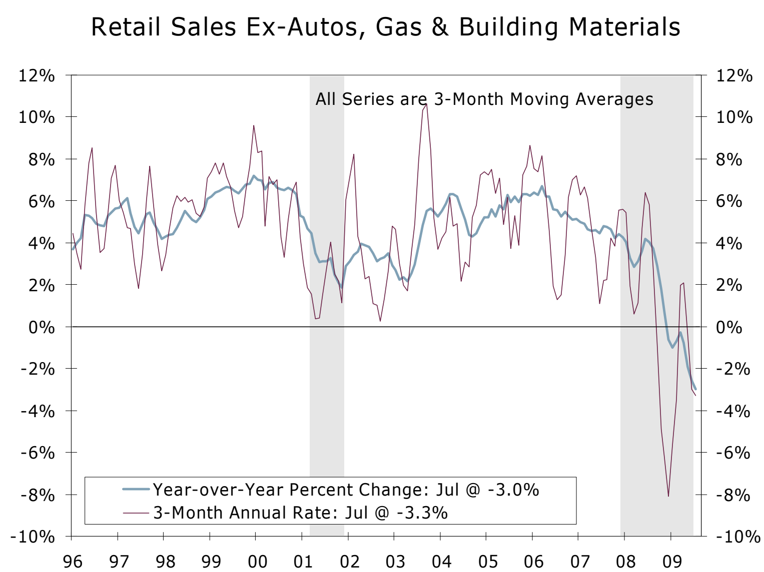
The sharper drop in hours worked has raised hopes that businesses may have cut employment and hours too much and will be quicker to ramp up both once demand revives. We are not sure this argument holds up. Nonfarm productivity growth is no stronger than it was at the tail end of the 2001 recession, which did not see the unemployment rate top out until 19 months after the recession ended. Year-to-year nonfarm productivity growth is actually lower today than it was back in 2001, which suggests businesses may try to squeeze out even more efficiency gains in coming months. Moreover, productivity in the manufacturing sector actually declined during the second quarter and remains much lower on a year-to-year basis than where it was at the end of the past two recessions.

Manufacturing productivity should get a boost from a revival of motor vehicle output in the third quarter. Output turned up sharply at the start of July and is set to nearly double from is second quarter average. The July industrial production figures show output of motor vehicles and parts rising 20.1 percent during the month. Hours worked rose 12.0 percent, so productivity will certainly get a boost. Aside from the pick-up in motor vehicle output, however, industrial production was actually down 0.1 percent. Most of that drop was at utilities, which saw production slide 2.4 percent, reflecting less demand for electricity amid this summer's unusually mild temperatures.

Retail sales were another piece of disappointing news. Cash-for-clunkers provided a huge boost, resulting in a 2.4 percent rise in sales at motor vehicle dealers. Excluding motor vehicles, however, sales declined 0.1 percent, with declines spread across nearly every key sector. Moreover, the key core measure of retail sales, which excludes motor vehicles, gasoline and building materials, fell 0.2 percent, marking the fourth drop in the past five months. The weak showing casts some doubt on forecasts for a rebound in consumer outlays during the third quarter.





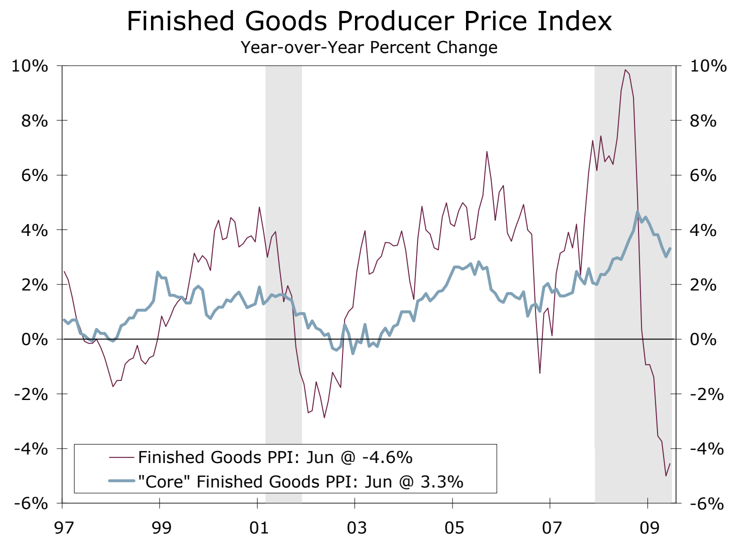


Producer Price Index • Tuesday

The PPI for total finished goods rose 1.8 percent in June driven by an out-sized gain in gasoline prices, which were up 18.5 percent on the month. The recent decline in gasoline prices should help pull the headline number down significantly. Food prices which also tend to be volatile rose 1.1 percent, but should give back some of the gain in July. Food prices were down 2.2 percent in June from year ago levels. Core finished goods prices rose 0.5 percent in June also driven by transportation-related prices with car and light truck prices spiking 2.0 and 3.0 percent, respectively. Core intermediate goods prices rose 0.4 percent in June, the first increase in nine months, but are down 6.6 percent from a year ago. We expect core intermediate goods prices will be down 0.1 percent suggesting that pipeline inflation pressures should remain subdued. Economic weakness should continue to exert downward pressure on wholesale inflation in the months ahead.

Previous: 1.8% **Wells Fargo: -1.3%**

Consensus: -0.2%

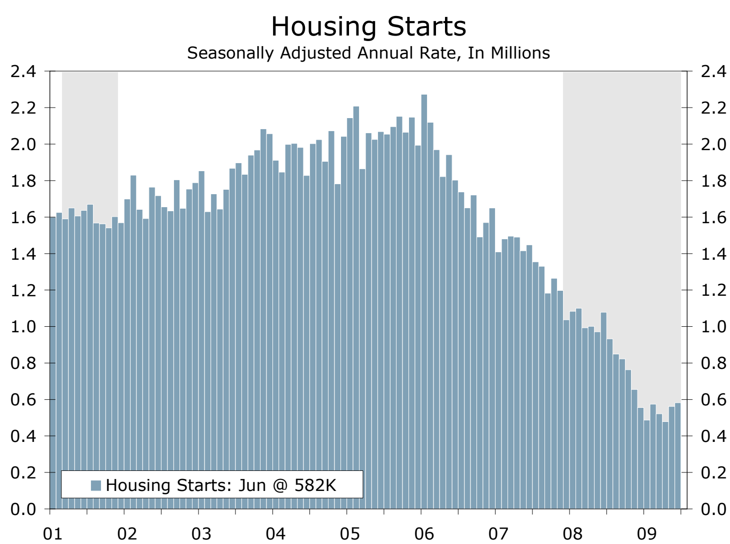


Housing Starts • Tuesday

Housing starts rose 3.6 percent in June with single-family starts accounting for all of the increase. Single-family starts rose 14.4 percent, while multi-family starts fell 25.8 percent. While single-family housing starts have risen four consecutive months, the level of homebuilding still remains incredibly distressed. Starts of single-family homes tumbled to modern era lows in January and February, as homebuilders were unable to get credit to start new projects. The drop in housing starts earlier this year brought construction below the historic levels of teardowns, or net removals from the housing stock. While reduced levels of homebuilding are needed in order to bring the supply of homes back in line with demand, those earlier cutbacks in starts were likely too much. As a result, single-family starts should continue to rise in the coming months.

Previous: 582K **Wells Fargo: 590K**

Consensus: 598K

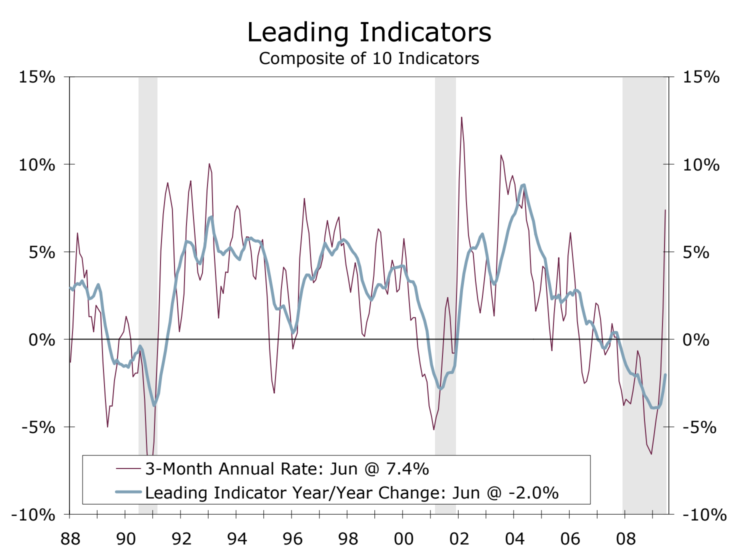


Leading Economic Index • Thursday

The Leading Economic Index (LEI) gained 0.7 percent in June, the third consecutive monthly increase. Most of the rise in the index was due to an increase in the interest rate spread and building permits, which added 0.6 percentage points to the index in June. We expect seven of the ten indicators will contribute to LEI in July. The ISM index for supplier deliveries rose for the fourth consecutive month and is now at 52.0 in July suggesting a rise in demand for manufactured goods. The average hourly workweek in manufacturing, positive yield curve, stock prices, housing permits and initial claims will also likely contribute positively. Consumer expectations, real money supply and orders will likely detract from the index. The consecutive increases in LEI are consistent with our forecast that the economy will begin to show growth in the third quarter.

Previous: 0.7% **Wells Fargo: 0.7%**

Consensus: 0.6%



Global Review

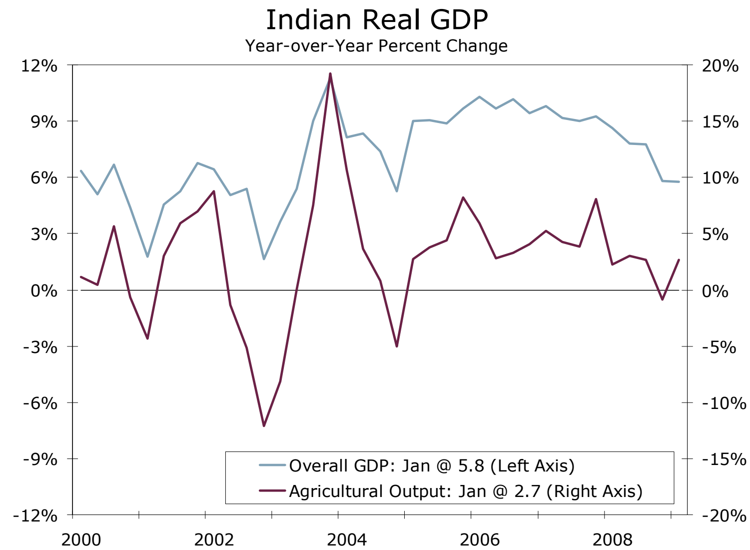
Indian Economy Shows Signs of Acceleration

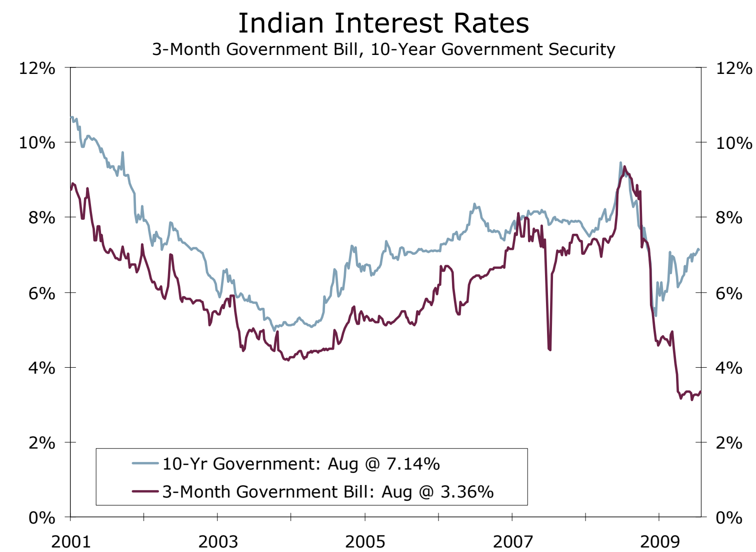
We have been writing recently that many Asian economies are showing bona fide signs of recovery. If there were any doubts about recovery in the Indian economy, they were put to rest this week when data showed that industrial production shot up 7.8 percent (year-over-year) in June, which was much stronger than most investors had expected. Even if the volatile monthly numbers are smoothed with a 3-month moving average, the upturn in industrial production growth is unmistakable (see graph on the front page). Add India to the list of Asian economies that are recovering from their recent slowdown.

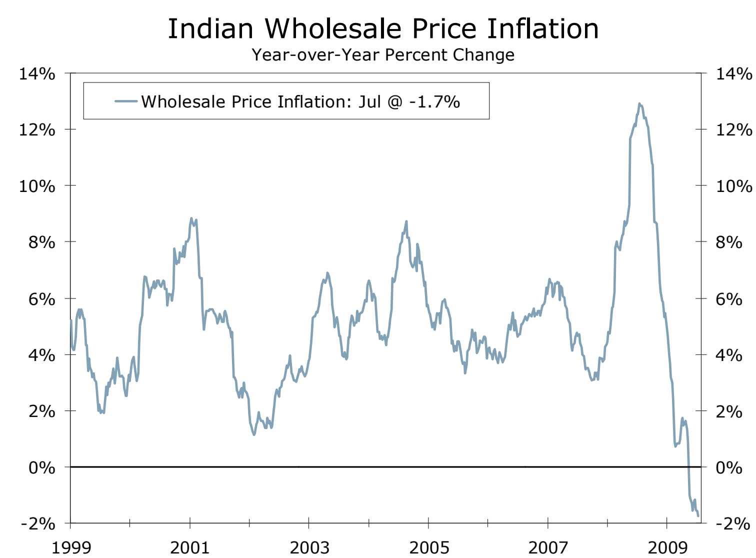
From where is the upturn emanating? Statistics on overall retail spending are not readily available, but the 11 percent rise in car sales in the second quarter relative to the same period last year suggests that the consumer is alive and well. Indeed, production of consumer durable goods, which includes automobiles, jumped 15 percent in the second quarter, helping to fuel the overall rise in industrial production recently. Unfortunately, exports remain depressed, with the overall value of exports down 30 percent in the second quarter on a year-over-year basis. However, the rest of the world is showing signs of economic stability at present, which should lead to rising Indian exports in the months ahead. Everything else equal, industrial production should strengthen further.

But is everything else equal? Are there any factors that could cause the economy to weaken anew? Yes, and the most visible factor is well beyond the control of policymakers. Namely, the annual monsoon has not been very good so far—rainfall is about 20 percent lower than normal—and the effects on the overall economy of a monsoon that does not bring adequate rain can be noticeable. For example, the 2002 monsoon was unusually bad, and it caused agricultural output to decline more than 10 percent in late 2002. Consequently, the year-over-year rate of overall GDP dipped to less than two percent in the fourth quarter of that year (top chart). Although the monsoon typically lasts through September, it will be difficult to realize a normal season this year due to the slow start to the rain over the past two months.

Over the past few years the correlation between agricultural output and real GDP growth has become less tight as the non-agricultural sectors of the economy have boomed. However, the agricultural sector still accounts for more than 15 percent of Indian GDP, which poses significant downside risks to the overall economy should the monsoon not bring enough rain. With the economy not completely out of the woods yet, the Reserve Bank of India (RBI), which has guided short-term interest rates significantly lower since last summer, is likely to keep policy accommodative for the foreseeable future. And with wholesale price inflation, which is the benchmark inflation gauge in India, still in negative territory, the RBI has the luxury of remaining in wait-and-see mode for some time. If the monsoon passes without significant negative effects on the economy, then the RBI will slowly start to withdraw policy support in late 2009/early 2010.







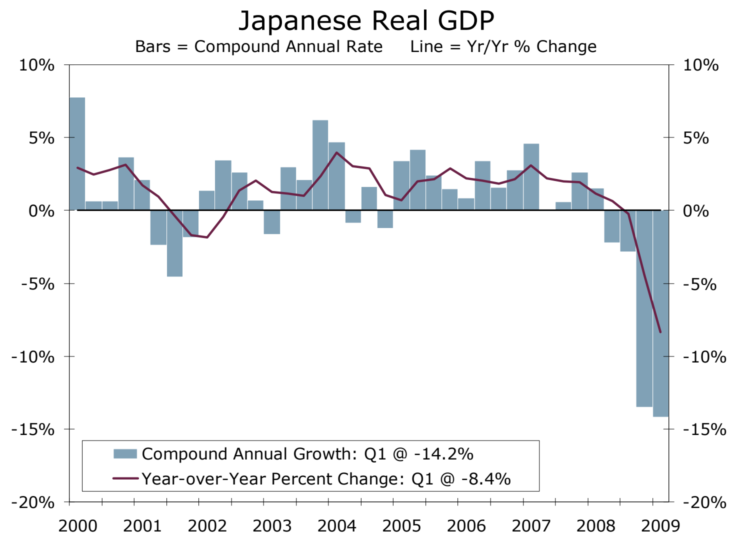
Japanese GDP • Monday

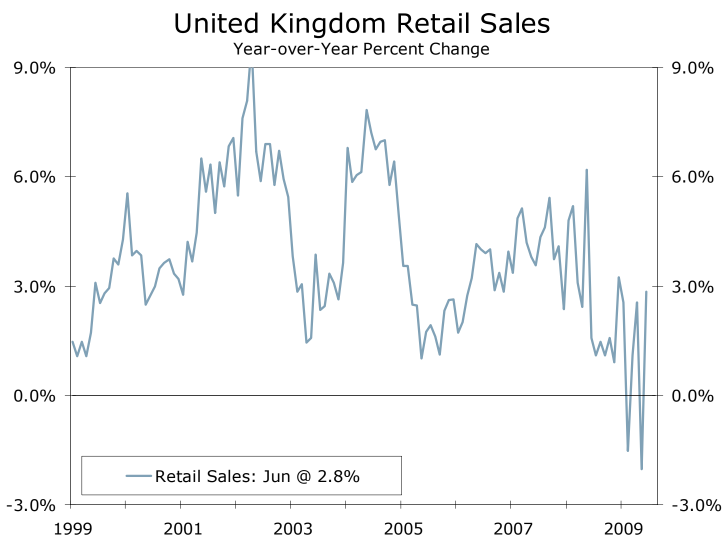
The Japanese economy fell into its deepest recession in decades late last year and earlier this year. Indeed, real GDP has contracted more than eight percent since peaking in early 2008. However, the turnaround in the rest of Asia has caused Japanese industrial production to bounce about 15 percent from its bottom earlier this year. This increase in IP is one reason why most analysts look for a positive GDP growth rate when the second quarter numbers are released on Monday.

Analysts will also be interested in the demand-side components in the real GDP data to determine the sources of growth. How is consumer spending faring, and how much inventory adjustment has occurred already? The answers to these and other questions will shed some light on Japanese growth prospects in the quarters ahead.

Previous: -14.2% (CAGR) **Wells Fargo: 3.0%**

Consensus: 3.9%





U.K. Retail Sales • Thursday

Real retail spending in the United Kingdom has bounced around so far this year. However, smoothing the monthly volatility shows that growth in spending has stabilized over the past few months following the sharp slowdown at the end of last year. The consensus forecast anticipates that retail sales rose modestly in July relative to the previous month.

Data on CPI inflation in July will print on Tuesday, and the year-over-year rate of inflation likely will decline further from the 1.8 percent rate that was registered in June. Wednesday sees the release of the minutes of the Bank of England's policy meeting earlier this month. The Bank surprised investors by increasing the size of its asset purchase program, and the minutes should offer some insights into the Bank's reasoning for increasing the size of the program.

Previous: 1.2% (month-on-month change)

Consensus: 0.3%

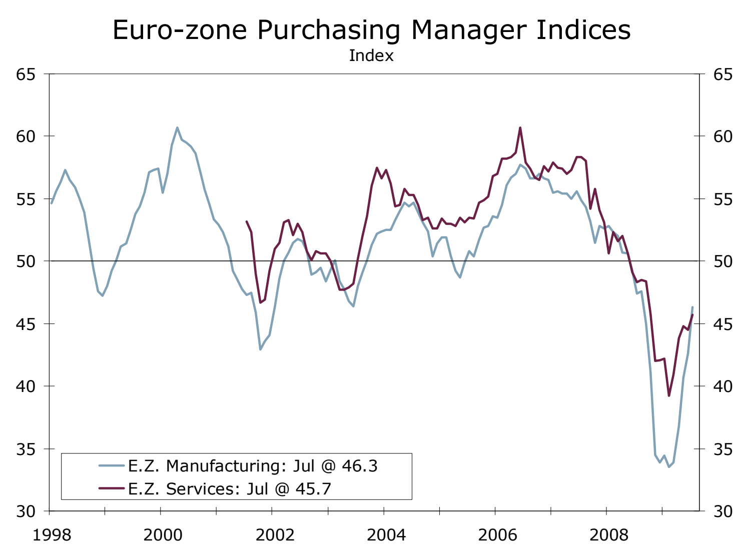
Euro-zone PMIs• Friday

Investors cheered the news this week that real GDP in the Euro-zone edged down only 0.1 percent in the second quarter relative to the previous quarter, the slowest sequential rate of decline in more than a year. The rise in the PMIs over the past few months signaled that the rate of decline in economic activity was slowing down, and the consensus forecasts look for further improvement in the PMIs in August. If the PMIs continue to rise, positive GDP growth in the Euro-zone could be right around the corner.

In Germany, the ZEW index, a measure of economic sentiment among institutional investors, prints on Tuesday. After a modest decline in July, the index is expected to rebound in August.

Current Manufaturing PMI: 46.3 **Consensus: 47.5**

Current Service PMI: 45.7 **Consensus: 46.3**



Interest Rate Watch

FOMC begins to normalize rates

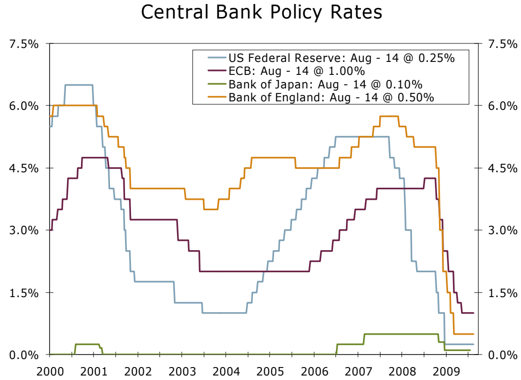
Investors, coddled by Fed intervention over the last year, will begin their perilous journey in search of free market prices on Treasuries. In its latest statement the FOMC cited 1) economic activity is leveling out, 2) inflation will remain subdued for some time and 3) the FOMC is gradually withdrawing its support in the Treasury market through October and there will be, at least at this point, no intention to extend nor enlarge that intervention.

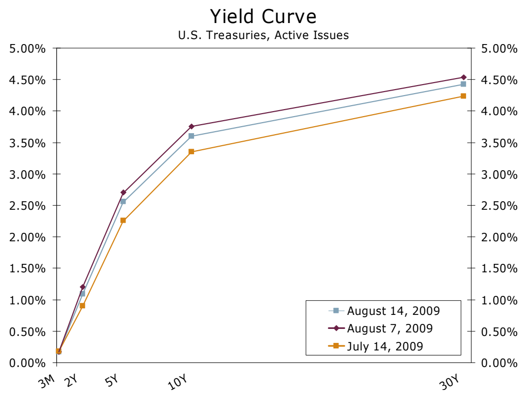
While the FOMC, however, recognizes the risks in such an approach so the withdrawal is indeed gradual and, if needed, could be slowed or even reversed. The broader economic problem is that the FOMC is effectively ending its interest rate controls and letting interest rates float.

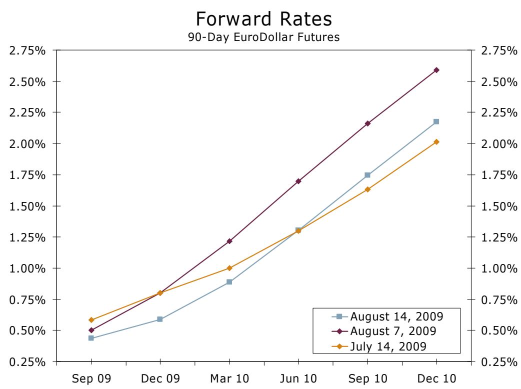
Both Interest Rates and Their Volatility Rises

Economic history is replete with examples of price/wage/interest rate decontrols and each time volatility rises and the jump in prices were greater than estimated. For decision-makers therefore the reduction in Fed intervention is likely to be accompanied by an increase in both the level and volatility of Treasury rates. Moreover, since the purchase of Treasury securities was biased toward the short/intermediate maturity range of Treasuries then this part of the yield curve is likely to rise faster/greater than the move at the long end of the curve.

In addition, given the flight to safety trade over the last year we are likely to see a greater than expected upward move in Treasury yields as investors first anticipate higher rates (capital losses) and then realize losses. These losses are likely to lead portfolio managers, in an attempt to protect profits, to move a bit quicker to sell Treasuries and thereby accelerate interest rate increases. The history of price/interest rate decontrols suggests that markets move faster and greater than implied by naive expectations.







Consumer Credit Insights

Fundamentals Turn, How About Credit Quality?

Over the last year yields have been historically low and therefore vulnerable to changes in market expectations to economic, inflation and credit conditions. In addition, we have witnessed caution by both the demanders (consumer) and suppliers (banks) of credit. This has been most evident in the outright declines in revolving (credit cards) consumer credit. Households are deleveraging and banks are increasing their fees and credit standards.

In addition, TALF qualified credit instruments such as auto loans have benefitted from this federal program and thereby have lower-than free market rates at this point. In recent months we have also seen a modest decline in credit card delinquencies for the six major issuers.

Now that the Federal Reserve, always being cautious, is beginning to slowly execute its exit strategy what can we expect about the persistence of an environment of low rates and improving credit card quality?

According to the Blue Chip Economic consensus the pace of the recovery in the second half of this year will be below trend with very little improvement in the labor market. Effectively this suggests that consumer incomes will be slow to improve. Meanwhile, Fed moves to exit from its easy policy will raise rates. This pincer action suggests far slower improvement in consumer credit quality than in prior recoveries.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	5.29%	5.22%	5.14%	6.52%
15-Yr Fixed	4.68%	4.63%	4.63%	6.07%
5/1 ARM	4.75%	4.73%	4.83%	6.02%
1-Yr ARM	4.72%	4.78%	4.76%	5.18%
MBA Applications				
Composite	499.0	517.3	514.4	425.9
Purchase	267.2	264.4	258.8	315.2
Refinance	1,853.8	1,996.7	2,009.4	1,074.6

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

Topic of the Week

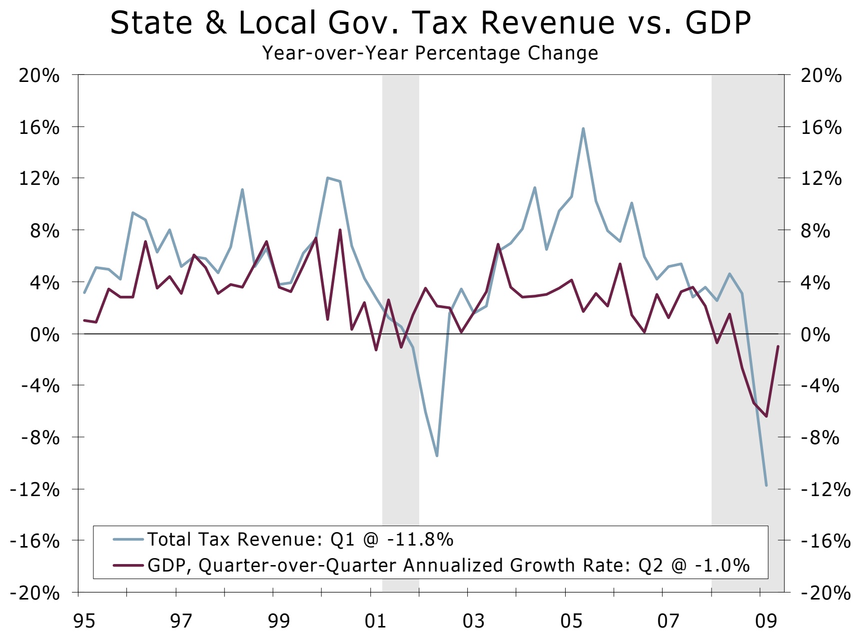
State and Local Government Financial Woes

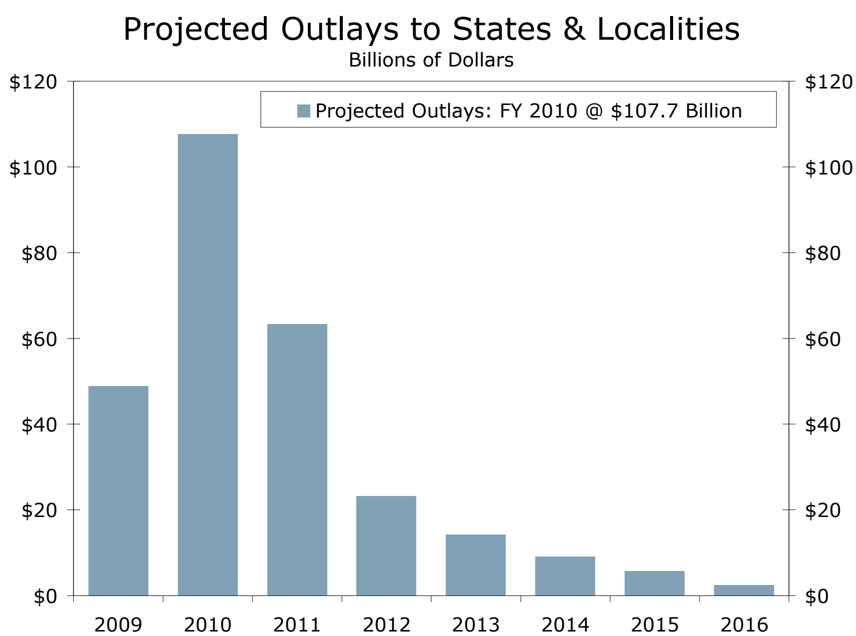
While the recession appears to be winding down, the deterioration in state and local finances is still building momentum. The recession took a heavy toll on state and local tax receipts, with fiscal conditions weakening in nearly every state. California's much publicized issuance of IOUs is one of the most severe examples and will likely be one of the more memorable events of the "Great Recession." Layoffs are cutting into personal income tax receipts, while falling home prices and sluggish retail sales are hitting property and sales tax collections.

State tax collections are now down roughly 33 percent from the peak reached in the second quarter of 2008. Revenues are expected to decline further as state and local tax collections traditionally lag the overall economic recovery. At the same time, state and local governments are grappling with increases in a whole host of expenditures like Medicaid and higher education, which tend to rise during downturns as household balance sheets become stressed.

States such as California, New York, New Jersey, Florida and Illinois had the largest projected fiscal year 2009 – 2012 budget gaps, accounting for half of the total shortfall. In many cases, states with the largest budget gaps have some combination of the following factors: 1) hardest hit by the housing downturn and financial crisis 2) have a large manufacturing base or 3) rely heavily on one source of tax revenue.

While the fiscal stimulus package will likely help offset some of the declines, it will only cover around two-thirds of the total budget gap for fiscal years 2009 through 2012. Most of the $275 billion states will receive from the $787 billion stimulus package will be spent between fiscal years 2009 and 2011 budgets, with fewer dollars available in fiscal 2012. Thus, state and local government finances will likely remain under considerable stress well into fiscal year 2012.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/14/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.17	0.17	1.85
3-Month LIBOR	0.43	0.46	2.81
1-Year Treasury	0.50	0.58	2.13
2-Year Treasury	1.08	1.30	2.43
5-Year Treasury	2.54	2.82	3.15
10-Year Treasury	3.60	3.85	3.89
30-Year Treasury	4.43	4.60	4.52
Bond Buyer Index	4.65	4.65	4.67

Foreign Exchange Rates

	Friday 8/14/2009	1 Week Ago	1 Year Ago
Euro ($/€)	1.430	1.418	1.483
British Pound ($/₤)	1.658	1.668	1.870
British Pound (₤/€)	0.862	0.850	0.793
Japanese Yen (¥/$)	94.897	97.570	109.740
Canadian Dollar (C$/$)	1.087	1.081	1.064
Swiss Franc (CHF/$)	1.068	1.081	1.093
Australian Dollar (US$/A$)	0.843	0.837	0.872
Mexican Peso (MXN/$)	12.847	12.954	10.168
Chinese Yuan (CNY/$)	6.834	6.832	6.862
Indian Rupee (INR/$)	48.247	47.835	43.050
Brazilian Real (BRL/$)	1.824	1.820	1.624
U.S. Dollar Index	78.285	78.975	76.669

Foreign Interest Rates

	Friday 8/14/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.83	0.84	4.96
3-Month Sterling LIBOR	0.77	0.86	5.76
3-Month Canadian LIBOR	0.60	0.60	3.32
3-Month Yen LIBOR	0.40	0.41	0.89
2-Year German	1.35	1.58	4.02
2-Year U.K.	0.95	1.31	4.56
2-Year Canadian	1.33	1.47	2.78
2-Year Japanese	0.27	0.27	0.70
10-Year German	3.38	3.51	4.20
10-Year U.K.	3.72	3.80	4.64
10-Year Canadian	3.50	3.62	3.60
10-Year Japanese	1.39	1.44	1.44

Commodity Prices

	Friday 8/14/2009	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	70.81	70.93	115.01
Gold ($/Ounce)	958.78	954.95	806.63
Hot-Rolled Steel ($/S.Ton)	465.00	465.00	1125.00
Copper (¢/Pound)	290.15	278.15	332.30
Soybeans ($/Bushel)	11.66	11.70	12.82
Natural Gas ($/MMBTU)	3.38	3.67	8.14
Nickel ($/Metric Ton)	20,533	19,537	19,500
CRB Spot Inds.	447.83	441.33	469.14

Next Week's Economic Calendar

	Monday 17	Tuesday 18	Wednesday 19	Thursday 20	Friday 21
U.S. Data	**Empire Manufacturing** July -0.55 August 2.20 (C)	**Housing Starts** June 582K July 590K (W) **PPI** June 1.8% July -1.3% (W) **Core PPI** June 0.5% July -0.1% (W)		**Leading Indicators** June 0.7% July 0.7% (W)	**Existing Home Sales** June 4.89M July 4.90M (W)
Global Data	**Japan** **GDP Annualized** Previous (1Q) -14.2%	**UK** **CPI (YoY)** Previous (Jun) 1.8%		**UK** **Retail Sales (MoM)** Previous (Jun) 1.2%	**Euro-zone** **PMI Manufacturing** Previous (Jul) 46.3 **Euro-zone** **PMI Services** Previous (Jul) 45.7

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

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