August 21, 2009

WELLS FARGO SECURITIES

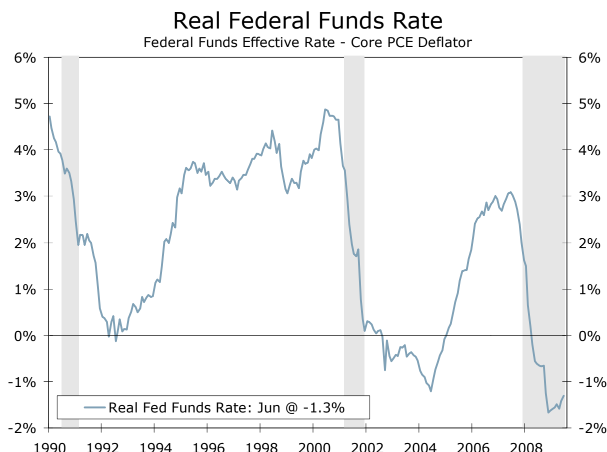
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Stimulus is Working, So is it Time to Take it Away?

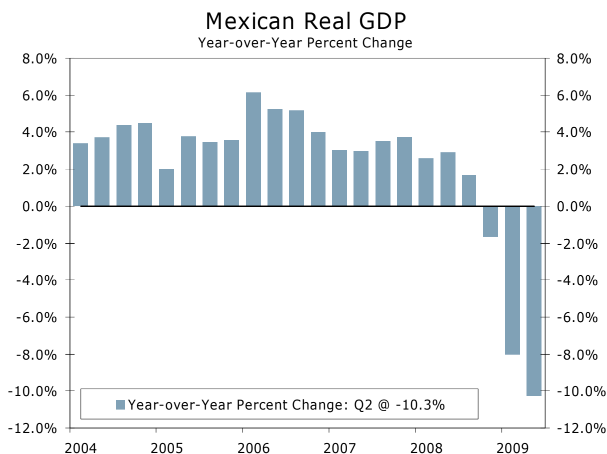
- The economy and financial markets continue to benefit from the flood of monetary and fiscal stimulus put in place over the past year.
- The Fed's purchases of Treasury bonds and asset-backed securities have reduced mortgage rates, helped cut credit spreads, and set off a huge stock market rally.
- The federal government's cash-for-clunkers program and tax credit for first time home buyers has also helped spark activity in these two cyclically important but incredibly depressed sectors.



Global Review

Mexican Economy Will Lag The Rest of the Region

- The Mexican economy continued to plunge into its worst crisis in decades during the second quarter of this year, even surpassing the effects of the Tequila Crisis back in 1994-1995.
- With 90 percent of Mexican exports destined for the United States, the recession north of the border took a toll on Mexican exports. Another way the slowdown in the United States is hurting the Mexican economy is a drop in remittances, or transfer payments back home from Mexican workers in America.



Wells Fargo U.S. Economic Forecast

	Actual						Forecast		Actual				Forecast	
	2008				2009				2005	2006	2007	2008	2009	2010
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
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

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Together we'll go far

U.S. Review

It May be Time to Take One of the Punch Bowls Away

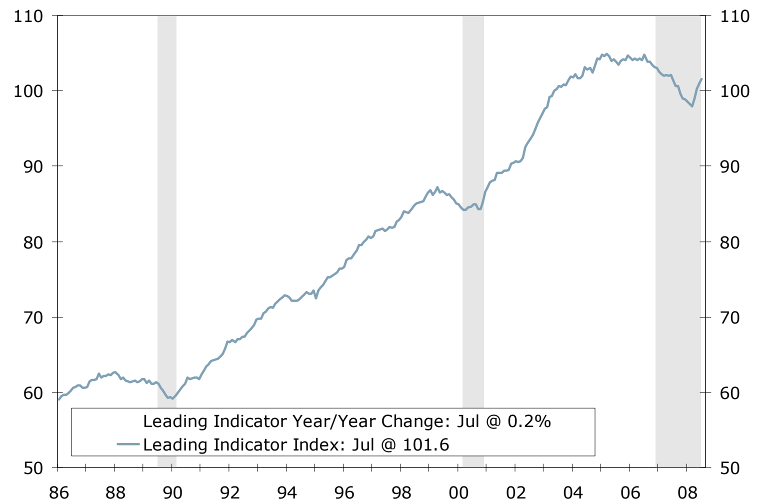
With the economy on the mend, the Fed has been openly contemplating its exit strategy. More and more economic indicators are improving with each passing week and most forecasters inside and outside the Fed now believe a recovery is underway. The challenge for the Fed will be to remove stimulus from where it is no longer needed without crippling the recovery. Fortunately, this is not a case of whether or not to take the punch bowl away. The Fed has put so many programs and facilities in place that they effectively have ten punch bowls out there. The decision they face today is whether they can shut some of these down without putting the budding economic recovery at risk.

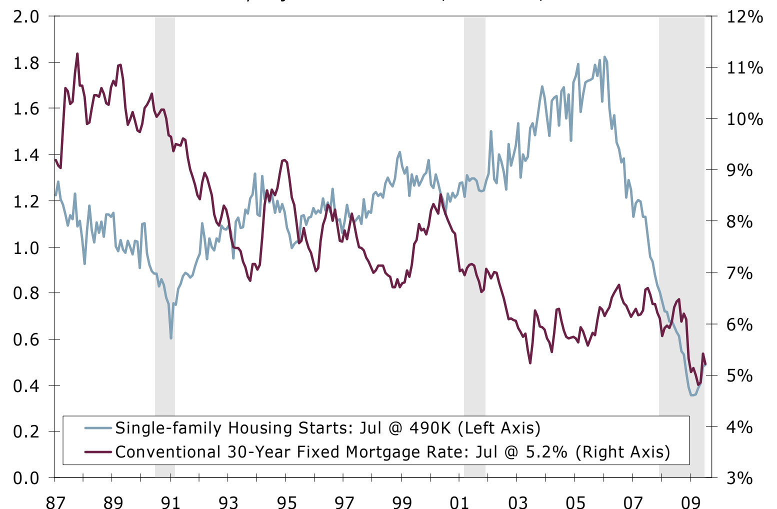
The Fed's actions have produced tangible results for the financial markets and the economy. The interbank lending market has returned to levels that existed before the onset of the financial crisis and other short-term funding markets are also functioning much more normally. In addition, a growing number of companies have been able to tap the equity and debt markets, allowing them to fortify their balance sheets. The improvement in financial conditions paves the way for a sustainable recovery. The Fed and many private forecasters expect the recovery to be slow at first and to gradually build momentum. Under that scenario, we would expect the Fed to gradually wind down and end many of the programs enacted during the last year, effectively removing one punchbowl at a time.

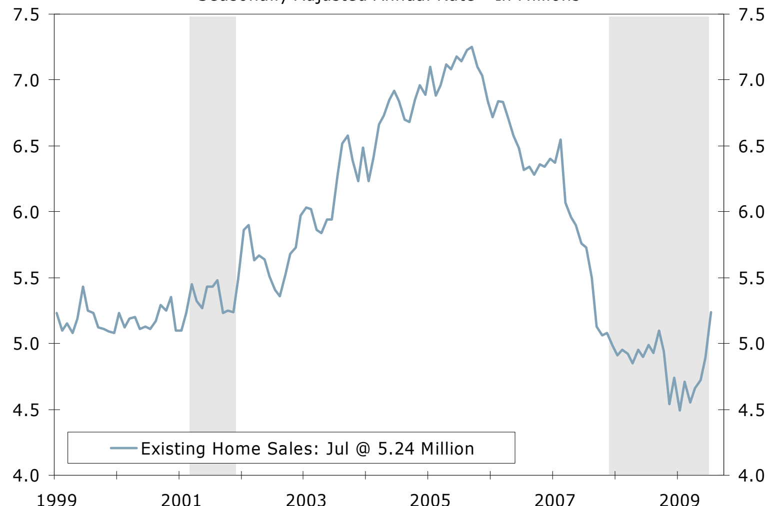
A good place for the Fed to start would be the lending programs aimed at short term funding, including the programs aimed at restarting the commercial paper and short-term asset-backed paper lending markets. The Fed has also announced plans to wind down its purchase of Treasury securities. They will probably need to leave programs designed to reinvigorate long-term funding in place longer, including the Fed's purchases of mortgage-back and asset-backed loans and the Term Asset Lending Facility, which is designed to strengthen private sector demand for these assets. The Fed will also likely leave the federal funds rate alone until the middle of next year but we believe they will raise short-term interest rates in 2010 and will move quickly to bring the federal funds rate back to a neutral level.

Fiscal stimulus is also making its mark. The widely reported cash-for-clunkers program is coming to an end this Monday and is reported to have helped fund the purchase of close to half a million vehicles. The increase in motor vehicle sales has been strong enough that Ford and General Motors announced plans to slightly increase their production later this year. The rise in auto sales will boost overall retail sales in August and lift overall growth for the quarter. There may be a payback later this year, however, as some sales were pulled forward and many of the folks trading in clunkers now have car payments to meet each month and less to spend on everything else.

The $8000 tax credit for first-time homebuyers is also producing some tangible benefits. Single-family housing starts have now risen for five straight months and sales of existing single-family homes have risen for four months in a row.





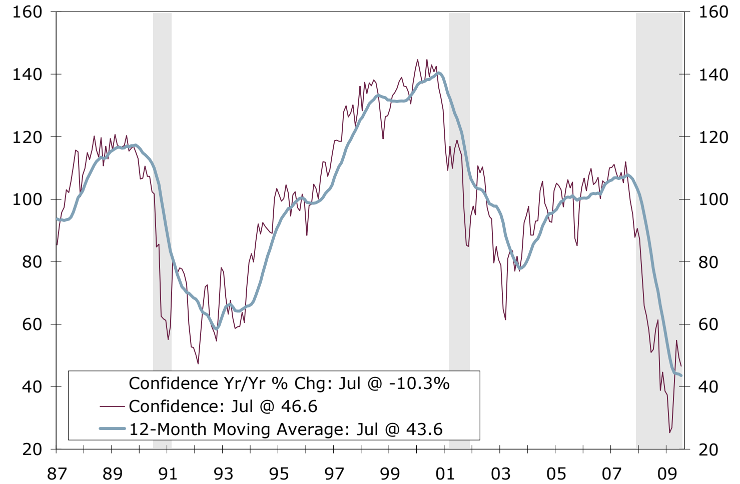


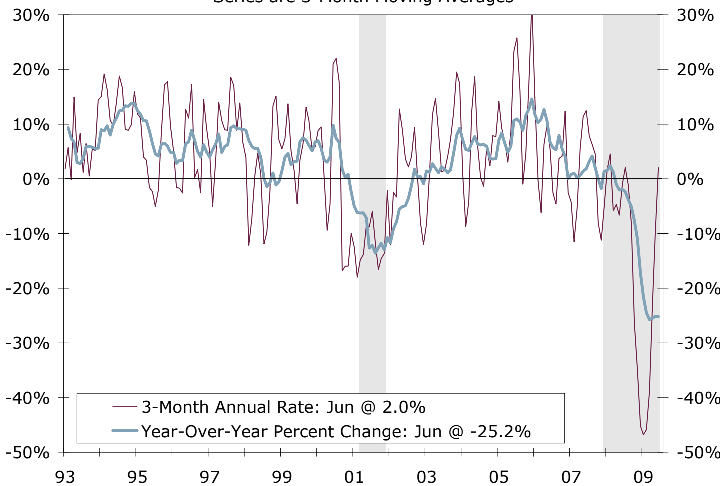
Consumer Confidence • Tuesday

The Consumer Confidence Index retreated 2.7 points to 46.6 in July, the second consecutive monthly decline. The decline shows consumers remain very concerned about their employment and income prospects. The labor market has shed roughly 6.5 million jobs since the recession began and while layoffs have subsided, hiring has not picked up. The number of consumers who found jobs "hard to get" spiked in July continuing to widen the labor differential. With the economy still losing an average of 331,000 jobs in the last three months and the unemployment rate expected to eventually reach double digits, consumer confidence will likely decline for a third consecutive month. We expect the consumer confidence index fell 4.6 points in August to 42.0. The historically low level of consumer confidence will keep a tight rein on discretionary purchases.

Previous: 46.6 **Wells Fargo: 42.0**

Consensus: 48.0





Durable Goods Orders • Wednesday

New orders for durable goods declined more than expected in June after increasing in both April and May. The headline number was driven by a significant decline in the volatile transportation sector. Non-defense capital goods orders excluding aircraft, however, has posted two consecutive monthly gains. The recent significant gain in industrial production due to an out-sized increase in motor vehicle production suggests a similar spike in new durable goods orders in July. The cash-for-clunkers program should continue to boost new orders through August as the second appropriation of stimulus dollars will likely be exhausted by Monday, August 24th. While cash-for-clunkers should provide positive momentum in the coming months, the gains will likely be unsustainable. Domestic demand in particular is being restrained by continued job losses, sluggish wage and salary growth and a massive loss of wealth.

Previous: -2.5% **Wells Fargo: 1.9%**

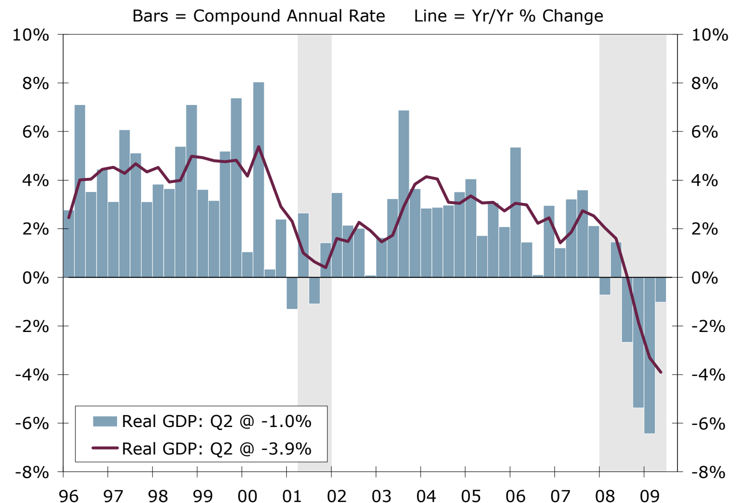
Consensus: 3.3%

Real GDP • Thursday

The advance estimate of second quarter real GDP reported that output fell at a 1.0 percent annual rate, significantly slower than the 6.4 percent and 5.4 percent annual rate declines in the first and fourth quarters, respectively. The upward revision to net exports will be more than offset by a larger-than-expected negative contribution from inventory investment. Real GDP will likely decline at a 1.6 percent annual rate. Businesses slashed output much more dramatically than sales declined, producing a huge drop in business inventories. While personal consumption, business fixed investment and residential construction will likely also post declines, the pace of declines has slowed significantly suggesting the worst of the recession is behind us.

Previous: -1.0% **Wells Fargo: -1.6%**

Consensus: -1.4%



Global Review

Mexican Economy Will Lag the Rest of the Region

As expected, the Mexican economy continued its plunge in the second quarter, even surpassing the effects of the Tequila Crisis back in 1994-1995. Mexican real GDP declined by 10.3 percent in the second quarter compared to the same period last year. (chart on front page)

On a seasonally-adjusted quarter-over-quarter basis, GDP dropped by 1.12 percent in the second quarter. INEGI noted that the Easter week was in April of this year, not March, and this has negatively affected the second quarter results.

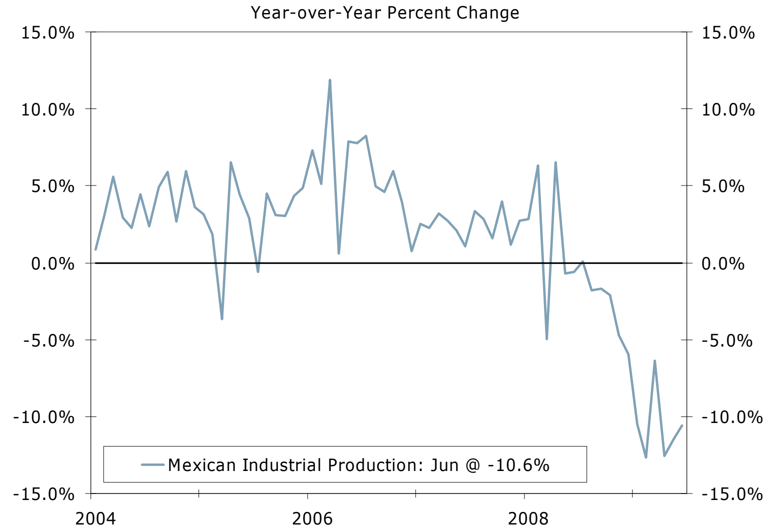
The only sector posting a positive quarter was the agricultural sector, up 1.1 percent. The industrial sector plunged by 11.5 percent and the service sector dropped by 10.4 percent. However, the fine print shows the plunge in the Mexican economy is due to its dependence on the U.S. economy (middle chart). This becomes even clearer when we observe the manufacturing sector. While manufacturing GDP dropped a severe 16.4 percent year-over-year, the production of transportation equipment fell off a precipice, down by an astonishing 44.5 percent year-over-year.

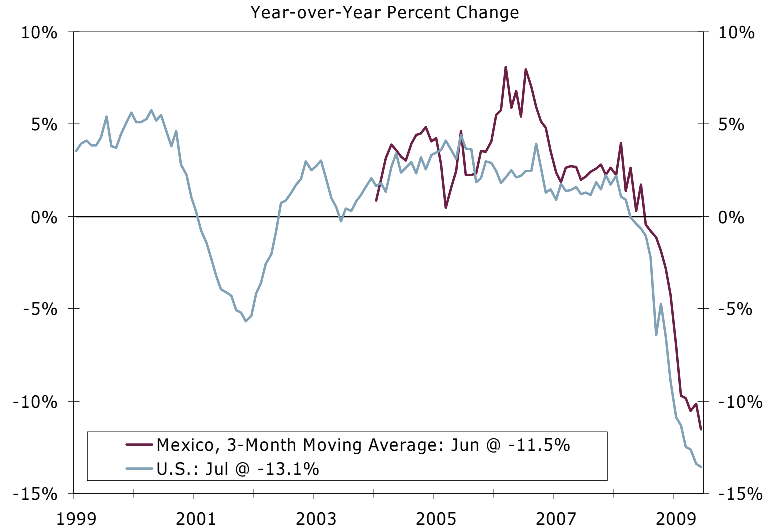
The Mexican economy during the last several decades has been specializing to provide the U.S. auto manufacturing sector a relatively cheap way of producing North American cars. Furthermore, U.S. auto manufacturers in Mexico have been producing mainly SUVs for the U.S. market for more than a decade.

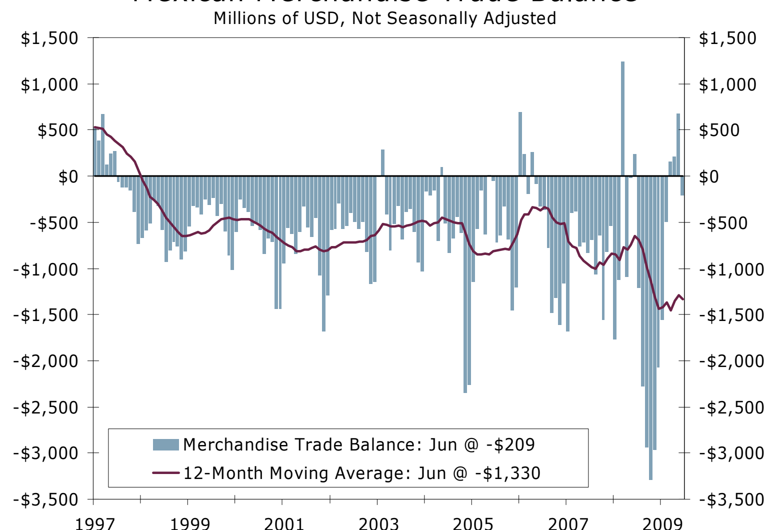
Because of the focus on producing vehicles aimed for the U.S. market, when the crisis hit this time, the auto manufacturing sector in Mexico completely collapsed. However, the most serious issue is that this reduction in demand for SUVs in the U.S. pre-dates the financial crisis and will probably continue after the crisis is over. This is bad news for the Mexican automobile production complex in particular and for the Mexican economy in general. In fact, this trend actually started with the surge in the price of petroleum. The financial crisis was just what pushed the sector off the cliff.

But the Mexican economy's problems are much broader. Almost 90 percent of total Mexican exports go to the U.S. market. With the weak prospects for U.S. consumption in the short to medium term, the prospects for the Mexican economy are not good, especially if it is not able to diversify its export markets. Furthermore, the only sector that posted positive economic growth (the agricultural sector) is probably going to go under during the third and fourth quarters due to the severe drought affecting the country.

Meanwhile, the domestic economy is also suffering from a large drop in remittances from Mexicans living in the U.S., down 12 percent during the first half of 2009 compared to the same period a year earlier. The number of jobs in the U.S. will need to actually increase and not merely decrease at a slower rate before remittances pick up in a substantive way. We expect remittances to remain weak, which will also weigh on the Mexican economy for the foreseeable future.







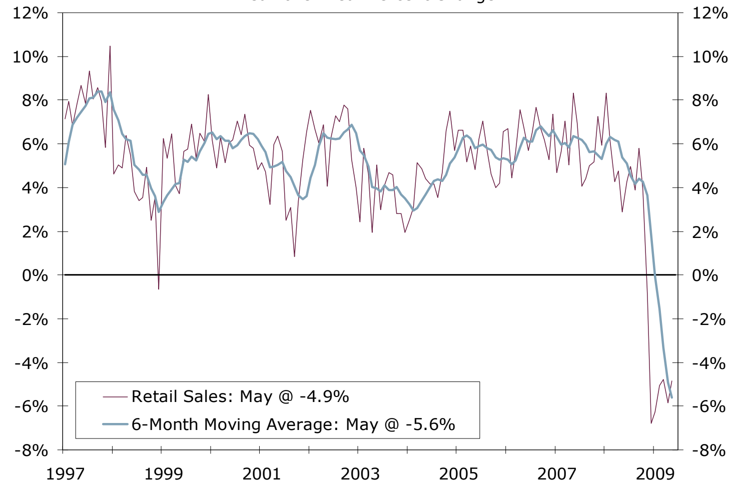
Canadian Retail Sales • Monday

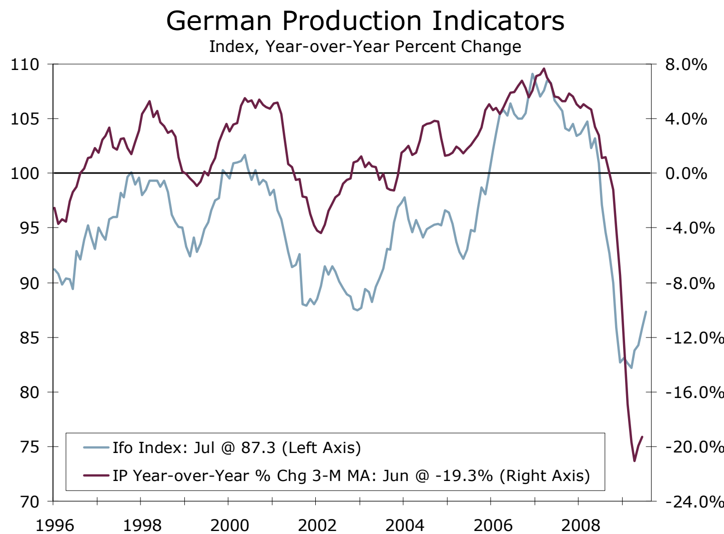
Toward the end of last year when financial markets were in a tailspin, Canadian retail sales fell off a cliff. However domestic demand in Canada has been remarkably resilient. While sales remain well below where they were last year at this time, retailers in Canada have been ringing up slightly larger sales in four out of the last five months. The consensus is expecting a roughly flat number for June retail sales which will be reported on Monday of next week. Given the ongoing challenges in the labor market, we see little reason to be optimistic about consumer spending.

At the end of the week, markets will digest July data for industrial production prices which will print on Friday. June production data were helped by higher raw material and energy costs, but as oil and other commodity prices have moderated, that support will fade in July resulting in a modest pullback for the month.

Previous: 1.2%

Consensus: 0.1%





German Ifo Index • Wednesday

Investors follow the Ifo index of German business sentiment because it is highly correlated with movements in German industrial production. Indeed, the rise in the Ifo index off its lows earlier this year has been associated with the recent stabilization in industrial production. If, as expected by the consensus forecast, the Ifo index rises further in August, then investors would infer that industrial production has strengthened this month.

Speaking of strengthening production, data released last week showed that German real GDP rose 0.3 percent (not annualized) in the second quarter relative to the first quarter. A breakdown of real GDP into its underlying demand components will be released on Tuesday. The data will highlight the sources of German growth in the second quarter, and it will offer some insights into the sustainability of the recovery.

Previous: 87.3

Consensus: 88.9

Japanese Unemployment Rate • Friday

The unemployment rate in Japan has skyrocketed higher over the past year as the Japanese economy has tanked. Although real GDP rose at an annualized rate of 3.7 percent in Q2, the unemployment rate will probably drift higher over the next few months. Indeed, the consensus forecast anticipates that the unemployment rate rose from 5.4 percent in June to 5.5 percent in July.

Data on consumer prices in July will also print on Friday. The combination of deep recession and the collapse in oil prices since last summer has caused the overall CPI to fall 1.8 percent over the past twelve months, the sharpest rate of deflation in decades. However, the consensus forecast looks for the rate of deflation to have breeched 2.0 percent in July.

Previous: 5.4%

Consensus: 5.5%

Interest Rate Watch

Deceivingly Low Real Interest Rates

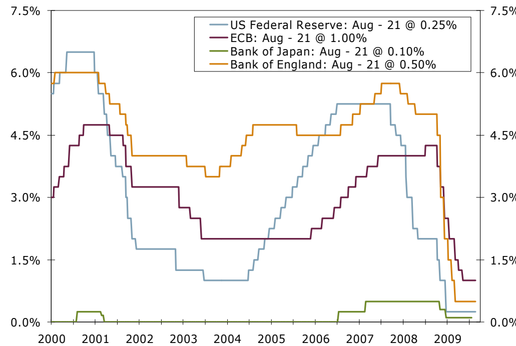
There has been a great deal of discussion about today's negative real interest rates. The overall Consumer Price Index is down 2.1 percent over the past year and the overall Producer Price Index is down 6.8 percent. Both mark the largest drops in about half a century, which got tongues wagging this week about outright deflation.

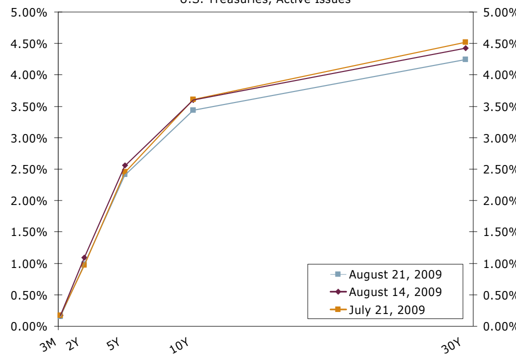
We noted late last year that deflation this year was all but certain from a technical standpoint. Most of the drop, however, is due to falling energy prices. Excluding food and energy prices the core CPI is up 1.5 percent year-to-year and the core PPI is up 2.6 percent. With the federal funds rate close to zero that still leaves real interest rates solidly in negative territory but much less so than the worrywarts would believe. We have long felt the best way to measure real interest rates is to use the core PCE deflator.

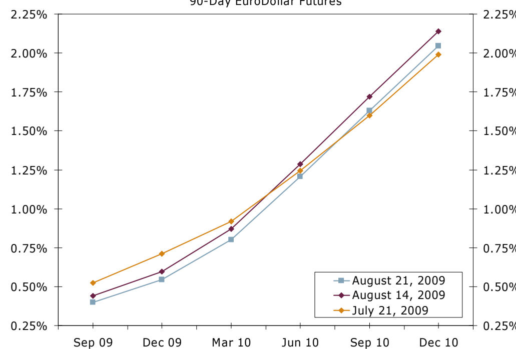
The real federal funds rate provides a good real time assessment as to how accommodative or restrictive monetary policy is. The current level reflects the enormous liquidity provided by the Federal Reserve over the past year. Over time, we expect the Federal Reserve to remove this liquidity and to push the federal funds rate back to a neutral level. The neutral federal funds rate tends be about two points over the core inflation rate and the Fed usually brings the federal funds rate there as the economy approaches full employment.

The yield curve and forward rates clearly anticipate some rise in short-term interest rates over the next year. Expectations are being fueled by the recent run of better-than-expected economic news, a weak dollar and some truly resilient fears about higher inflation. On the plus side, yields have been held down by better news on the federal budget deficit, it will "only" be $1.5 trillion this year, and lower inflation.

We expect interest rates to gradually rise over the next year as the recovery gains momentum and investors become more willing to take risk. While interest rates will rise, they will remain low by historical standards, with the 10 year Treasury rising to just 4.3 percent by the end of next year.







Consumer Credit Insights

TALF Extension

In this space and others we have frequently discussed the issue of the "haves" and the "have nots" in asset backed securities—those issuers who have access to the Term Asset-Backed Securities Loan Facility (TALF) and those who do not. While conditions have "improved considerably in recent months," according to the Federal Reserve Board, financial markets remain stressed, and the quick removal of a key stabilizing facility could create a major setback for markets. Realizing this as well as the necessity to act early enough to ensure continued smooth operation of financial markets, the Federal Reserve Board and the Treasury announced an extension of TALF this past week. The program for newly issued ABS and legacy CMBS will continue until March 31, 2010. Also, newly issued CMBS will be eligible for an additional three months to address the ongoing concerns in that market. While the good news for markets is that TALF is not ending in the very near-term it does remind us this program and others will eventually have to be unwound and markets will again have to price credit and risk without public assistance. The Fed and the Treasury did not slam the door on further extensions, but seemed reluctant, and rightfully so, to commit indefinitely. At this point it is essential that the Fed transparently begins planning and implementing its "exit strategy" to remove unprecedented monetary easing across its support programs.

Mortgage Data

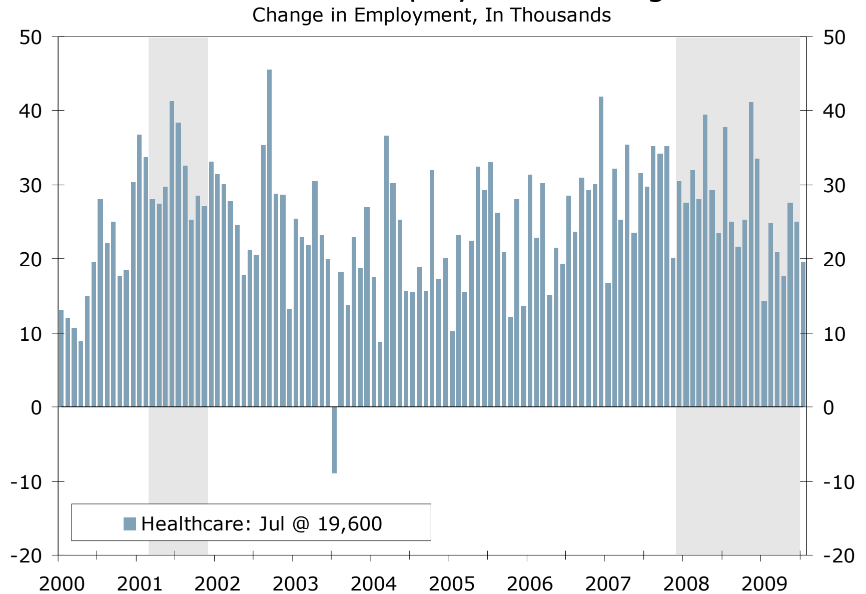
	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	5.12%	5.29%	5.20%	6.47%
15-Yr Fixed	4.56%	4.68%	4.68%	6.00%
5/1 ARM	4.57%	4.75%	4.74%	5.99%
1-Yr ARM	4.69%	4.72%	4.77%	5.29%
MBA Applications				
Composite	527.0	499.0	528.9	419.3
Purchase	277.7	267.2	262.1	314.0
Refinance	1,982.5	1,853.8	2,089.7	1,034.5

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

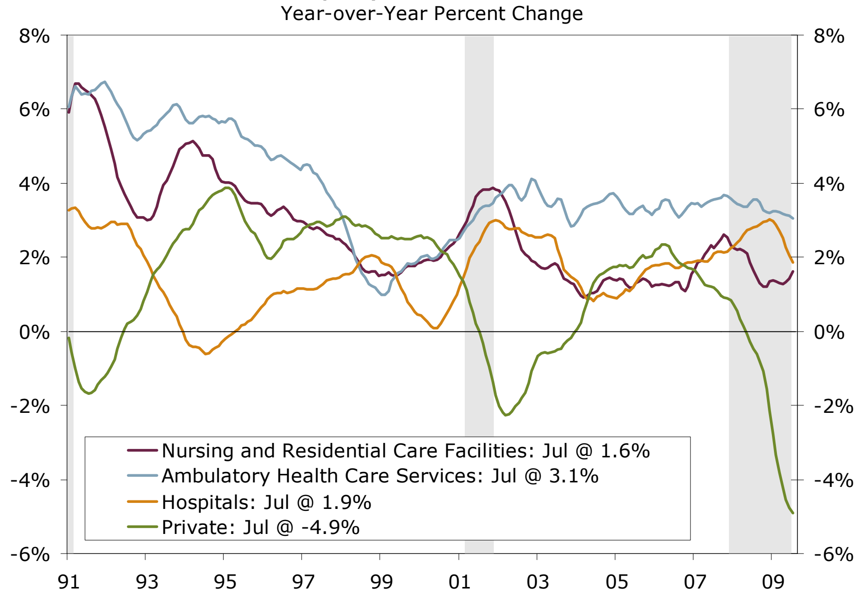
Topic of the Week

Healthcare Employment Avoids the Sick Ward

The labor market today is in a state of severe distress. Through this cycle the United States has witnessed the loss of 6.5 million jobs, and the unemployment rate has skyrocketed to nearly 10 percent. Unfortunately the outlook is still quite bleak—we expect job losses to continue for the remainder of the year at a pace of about 250,000 per month. No sector has been truly immune to the problems facing the labor market and the economy in general, but some sectors have managed to avoid the catastrophic declines witnessed in others. In the private labor market, healthcare is the only industry that has stayed successfully out of the sick ward—over the past 10 years the healthcare sector has managed to increase employment by 2.4 percent per year, despite two recessions. In contrast, private employment has barely managed an increase over the same period. Healthcare employment is up just 1.6 percent at an annual rate over the past three months, but this is a far better performance than every other sector in the economy.



Beyond the obvious benefit of providing a job in such a difficult period, the healthcare sector provides jobs we ought to celebrate. In terms of hourly earnings, they pay more than the average private sector job, raising the average standard of living for the nation at a key juncture. Favorable demographics along with changing consumer preferences and technological developments lend support to the sector. On the consumer front, there is a shift in preferences toward home healthcare. Changing tastes are partially attributable to demographics, specifically the aging U.S. population. Certain subsectors have much to gain from these trends. The ambulatory health services subsector, encompassing offices of physicians, outpatient care services and home healthcare services, has experienced record job creation. Home healthcare has added jobs at a particularly strong pace, up 6.3 percent from a year ago. These trends are persistent, allowing healthcare to continue to play a pivotal role in the U.S. labor market, even after job losses stop plaguing the economy.



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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/21/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.16	0.17	1.71
3-Month LIBOR	0.39	0.43	2.81
1-Year Treasury	0.39	0.50	1.90
2-Year Treasury	0.98	1.05	2.30
5-Year Treasury	2.41	2.51	3.06
10-Year Treasury	3.43	3.57	3.83
30-Year Treasury	4.25	4.42	4.46
Bond Buyer Index	4.58	4.65	4.64

Foreign Exchange Rates

	Friday 8/21/2009	1 Week Ago	1 Year Ago
Euro ($/€)	1.433	1.420	1.490
British Pound ($/£)	1.656	1.654	1.878
British Pound (£/€)	0.865	0.858	0.793
Japanese Yen (¥/$)	93.665	94.940	108.435
Canadian Dollar (C$/$)	1.085	1.098	1.043
Swiss Franc (CHF/$)	1.058	1.072	1.086
Australian Dollar (US$/A$)	0.834	0.833	0.881
Mexican Peso (MXN/$)	12.838	12.847	10.093
Chinese Yuan (CNY/$)	6.831	6.834	6.844
Indian Rupee (INR/$)	48.605	48.247	43.529
Brazilian Real (BRL/$)	1.834	1.848	1.609
U.S. Dollar Index	77.968	78.885	76.196

Foreign Interest Rates

	Friday 8/21/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.83	0.83	4.95
3-Month Sterling LIBOR	0.72	0.77	5.76
3-Month Canadian LIBOR	0.59	0.60	3.34
3-Month Yen LIBOR	0.39	0.40	0.87
2-Year German	1.32	1.30	4.08
2-Year U.K.	0.88	0.92	4.58
2-Year Canadian	1.26	1.32	2.85
2-Year Japanese	0.25	0.27	0.69
10-Year German	3.26	3.32	4.18
10-Year U.K.	3.61	3.68	4.57
10-Year Canadian	3.39	3.47	3.60
10-Year Japanese	1.32	1.39	1.42

Commodity Prices

	Friday 8/21/2009	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	73.96	67.51	121.18
Gold ($/Ounce)	945.15	948.55	837.00
Hot-Rolled Steel ($/S.Ton)	465.00	465.00	1125.00
Copper (¢/Pound)	275.00	283.40	356.10
Soybeans ($/Bushel)	10.02	11.66	13.00
Natural Gas ($/MMBTU)	2.93	3.24	8.25
Nickel ($/Metric Ton)	18,878	20,533	19,865
CRB Spot Inds.	442.20	451.37	472.51

Next Week's Economic Calendar

	Monday 24	Tuesday 25	Wednesday 26	Thursday 27	Friday 28
U.S. Data		**Consumer Confidence** July 46.6 August 42.0 (W)	**Durable Goods Orders** June -2.5% July 1.9% (W) **Durables Ex Transp.** June 1.1% July 0.4% (W) **New Home Sales** June 384K July 400K (W)	**GDP** 2009:Q2 -1.0% (Advance) 2009:Q2 -1.6% (P) (W)	**Personal Income** June -1.3% July 0.4% (W) **Personal Spending** June 0.4% July 0.3% (W) **PCE Deflator** June -0.4% July -0.8% (W)
Global Data	**Canada** **Retail Sales (MoM)** Previous (May) 1.2%		**Germany** **IFO-Business Climate** Previous (Jul) 87.3		**Japan** **Jobless Rate** Previous (Jun) 5.4% **Japan** **CPI (YoY)** Previous (Jun) -1.8%

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

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