July 17, 2009

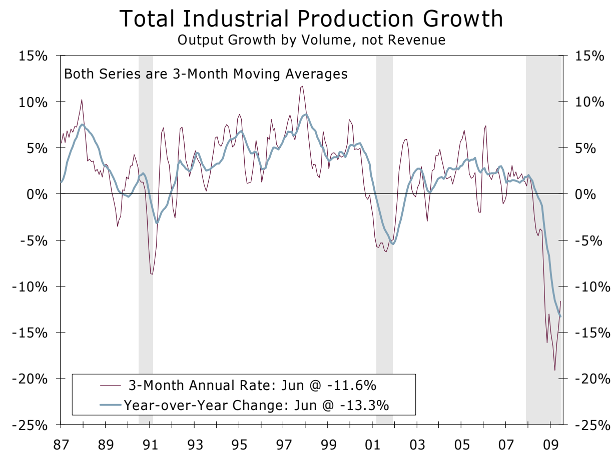
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

The Stage is Set for at Least a Technical Rebound

- Production and inventory cuts during the first half of 2009 were likely a bit overdone and production is expected to bounce back during the second half of the year, leading to growth in real GDP.
- The unusual timing of motor vehicle assembly plant shutdowns is wreaking havoc with the economic indicators, leading to exaggerated declines in weekly first-time unemployment claims.
- Swings in inventories and international trade may produce surprisingly robust GDP numbers. Final demand is still weak, however, and hiring has not seemed to picked up.



Global Review

Indications of Stronger Growth in Asia Confirmed

- As recent monthly data had indicated, real GDP growth in China strengthened in the second quarter due, at least in part, to the effects of policy stimulus. Although the recent surge in credit growth raises some interesting long-term issues, the relaxation of lending restrictions certainly has helped to stimulate the Chinese economy.
- Real GDP in Singapore rebounded in the second quarter. The city-state is one of the most open economies in the world, and the return of global trade over the past few months has helped to stimulate the Singaporean economy.

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]	0.9	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

Inside

U.S. Review

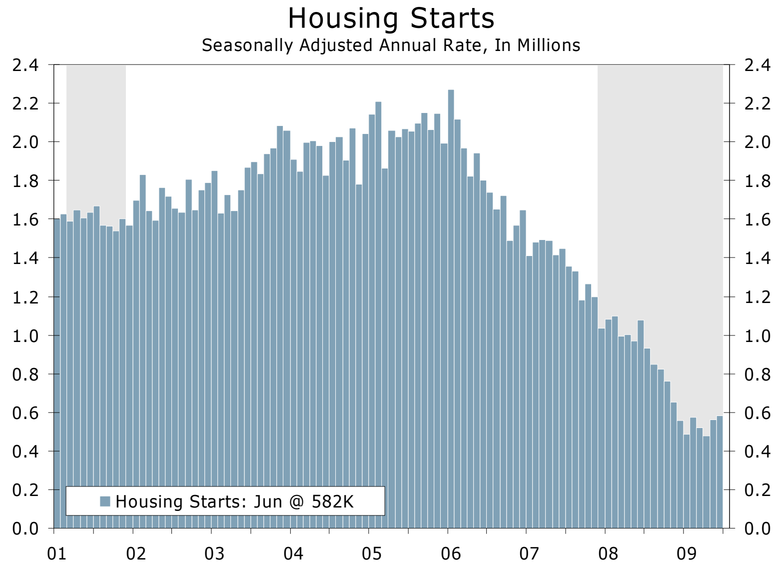
Economic Conditions Remain Stressed

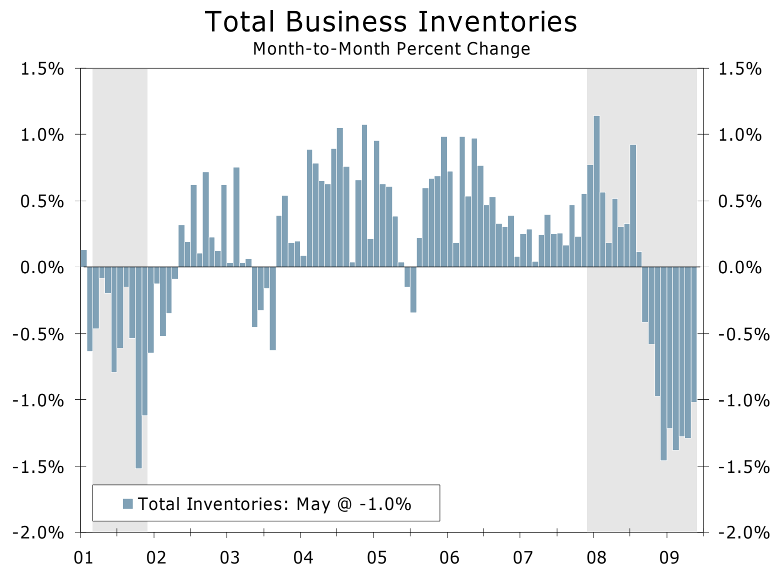
The past week's full plate of economic indicators provided a clearer perspective of where we are in the recovery process. Businesses slashed production and inventories during the first half of 2009 and likely overdid it. Motor vehicle production, for example, was slashed to around a 3.5 million unit rate during the second quarter. Production is now set to ramp up to a 6.5 million unit pace. While that level still pales in comparison to its year ago level, the quarterly swing will lift output across the spectrum. A few steel producers have already announced plans to restart blast furnaces, and other supporting industries, including semiconductors, are reporting some improvement.

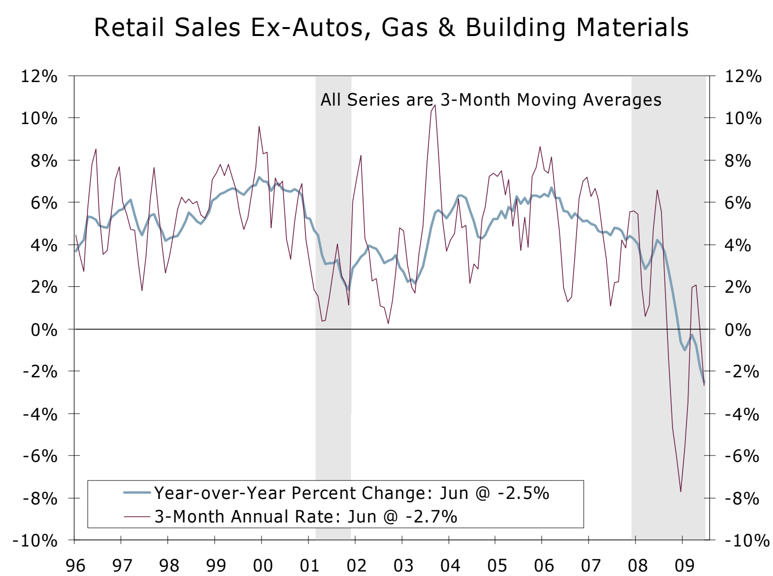
This same process appears to be playing out in the housing market. Starts of single-family homes tumbled to modern era lows in January and February, as builders were unable to get credit to start new projects. The drop in housing starts earlier this year brought construction below the historic levels 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 have risen in each of the past four months. The level of homebuilding still remains incredibly distressed but the lows for the cycle have likely been hit and conditions are likely to get marginally better for homebuilders over the next few quarters.

What appears to be playing out is the end of the remarkably long multi-year drawdown in real inventories. Our forecast for the second quarter calls for inventories to drop by around $100 billion, which would subtract 0.4 percentage points from second quarter real GDP. Some forecasts, however, call for much larger declines than that and inventory liquidations could easily shave a full percentage point off of second quarter real GDP. The latest business inventory data show inventories falling 1.0 percent in May, following a downwardly revised 1.3 percent drop in April. The swing in motor vehicle output that we noted earlier will cause inventories to fall much less in the third quarter, which means that inventories will likely add two percentage points or more to real GDP growth during the third quarter.

While the economy may technically expand during the third quarter nearly all the improvement will likely come from the swing in inventories. Final demand is not improving. The latest retail sales numbers show spending rising 0.6 percent in June, with a slight rise in motor vehicle sales and higher gasoline prices accounting for all of the increase. Core retail sales, which excludes motor vehicles, gasoline and building materials, fell 0.1 percent in June and declined at a 2.7 percent annual rate during the second quarter. This core category of retail sales has the strongest correlation with personal consumption expenditures. The latest figures suggest that our estimate of a 0.6 percent decline during the second quarter is likely too strong. Without any improvement in final demand, the rebound in production we are expecting for the third quarter will not be sustainable, setting us up for a decline in output this fall.





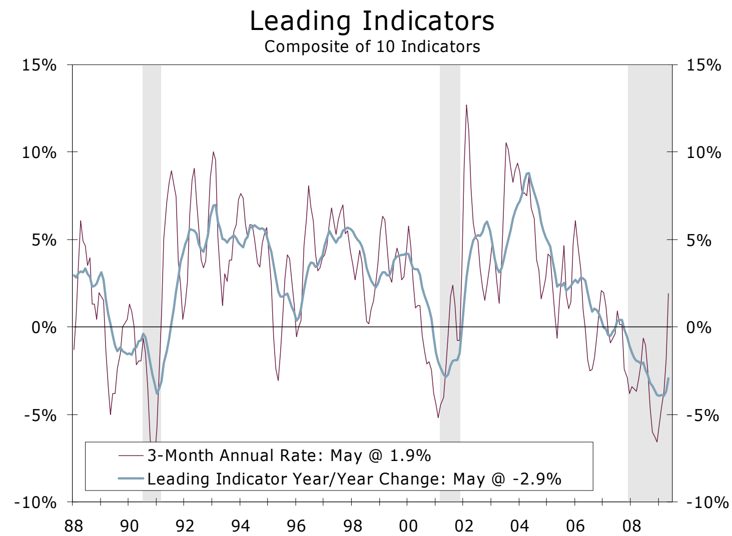


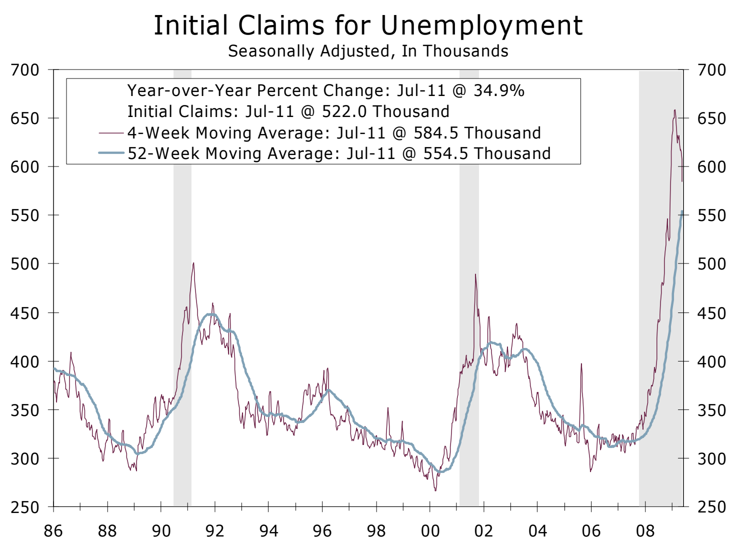
Leading Economic Index • Monday

The Leading Economic Index (LEI) gained 1.2 percent in May, surpassing last month's gain and posting the first back-to-back monthly increase in almost three years. Most of the rise in the index was due to a spike in supplier delivery times, which added 0.33 percent to the index in May. The ISM index for supplier deliveries rose to 50.6 in June, breaking the contraction/ expansion threshold of 50 for the first time since September 2008, and will likely provide its third consecutive positive contribution to LEI. Other positive contributions will likely be the average hourly workweek in manufacturing, the positive yield curve, stock prices, housing permits and initial claims. Consumer expectations and the real money supply fell in June and will likely detract from the index. The consecutive increases in LEI are consistent with our forecast that the recession will end later this year.

Previous: 1.2% **Wells Fargo: 0.8%**

Consensus: 0.5%





Initial Jobless Claims • Thursday

Initial jobless claims declined for two consecutive weeks, falling to 522,000 in the week ending July 11th from a revised 569,000 in the prior week. Declines in initial jobless claims have traditionally been a harbinger for an economic recovery, but seasonal factors due to the auto industry likely distorted recent figures. Auto plants typically shut down some production for a couple of weeks in early July for retooling. As such, seasonal factors take this into consideration and the figures are smoothed in anticipation of higher jobless claims. Auto bankruptcies in May and June caused many plants to shut down earlier than seasonal adjustments expected. Hence, the consecutive declines in jobless claims. We expect this distortion will likely occur throughout the summer. No green shoots here, just weeds.

Previous: 522K

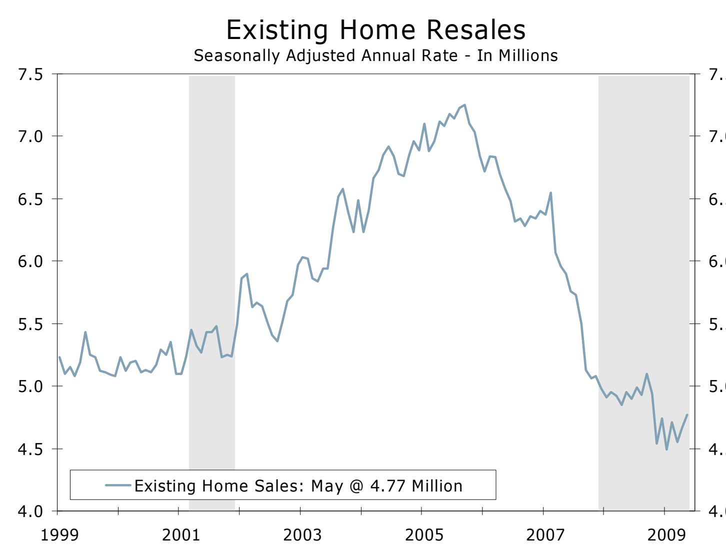
Consensus: 555K

Existing Home Sales • Thursday

Sales of existing homes rose 2.4 percent in May, pushing sales up to a 4.77 million unit annual rate. Existing home sales have been holding in a relatively tight range since late 2008 but likely bottomed in January, putting the peak-trough decline at about 38 percent. While existing sales have increased for two consecutive months, distressed sales accounted for 33 percent of activity in May. With distressed sales still representing about a third of existing home sales, we are not expecting a near-term rebound. We expect sales will continue to hold within the same narrow range increasing a modest 0.2 percent to a 4.78 million unit annual rate. Since existing home sales represent closings (as opposed to contract signings in the new home sales) these data represent sales contracts around March and April when the 30-year fixed mortgage rate broke below five percent.

Previous: 4.77M **Wells Fargo: 4.78M**

Consensus: 4.80M



Global Review

Indications of Stronger Growth in Asia Confirmed

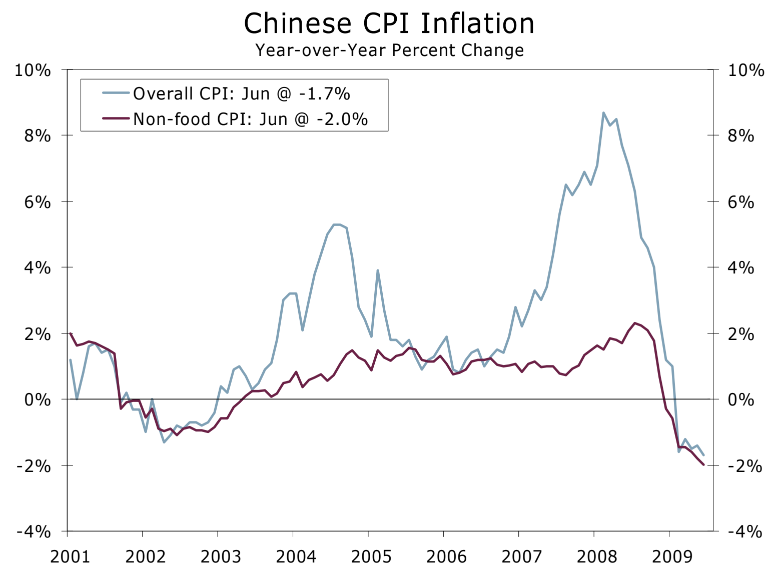
Economic data over the past few months seemed to suggest that growth in Asia was strengthening, which was confirmed this week by real GDP data for the second quarter. For example, the year-over-year rate of real GDP growth in China rose from 6.1 percent in the first quarter to 7.9 percent in the second quarter (see chart on front page). In response to the global financial crisis last autumn, the Chinese government took rapid and aggressive steps to ensure that economic growth would remain reasonably supported. The recent upturn in China shows that their efforts are working. Moreover, the quarter appears to have ended on a strong note as growth in industrial production rose to 10.7 percent in June from 8.9 percent in May.

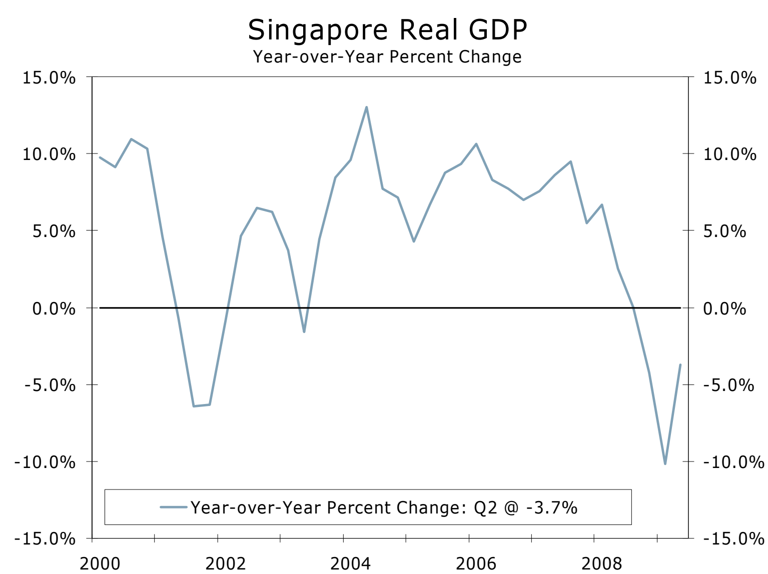
Not only did the government loosen the fiscal taps via modest tax cuts and a large infrastructure spending program, but it relaxed lending restrictions that were put in place in early 2008. Indeed, lending growth has surged over the past few months (top chart). Although rapid growth in lending raises some interesting long-run issues, the recent surge in credit has certainly helped to stimulate the economy (for further reading, see "Is China the Next Bubble?" which is posted on our website).

Inflation is a lagging indicator, so it would be premature to expect the recent acceleration in economic activity to show up as higher inflation. Indeed, consumer prices in China have been falling on a year-over-year basis for the past few months (middle chart). Not only are food prices lower relative to last year at this time, but non-food prices have also declined. If, as we expect, Chinese growth strengthens further in the quarters ahead, then non-food prices will start to rise again. However, runaway inflation in China is very unlikely, at least in the foreseeable future.

In Singapore, real GDP declined 3.7 percent in the second quarter relative to the same quarter in 2008 (bottom chart). Not only was the year-over-year rate of contraction much less severe than in the first quarter, but real GDP shot up at an annualized rate of 20 percent on a sequential basis. Singapore is one of the most open economies in the world, and real GDP can exhibit large fluctuations on a quarter-by-quarter basis as exports and imports rise and fall.

Not only did manufacturing activity in the Lion City strengthen, which reflects, at least in part, a rebound in exports, but activity in the service sector also picked up. Regarding exports, the value of non-oil exports, which went into freefall late last year, rose about eight percent (non-annualized) in the second quarter relative to the first quarter. Notably, exports of electronics and pharmaceuticals strengthened in the second quarter. As noted above, Singapore is very open to trade flows. The recent increase in global trade, if sustained, which we believe it will be, should continue to boost real GDP growth in Singapore in the quarters ahead.



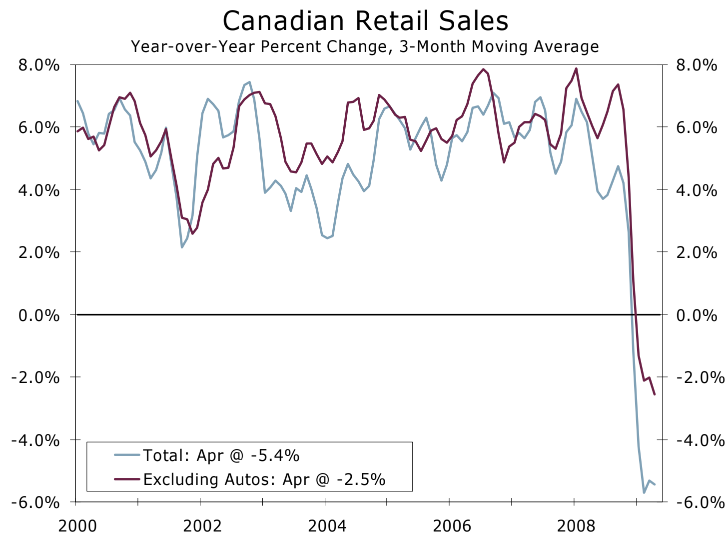


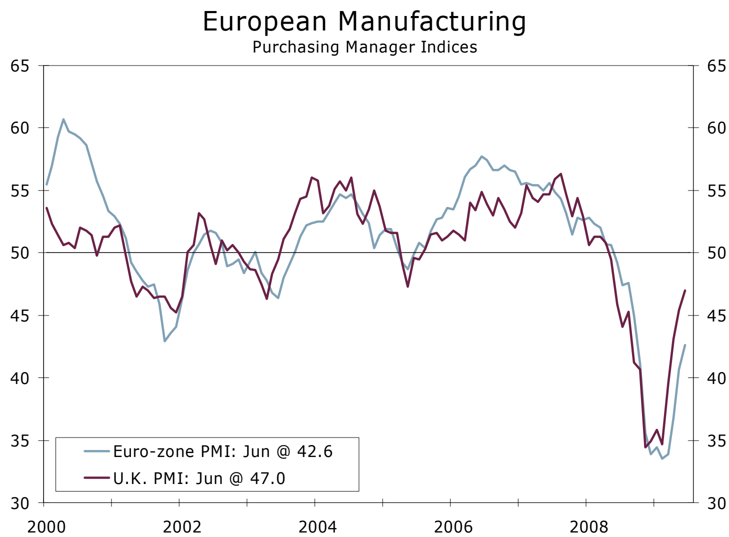
Canadian Retail Sales • Wednesday

The Canadian consumer was in full retreat at the end of last year, and sales fell dramatically each month during the last quarter. Domestic demand, however, began to show signs of life, posting modest increases in the first three months of this year. Still, April retail sales gave back some gains, and with the unemployment rate at 8.6 percent and rising, there is little hope for a quick recovery in consumer spending. We will get a sense of how the consumer is holding up when retail sales data for the month of May print this Wednesday.

The Bank of Canada (BoC) is expected to keep the benchmark rate at a record low 0.25 percent when it announces it rate decision this week. The BoC has repeatedly made clear that unless the inflation outlook changes, it will keep rates where they are until June of 2010 to help spur economic recovery.

Previous: -0.8% (MoM)





Euro-zone PMIs • Friday

Purchasing managers' indices in the Euro-zone, which tanked late in 2008 and early this year, have rebounded lately. However, the respective PMIs for both the manufacturing and service sectors remain below the demarcation line that separates expansion from contraction. Although the consensus forecasts anticipate some further improvement in July, both indices are expected to remain below 50. "Hard" data on Euro-zone industrial orders in May are slated for release on Wednesday. The sharp rise in German factory orders that were reported in May should help to boost orders in the overall Euro-zone.

Another widely-followed index of business sentiment, the German Ifo index, will also print on Friday. The index will probably rise further in July but likely remain depressed in a historical context.

Previous Mfg. PMI: 42.6 **Consensus: 43.5**

Previous Service PMI: 44.7 **Consensus: 45.2**

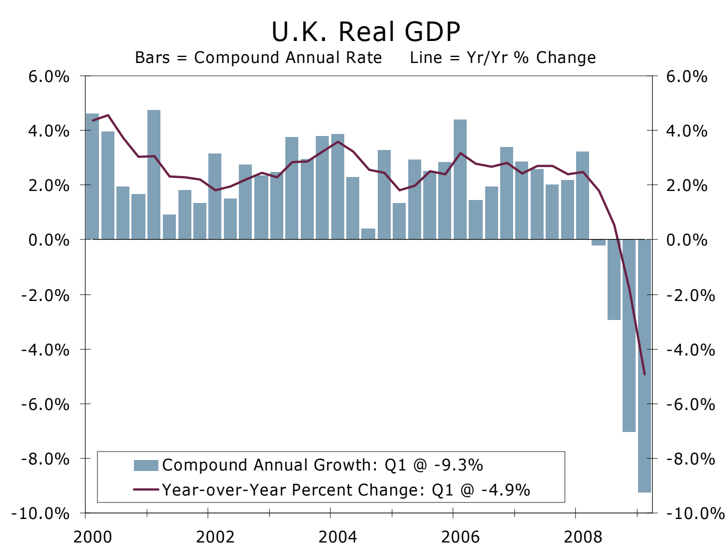
U.K. Real GDP • Friday

Real GDP in the United Kingdom declined 2.4 percent (not annualized) in the first quarter, the sharpest rate of contraction in about 30 years. Indeed, the British economy is enduring its worst downturn since, arguably, the end of the Second World War. However, monthly data over the past few months suggest the rate of contraction slowed significantly in the second quarter. Positive GDP growth in the third quarter is a distinct possibility.

As one would expect in a deep recession, the pace of retail spending growth has slowed markedly over the past year or so. Retail sales data for June will be released on Thursday and the consensus forecast anticipates that spending rose in June in partial payback for weakness during the previous month. On a year-over-year basis, real retail sales are barely growing at present—not awful, but not strong either.

Previous: -2.4% (quarter-on-quarter, not annualized)

Consensus: -0.3%



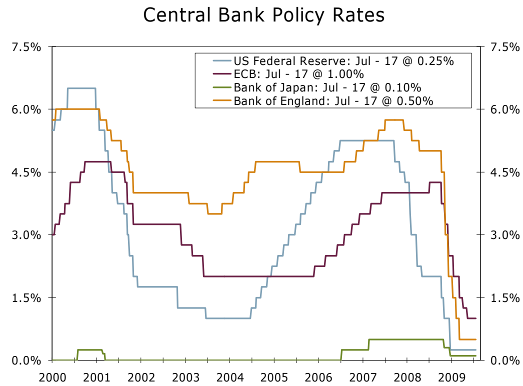
Interest Rate Watch

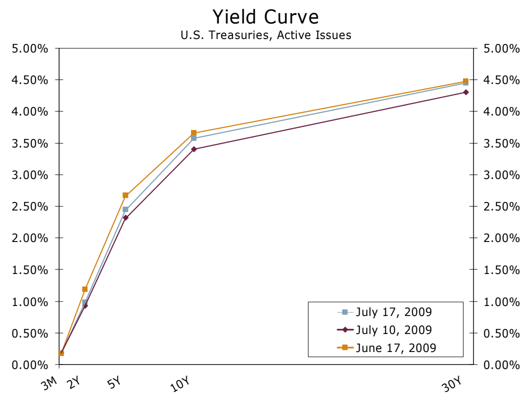
FOMC Outlook

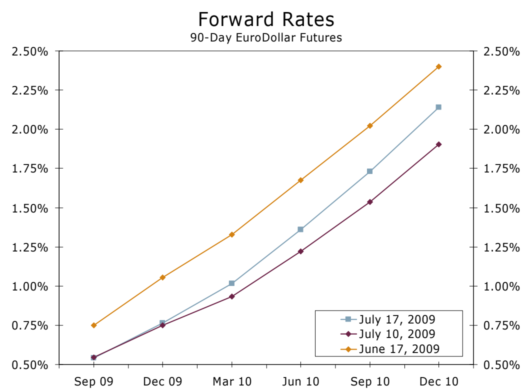
Minutes of the June 23-24 Federal Open Market Committee (FOMC) meeting suggested that the FOMC sees the economy remaining weak but with a moderating pace of decline. We would agree. Our July outlook posts a second quarter decline in Gross Domestic Product (GDP) of 1.6 percent, which is far better than the decline of 5.5 percent in the first quarter. We do have growth turning positive in the second half. Growth is being driven by federal government spending and turnarounds in both housing and consumer spending.

Inflation expectations, meanwhile, were raised by the FOMC for both overall and core (excluding food & energy) inflation. The Fed staff raised its inflation numbers due to the rise in energy prices, less-favorable import prices and the absence of any downward movement in inflation expectations. In an interesting side note, the FOMC also makes the case that low levels of resource utilization would lead to an "appreciable" deceleration of core consumer prices through 2010. Our outlook would not allow for an "appreciable" deceleration, in fact, our outlook is for stability with a slight upward bias in core inflation through 2010. In part, this inflation outlook reflects our view that oil prices will rise and the dollar will slightly depreciate. These two factors suggest upside, not downside, risk to core inflation.

We view the FOMC comments as supportive of our view that the Federal Reserve is not likely to alter the formal federal funds target range for the rest of this year. However, we still expect a modest rise in longer-term rates for two primary reasons. First is the continued decline of the flight to safety trade. Second, there remains the conflict of a very limited supply of savings in the face of increased U.S. Treasury debt issuance. Foreign concerns continue to be expressed about the value of the dollar as a global standard given the decline in foreign confidence in U.S. economic policy and concerns about future debt issuance.







Consumer Credit Insights

The Fed Reviews the Credit Markets

Within the Federal Open Market Committee minutes, the members cited that "financial markets over the inter-meeting period were seen as broadly positive, reflecting a reduction in the perceived risk..." This has certainly been true of investment grade corporate spreads over Treasuries which have narrowed fairly steadily since March.

However, the FOMC also raised unemployment expectations for both 2009 and 2010. In their minutes the FOMC cited that "labor market conditions were of particular concern..." Job losses remained "substantial" and the unemployment rate continued to rise "rapidly." For the economy, higher unemployment suggests lower government revenues and higher consumer credit delinquencies. California was downgraded by Fitch and 10-year California G.O. bond rates have risen since mid-May. Meanwhile both prime and sub-prime fixed-rate mortgage delinquencies have continued to rise since late 2006.

Going forward, we anticipate continued Fed intervention at least until next February, which will keep credit spreads narrower than they would be otherwise. This is particularly true for asset-backed and mortgage-backed securities. In recent weeks, we have seen spreads widen with the announcement of Fed intentions for purchases of these securities. Meanwhile, the de-leveraging of the consumer will continue with household saving expected to rise over the next six months.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	5.14%	5.20%	5.38%	6.26%
15-Yr Fixed	4.63%	4.69%	4.89%	5.78%
5/1 ARM	4.83%	4.82%	4.97%	5.80%
1-Yr ARM	4.76%	4.82%	4.95%	5.10%
MBA Applications				
Composite	514.4	493.1	514.4	522.2
Purchase	258.8	285.6	261.2	359.7
Refinance	2,009.4	1,707.7	1,998.1	1,474.9

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

Topic of the Week

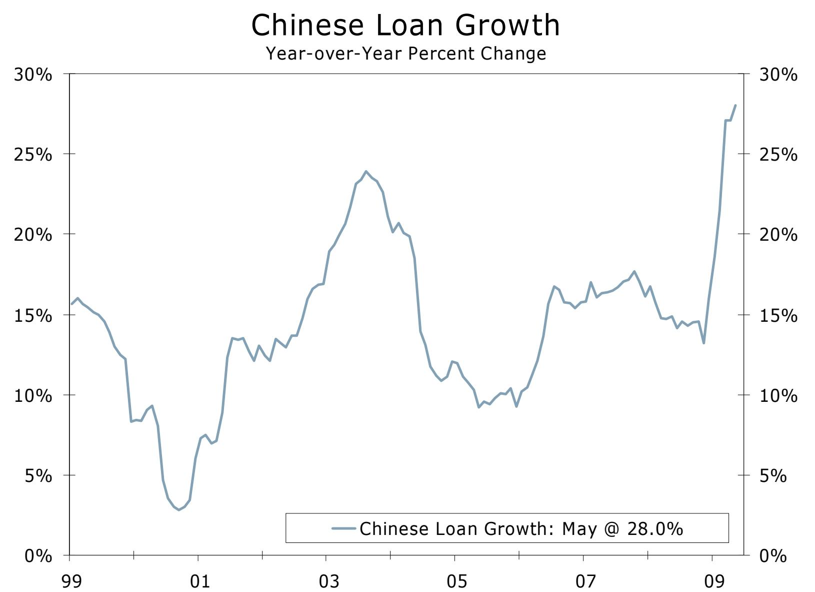
Is China the Next Bubble?

Recently released data showed that the year-over-year growth rate of Chinese real GDP rose from 6.1 percent in the first quarter of this year to 7.9 percent in the second quarter. Monthly data certainly suggested that economic growth in China was picking up steam in the second quarter, so the confirmation that overall GDP accelerated in the recently completed quarter was a pleasant, albeit not totally unexpected, outturn.

Why is the Chinese economy accelerating again? A breakdown of real GDP into its underlying demand components is not available, but monthly data offer some clues. First, foreign trade is starting to stabilize. The swoon in exports in the second half of 2008 and early this year exerted a powerful drag on the Chinese economy. Now that foreign trade is starting to stabilize, Chinese real GDP growth is returning to its underlying "run rate." In addition, growth rates of retail spending and investment spending have also strengthened over the past few months.

So why are Chinese consumers and Chinese businesses opening up their wallets with newfound vigor? The Chinese government responded very quickly and aggressively to the global financial crisis last year, and the recent acceleration in domestic spending reflects, at least in part, the effects of policy stimulus. The government has been actively encouraging banks to lend, and loan growth has simply exploded over the past few months. The current rate of lending growth exceeds the super-charged rates that were registered earlier this decade when the government was attempting to stimulate the economy at that time.

If China is the next bubble, it is probably in its very early stages of development. Despite the sharp increase in lending over the past few months, there is little evidence to support the notion that important sectors of the Chinese economy have excessive amounts of leverage at present. Obviously, specific households and individual businesses may have borrowed too much recently, and they could run into problems. However, leverage does not seem to be a systemic problem at present. That said, if Chinese credit growth remains unabated over the next few years, our nights may eventually become more restless.



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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 7/17/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.17	0.17	1.39
3-Month LIBOR	0.50	0.51	2.79
1-Year Treasury	0.40	0.14	1.91
2-Year Treasury	0.99	0.90	2.49
5-Year Treasury	2.48	2.22	3.27
10-Year Treasury	3.60	3.30	3.99
30-Year Treasury	4.48	4.20	4.61
Bond Buyer Index	4.68	4.71	4.65

Foreign Exchange Rates

	Friday 7/17/2009	1 Week Ago	1 Year Ago
Euro ($/€)	1.409	1.394	1.586
British Pound ($/£)	1.631	1.621	2.004
British Pound (£/€)	0.864	0.859	0.792
Japanese Yen (¥/$)	93.951	92.545	106.283
Canadian Dollar (C$/$)	1.116	1.164	1.006
Swiss Franc (CHF/$)	1.080	1.087	1.019
Australian Dollar (US$/A$)	0.801	0.779	0.972
Mexican Peso (MXN/$)	13.541	13.688	10.235
Chinese Yuan (CNY/$)	6.832	6.833	6.829
Indian Rupee (INR/$)	48.735	49.005	42.820
Brazilian Real (BRL/$)	1.931	1.996	1.598
U.S. Dollar Index	79.595	80.233	72.242

Foreign Interest Rates

	Friday 7/17/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.94	0.98	4.96
3-Month Sterling LIBOR	0.96	1.05	5.81
3-Month Canadian LIBOR	0.60	0.60	3.39
3-Month Yen LIBOR	0.42	0.44	0.91
2-Year German	1.26	1.20	4.38
2-Year U.K.	1.16	1.12	4.97
2-Year Canadian	1.21	1.16	3.12
2-Year Japanese	0.27	0.25	0.76
10-Year German	3.38	3.26	4.44
10-Year U.K.	3.82	3.74	4.90
10-Year Canadian	3.43	3.28	3.78
10-Year Japanese	1.33	1.31	1.60

Commodity Prices

	Friday 7/17/2009	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	61.32	59.89	129.29
Gold ($/Ounce)	935.13	913.05	957.43
Hot-Rolled Steel ($/S.Ton)	405.00	335.00	1125.00
Copper (¢/Pound)	238.10	220.05	373.50
Soybeans ($/Bushel)	10.11	11.07	15.77
Natural Gas ($/MMBTU)	3.63	3.37	10.54
Nickel ($/Metric Ton)	16,021	14,814	20,238
CRB Spot Inds.	414.61	405.49	495.03

Next Week's Economic Calendar

	Monday 20	Tuesday 21	Wednesday 22	Thursday 23	Friday 24
U.S. Data	**Leading Indicators** May 1.2% June 0.8% (W)		**House Price Index (MoM)** April -0.1% May -0.2% (C)	**Existing Home Sales** May 4.77M June 7.78M (W) **Initial Jobless Claims** Previous (July 11) 522,000	
Global Data			**Canada** **Retail Sales (MoM)** Previous (Apr) -0.8%	**UK** **Retail Sales (MoM)** Previous (May) -0.6%	**UK** **GDP (QoQ)** Previous (Q1) -2.4% **Euro-zone** **PMI Manufacturing** Previous (Jun) 42.6

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

Wells Fargo Securities, LLC Economics Group

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