January 14, 2010

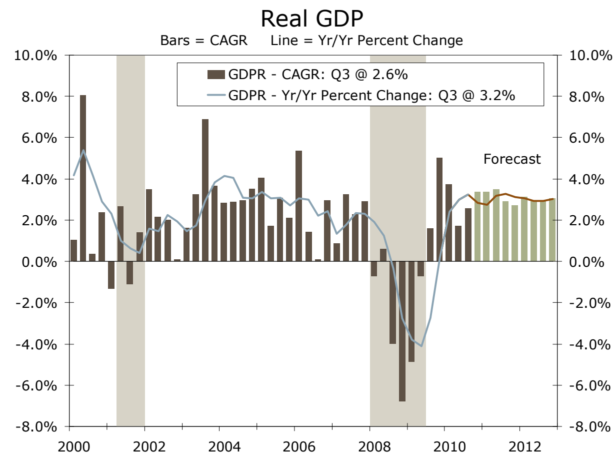
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Moderate Economic Recovery Remains Under Way

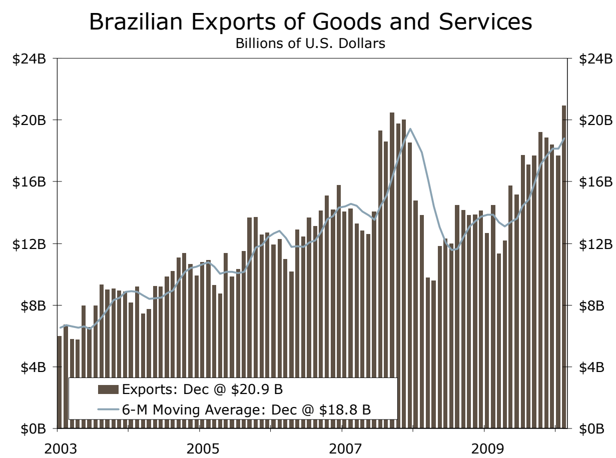
- Economic indicators released during the week continue to suggest a moderate recovery is underway. The nominal trade deficit narrowed slightly from a revised $38.4 billion in October to $38.3 billion in November. The upside risk to the forecast from international trade, however, will likely by tapered by less inventory building.
- The Fed's Beige Book also noted moderate economic conditions in most districts. Districts' with higher concentrations of manufacturing, retail and nonfinancial services sectors saw better activity.



Global Review

Strong Growth in Latin American Exports

- The last months of 2010 saw a large increase in exports from Latin American countries to the rest of the world. Although some of this increase may be reflecting an increase in commodity prices the sheer strength and size of the move in export numbers from the region cannot be explained solely by this increase in prices.
- Growth numbers for the last quarter of the year for the world economy, but especially for emerging markets, may surprise on the upside as the export sector in Latin America is not showing any signs of slowing down, just the opposite.



Wells Fargo U.S. Economic Forecast

	Actual 2010			Forecast	2011				Actual		Forecast		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2008	2009	2010	2011	2012
Real Gross Domestic Product [1]	3.7	1.7	2.6	3.4	3.4	3.5	2.9	2.7	0.0	-2.6	2.9	3.1	3.0
Personal Consumption	1.9	2.2	2.4	3.7	2.3	2.2	2.3	2.7	-0.3	-1.2	1.7	2.6	2.4
Inflation Indicators [2]													
"Core" PCE Deflator	1.8	1.5	1.2	0.8	0.8	0.8	1.0	1.3	2.3	1.5	1.3	1.0	1.6
Consumer Price Index	2.4	1.8	1.2	1.2	1.6	2.3	2.4	2.3	3.8	-0.3	1.6	2.2	2.5
Industrial Production [1]	7.1	7.2	6.5	2.4	5.1	3.7	3.7	3.7	-3.3	-9.3	5.7	4.4	4.2
Corporate Profits Before Taxes [2]	37.6	37.0	26.4	12.5	8.2	6.2	6.2	6.7	-16.4	-0.4	27.5	6.8	7.0
Trade Weighted Dollar Index[3]	76.1	78.8	73.6	73.2	72.5	73.0	74.0	75.0	74.3	77.7	75.6	73.6	78.0
Unemployment Rate	9.7	9.6	9.6	9.6	9.6	9.4	9.3	9.2	5.8	9.3	9.6	9.4	9.0
Housing Starts[4]	0.62	0.60	0.59	0.55	0.59	0.65	0.70	0.75	0.90	0.55	0.59	0.68	0.84
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	1.88	0.25	0.25	0.25	0.50
Conventional Mortgage Rate	4.97	4.74	4.35	4.71	4.90	5.00	5.20	5.20	6.04	5.04	4.69	5.08	5.55
10 Year Note	3.84	2.97	2.53	3.30	3.30	3.40	3.60	3.70	3.66	3.26	3.22	3.50	4.03

Forecast as of: January 14, 2011
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units
[5] Annual Numbers Represent Averages

Inside

U.S. Review

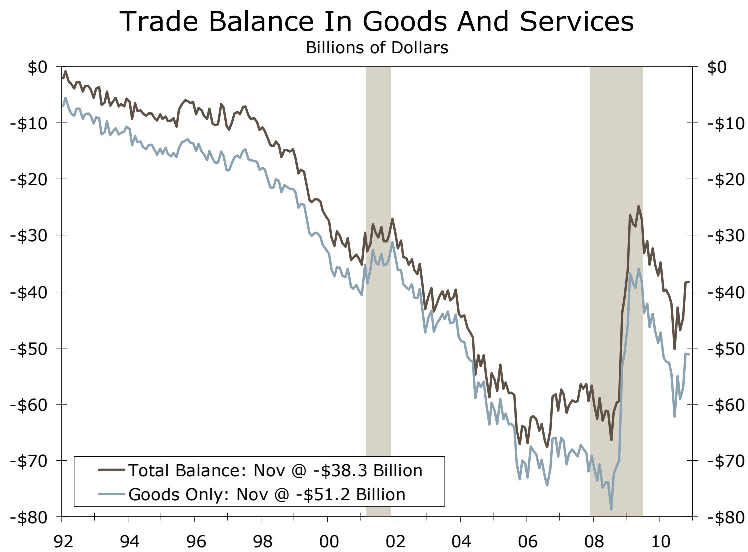
Fourth-Quarter Real GDP Brings Brighter Days

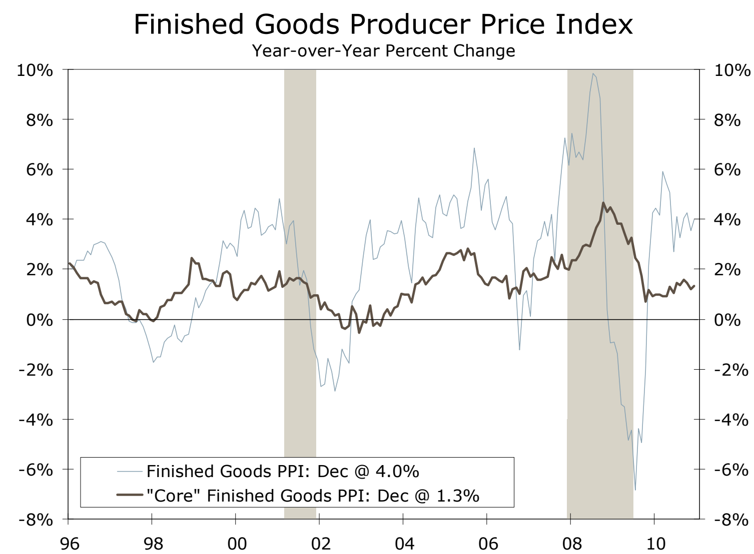
Economic indicators released during the week continue to suggest a moderate recovery is underway. The nominal trade deficit narrowed slightly from a revised $38.4 billion in October to $38.3 billion in November. Exports and imports both nudged higher on the month. Exports have now risen for the third consecutive month with increases being driven by solid growth in the rest of the world. While the real trade deficit widened to $45.2 billion, October's sharp narrowing will help contribute around 1.5 percentage points to fourth-quarter real GDP. The upside risk to the forecast, however, will likely by tapered by less inventory building. Business inventories rose 0.2 percent in November, which means part of the outsized contribution from international trade could be offset by less of a contribution from inventories. Consequently, our estimate for fourth-quarter real GDP remains unchanged at an increase of a 3.4 percent annual pace.

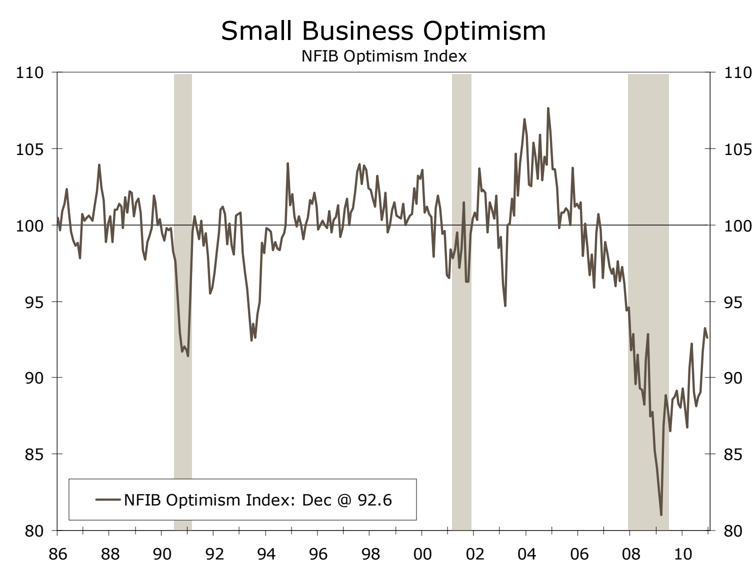
The Fed's Beige Book also noted moderate economic conditions in most districts. Districts with higher concentrations of manufacturing, retail and nonfinancial services sectors saw better activity. As expected, residential real estate markets remained weak across all districts and commercial construction remained slow. Labor markets in most districts appear to be firming somewhat, but with virtually no upward pressure on wages. Districts also mentioned increasing cost pressures but only modest pass-through into final prices because of competitive pressures. This week's producer price index and consumer price index both corroborate this story. Wholesale prices rose a more-than-expected 1.1 percent in December with prices further back in the pipeline continuing to build momentum. The consumer price index, however rose only 0.5 percent, which suggests very little pass-through to the consumer.

One of the more disappointing reports released this week was the Small Business Optimism Survey conducted by the National Federation of Independent Business. Small businesses play a critical role in the economy and make up around 45 percent of private-sector employment. The survey fell 0.6 points in December and showed little to no improvement in most of its key components. Small businesses remain pessimistic about the near-term economic outlook and credit conditions were tighter on the month. While hiring plans picked up to their highest level since September 2008, the level remains at historic lows.

Speaking of jobs, labor market indicators for the week were also less than encouraging. Initial jobless claims rose by 35,000 to 445,000, dashing hopes of a quicker-than-expected labor market recovery. On a trend basis, the four-week moving average rose by 5,000, to 416,500. While the increase was disappointing, it remains below the average of around 460,000 since January. The Job Openings and Labor Turnover Survey also illustrated a sluggish labor market. The hires rate, which is the rate of hires as a percentage of total nonfarm payrolls fell to 3.2 percent, while the separations rate rose to 3.2 percent in November from 3.1 percent.





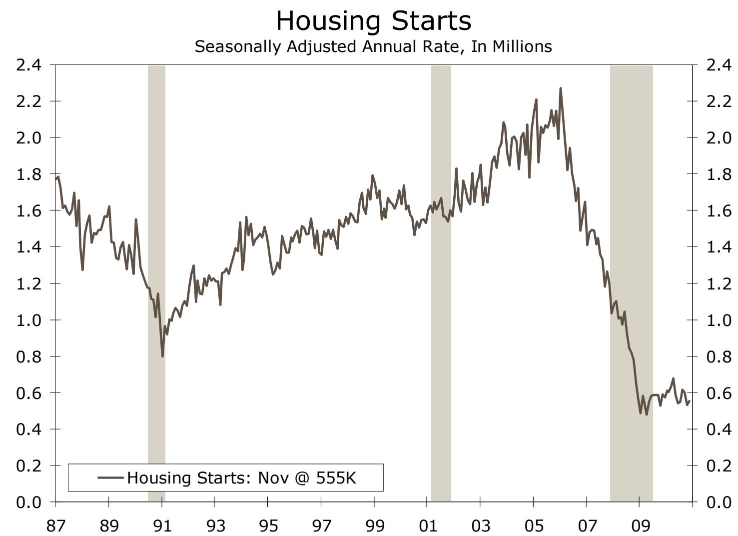


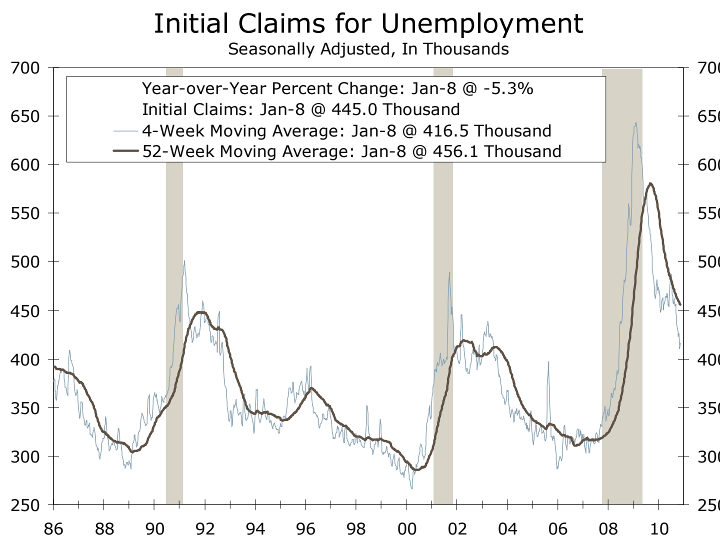
Housing Starts • Wednesday

November housing starts rose 3.9 percent to a 555,000-unit pace. Single-family starts in November rose a modest 6.9 percent, while the more volatile multifamily starts declined 9.1 percent. The slight increase in housing starts is welcomed news, but the positive reading was likely due to seasonal adjustment factors as opposed to signaling a rebound in starts. Single-family housing permits in November were running below the level of housing starts, which suggests continued weakness in the housing starts numbers. Our expectation is that housing starts fell in December to 546,000 units. With a large number of homes in foreclosure combined with the oversupply of existing homes, we anticipate continued weakness in housing starts. Our forecast for 2011 continues to indicate that starts will improve slightly this year by approximately 680,000 units; however the pace of starts will likely be agonizingly slow over the next few quarters.

Previous: 555K **Wells Fargo: 546K**

Consensus: 550K





Initial Jobless Claims • Thursday

Initial jobless claims, a leading indicator of the labor market, have continued to signal gradual improvement in the unemployment situation. This week, initial claims rose to 445,000, an 8.5 percent increase from the previous week. The slight increase is likely due to noise from temporary holiday workers. Although week-to-week changes may show some slight increases, the trend as measured by the four-week moving average continues to indicate a gradual decline in the number of initial jobless claims. Based on historical trends, the fact that claims are trending towards the 400,000 level signals that slightly stronger labor market is on the horizon. Continuing claims have also shown signs of gradual improvement declining by 248,000 or 6.0 percent this week. We anticipate continual improvement in the labor market over the next year with a monthly average of approximately 160,000 jobs created.

Previous: 445K

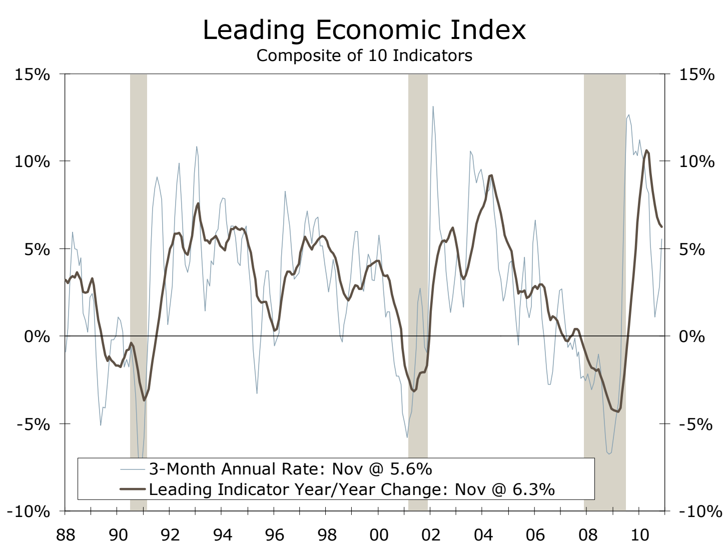
Consensus: 425K

Leading Economic Index • Thursday

The leading indicator index, which increased 1.1 percent in November, continues to provide further evidence of modest economic growth. Many of the leading indicators that make up the LEI have improved. Specifically, interest rate spreads and the pace of supplier deliveries helped to boost the index slightly higher in November. The only component that detracted from the index was building permits, which have continued to show the weakness in the housing market. As of the November reading, the LEI has increased for the fifth consecutive month. Additionally, the six-month trend continues to improve, up 4.4 percent on an annual basis. We anticipate that the positive trend in the LEI continued in December, increasing 0.7 percent. The overall improvement should be led by continued positive contributions from all major categories with the exception of supplier deliveries which were slightly lower in the previous ISM reading.

Previous: 1.1% **Wells Fargo: 0.7%**

Consensus: 0.6%



Global Review

Strong Growth in Latin American Exports

The last months of 2010 saw a large increase in exports from Latin American countries to the rest of the world. While some of this increase may be reflecting an increase in commodity prices, the sheer strength and size of the move in export numbers from the region cannot be explained solely by this increase in prices.

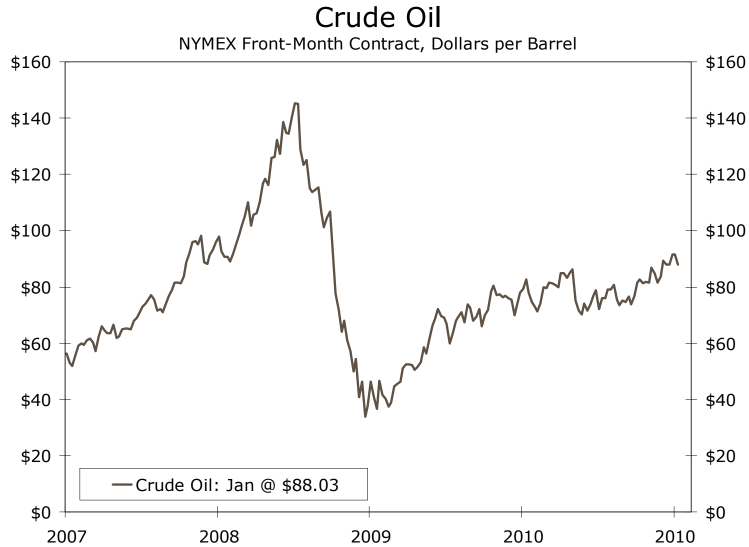
Although this contention is very difficult to prove, there are some countries in the region that provide the segmentation regarding whether exports increase due to price effects and/or quantity effects. Argentina is such a country and the one we will use for this explanation. In the case of Argentina, exports increased by 23.3 percent in November 2010 compared to the same month a year earlier. Out of this increase in the value of exports, the quantity of goods exported increased by 12 percent while the price of those goods increased by 10 percent.

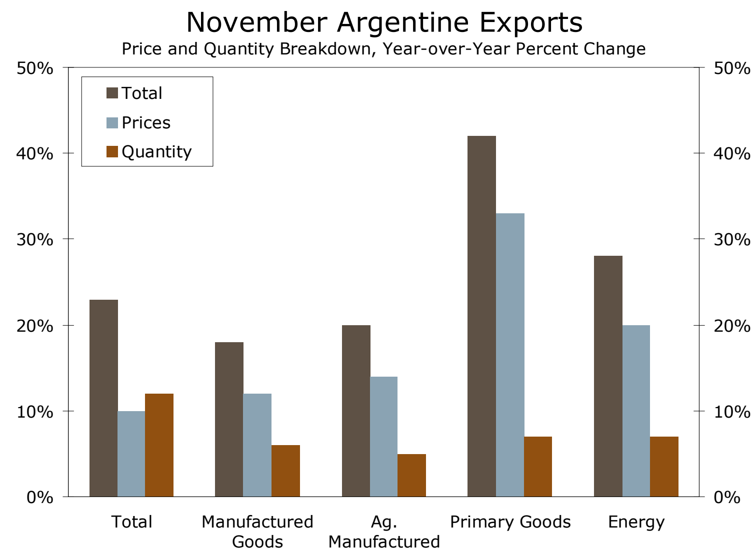
Meanwhile, imports of goods, which, of course, are exports of other countries to Argentina, increased by 53 percent in November, year-over-year. Of this increase in imports to Argentina the quantity of goods imported increased by a whopping 39 percent while prices of these imports rose by only by 9 percent.

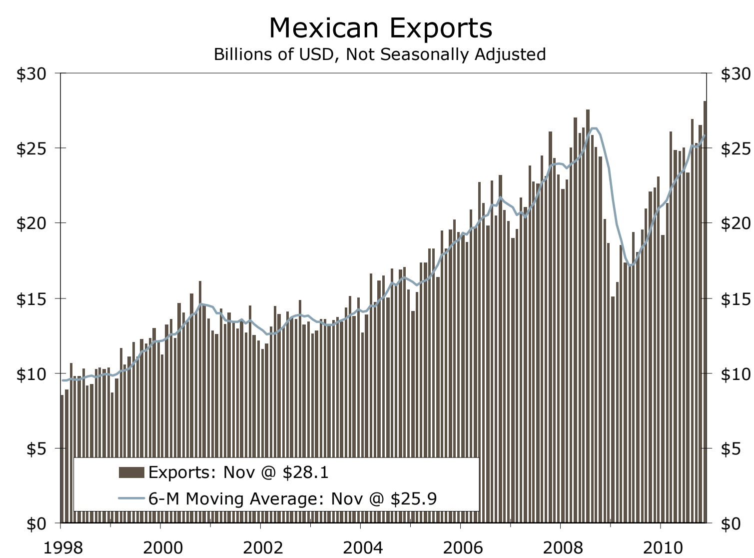
For Brazil, exports during December 2010 surged by 52.5 percent compared to December 2009. Although we don't have the numbers regarding the composition of this increase in imports, we can deduce from Argentina's numbers that the increase in the value of exports was due, fundamentally, to an increase in the quantity of goods exported by Brazil rather than by only an increase in price effect. By looking at the breakout in Brazilian exports during December 2010 it is clear that raw materials were leading the way with metals and petroleum in the vanguard of the charge. In fact, petroleum exports increased by 192 percent in December 2010 compared to December 2009. However, petroleum prices increased by only 20 percent during the same period of time. Meanwhile, iron ore exports surged by 208 percent during this period with the largest buyers of iron ore being China, Japan and Germany.

Mexican exports were also strong at the end of 2010, increasing by 25.9 percent in November compared to the same month a year earlier. Although Mexican exports may have been helped more by the increase in commodity prices than Argentina and Brazil, Mexican exports were already growing strongly a year ago and thus they are also benefiting from an increase in the quantity of goods rather than this being just a price issue.

The bottom line here is that growth numbers for the last quarter of the year for the world economy, but especially for emerging markets, may surprise on the upside as the export sector in Latin America is not showing any signs of slowing down, just the opposite. And since a large share of Latin American exports to the rest of the world comprise raw materials for the production of other goods then it is clear that even growth for developed countries may also surprise on the upside once these numbers are released.







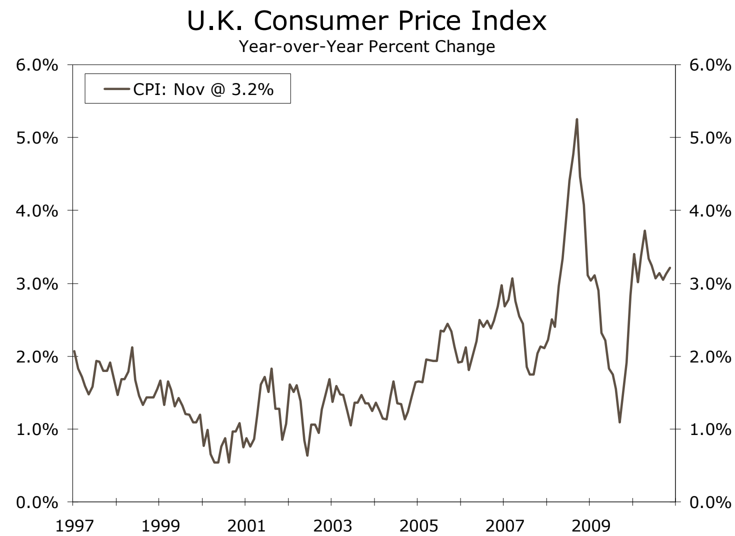
U.K. CPI • Tuesday

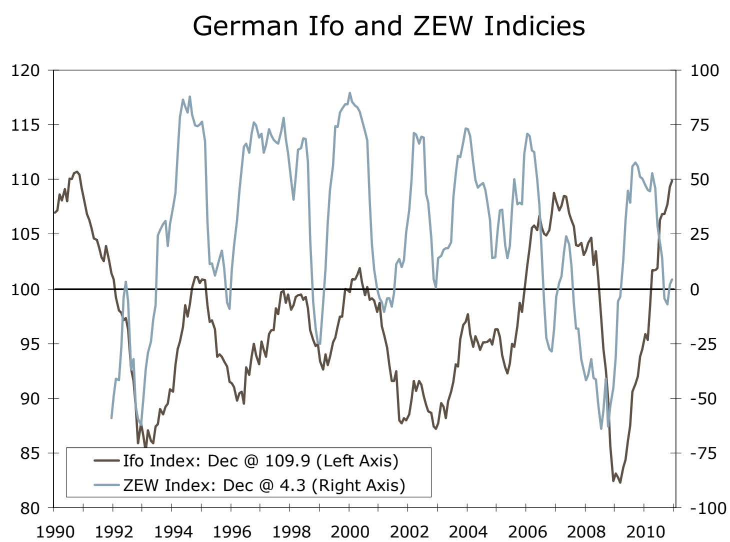
Consumer prices in the United Kingdom increased 0.4 percent in November, lifting the year-over-year inflation rate to 3.3 percent—a six-month high. The inflation rate has remained at or above the Bank of England's (BoE) ceiling of 3 percent in each of the first 11 months of 2010. December consumer prices are due out on Tuesday of next week, and we expect to see a twelfth month where inflation is above 3 percent. This will increase pressure on the BoE to reign in prices without snuffing out the recovery.

Prices could be pushed even higher in January by an increase in the value-added tax—a national sales tax. Prices are not the only measure influenced by the tax hike. Retail sales for December are due out on Friday of next week and we may find that U.K. consumers increased spending in December to get major purchases in ahead of the higher tax rate in January.

Previous: 3.2% **Wells Fargo: 2.9%**

Consensus: 3.3% (Year-over-Year)





German Zew Index • Tuesday

The December reading of the ZEW economic sentiment survey suggested an improving outlook for the largest economy in the euro-zone, despite indications of an intensifying sovereign debt crisis. This view was confirmed by the Ifo business climate survey which surged to a record high in November before slipping by a tenth of a point in December.

Subsequent German economic data have been mixed. November retail sales figures were a disappointment, but factory orders jumped 5.2 percent in November. The German PMIs both remain firmly in expansion territory. Will sentiment deteriorate as a result of the escalation of the sovereign debt situation? We will find out next week when the December reading of the ZEW survey hits the wire on Tuesday and the Ifo survey comes out on Friday.

Previous: 4.3

Consensus: 5.8

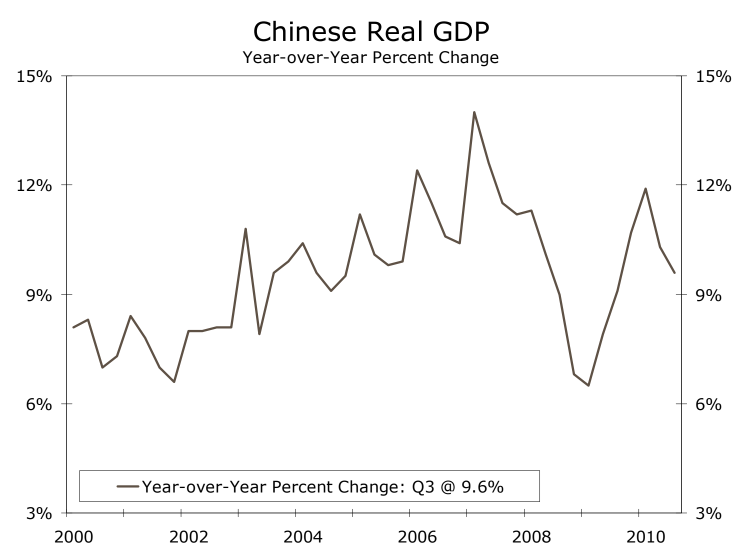
Chinese GDP • Thursday

The Chinese economy expanded 9.6 percent on a year-over-year basis through the third quarter of 2010. While the outturn was slightly stronger than the consensus estimate, it marked a slowing in the pace of Chinese economic growth. Growth was held back by measures implemented earlier in the year to reign in Chinese lending. Fourth-quarter GDP data are due out on Thursday of next week and we expect to see the world's second-largest economy grew at about the same rate for the full year 2010.

Also due out next week are the latest readings for both retail sales and industrial production. Both measures are expected to show double-digit percentage growth on a year-over-year basis.

Previous: 9.6% **Wells Fargo: 9.4%**

Consensus: 9.4% (Year-over-Year)



Interest Rate Watch

Recovery Takes Shape: Rising Rates

While our outlook for sustained economic growth has been in place for a while, the recent rise in food and energy prices suggest another force building the case for rising intermediate and long-term interest rates post-QE2. Disappointing harvests around the world have led to sharply higher farm prices. Oil prices have also risen due to rising demand and limited supplies. Increases in food and energy prices are expected to drive the headline CPI up 2.0 percent in 2011.

Growth at three percent and rising inflation means we have seen the lows for interest rates in this cycle. Of course, there may be a temporary dip in rates as expectations adjust, but over the course of the year long-term Treasury rates are expected to rise.

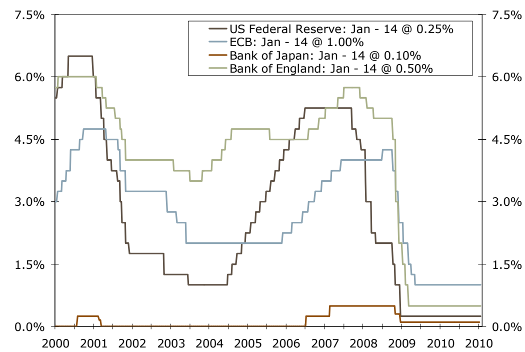
Yet, we also recognize that this pattern of rising rates during an economic expansion is actually the typical business cycle pattern. The challenge is that the rise in rates should be met by an increase in the expected rate of return on invested capital. Therefore, a rise in rates that reflects better growth expectations and the end to deflation concerns would be consistent with continued economic growth—not a double dip.

Why are interest rate rises key for our view on the economy? Concerns about U.S. fiscal deficits or the dollar or a rapid rise for inflation would send a very different signal to the markets and would be met by a turn to the dark side of economic growth.

We expect U.S. fiscal deficits to decline modestly, but if this turns out to be too optimistic then the excess demand for credit by the Treasury will outstrip supply and rates would rise faster than the expected rate of return on capital; thereby weakening investment spending and growth.

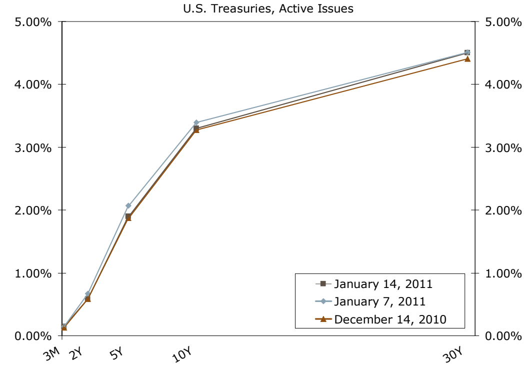
Similarly, concerns about the dollar or an outsized rise of inflation would produce a rise in rates not associated with a better economy and therefore would exert downward pressure on the economy. Credit markets and interest rates are always a balancing act—for now in our favor.

Central Bank Policy Rates



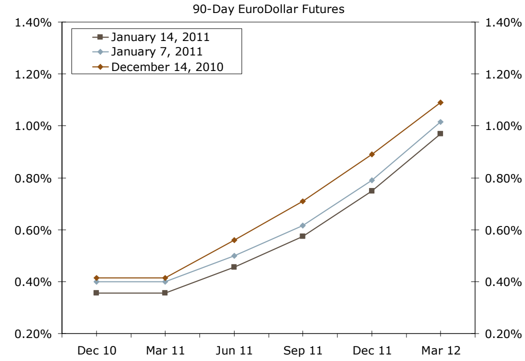
Yield Curve

U.S. Treasuries, Active Issues



Forward Rates

90-Day EuroDollar Futures



Credit Market Insights

Mixed Signals from Small Businesses

The Small Business Optimism Index dipped slightly to 92.6 in December from 93.2 in November, which was the highest since the recession began. On the positive side, capital spending plans increased, while sales expectations and hiring plans were the highest in over two years. Dragging down the index were a drop in plans to increase inventories, a decline in the earnings outlook, a near halving of the share expecting a better economy and a slight worsening of credit conditions. The share experiencing an easing of credit conditions was -11 percent. This says that more small businesses are experiencing tighter credit conditions on net. While this may not sound good for the lending outlook, the truth is that this indicator has never been positive since records began in 1999. In addition, it is off the lows of -16 percent reached several times in the last couple of years. Although hiring plans, spending plans and sales expectations rose, this does not necessarily mean more small businesses will come seeking a loan. Bank loans on the balance sheets of non-farm, non-corporate businesses have dropped for seven consecutive quarters through the third quarter and are down nearly a third from the peak. And although small business cash reserves are down 15 percent from the peak, they are still nearly triple levels seen seven years ago. It will likely be some time before sales are strong enough and cash reserves are low enough for small business loan demand to rebound.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.71%	4.77%	4.83%	5.06%
15-Yr Fixed	4.08%	4.13%	4.17%	4.45%
5/1 ARM	3.72%	3.75%	3.77%	4.32%
1-Yr ARM	3.72%	3.24%	3.35%	4.39%
MBA Applications				
Composite	482.7	472.1	589.7	528.1
Purchase	192.4	199.8	200.3	213.7
Refinance	2,219.2	2,115.4	2,910.9	2,407.2

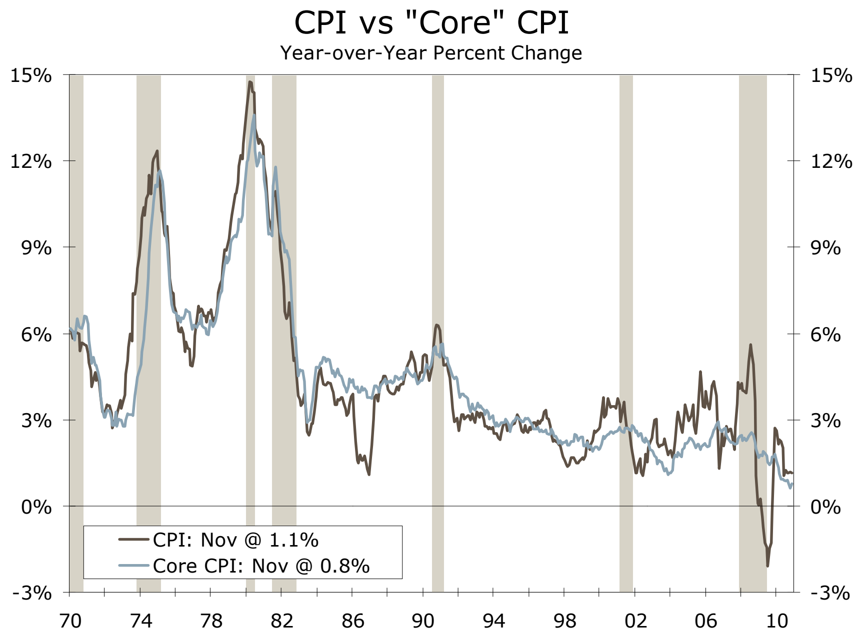
Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

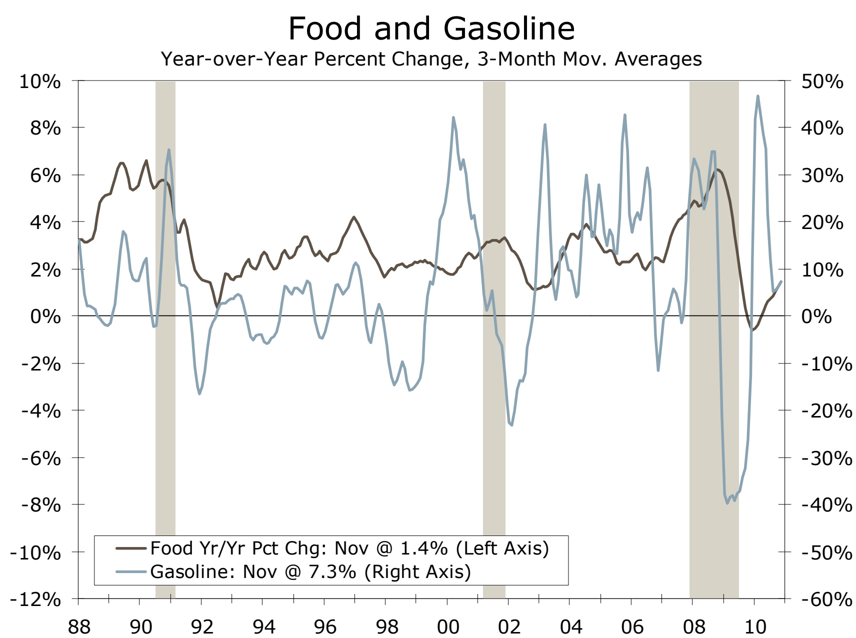
Topic of the Week

Are Price Pressures Starting to Emerge?

This week's release of several inflation indicators may raise some concerns about the onset of a longer-term inflationary spiral. In short, we do not think this sort of inflation spiral is likely to occur. The recent increases in the consumer price, import price and producer price indices reflect upward pressure from two main sources: energy and commodity prices have been rising steadily over the past couple of months. While the increase in prices from these two sources may be putting some strain on household budgets, there is little evidence to suggest that the food and energy price pressures will spill over to other goods and services.

We can see from the graph to the right that in the 1970s, core inflation was highly correlated with headline CPI numbers. The reason for the tight relationship can be attributed to wage contracts during this time period. Most of these contracts required wage increases to keep pace with headline inflation. The result was a spill-over effect that allowed higher volatility in food and oil prices to spill over into wages, thus affecting both core and headline inflation readings by nearly the same amount. The higher costs of food and energy today are not likely to produce the same effects that were observed in the 1970s. We now see greater separation between the core CPI and the headline numbers as a result of the reduction in the number of inflation-adjusted wage contracts. Evidence of this change can be seen in 2008 when oil prices led to higher headline CPI numbers while the core values remained relatively stable. The large volatility of food and gasoline prices underscores the reason for measuring core inflation. Another key factor that will likely prevent more widespread inflationary pressure is the high unemployment rate. Today's employment situation makes spill-over effects on wages unlikely due to the scarcity of jobs and the willingness of employees to accept lower wages. Therefore, unless we begin to see the core inflation measure begin to rise, our outlook for inflation will remain subdued.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 1/14/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.14	0.13	0.05
3-Month LIBOR	0.30	0.30	0.25
1-Year Treasury	0.25	0.25	0.30
2-Year Treasury	0.59	0.59	0.92
5-Year Treasury	1.92	1.96	2.49
10-Year Treasury	3.30	3.32	3.74
30-Year Treasury	4.49	4.48	4.63
Bond Buyer Index	5.39	5.08	4.31

Foreign Exchange Rates

	Friday 1/14/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.335	1.291	1.450
British Pound ($/£)	1.585	1.555	1.634
British Pound (£/€)	0.842	0.830	0.888
Japanese Yen (¥/$)	82.900	83.150	91.210
Canadian Dollar (C$/$)	0.995	0.994	1.023
Swiss Franc (CHF/$)	0.968	0.967	1.019
Australian Dollar (US$/A$)	0.988	0.996	0.932
Mexican Peso (MXN/$)	12.155	12.232	12.672
Chinese Yuan (CNY/$)	6.598	6.632	6.827
Indian Rupee (INR/$)	45.365	45.385	45.625
Brazilian Real (BRL/$)	1.684	1.684	1.760
U.S. Dollar Index	79.239	81.012	76.732

Foreign Interest Rates

	Friday 1/14/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.94	0.93	0.63
3-Month Sterling LIBOR	0.77	0.76	0.61
3-Month Canadian LIBOR	1.25	1.24	0.45
3-Month Yen LIBOR	0.19	0.19	0.26
2-Year German	1.15	0.87	1.18
2-Year U.K.	1.36	1.20	1.23
2-Year Canadian	1.80	1.72	1.32
2-Year Japanese	0.19	0.19	0.17
10-Year German	3.03	2.87	3.30
10-Year U.K.	3.63	3.51	3.98
10-Year Canadian	3.25	3.19	3.56
10-Year Japanese	1.21	1.22	1.34

Commodity Prices

	Friday 1/14/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	90.48	88.03	79.39
Gold ($/Ounce)	1361.70	1369.57	1142.85
Hot-Rolled Steel ($/S.Ton)	724.00	710.00	570.00
Copper (¢/Pound)	436.70	432.10	338.75
Soybeans ($/Bushel)	13.87	13.51	9.73
Natural Gas ($/MMBTU)	4.41	4.42	5.59
Nickel ($/Metric Ton)	25,527	24,525	18,227
CRB Spot Inds.	591.45	582.51	496.69

Next Week's Economic Calendar

	Monday 17	Tuesday 18	Wednesday 19	Thursday 20	Friday 21
U.S. Data		**Empire Manufacturing** December 10.57 January 12.0 (C)	**Housing Starts** November 555K December 546K (W)	**Existing Home Sales** November 4.68M December 4.93M (W) **Leading Indicators** November 1.1% December 0.7% (W)	
Global Data		**U.K.** **CPI (YoY)** Previous (Nov) 3.2% **Germany** **Zew Index** Previous (Dec) 4.3	**China** **Industrial Prod. (YoY)** Previous (Dec) 13.3%	**China** **GDP (YoY)** Previous (Q3) 9.6%	**Germany** **Ifo Index** Previous (Dec) 109.9 **U.K.** **Retail Sales (MoM)** Previous (Dec) 0.3%

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

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