January 21, 2011

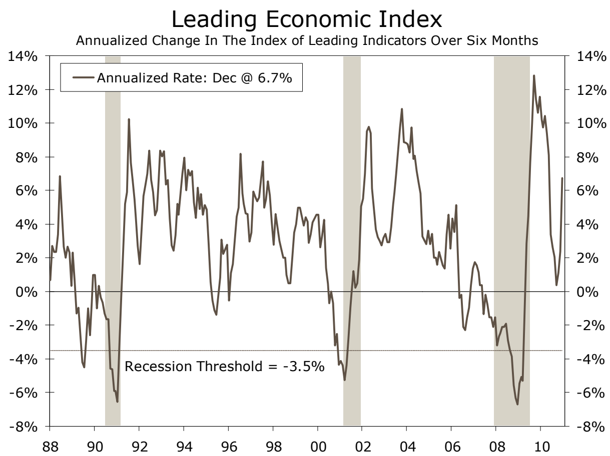
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Economic Recovery Remains on Solid Foundation

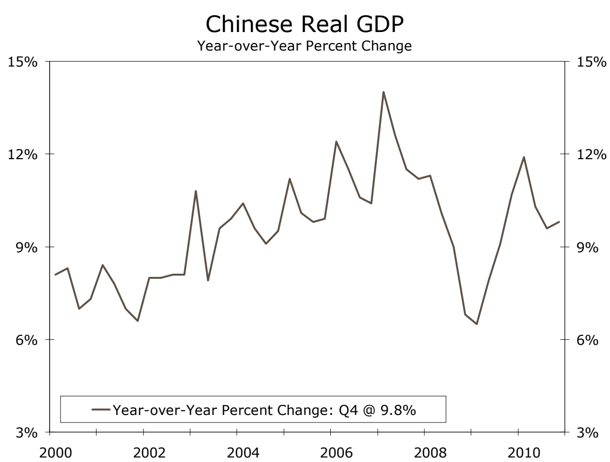
- The U.S. economy continues to generate solid economic growth. The December retail sales and industrial production reports released last Friday revealed a consumer that is spending a little more readily and a manufacturing sector that is being re-energized by growing end demand.
- The outlook also appears fairly bright. The December leading indicators report released by the Conference Board has jumped more than 2.0 percentage points over the past two months and has been gaining ground since last June when the economy hit its summer lull.



Global Review

Inflation Becoming More of an Issue for China

- Following a modest slowdown earlier in 2010, Chinese real GDP growth stabilized at a high rate in the fourth quarter.
- Unacceptably high inflation is replacing insufficient growth as the most important risk facing Chinese policymakers today. The underlying inflation rate rose to a two-year high in December.
- In our "Topic of the Week," we place the U.S.–Chinese trade deals announced in Washington this week into context.



Wells Fargo U.S. Economic Forecast

	Actual			Forecast					Actual		Forecast		
	2010				2011				2008	2009	2010	2011	2012
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	3.7	1.7	2.6	3.9	3.1	3.1	3.0	2.8	0.0	-2.6	2.9	3.1	3.0
Personal Consumption	1.9	2.2	2.4	3.7	2.2	2.0	2.3	2.8	-0.3	-1.2	1.7	2.5	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	0.54	0.56	0.61	0.66	0.71	0.90	0.55	0.59	0.64	0.83
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	5.00	5.10	5.20	5.20	6.04	5.04	4.69	5.13	5.60
10 Year Note	3.84	2.97	2.53	3.30	3.40	3.50	3.60	3.70	3.66	3.26	3.22	3.55	4.08

Forecast as of: January 21, 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

Inside

U.S. Review

Strong Economic Data Where It Counts

The December readings on retail sales and industrial production painted an increasingly bright picture of sustained economic growth. While retail sales growth slowed to a 0.6 percent monthly rate in December from a 0.8 percent gain in November, the three-month moving average of retail sales improved to a 14.0 percent annualized growth rate, showing a clear acceleration in consumer spending in the fourth quarter. These numbers are strong enough to ensure real consumer spending growth of nearly 4.0 percent in the fourth quarter. And, it is not just autos and gas that consumers are springing for. December also saw solid sales gains in furniture, building materials and healthcare.

Manufacturing is also getting its mojo back. The manufacturing component of December industrial production increased another 0.4 percent in December despite a modest deceleration in auto production. Strong increases in production were noted in information processing, computer and electronics, consumer goods, materials and energy.

Stronger consumer spending growth, if sustained, could help ignite another round of business spending growth and more hiring, especially from smaller businesses that have largely been left behind so far in this economic expansion. This will help strengthen the virtuous cycle that often takes shape during economic expansions and help wean the United States off of government support.

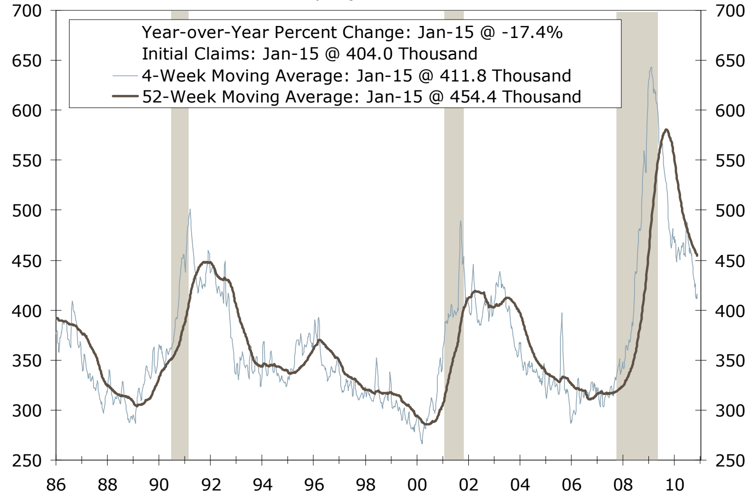
The Conference Board’s index of leading indicators for December, released this week, confirms a sustainable U.S. economic recovery over the near term. Many of the components that make up the index continue to support solid economic activity. The December reading got additional support from an improvement in initial jobless claims, nondefense capital goods orders, building permits, stock prices, consumer expectations and the interest rate spread.

Initial jobless claims continue to move lower, slipping to 404,000 for the second week of January, suggesting labor market conditions continue to improve in the new year. Jobless claims are now 50,000 below their trend level over the past 52 weeks.

Even the U.S. housing market got a modest dose of good news this week. December existing home sales jumped to 5.28 million on an annualized basis in December, a 12.3 percent gain that followed a large 6.1 percent increase in November. This was strong enough to reduce the months’ supply of existing homes to 8.1 months, a marked improvement in the supply-and-demand balance for the existing home market. The homebuilders didn’t see much improvement in the housing outlook from their perspective, however. The Wells Fargo/NAHB housing market index for January held at a low 16.0, and housing starts for December sank again, down 4.3 percent on the month. Weather could be a contributing factor to the drop in starts, though residential building remains weak nonetheless.

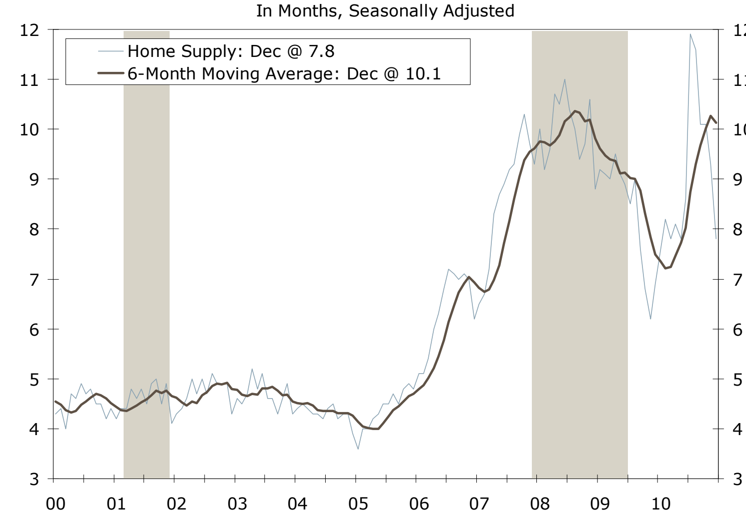
Initial Claims for Unemployment

Seasonally Adjusted, In Thousands



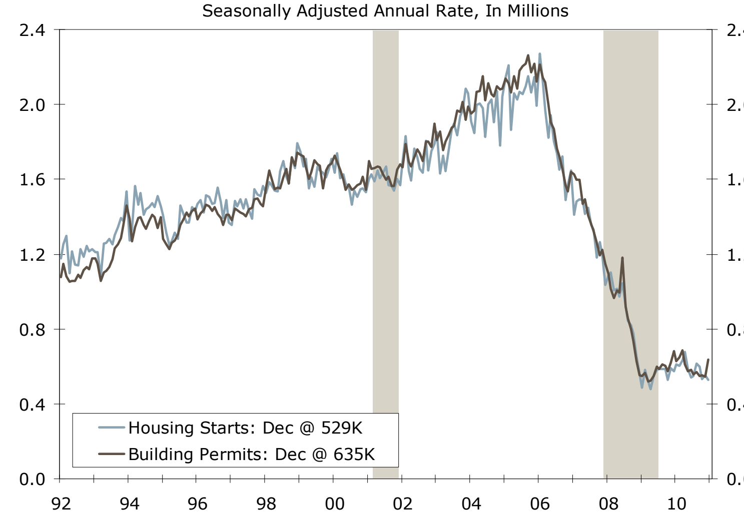
Existing Single-Family Home Supply

In Months, Seasonally Adjusted



Housing Starts and Building Permits

Seasonally Adjusted Annual Rate, In Millions

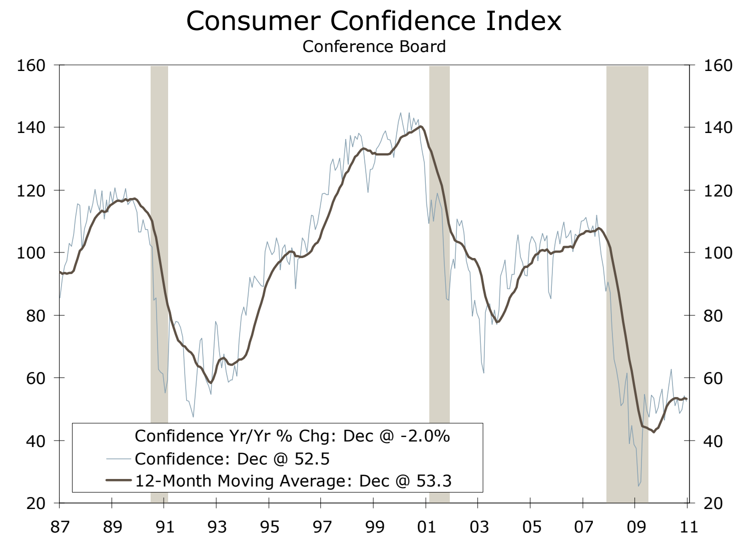


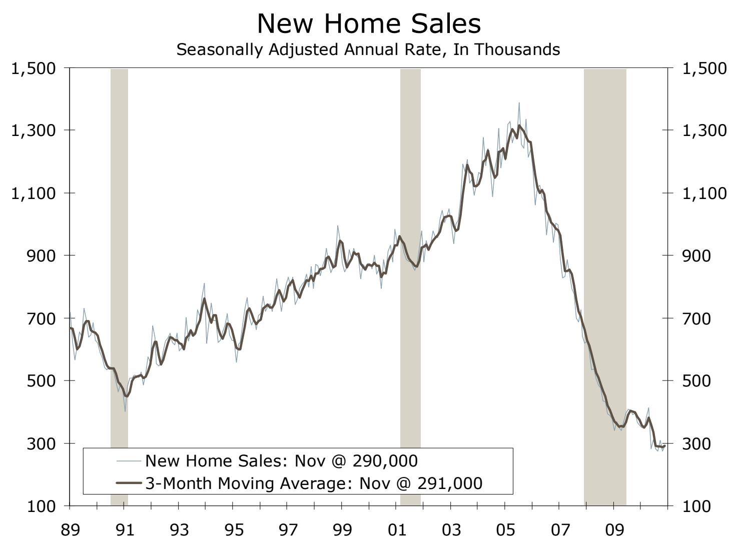
Consumer Confidence • Tuesday

After two consecutive increases, consumer confidence fell 1.8 points to 52.5 in December as the weak labor market continues to weigh on consumers' psyche. While confidence is well above its record low of 25.6 reached in early 2009, it was little changed in 2010 and remains at depressed levels. Both the present situation and expectations indices fell on the month. With confidence more closely correlated to the labor market, the stubbornly high unemployment rate will likely continue to keep confidence low. In fact, the percentage of those who reported that jobs were "hard to get" continued to climb in December, while the percentage of those who cited "jobs were plentiful" declined. Until we see acceleration in the pace of private sector job growth, we will not see much improvement in consumer confidence.

Previous: 52.5 **Wells Fargo: 53.7**

Consensus: 54.3





New Home Sales • Wednesday

New home sales are beginning to gain momentum. Sales have risen in two of the last three months, but are increasing from very depressed levels. Consequently, any true recovery in new home sales will be gradual and will likely not pick up significant traction until next homebuying season. Moreover, foreclosures and short sales will largely keep builders on the sidelines until they have a better idea as to where prices will settle and the oversupply of existing homes whittles down. According to the Wells Fargo/NAHB Housing Market Index, builders continue to report little to no improvement in buyer traffic and expectations for future conditions also remain low. The inventory of unsold homes continues to slide and remains at a four-decade low. We expect new home sales to increase 4.8 percent to 304,000 in December.

Previous: 290K **Wells Fargo: 304K**

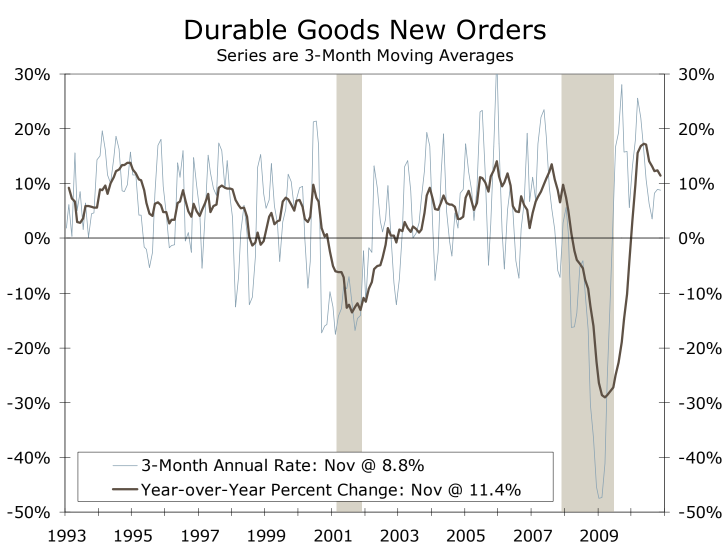
Consensus: 300K

Durable Goods • Thursday

Orders for durable goods fell 1.3 percent in November relative to the previous month. Excluding transportation, durable goods orders were up 2.4 percent in November. Outside of the transportation sector, the rise in orders in November was broad based, which continues to show the recovery in the factory sector is becoming self-sustaining. Moreover, over the past three months, unfilled orders rose at an annualized rate of 12.8 percent, suggesting that the production pipeline is filling up. Consistent with the new orders component of the ISM manufacturing index and regional manufacturing reports, we expect durable goods orders to increase 1.7 percent in December. Production in the factory sector should continue to expand further in the months ahead, which reinforces our expectation that the U.S. economy will continue to grow in 2011.

Previous: -1.3% **Wells Fargo: 1.7%**

Consensus: 1.5%



Global Review

Robust Growth Continues in China

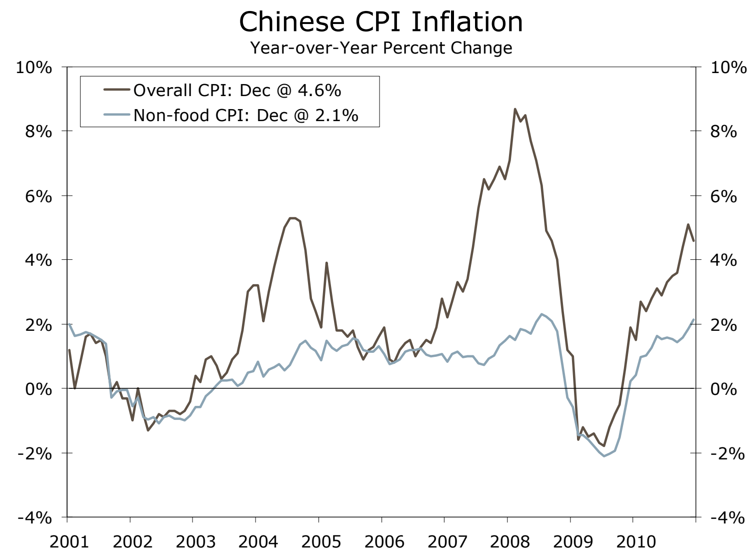
China was very much in the headlines this week. Not only did Chinese President Hu visit President Obama in Washington, but economic data showed that the Chinese economy continues to grow at a rapid rate. As shown on the graph on the front page, real GDP in China rose 9.8 percent on a year-ago basis in the fourth quarter. Following a modest slowdown over most of 2010, which was due, at least in part, to increasingly more difficult year-over-year comparisons, it appears that the growth rate is stabilizing at a high level.

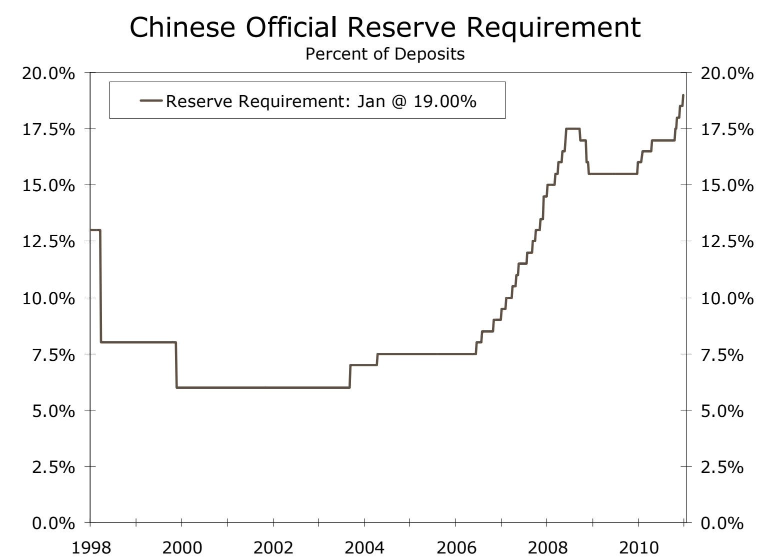
A breakdown of the GDP data into its underlying demand components is not readily available. However, monthly data suggest that most spending categories continued to grow at strong rates in the fourth quarter. Retail spending continued to grow at a year-over-year rate approaching 19 percent in the fourth quarter, indicating that Chinese consumers are alive and well. The value of exports was up 25 percent in the fourth quarter, which is consistent with other indicators of solid global growth. Loan growth, which slowed sharply after the Chinese government directed banks to rein in excessive lending, stabilized in the fourth quarter. Solid loan growth of 20 percent in the quarter helped to finance the 25-percent growth rate in investment spending that occurred during that three-month period.

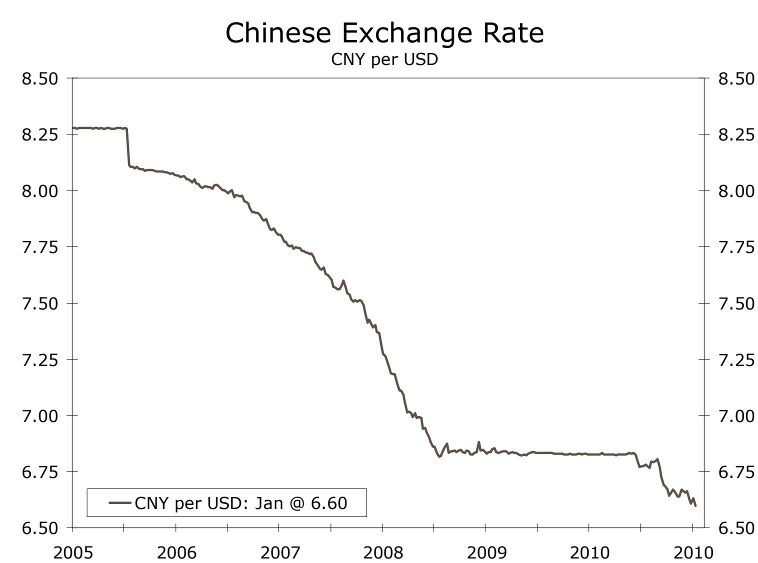
Inflation Is Priority No. 1

The inflation data that printed this week brought good news and bad news. The good news is that the overall rate of CPI inflation dropped from 5.1 percent in November to 4.6 percent in December as food prices, which constitute one-third of the Chinese CPI, stabilized (top chart). The bad news is that nonfood price inflation rose to 2.1 percent, nearing the highs that were reached in 2008. This underlying inflation rate fell sharply two years ago as the global financial crisis caused the global economy to careen into recession. If, as we project, the global economy continues to grow at a solid rate, then a significant slowdown in the underlying rate of Chinese CPI inflation does not seem likely. Although the Chinese economy may not be "overheating," unacceptably high inflation has replaced insufficient growth as the biggest problem facing the Chinese economy today.

In that regard, Chinese economic policy is tightening. Not only has the central bank raised its benchmark lending rate by 50 bps since mid-October, but it has also raised reserve requirements for banks to record highs (middle chart). The latter step is intended to help sterilize the country's balance of payments surpluses that contribute to strong growth in the money supply. In addition, authorities have allowed modest appreciation of the currency—the renminbi has risen about 3 percent versus the U.S. dollar since September—that also helps to tamp down inflation (bottom chart). Although authorities will probably not allow runaway appreciation of the currency, further renminbi gains against the greenback are likely in the coming year. (The currency strategy team looks for the renminbi to strengthen more than 5 percent against the dollar between now and the end of the year.)







Eurozone PMIs • Monday

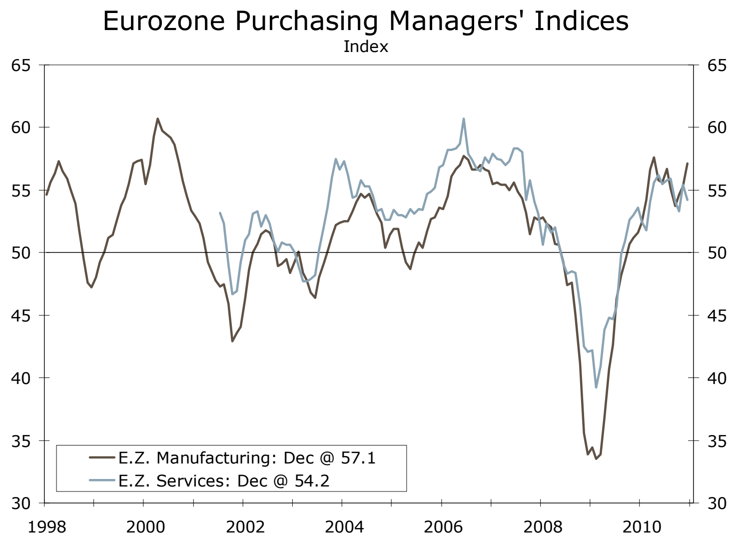
The 16-member Eurozone economy expanded at a 1.4-percent pace in the third quarter, marking the fifth consecutive quarterly expansion. Still, the level of GDP remains roughly 3 percent below the pre-recession peak.

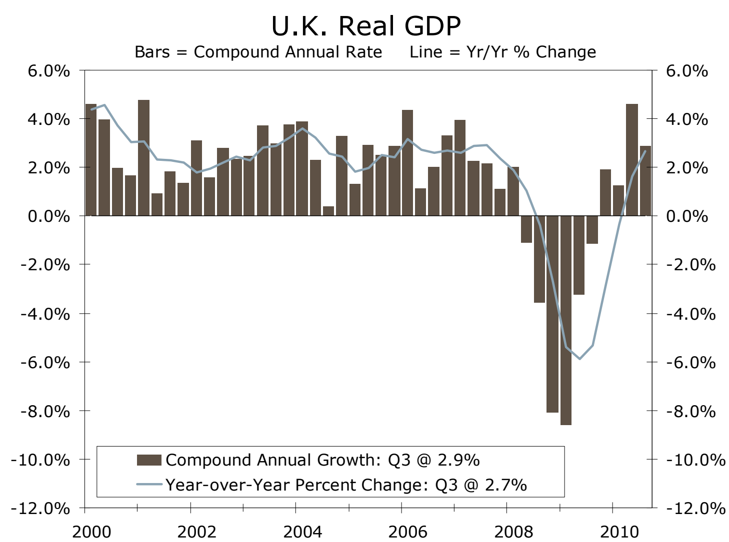
We expect the Eurozone grew at a slightly faster pace in the fourth quarter of the year. In addition to decent growth in industrial production in the fourth quarter, the various purchasing managers' surveys also remained firmly in expansion territory.

That said, the Eurozone is not without its share of problems at the moment. The ongoing challenge of the sovereign debt crisis certainly is not a positive for the outlook in Europe. On Monday (Jan. 24), January readings for the PMIs will tell us whether the fiscal problems in a few member countries will be enough to dampen sentiment across the Eurozone.

Previous: 57.1 (Man.) 54.2 (Services)

Consensus: 57.1 (Man.) 54.3 (Services)





U.K. GDP • Tuesday

The U.K. economy expanded at a 2.9-percent annualized pace in the third quarter. Available monthly indicators, including the manufacturing and service sector PMIs, suggest that the recovery continued in the fourth quarter of 2010, although the pace of growth may have slowed somewhat. Official numbers are due out on Tuesday.

Consumer sentiment deteriorated in the fourth quarter, though most analysts still expected only a modest slip in retail sales for December, thinking that an increase in the value-added tax in January would bring sales forward into December, softening the decline. The dip in sales was larger than expected, falling 0.8 percent in December. Combined with weaker-than-expected industrial production growth in the quarter, we expect U.K. GDP growth likely slowed to a 2.2-percent annualized pace in Q4.

Previous: 2.9% **Wells Fargo: 2.2%**

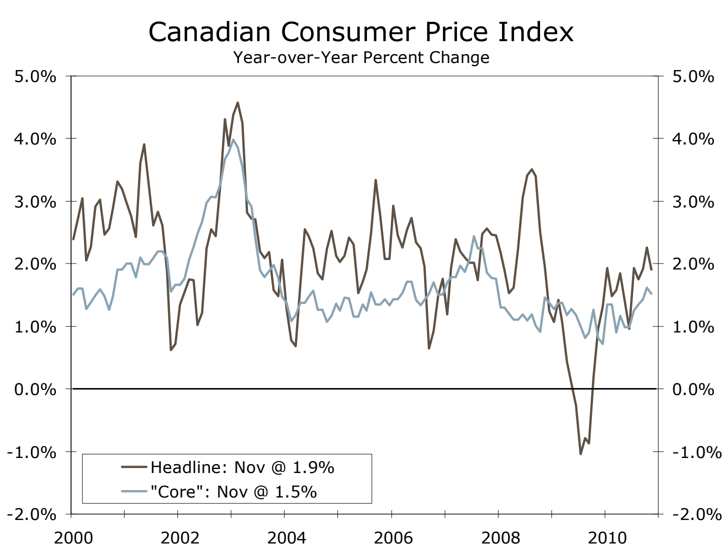
Consensus: 2.6% (CAGR)

Canadian CPI • Tuesday

In 2010 as the Canadian economy outpaced the recoveries in other large developed economies, the Bank of Canada (BoC) was among the few central banks in the world raising its key lending rate. The BoC's primary consideration in setting monetary policy is targeting a core inflation rate between 1 percent and 3 percent. So when a 0.4-percent jump in core consumer prices in October lifted the year-over-year inflation rate to 1.8 percent, some market-watchers became concerned that rising inflation might force the BoC to raise rates again to combat rising prices. November data revealed that prices were essentially unchanged for the month, which allowed the annual measure to settle to a 1.4-percent rate. Headline inflation for December will most likely show an increase as food and gasoline prices across Canada were higher in December. The core rate of inflation will likely stay near the midpoint of the BoC's target range.

Previous: 2.0% **Wells Fargo: 2.1%**

Consensus: 2.5% (Year-over-Year)



Interest Rate Watch

Rising Rates: Fundamental Drivers

Treasury benchmark rates have risen in line with the changing fundamentals and investor and business confidence. Better than consensus economic releases, the outlook for rising inflation over time and the renewal of the Bush tax cuts all suggest the case for rising rates to continue ahead. Moreover, capital markets are also seeing strength in bond issuance and loan finance—another sign that economic strength is being financed despite the rise in benchmark Treasury rates. Higher interest rates often accompany better economic growth and are not a recovery-killer as some commentators are claiming.

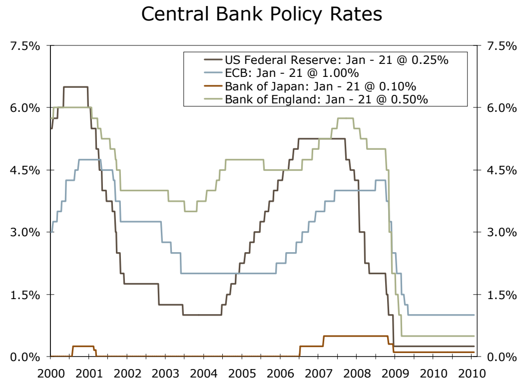
Fundamentals Matter

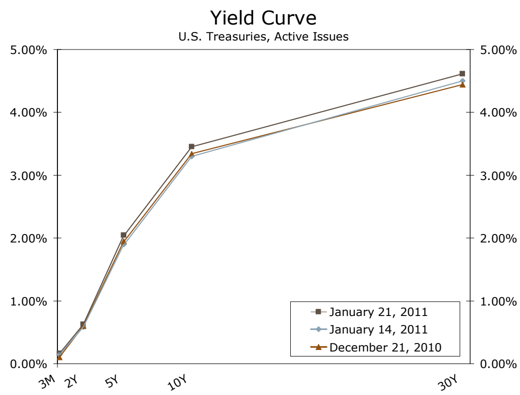
Declining jobless claims filled in their usual role as an indicator of an improving economy. Then, along came the continued gains in the Institute for Supply Management (ISM), better retail sales, better regional supply management surveys and even the upturn in architectural billings, which all supported the better growth outlook. Then, throw in the trade data and estimates of fourth quarter GDP approached 4 percent and the outlook for 2011 improved in many surveys.

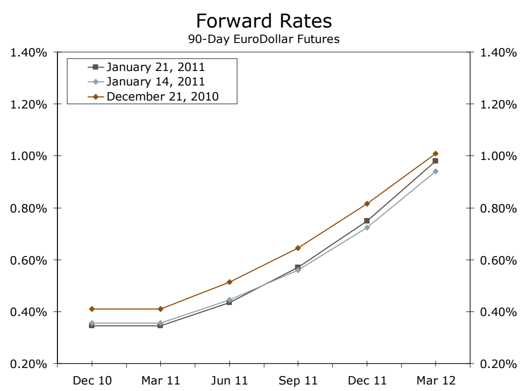
On the policy front, the Fed is committed to further growth and the goal of raising the core inflation rate. The commodity notes in the ISM report also revealed a broader set of increases in basic commodities, including corn and wheat. According to the University of Michigan Consumer survey, the one-year inflation expectations measure jumped to 3.3 percent in early January from 3.0 percent in December. This is the highest reading since 3.9 percent back in October 2008.

Confidence Shown in Bond Issuance

Renewal of the Bush tax cuts were viewed, by your trusty interest rate watcher at least, as positive for the economy and, more important, as a signal policymakers in Washington can get beyond the petty politics. This confidence is reflected in the strength of high-grade and high-yield bond issuance. We view this strength as confidence in the recovery and that the recent rise in rates is not a recovery-killer.







Credit Market Insights

Mortgage Market Activity Update

Mortgage applications for the purchase of a home have faltered recently, declining in five of the past six weeks likely due to increasing mortgage rates and tighter credit qualifications. Application activity, however, is still up over 11 percent since August. Refinancing activity, on the other hand, has improved in recent weeks, up over 17 percent since the end of December.

Since bottoming back in November, mortgage rates have risen 13 percent. The rate on a 30-year fixed mortgage is currently around 4.74 percent. Adjustable rate mortgages (ARMs) have not risen as much as fixed-rate mortgages over the past few months and remain relatively low. The rate on a one-year ARM is around 3.25 percent.

While many have speculated that the recent rise in mortgage rates threatens to derail the nascent housing recovery, we believe these views are overblown. First, mortgage rates are still very low—the average 30-year fixed mortgage rate from 1990 to 2005 was around 7.50 percent. And second, access to credit remains a much bigger issue than cost of credit for homebuyers. With nearly 23 percent of homeowners having negative equity on their home mortgages and tighter underwriting standards on the part of lenders, many prospective buyers—or those simply looking to refinance—just do not qualify in today's credit environment despite the fact that housing affordability is still near all-time highs.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.74%	4.71%	4.81%	4.99%
15-Yr Fixed	4.05%	4.08%	4.15%	4.40%
5/1 ARM	3.69%	3.72%	3.75%	4.27%
1-Yr ARM	3.25%	3.23%	3.40%	4.32%
MBA Applications				
Composite	507.0	482.7	479.9	575.9
Purchase	188.8	192.4	195.3	223.0
Refinance	2,390.7	2,219.2	2,196.1	2,663.8

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

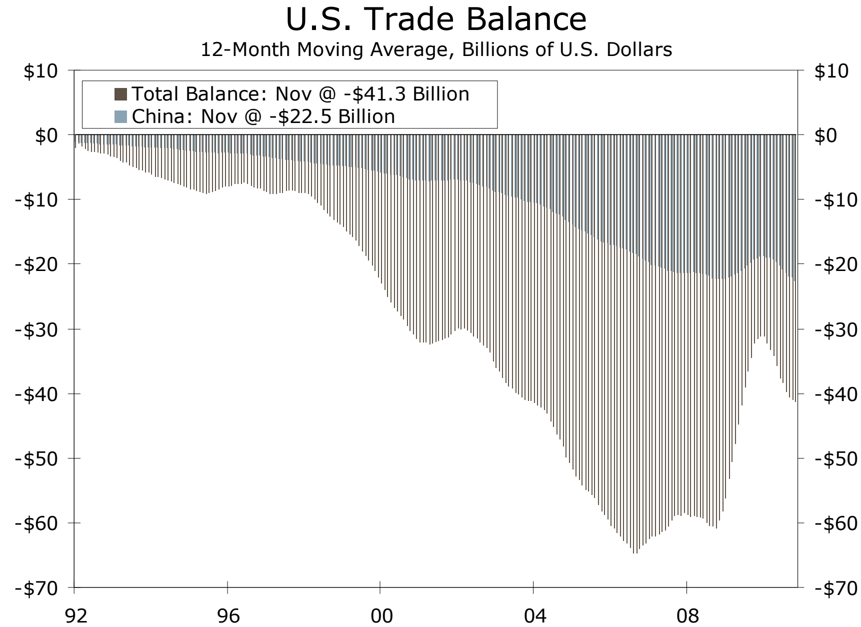
Topic of the Week

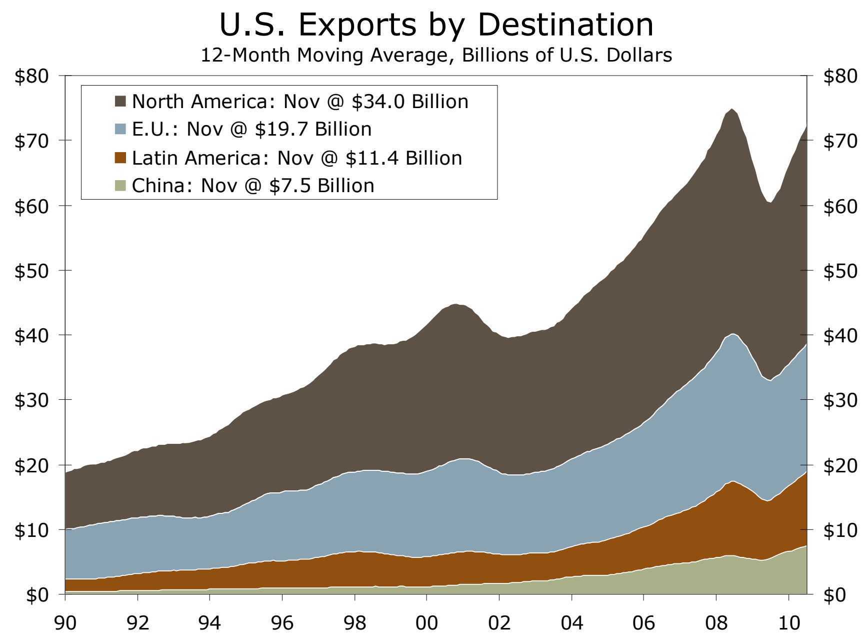
From Deng to Hu: "To Get Rich Is Glorious"

Chinese President Hu's first visit to the United States in five years was marked by great pomp and circumstance as well as sober acknowledgements of the challenges to bilateral political relations. Few expected Hu to follow in Deng Xiaoping's footsteps and don a cowboy hat and make his way down to Texas for a rodeo. Since the beginning of Deng's liberalization of the Chinese economy in 1979, the U.S.–Chinese bilateral trade balance has been on a steep slide in China's favor, but the imbalance accelerated greatly circa 2002 (about the time Hu succeeded Ziang Jemin).

Although the bilateral trade deficit with China continues to widen, the overall U.S. trade deficit has narrowed in recent years to levels seen in the early 2000s. This pattern reflects China's continued expansion as an industrial center for consumer goods. Today, many of the goods Americans imported from Europe or Latin America are instead being assembled and exported from China. As China's industrial prowess rises and the yuan remains undervalued, we are likely to see the bilateral trade deficit continue to widen, especially if China maintains a weak yuan policy. However, headline trade numbers often reflect goods that are simply assembled in China, while the parts are sourced from third-party countries and profits flow to foreign corporations.

During the summit, Presidents Hu and Obama announced a $45 billion export deal, but nearly half the value of the deal represents a "final" approval from Chinese officials for a planned purchase from Boeing. American companies, such as Boeing and Coca Cola, have had longstanding relationships with China, beginning with President Deng's visits to Seattle and Atlanta in the 1970s. While America's largest companies may benefit marginally from one-off trade deals, the bilateral trade deficit with China likely will remain large, especially if the yuan remains undervalued. Therefore, trade tensions with China probably will remain an issue in U.S.–Sino relations for some time.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 1/21/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.15	0.15	0.04
3-Month LIBOR	0.30	0.30	0.25
1-Year Treasury	0.27	0.28	0.31
2-Year Treasury	0.63	0.57	0.83
5-Year Treasury	2.06	1.92	2.34
10-Year Treasury	3.45	3.32	3.59
30-Year Treasury	4.61	4.53	4.49
Bond Buyer Index	5.41	5.39	4.30

Foreign Exchange Rates

	Friday 1/21/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.355	1.339	1.408
British Pound ($/£)	1.598	1.587	1.620
British Pound (£/€)	0.848	0.844	0.870
Japanese Yen (¥/$)	82.710	82.870	90.430
Canadian Dollar (C$/$)	0.991	0.991	1.052
Swiss Franc (CHF/$)	0.961	0.963	1.043
Australian Dollar (US$/A$)	0.991	0.989	0.900
Mexican Peso (MXN/$)	12.018	12.047	12.965
Chinese Yuan (CNY/$)	6.587	6.598	6.827
Indian Rupee (INR/$)	45.620	45.365	46.045
Brazilian Real (BRL/$)	1.671	1.685	1.803
U.S. Dollar Index	78.344	79.162	78.320

Foreign Interest Rates

	Friday 1/21/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.96	0.94	0.62
3-Month Sterling LIBOR	0.78	0.77	0.62
3-Month Canadian LIBOR	1.24	1.25	0.45
3-Month Yen LIBOR	0.19	0.19	0.26
2-Year German	1.29	1.15	1.12
2-Year U.K.	1.37	1.34	1.23
2-Year Canadian	1.75	1.78	1.19
2-Year Japanese	0.19	0.19	0.17
10-Year German	3.20	3.03	3.21
10-Year U.K.	3.71	3.61	3.93
10-Year Canadian	3.36	3.27	3.39
10-Year Japanese	1.22	1.21	1.35

Commodity Prices

	Friday 1/21/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	89.60	91.40	76.08
Gold ($/Ounce)	1342.55	1361.72	1093.95
Hot-Rolled Steel ($/S.Ton)	724.00	724.00	570.00
Copper (¢/Pound)	427.30	436.70	328.50
Soybeans ($/Bushel)	13.85	13.86	9.44
Natural Gas ($/MMBTU)	4.75	4.41	5.62
Nickel ($/Metric Ton)	25,744	25,527	18,728
CRB Spot Inds.	595.31	592.67	494.87

Next Week's Economic Calendar

	Monday 24	Tuesday 25	Wednesday 26	Thursday 27	Friday 28
U.S. Data		**Consumer Confidence** December 52.5 January 53.7 (W)	**New Home Sales** November 290K December 304K (W)	**Durable Goods Orders** November -0.3% December 1.7% (W)	**GDP** 3Q (3rd) 2.6% 4Q 3.9% (W)
			FOMC Rate Decision Previous 0.25% Expected 0.25% (W)	**Pending Home Sales** November 3.5% December 0.5% (W)	**Employment Cost** 3Q 0.4% 4Q 0.5% (W)
Global Data	**Eurozone** **PMI (Man)** Previous (Dec) 57.1	**U.K.** **GDP (CAGR)** Previous (Q3) 2.9%	**Mexico** **Retail Sales (YoY)** Previous (Oct) 4.4%	**Germany** **CPI (YoY)** Previous (Dec) 1.7%	
		Canada **CPI (YoY)** Previous (Nov) 2.0%		**Japan** **CPI (YoY)** Previous (Nov) 0.1%	

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

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 715-0134	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economist	(704) 374-4407	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 715-0569	michael.brown4@wellsfargo.com
Tyler B. Kruse	Economic Analyst	(704) 715-1030	tyler.kruse@wellsfargo.com
Joe Seydl	Economic Analyst	(704) 715-1488	joseph.seydl@wellsfargo.com
Sarah Watt	Economic Analyst	(704) 374-7142	sarah.watt@wellsfargo.com

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