October 22, 2010

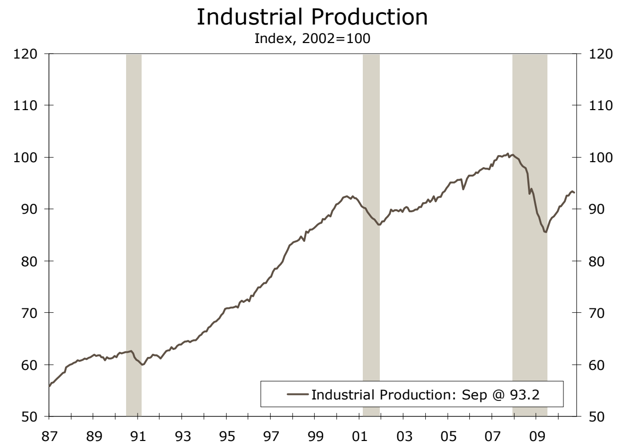
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Growth Signals Continue—As Does Subpar Consumer

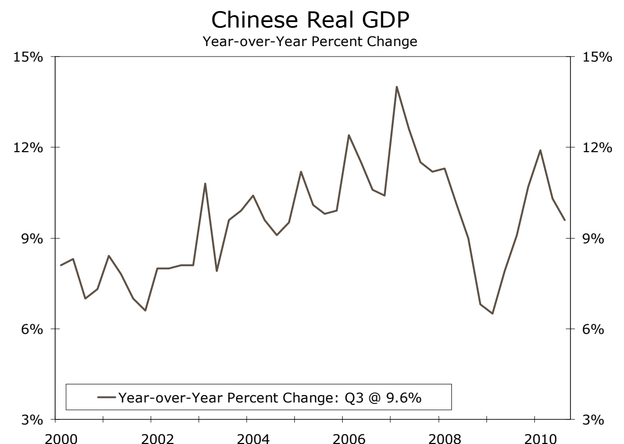
- Sustained, if only moderate, growth signals came through this week as housing starts, industrial production and the leading indicators suggest further growth in the economy. Odds of a double-dip will now reflect the political agenda going forward more than the economic indicators.
- For the consumer, slow income growth, high unemployment rates and deleveraging suggest modest consumer spending going forward. Our outlook remains for subpar growth reflecting a cautious consumer and the end to fiscal stimulus.



Global Review

Chinese Economic Policymakers Taking a Harder Line?

- Real GDP growth in China slowed a bit further in the third quarter, although at 9.6 percent the year-over-year growth rate remains rather strong. The overall rate of CPI inflation ticked up in September, driven by acceleration in food prices.
- The major risk to the Chinese economy at present appears to be uncomfortably high inflation rather than insufficient economic growth. Although this week's rate hike will do very little to slow economic growth, Chinese officials may take further steps to insure that the economy does not overheat.



Wells Fargo U.S. Economic Forecast

	Actual						Forecast					Forecast		
	2009				2010				2007	2008	2009	2010	2011	2012
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product [1]	-4.9	-0.7	1.6	5.0	3.7	1.7	1.7	2.4	1.9	0.0	-2.6	2.7	2.1	3.0
Personal Consumption	-0.5	-1.6	2.0	0.9	1.9	2.2	2.2	1.4	2.4	-0.3	-1.2	1.6	1.6	1.6
Inflation Indicators [2]														
"Core" PCE Deflator	1.6	1.5	1.3	1.7	1.8	1.5	1.4	1.1	2.4	2.3	1.5	1.4	1.1	1.4
Consumer Price Index	-0.2	-1.0	-1.6	1.5	2.4	1.8	1.2	0.8	2.9	3.8	-0.3	1.6	1.2	1.7
Industrial Production [1]	-17.6	-10.3	8.3	7.0	7.1	7.0	4.8	1.2	2.7	-3.3	-9.3	5.4	3.2	5.2
Corporate Profits Before Taxes[2]	-17.3	-11.4	-3.9	42.5	37.6	37.0	17.0	12.0	-6.1	-16.4	-0.4	24.9	6.5	6.9
Trade Weighted Dollar Index[3]	83.2	77.7	74.3	74.8	76.1	78.8	73.6	72.0	73.3	74.2	77.5	75.1	75.1	80.5
Unemployment Rate	8.2	9.3	9.6	10.0	9.7	9.7	9.6	9.9	4.6	5.8	9.3	9.7	9.7	9.0
Housing Starts[4]	0.53	0.54	0.59	0.56	0.62	0.60	0.59	0.55	1.34	0.90	0.55	0.59	0.77	1.04
Quarter-End Interest Rates														
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	4.25	1.63	0.25	0.25	0.25	0.50
Conventional Mortgage Rate	5.00	5.42	5.06	4.93	4.97	4.74	4.35	3.90	6.10	5.92	5.10	4.49	4.33	4.89
10 Year Note	2.71	3.53	3.31	3.85	3.84	2.97	2.53	2.40	4.04	3.39	3.35	2.94	2.93	3.30

Forecast as of: October 22, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

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Together we'll go far

U.S. Review

Neither the Best of Times Nor the Worst

Mr. Dickens would be hard pressed to sell his publisher with that headline. Yet, economic data suggest continued moderate growth, low inflation and a Fed focused on further easing. It is hard to sell books that do not scream the end of the world or the coming boom.

Mr. Pickwick Visits the Countryside

So how does the world look outside of the Beltway? Housing starts, industrial production and the leading indicators gave us positive signals for sustained, if only moderate, growth. Housing starts rose in September with the big winner being single-family starts. After bottoming in early 2009, starts have improved, but not as much as many had expected. The homebuyer tax credits shifted home buying, but did not provide any lasting stimulus. Moreover, increased scrutiny of the foreclosure process will delay price discovery in housing and increase the scrutiny applied to mortgage application and processing procedures. The result is an improvement in housing over the next 12 months, but at a pace that suggests no rapid boom in housing.

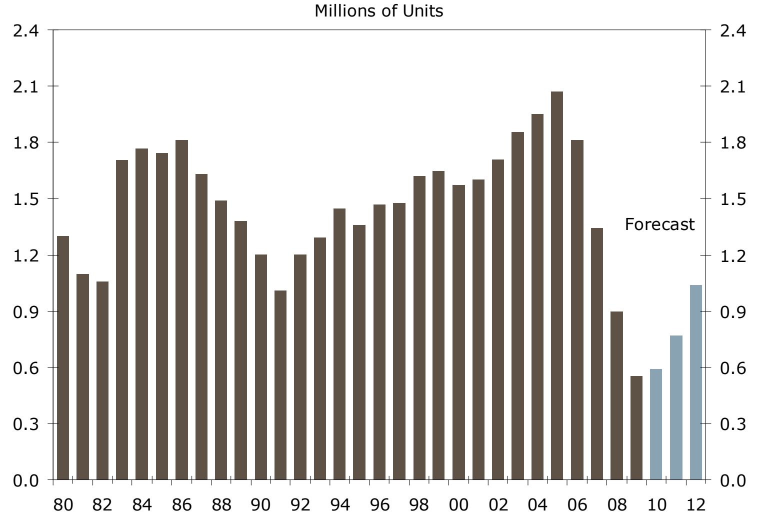
Industrial production dipped in September, primarily due to a dip in utility output. Over the past three months, production has recorded a modest gain of 4.8 percent (annualized) with positive contributions from durable and non-durable goods, including mining. Within durables, there have been gains in computer & office equipment (up 5.7 percent over the last three months, annualized), along with gains in machinery, motor vehicles & parts and electrical equipment over the same period. Capacity utilization has also improved over the past six months, but remains low (74.7 percent) compared to the 78-80 percent range associated with the prior expansion. Low capacity levels suggest minimal inflation concerns at the production level.

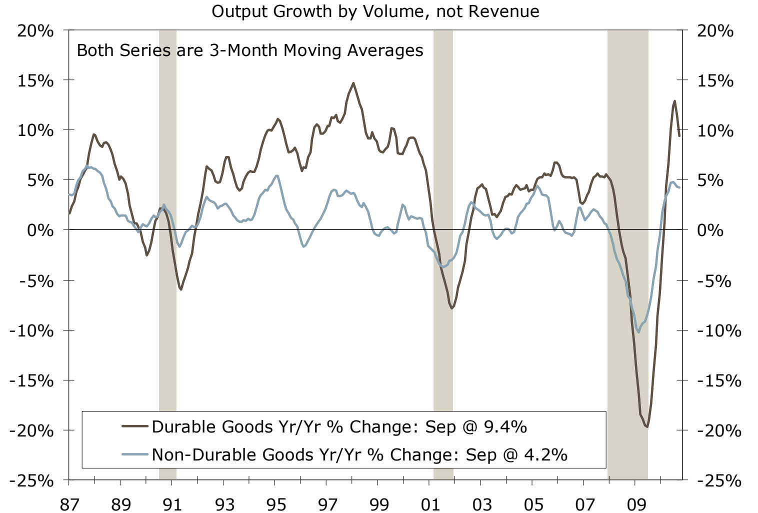
Leading indicators rose 0.3 percent in September and have increased each month for the past three months. Positive contributions came from lower jobless claims and the three financial indicators—equity prices, money supply and the yield curve. Modest monthly gains in the leading indicator support the outlook for continued, modest economic growth.

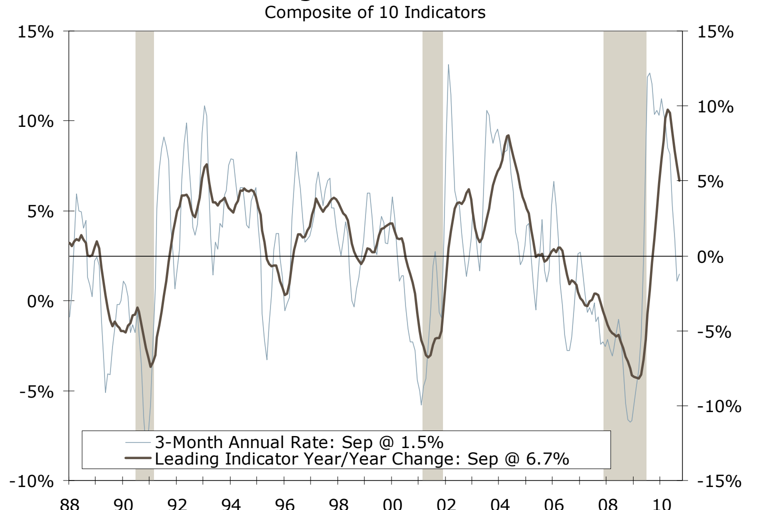
"Please sir, I want more"

Yes, Oliver, you shall have more stimulus! With economic growth modest and inflation risks minimal in the short-run, the Fed will provide more stimulus at the November meeting. Quantitative easing will be slow at the start, while the Fed watches the impact of easing. Meanwhile, Congress is likely to renew the Bush tax cuts given that the benefits of reducing the deficit will be overwhelmed by the risk of a fiscal shock hitting the pocketbooks of voters who are already angry.

Or, no Oliver, you are a troublemaker and we will raise your taxes come January! Given that the economy has been running on thin ice, higher taxes will hit the consumer and growth, and regretfully, does indeed raise the risk of a new recession. Policy shocks are nothing new, but here the margin for error is very thin.







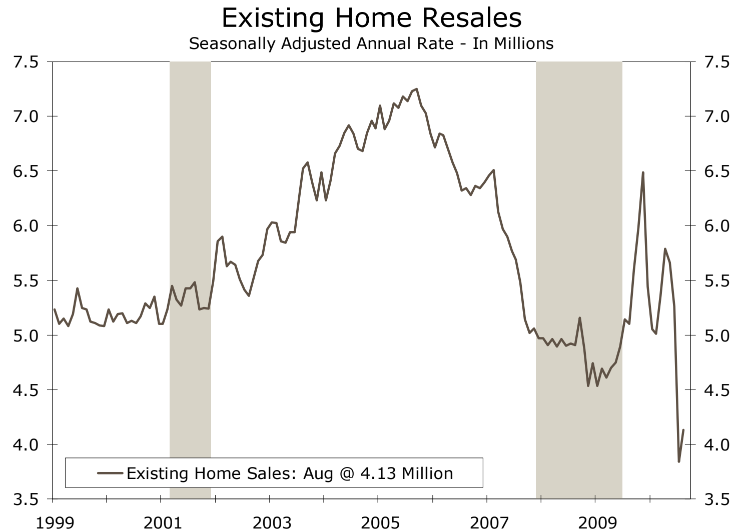
Existing Home Sales • Monday

Following the plunge in July in the wake of the expiration of the homebuyer tax credits, existing home sales rebounded slightly in August, with single-family and multi-family sales seeing increases. As most of the sales prior to the expiration of the tax credit were brought forward, we do not expect much upward movement in sales for the next few months. With sales at such a low level, increases would not be surprising, but they will likely be miniscule at best.

Tight credit conditions, high unemployment, underwater homeowners and slowing wage growth are all obstacles for the housing market. While September sales data will not reflect recently enacted foreclosure freezes, the impacts of these freezes could lead to slowing home sales as investors and homebuyers shy away from purchasing foreclosed homes amid all the uncertainty.

Previous: 4.13M **Wells Fargo: 4.35M**

Consensus: 4.30M



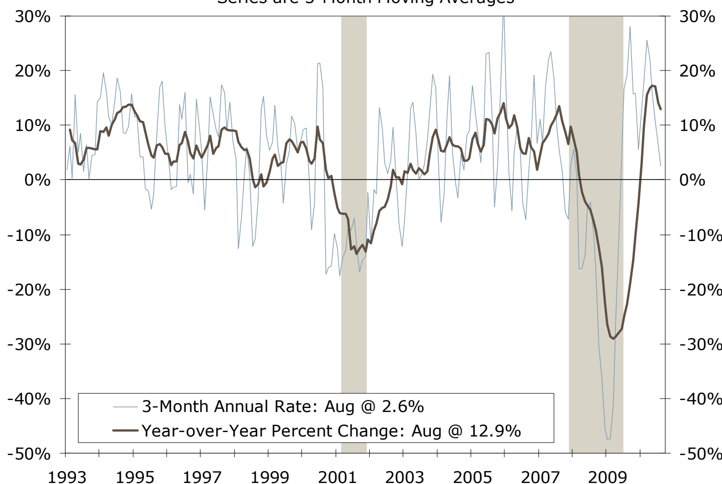
Durable Goods Orders • Wednesday

Durable goods orders dropped the most this year in August. However, the decline was largely driven by a big drop in non-defense aircraft orders. Vehicles and parts also saw the biggest pullback since February. Non-defense capital goods excluding aircraft, a proxy for future business investment, rose a solid 4.1 percent. Orders for computers and electronics rose the most since March.

This series, particularly the aircraft component, is quite volatile. While we expect a bounce back in aircraft orders, it is evident that the trend in overall orders has been slowing since the beginning of the year. With consumers still battling high unemployment, tight credit and housing issues, and with business restocking tapering, growth in durable orders may continue to trend lower. The decline in September industrial production reflects these headwinds.

Previous: -1.5% **Wells Fargo: 1.8%**

Consensus: 2.0% (Month-over-Month)

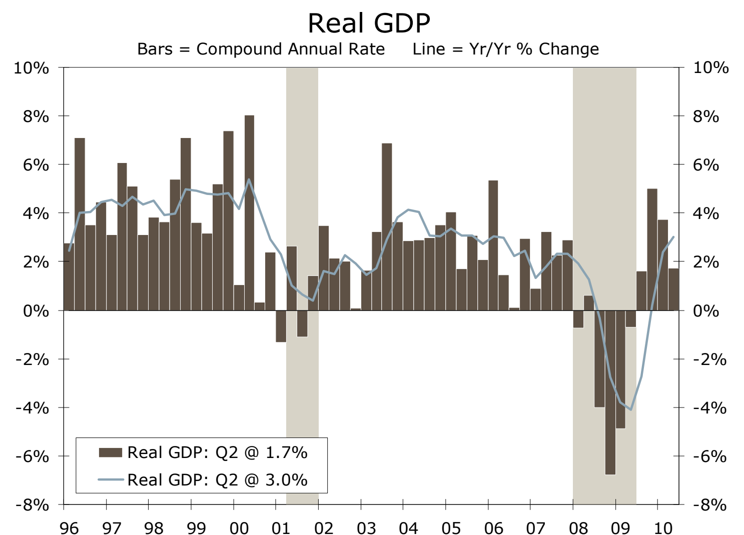


Gross Domestic Product • Friday

Following the rebound out of the recession, gross domestic product growth has slowed over the past couple quarters, largely due to the heavy drag imposed by international trade. In the second quarter, we also saw a substantially smaller contribution from inventories, suggesting companies were comfortable with their inventory levels and being cautious about further additions. However, the economy did get a boost from strong equipment and software spending, as well as a surge in residential fixed investment. We expect the economy grew in the third quarter at around the same pace as the second quarter. We expect less of a drag from trade as the trade deficit has only widened marginally during the quarter. Consumer spending growth probably also held near second-quarter levels. We are expecting a pullback in residential fixed investment and smaller contributions from business fixed investment and inventories.

Previous: 1.7% **Wells Fargo: 1.7%**

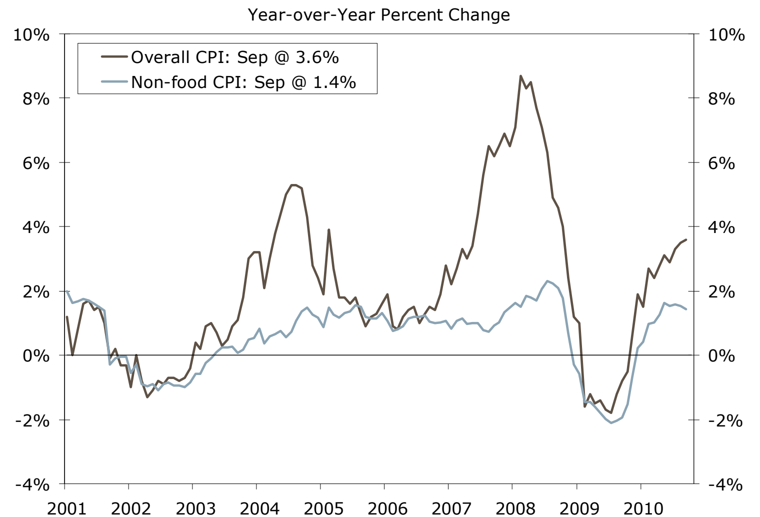
Consensus: 2.2%



Global Review

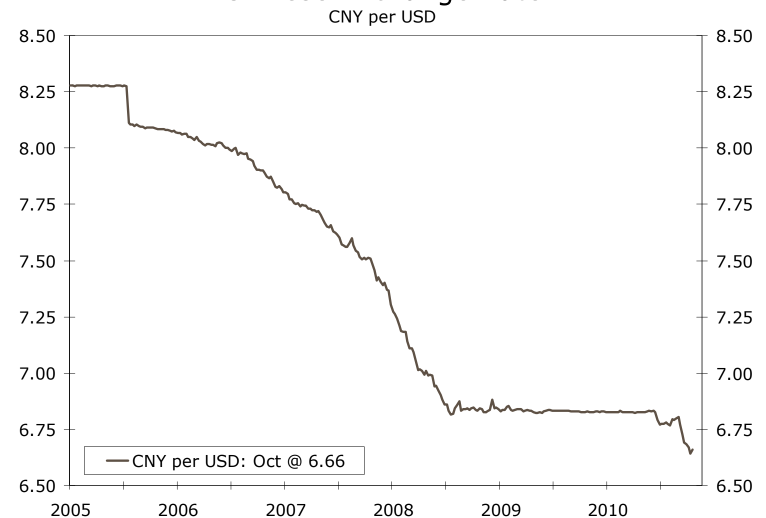
Chinese Economic Policymakers Taking a Harder Line?

The Chinese economy was front-and-center in the news this week. For starters, data showed that the year-over-year rate of real GDP growth in China slowed modestly from 10.3 percent in the second quarter of this year to 9.6 percent in the third quarter (see chart on front page). There are two underlying reasons for the modest slowdown recently. First, the nadir of Chinese economic activity in the recent cycle was reached in early 2009. Therefore, comparisons on a year-ago basis are becoming more challenging. Second, Chinese authorities took steps earlier this year to slow the rapid rate of economic growth via directives to the country's banks to rein in loan growth, a point to which we return below. These previous tightening measures appear to have had a dampening effect on economic growth in the third quarter.



CPI inflation data for September also printed this week. The overall rate of inflation edged up from 3.5 percent in August to 3.6 percent in September due largely to acceleration in food prices, which comprise one-third of the Chinese consumer price index (top chart). Excluding food, consumer prices were up only 1.4 percent in September. However, Chinese officials made it abundantly clear through their actions this week that they view the primary risk to the economy to be unacceptably high inflation rather than insufficient growth. To wit, the People's Bank of China (PBoC)—the country's central bank—raised its benchmark one-year lending rate by 25 bps to 5.56 percent, the first rate hike in three years. Although financial markets in many countries reacted negatively to the news, the move will have little direct effect on the global economy.

First, a 25 bps rate hike will do little to slow the Chinese economic juggernaut. Second, monetary policy in China really works through the directives that the government issues to the banks concerning the pace of lending. When the government wants to stimulate the economy, it directs the banks to accelerate lending, as it did in early 2009 when the global financial crisis posed significant downside risks to economic growth in China (middle chart). Likewise, the government ordered the banks to cool off lending growth earlier this year when the economy was booming, authorities were worried about a house price bubble forming, and inflation was starting to rise.



As noted above, a small increase in interest rates will do little to slow economic growth in China. That said, the rate hike may serve an important signaling function. By tightening policy, Chinese authorities are signaling their belief that the major risk to the economy is uncomfortably high inflation rather than insufficient economic growth. Therefore, the government may be quietly telling banks to rein in lending growth again. In addition, the government may allow the renminbi to continue to strengthen at a moderate pace. Not only would further appreciation mollify foreign governments, but it would also dampen down inflationary pressures in China. We look for some further slowing in China in the quarters ahead, although we expect the year-over-year growth rate to remain strong, at least by Western standards.

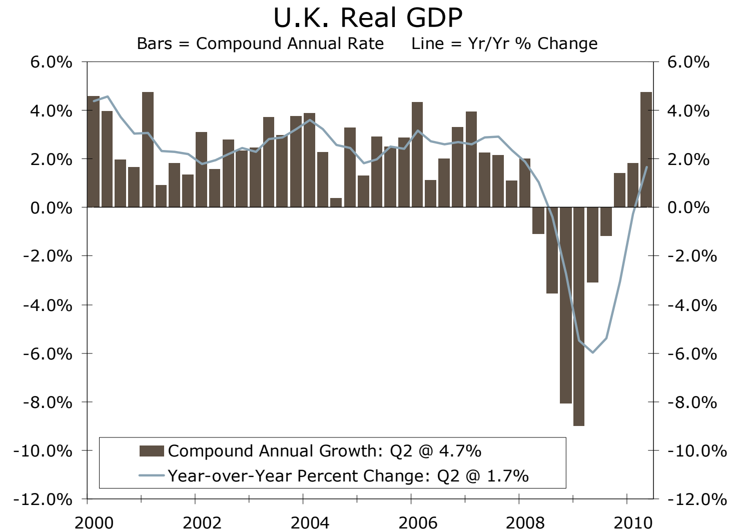
U.K. GDP • Tuesday

British real GDP grew at an annualized rate of 4.9 percent in the second quarter, the strongest sequential growth rate in more than 10 years. The torrid pace of growth in the second quarter was largely fueled by a sharp inventory swing, which will fade over the next few quarters.

Even without as much help from an inventory boost, we would expect other components to help provide some continued expansion with the largest positive contribution coming from private consumption. That said, the sequential growth rate in Q3 will probably slow to less than half the pace seen in Q2. The various purchasing managers' indexes in the United Kingdom remain above 50, which is consistent with expansion, but they have slipped from their high levels seen earlier this year.

Previous: 4.7% **Wells Fargo: 2.0%**

Consensus: 1.6%



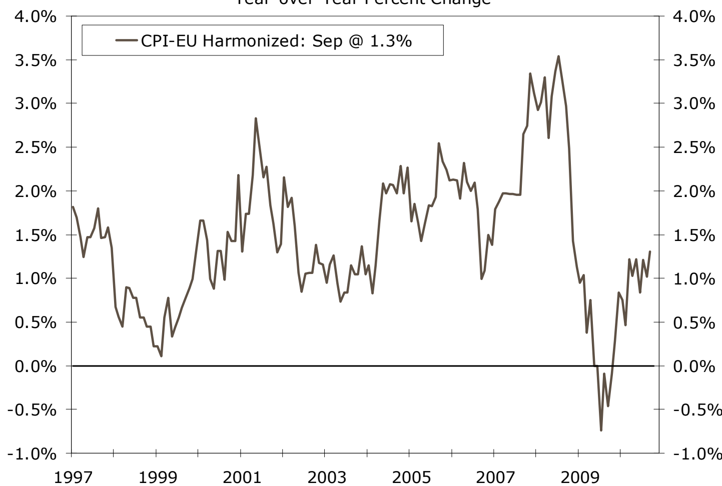
German CPI • Wednesday

As in the United Kingdom, economic growth surged in Germany in the second quarter fueled by net export growth and increased business spending. However, the growth spurt in the economy did not translate into increased consumer prices. Since growth likely slowed in the third quarter, there is little concern for building pressures at least in the near future. The European Central Bank (ECB) keeps fairly close tabs on inflation in Germany, the largest of the 16 economies that collectively form the Euro-zone.

Consumer prices actually came down marginally in September as the German Consumer Price Index shed 0.1 percent. On a year-over-year basis, consumer prices climbed 1.3 percent, which gives the ECB cover to keep rates accommodative.

Previous: 1.3%

Consensus: 1.3% (Year-over-Year)

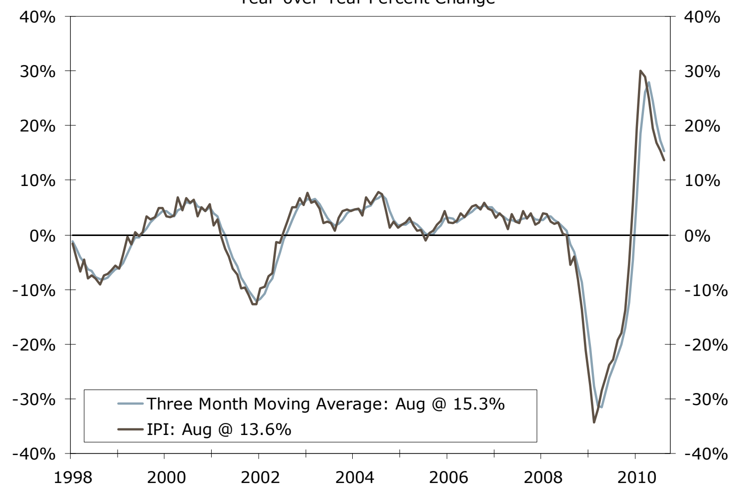


Japanese Industrial Production • Friday

In most of the world's large, developed economies the current economic theme is one of slowing growth; in Japan, however, there appears to be serious risk of a double-dip, particularly in the manufacturing sector. After plummeting during the recession, Japanese industrial production (IP) snapped back earlier this year, posting some of the strongest monthly increases on record. But beginning in June, output began to slow. The year-over-year growth in IP is still growing at double-digit rates—benefitting from the low levels of output last year. On a sequential basis, however, Japanese IP is on a three-month slide, falling a cumulative 1.9 percent since May. September output data are due out on Friday of next week and the consensus expectation is for a fourth monthly drop, though the year-over-year numbers will continue to benefit from easy comps through next spring.

Previous: 13.6%

Consensus: 12.3% (Year-over-Year)



Interest Rate Watch

QE2: Big Ship, Little Wake

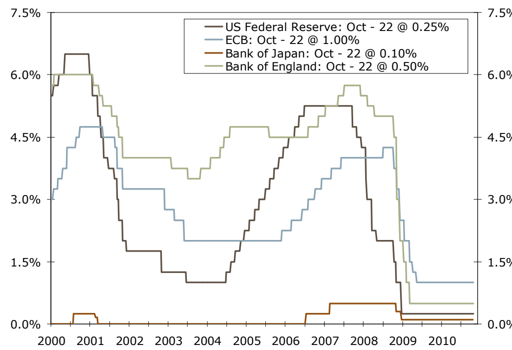
Our expectation is that quantitative easing will proceed ahead. At face value, we will go with New York Fed President Bill Dudley's trial balloon of $500 billion and add our expectation that this buying will be spread out over the next six months depending on the incoming economic data.

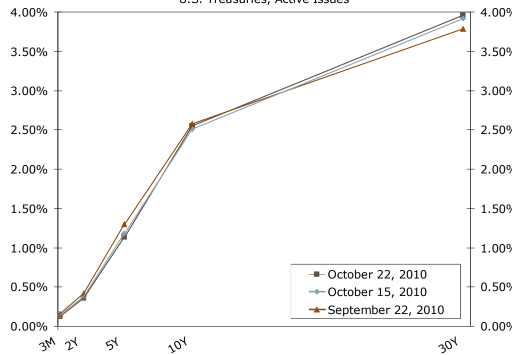
While $500 billion sounds big, we suspect that the movement in interest rates will be small and that the short-run liquidity effect of lowering rates will be offset over time by the inflation and exchange rate risk effects. A weaker dollar, higher inflation and continued large federal deficits will produce a quick, upside move in interest rates similar to the movements in 1994, which caught many bond investors on the wrong side of the trade.

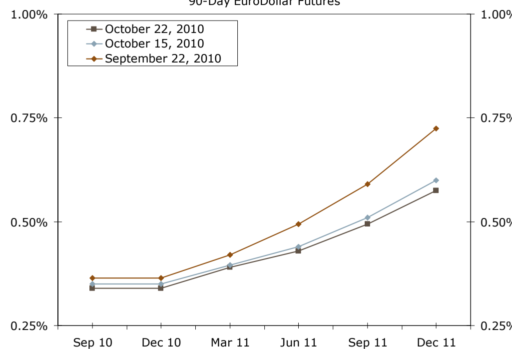
Inflation alone does not drive interest rates. There is a complacency among some investors, at our meetings, that is based upon the view that inflation is low and likely to stay that way for a while and so interest rates will also remain low for sometime. Perhaps that is the best case, but there is a risk.

Our scenario alternative is that investors are forward looking, and looking forward, they see a weaker dollar with little opposition from policymakers in Washington. They also see a pattern of large federal fiscal deficits for a long time with little opposition from policymakers in Washington. Finally, they also see a willingness on the part of the central bank to ease further in the short-run with a goal of stimulating the economy and reducing unemployment with lots of support from policymakers in Washington.

Yet there are lots of concerns from private sector economists and policymakers outside the Beltway. Perhaps, it is old school, but the lessons of theory and practice over the past 50 years has been that monetary policy moves are neutral on growth and employment in the long-run and further monetary expansion shows up in higher inflation or a weaker dollar, or both. The risk remains for both over time and given the results of history, picking that exact timing is not for mere mortals.







Credit Market Insights

C&I Lending, a Mixed Bag

On trend, the pace of decline in commercial and industrial lending has slowed substantially in recent months. On the demand side, firms continue to cite economic uncertainty as the primary factor holding back decisions to increase borrowing for current and near-term capital spending.

On the supply side, lending standards at banks for C&I loans are easing somewhat—though easing is concentrated mostly at large banks with high credit ratings. According to the Senior Loan Officer Survey, lending standards for the majority of banks remain unchanged, though at the margin, a growing number of banks are reporting easing standards on C&I loans to firms from large to small.

Outstanding commercial real estate (CRE) loans remain troublesome particularly for small banks, however. September data showed nearly 40 percent of total loans held by small banks are tied to CRE, compared to a 15 percent share at large banks. Furthermore, CRE loans at small banks are tied mostly to construction and development projects; whereas at large banks, many loans are tied to income-producing properties. Many development projects located in overbuilt markets such as Florida and Nevada have been halted, forcing write downs at small banks; income properties are looking slightly less problematic right now due to stabilizing rents and occupancy rates.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.21%	4.19%	4.37%	5.00%
15-Yr Fixed	3.64%	3.62%	3.82%	4.43%
5/1 ARM	3.45%	3.47%	3.54%	4.40%
1-Yr ARM	3.45%	3.43%	3.46%	4.54%
MBA Applications				
Composite	803.4	897.2	790.6	641.0
Purchase	169.7	181.8	177.6	268.8
Refinance	4,491.1	5,060.3	4,357.4	2,808.0

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

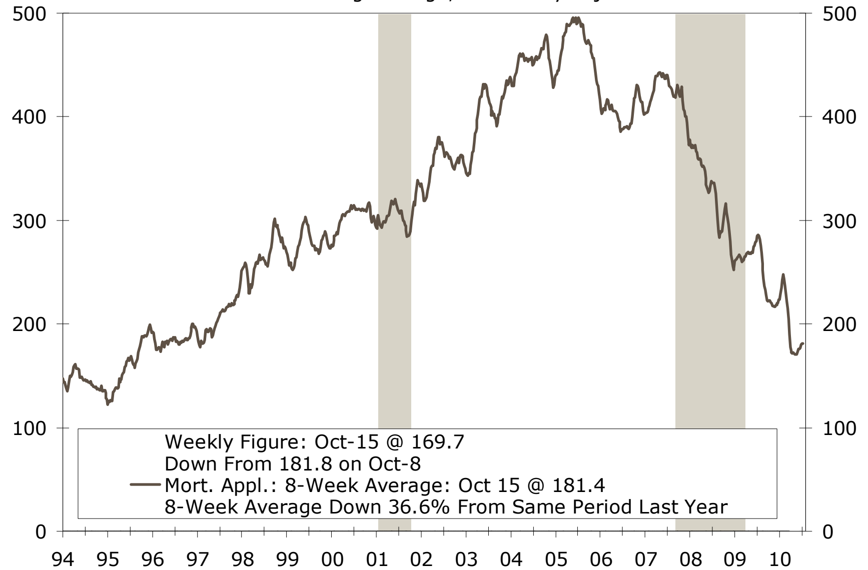
Topic of the Week

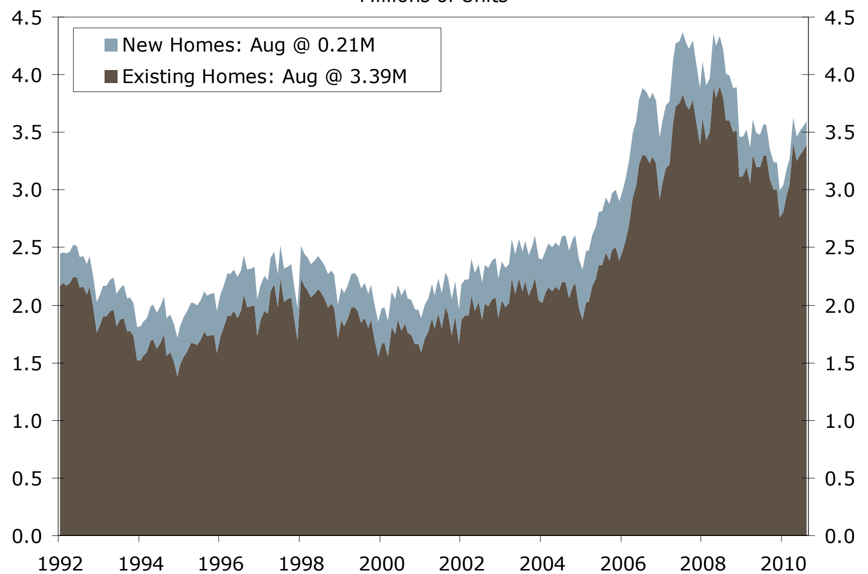
Foreclosure Crisis Threatens Recovery Process

The recent foreclosure crisis, which has led some lenders and servicers to temporarily suspend foreclose actions, threatens to lengthen the recovery process. Interruptions in foreclosures could stretch out the recovery timetable and cause home sales to slow even further. Not only would it take longer to clear out the mountain of foreclosed properties, but it would also create more uncertainty about home prices, potentially leading to even more conservative appraisals and tighter underwriting standards. Tougher appraisals and tight underwriting standards are already offsetting much of the benefit from record low mortgage rates and are a big reason why mortgage purchase applications have risen so little in recent weeks.

While foreclosures are expected to keep the inventory of homes available for sale elevated, home sales and new home construction will begin to recover well before the last foreclosure is sold. Much of the inventory of foreclosed homes and seriously delinquent home mortgages are concentrated in a handful of states, with Florida, Arizona, Nevada, California, Georgia, Illinois and Michigan topping the list. Housing markets will likely take longer to recover in these states and prices will likely fall a bit further than in the rest of the U.S.

Our forecast has been scaled back slightly due to the recent increased scrutiny of the foreclosure process. We continue to project a modest recovery in home sales and new home construction during the coming years. Sales of new single-family homes are expected to rise 29 percent next year, helping boost single-family housing starts nearly 30 percent. Apartment construction is also expected to strengthen modestly, lifting housing starts to 770,000 for all of 2011. That would still leave housing starts at their third lowest level in the modern era. Construction is expected to finally move back above 1.0 million units in 2012, but only barely so. By contrast, a “normal” year for housing would see around 1.45 million housing starts. We do not expect to hit that level until 2014 at the earliest.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 10/22/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.12	0.13	0.04
3-Month LIBOR	0.29	0.29	0.28
1-Year Treasury	0.22	0.22	0.46
2-Year Treasury	0.35	0.36	0.93
5-Year Treasury	1.14	1.19	2.36
10-Year Treasury	2.55	2.56	3.41
30-Year Treasury	3.92	3.98	4.24
Bond Buyer Index	3.84	3.82	4.31

Foreign Exchange Rates	Friday 10/22/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.393	1.398	1.503
British Pound ($/₤)	1.569	1.599	1.662
British Pound (₤/€)	0.888	0.874	0.904
Japanese Yen (¥/$)	81.360	81.450	91.300
Canadian Dollar (C$/$)	1.025	1.010	1.048
Swiss Franc (CHF/$)	0.976	0.959	1.005
Australian Dollar (US$/A$)	0.979	0.991	0.927
Mexican Peso (MXN/$)	12.380	12.434	12.887
Chinese Yuan (CNY/$)	6.659	6.641	6.829
Indian Rupee (INR/$)	44.590	44.105	46.743
Brazilian Real (BRL/$)	1.695	1.665	1.719
U.S. Dollar Index	77.393	77.041	75.094

Foreign Interest Rates	Friday 10/22/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.97	0.93	0.69
3-Month Sterling LIBOR	0.74	0.74	0.60
3-Month Canadian LIBOR	1.22	1.24	0.50
3-Month Yen LIBOR	0.20	0.20	0.33
2-Year German	1.00	0.81	1.37
2-Year U.K.	0.64	0.67	0.96
2-Year Canadian	1.39	1.44	1.50
2-Year Japanese	0.14	0.13	0.27
10-Year German	2.47	2.37	3.31
10-Year U.K.	2.95	2.95	3.71
10-Year Canadian	2.75	2.79	3.46
10-Year Japanese	0.90	0.89	1.37

Commodity Prices	Friday 10/22/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	81.16	81.25	81.19
Gold ($/Ounce)	1322.00	1368.40	1060.10
Hot-Rolled Steel ($/S.Ton)	505.00	535.00	515.00
Copper (¢/Pound)	378.30	383.45	298.80
Soybeans ($/Bushel)	11.49	11.34	10.04
Natural Gas ($/MMBTU)	3.33	3.54	4.95
Nickel ($/Metric Ton)	23,485	24,259	19,667
CRB Spot Inds.	543.21	543.18	434.07

Next Week's Economic Calendar

	Monday 25	Tuesday 26	Wednesday 27	Thursday 28	Friday 29
U.S. Data	**Existing Home Sales** August 4.13M September 4.35M (W)	**Consumer Confidence** September 48.5 October 49.0 (W)	**Durable Goods Orders** August -1.5% September 1.8% (W) **Durables Ex Transp.** August 1.7% September 0.0% (W) **New Home Sales** August 288K September 302K (W)		**GDP** Q2 1.7% Q3 1.7% (W) **Employment Cost** 2Q 0.5% Q3 0.5% (W)
Global Data		**UK** **GDP (QoQ)** Previous (2Q) 1.2%	**Germany** **CPI (YoY)** Previous (Sep) 1.3%	**Japan** **Large Retailers' Sales** Previous (Aug) -1.8% **UK** **House Prices (MoM)** Previous (Sep) 0.1%	**Japan** **Industrial Prod. (MoM)** Previous (Aug) -0.5%

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

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