August 20, 2010

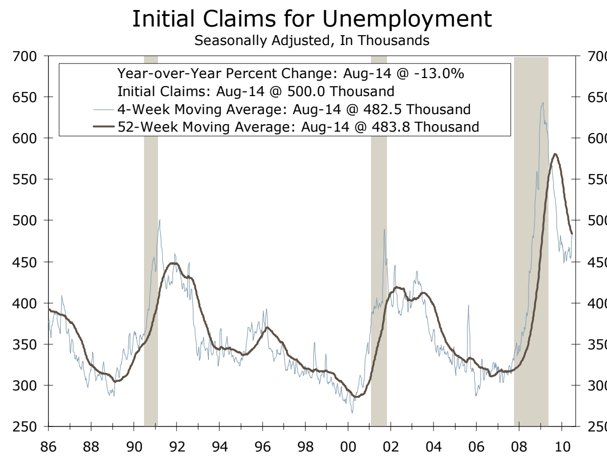
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

A Clear Step Backward

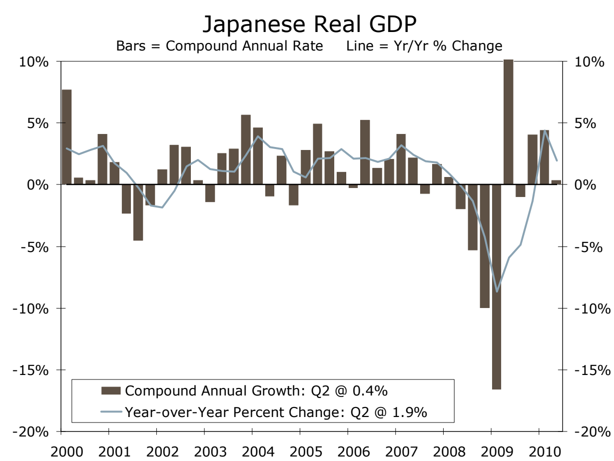
- Fears about a second-half slowdown kicked into higher gear following the release of the higher-than-expected weekly first-time unemployment figures.
- Industrial production rose 1.0 percent in July, but more recent data from the factory sector point to a substantial slowdown during the second half of the year.
- A pickup in apartment building helped pull housing starts slightly higher in June, but the previous month's data was revised lower and permits fell 3. 1 percent.



Global Review

Mixed Signals Creeping Back In

- The best description of the international economic data recently is mixed. More countries are releasing second-quarter GDP, and there have been some noticeable surprises both on the upside and downside.
- Japan's second-quarter GDP was much weaker than expected, prompting us to revise down our forecast for Japanese growth in 2010 and 2011. We now see growth of 2.7 percent in 2010 and 1.3 percent in 2011 for Japan.



Wells Fargo U.S. Economic Forecast

	Actual				Forecast				Actual				Forecast	
	2009				2010				2006	2007	2008	2009	2010	2011
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product [1]	-4.9	-0.7	1.6	5.0	3.7	2.4	1.8	2.0	2.7	1.9	0.0	-2.6	2.8	2.1
Personal Consumption	-0.5	-1.6	2.0	0.9	1.9	1.6	1.6	1.3	2.9	2.4	-0.3	-1.2	1.4	1.5
Inflation Indicators [2]														
"Core" PCE Deflator	1.6	1.5	1.3	1.7	1.8	1.5	1.2	1.0	2.3	2.4	2.3	1.5	1.4	1.0
Consumer Price Index	-0.2	-1.0	-1.6	1.5	2.4	1.8	1.1	0.6	3.2	2.9	3.8	-0.3	1.5	1.0
Industrial Production [1]	-17.6	-10.3	8.3	7.0	7.0	6.6	3.3	2.2	2.2	2.7	-3.3	-9.3	5.1	3.3
Corporate Profits Before Taxes [2]	-17.3	-11.4	-3.9	42.5	37.6	24.0	17.6	12.8	10.5	-6.1	-16.4	-0.4	22.3	6.8
Trade Weighted Dollar Index [3]	83.2	77.7	74.3	74.8	76.1	78.8	75.4	81.5	81.5	73.3	79.4	74.8	81.5	88.0
Unemployment Rate	8.2	9.3	9.6	10.0	9.7	9.7	9.6	9.8	4.6	4.6	5.8	9.3	9.7	9.6
Housing Starts [4]	0.53	0.54	0.59	0.56	0.62	0.60	0.54	0.60	1.81	1.34	0.90	0.55	0.59	0.81
Quarter-End Interest Rates														
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	5.25	4.25	0.25	0.25	0.25	0.50
Conventional Mortgage Rate	5.00	5.42	5.06	4.93	4.97	4.74	4.56	4.70	6.14	6.10	5.33	4.93	4.70	5.60
10 Year Note	2.71	3.53	3.31	3.85	3.84	2.97	2.86	3.00	4.71	4.04	2.25	3.85	3.00	3.60

Forecast as of: August 11, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

Inside

U.S. Review

The Economy's Engine Is Sputtering a Bit

Thursday morning's surprising 12,000-person rise in weekly first-time unemployment claims was a red letter moment for the economy. Jobless claims have risen for three weeks in a row and totaled a half million during the most recent week. The current level of jobless claims is more typically associated with the heart of a recession rather than one year into a recovery. While there are some statistical quirks in the data, there is no denying that unemployment claims are unusually high and at troublesome levels. Jobless claims only exceeded the current level during one week of each of the past two recessions. The four-week moving average has risen less dramatically and now totals 482,500, a level that is inconsistent with nonfarm employment growth.

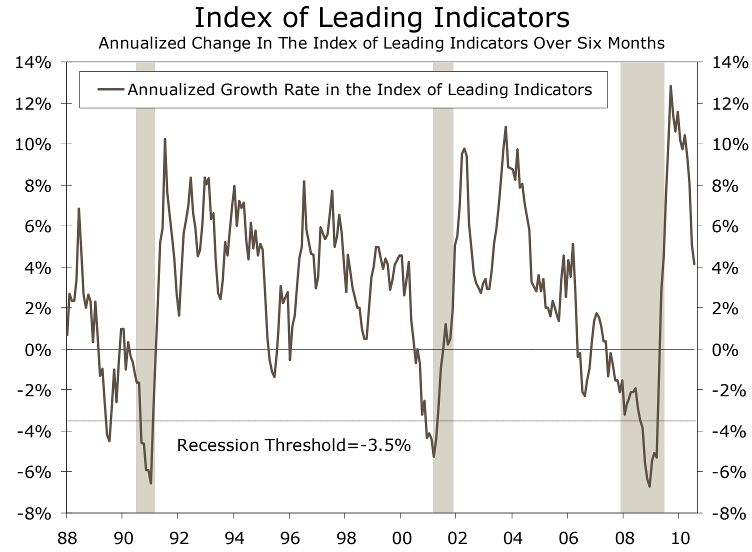
Continuing unemployment claims fell in the latest week, and the insured unemployment rate remained unchanged. Long-term unemployment remains a huge problem, as emergency claims continue to soar following the recent extension of that program.

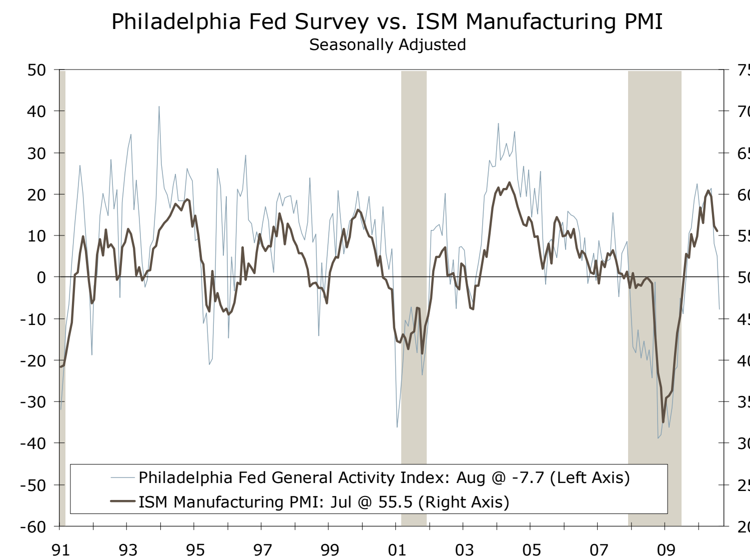
There were several other disconcerting reports issued this week, including a small increase in the Leading Economic Index and a downward revision to the previously reported data. The LEI rose just 0.1 percent in July after falling 0.3 percent the prior month. A widening in the interest rate spread, a rise in the average workweek, a small decline in jobless claims and some lengthening in supplier deliveries helped offset declines in consumer expectations, the money supply and building permits.

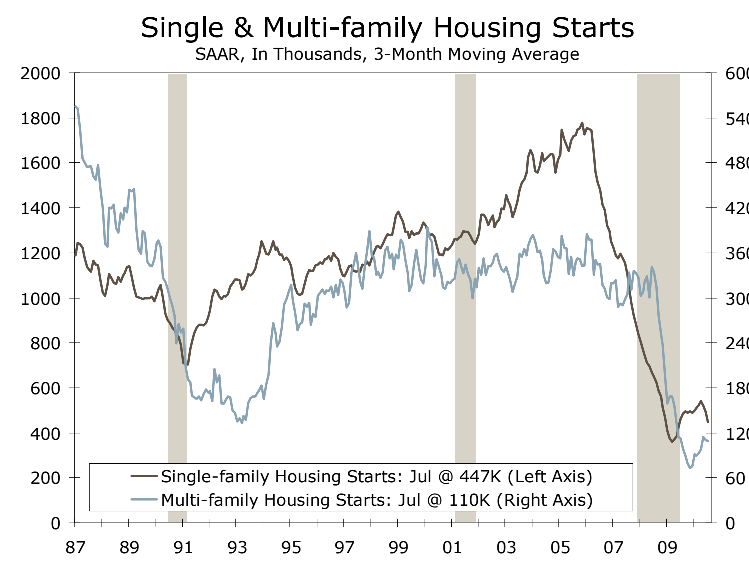
The LEI is probably a little weaker than the headline number suggests. The wider interest rate spread boosted the index by 0.3 percent in July and has made a slightly larger contribution to the index for six consecutive months. With the federal funds rate essentially at zero, the value of this component of the LEI is seriously in question. Without this component, the LEI would have fallen in three of the past four months and would have shown much less strength earlier this year. Conditions may already be taking care of themselves. The past month saw a dramatic flattening of the yield curve, with the yield on the 10-year Treasury falling to below 2.60 percent. When combined with the recent spike in jobless claims and the slide in share prices, we should see a drop in the LEI for August.

Early data for August are not promising. The Philadelphia Fed Manufacturing Survey tumbled 12.6 points to -7.7. New orders, shipments, unfilled orders and employment all fell during the month and delivery times shortened noticeably. The prices paid index fell 12.5 in August, marking its third consecutive drop. The bottom line from this report is that the strength in the factory sector is moderating and the weakness in the more leading components of the report suggests growth will slow more significantly later this year.

Housing starts were another disappointment. While starts rose on an overall basis, all of the gain was in the volatile multifamily component. Single-family starts and permits both declined during the month, and builder sentiment for August fell.





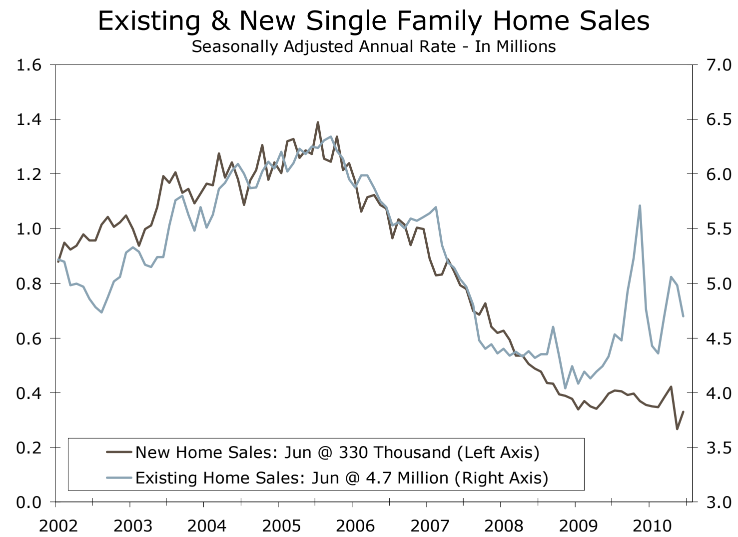


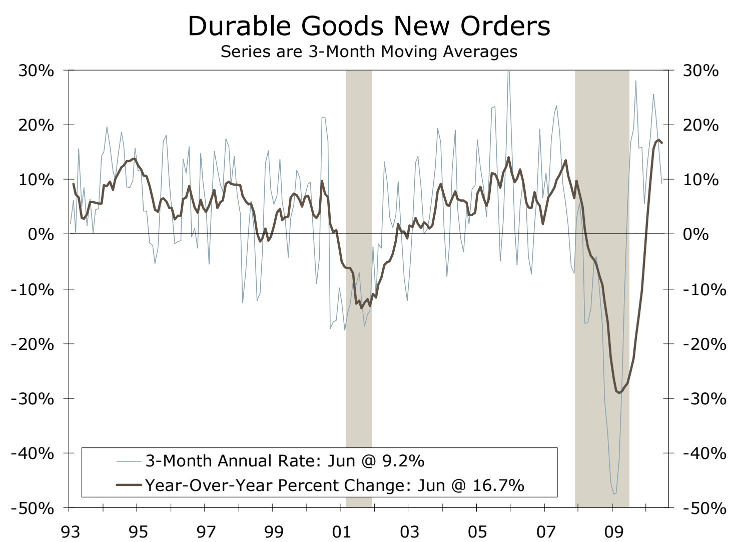
Existing Home Sales • Tuesday

Sales of existing homes fell 5.1 percent in June to a 5.37 million-unit pace. Existing homes moved at a faster pace than the consensus had expected. The tax credit is still affecting existing sales numbers. An extension of the closing deadline until September will likely make it difficult to lay the blame for a slowdown in any particular month on the expiration of the tax credit, but a general slowdown is widely expected. July existing home sales are to be reported on Tuesday of this week, and most market-watchers anticipate sales slowed to a roughly 4.6 million annual pace. Speaking of the housing market, new home sales data for July will become available the following day (Wednesday). Builders have been reeling in this cycle, and the level of sales is exceptionally low at just 330,000 units. But with prices of new homes very affordable and mortgage rates low, the pace of new home sales will not likely slacken as much as existing homes.

Previous: 5.37M **Wells Fargo: 4.55M**

Consensus: 4.63M





Durable Goods Orders • Wednesday

In the recovery following the global recession, durable goods orders posted an impressive rally, climbing more than 20 percent between the trough in orders in March 2009 and the current cycle peak in April 2010. A massive inventory rebuilding helped drive the gains in bookings. However, as inventory growth has slowed in recent months, durable goods orders have posted back-to-back monthly declines. This dynamic has led to a fair amount of hand-wringing that the inventory rebuild is now largely behind us. But July factory data were largely encouraging. Industrial production picked up 1 percent in the month, and while the new orders component of the ISM index slipped a bit, it remains in expansion territory. July durable goods numbers hit the wire on Wednesday, and after two straight monthly declines, some payback is expected. We are looking for a gain of 2.0 percent in the month.

Previous: -1.2% **Wells Fargo: 2.0%**

Consensus: 3.0%

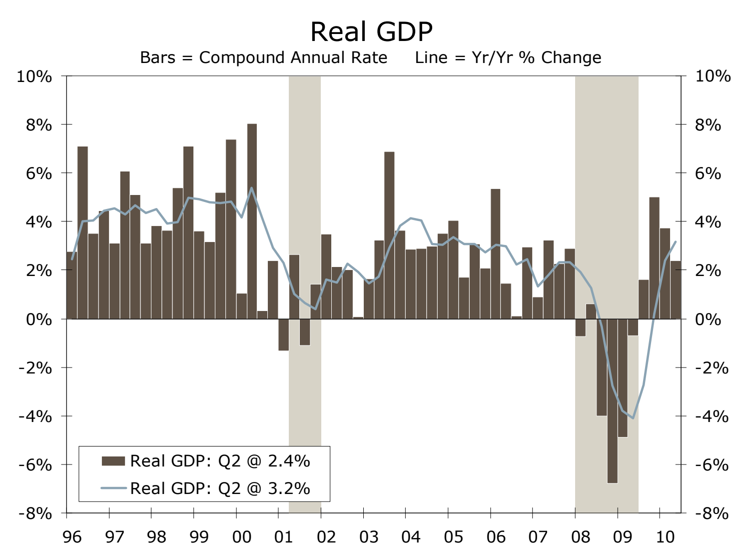
Q2 GDP (Second) • Friday

The initial reading of second-quarter GDP data revealed that the U.S. economy grew at a 2.4 percent annualized rate in the quarter. We said in our write-up at the time that most of the strength was in the early part of the quarter and the economy is thought to have lost momentum more recently, and we stand by that view.

The Bureau of Economic Analysis (BEA), the group tasked with publishing the official GDP data, does not have all of the previous quarter's data at the time of the first publication. So it estimates the components for which it does not yet have hard data. It appears that the BEA overshot its estimates for both trade and inventories. Consequently markets are now looking for a significant downward adjustment when revised second-quarter growth figures are released on Friday.

Previous: 2.4% **Wells Fargo: 1.6%**

Consensus: 1.4%



Global Review

Unbalanced Growth in Japan

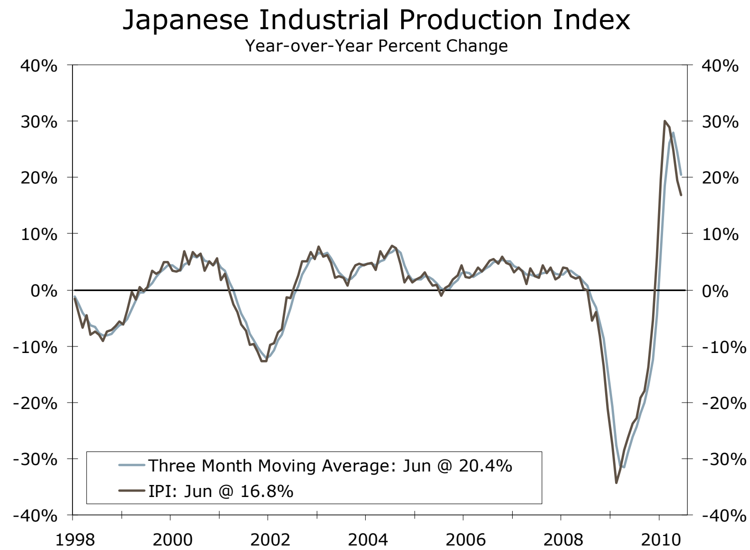
We were anticipating a swift slowdown in Japanese growth in the second quarter, but it turns out we weren't pessimistic enough. Japanese GDP rose a paltry 0.4 percent at an annualized rate in the second quarter—a huge letdown following the 4.4 percent annualized growth posted in the first quarter. Moreover, GDP data were revised down for past quarters by about half a percentage point from the third quarter of 2009 through the first quarter of 2010. Japan's GDP is now just 2.0 percent higher than a year ago, compared to our estimate of 3.1 percent prior to the second-quarter GDP release.

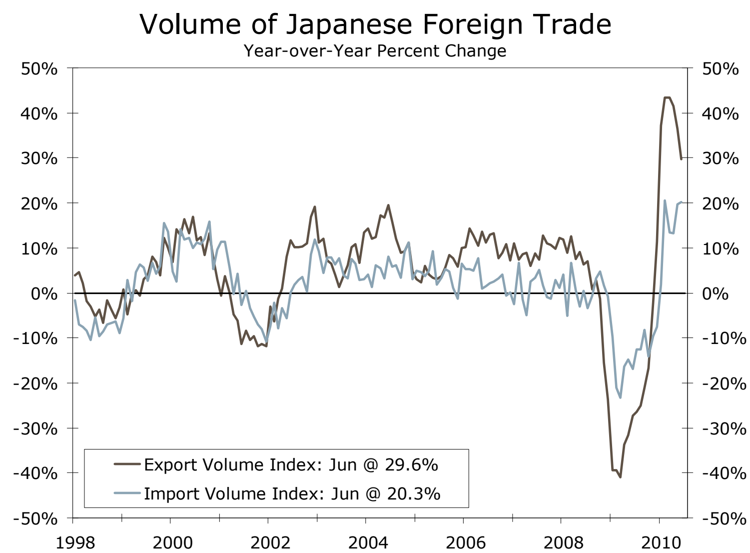
If the advance second-quarter Japanese GDP estimates are to be believed, domestic demand completely shut down in the second quarter. Indeed, domestic spending actually fell 0.9 percent on an annualized basis. Consumer spending was nearly flat in real terms in the second quarter, rising a stark 0.1 percent annualized rate from the first quarter. Residential investment plunged 5.0 percent on an annualized basis and is 10.5 percent lower than a year ago. Public investment offered no support either, dropping at a 12.9 percent annualized pace in the second quarter. If not for solid export growth in the second quarter of 25.9 percent annualized, the Japanese economy would have moved back into recession. With the yen strengthening to 15-year highs and growth slowing in China, Japan can not count on export growth alone to carry the economy forward. There is speculation brewing in the press that the BoJ is considering easing monetary policy further by increasing the size and loan period of its credit facility. This could take some of the air out of the appreciating yen, and give the country's exports a little bit of breathing room.

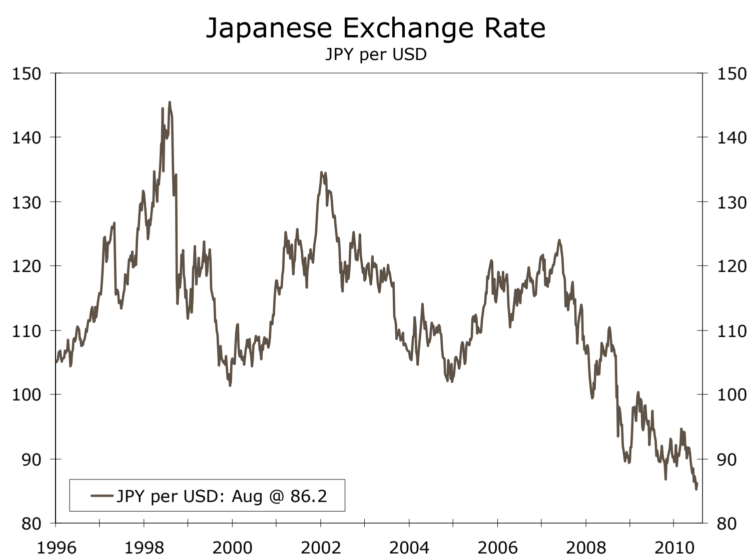
Deflation remains firmly entrenched with the GDP deflator falling 1.8 percent from a year ago. Given the poor domestic performance of Japan's economy in the second quarter, there are real concerns surrounding the vitality of Japan's economic rebound in a slowing export environment without additional fiscal and monetary stimulus.

We have shaved 0.6 percentage points off our Japan GDP growth estimates for 2010, and 0.2 percentage points off of 2011, which already had a fairly steep slowdown factored in. Japan's GDP growth is now forecast to advance 2.7 percent in 2010, and then slow to a 1.3 percent pace in 2011. We have also scaled back our expectations that Japan's recent deflationary episode subsides by the end of 2011. We now expect consumer prices to continue to contract in 2011 though perhaps at a slightly slower pace than they have in 2010. Consumer prices in Japan are expected to fall 0.9 percent in 2010 and contract another 0.5 percent in 2011.

On the positive side, for the time being at least, non-Japan Asia appears to be weathering the slowdown in Japan and China fairly well. Taiwan's second-quarter GDP expanded a larger-than-expected 12.5 percent year over year. Malaysia grew at an 8.9 percent pace from a year ago, and Hong Kong's GDP exceeded forecasts. Rising consumer and home prices are a growing concern in Taiwan, however, which could prompt another benchmark interest rate increase from the central bank.





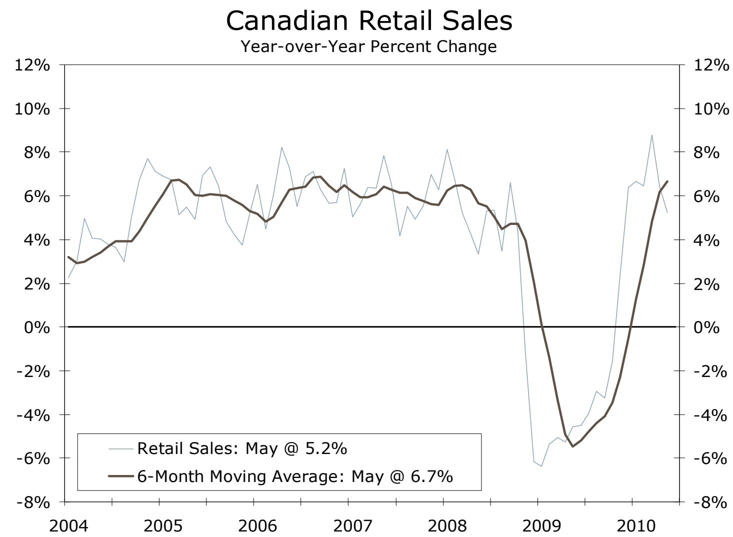


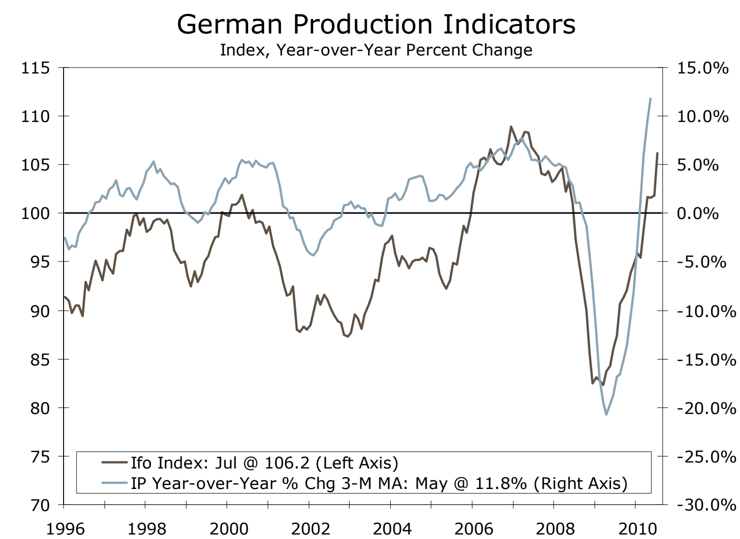
Canada Retail Sales • Tuesday

Canadian retail sales are expected to rise 0.5 percent in June from the month before. This should break two consecutive months of declines. Strong vehicle sales, up 2.5 percent in June, are expected to drive a good part of the total retail sales increases on the month. On average, new vehicle sales comprise about 19 percent of total retail sales. Ex-autos, Canadian retail sales are expected to advance a more modest 0.1 percent. Gasoline sales should exert a moderating influence on the headline figures, as gas station sales dropped 2.9 percent in June, according to the June CPI gas price index. With Canadian employment nearly back to pre-recession levels and interest rates relatively low, consumer spending in Canada appears well supported. However, should the United States experience a sharp slowdown in growth in the second half of 2010, Canada's economic fundamentals could quickly deteriorate.

Previous: -0.2% (M-o-M)

Consensus: 0.5% (M-o-M)





Germany IFO • Wednesday

The German IFO is expected to show a slight increase for August from July. The future expectations component could slip a bit to 105.0 from 105.5, reflecting a more uncertain outlook for the global economy. However, current conditions remain strong, which should ensure a slight increase in the overall index. Manufacturing confidence improved sharply in July from 10.6 to 18.4. Robust increases in confidence were also seen for the construction, wholesale and retail trade diffusion indexes. The future expectations component is a good leading indicator for German GDP and also has a good correlation with manufacturing orders. We also get the second release of second-quarter German GDP on Tuesday. No change in the initial strong reading is expected, but we will get a breakdown of the components of GDP that will give investors more insight in the drivers of Germany's GDP growth.

Previous: 106.2

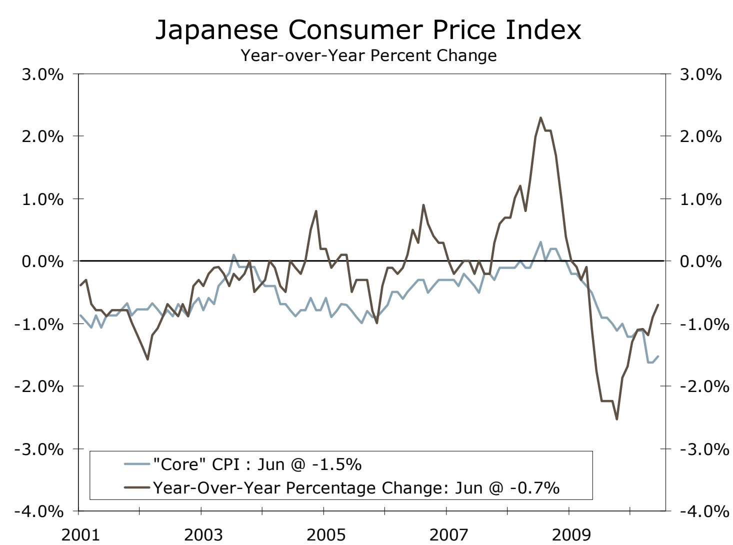
Consensus: 106.3

Japan CPI • Thursday

With a far weaker-than-expected second-quarter GDP report out of Japan, concerns about the country's deflation problem have intensified. Markets will be paying close attention to the CPI report for the clues it could hold about the BoJ's next steps to help bolster economic growth and end deflation. We look for further declines in Japan's national CPI index in July. The national core CPI was down 1.5 percent in June from a year ago. Deflation pressures are likely to linger into next year. The strong yen will only add to deflationary pressures as import prices become relatively cheaper. We believe this will prompt the BoJ off the fence, and back to priming the monetary pump through some form of monetary easing. Expansion of the current credit facilities would be a logical first place for the BoJ to start. Unless a second recession unfolds soon, it is likely that deflation will slowly abate even in Japan over time.

Previous: 0.0% (M-o-M) **Wells Fargo: -0.1% (M-o-M)**

Consensus: N/A



Interest Rate Watch

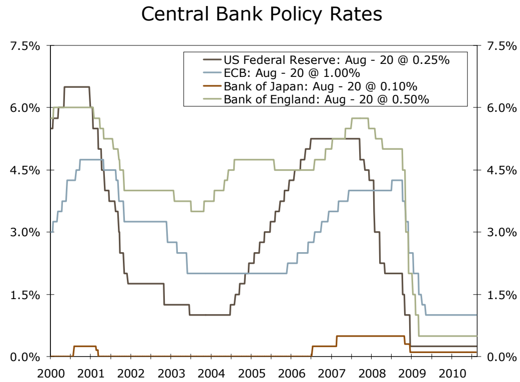
Treasury Yields Plummet

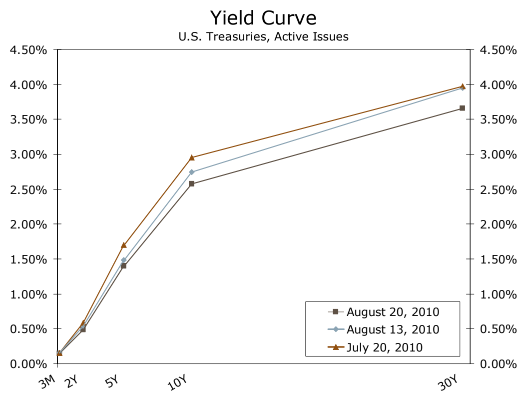
Treasury yields plummeted this week, with reports of weaker GDP growth in Japan kicking off the week with a massive rally in the 30-year bond. The yield on the 30-year bond has fallen nearly 16 bps over the past week and began Friday morning at just 3.60 percent. The yield on the Treasury's 10-year note fell 13 bps over the past week and began Friday morning at 2.54 percent. The plunge in long-term rates reflect growing concern about a double dip in the U.S. economy, increased fears of deflation, and growing expectations that economic growth will remain weak for years to come.

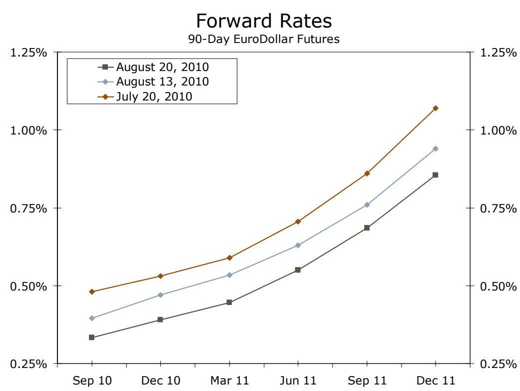
The bond market's view of the economy seems overly pessimistic to us. While we feel the Federal Reserve is now more likely to begin another round of quantitative easing, we view the odds of a decline in economic activity and problematic period of deflation as still relatively low.

The near-term economic calendar is likely to support the current rally in bonds. The August employment number will pick up many of the same themes reported in the recent unemployment claims data. The distortion surrounding the smaller number of motor vehicle assembly plant shutdowns in July will also adversely affect nonfarm employment, leading to a weaker number for that month. The unemployment rate also seems primed for a jump given the recent spike in extended unemployment claims.

One immediate benefit from lower long-term interest rate is that mortgage rates are now significantly lower. Interest rates for conventional 30-year mortgages have fallen to a record low of 4.51 percent and should move even lower in coming weeks. The drop has led to a mini-surge in mortgage refinancings but is likely to expose another serious structural problem with the U.S. economy, too few people can currently qualify for a mortgage today due to more stringent underwriting criteria and weakened credit scores. The drop in rates has done little to spur home sales. Mortgage applications for the purchase of a home continue to slide, falling 3.4 percent in the latest week.







Consumer Credit Insights

Lending Trends Mostly Improve

The results of the Federal Reserve's recently released July Senior Loan Officer Survey, detailing lending trends during the second quarter, were mostly positive for consumer lending. More banks increased their willingness to lend, fewer banks reported weaker demand and banks eased their lending standards. This is good news for a sluggish economy. However, there were clear differences in lending trends between large and small banks. Overall, banks eased standards for credit card loans in the second quarter, but it was all the large banks, as small banks' standards were unchanged. There were also differences in terms and conditions. For credit card loans, large banks increased credit limits, reduced required minimum credit scores and saw no change in spreads, while small banks continued to decrease credit limits, increase required minimum credit scores and widen spreads. The story was similar for non-credit card loans. In addition, while large banks reported stronger demand for consumer and home equity loans, small banks reported weaker demand, although fewer did so than in the previous quarter. Interestingly, small banks increased business credit lines, while large banks saw no change.

According to the FDIC, large banks account for less than 2 percent of all banks, but 70 percent of deposits. Thus, lending trends improved for the majority of the deposit base, but 98 percent of the nation's banks continued to tighten terms and conditions.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.42%	4.44%	4.56%	5.12%
15-Yr Fixed	3.90%	3.92%	4.03%	4.56%
5/1 ARM	3.56%	3.56%	3.79%	4.57%
1-Yr ARM	3.53%	3.53%	3.70%	4.69%
MBA Applications				
Composite	829.7	734.3	753.5	527.0
Purchase	169.4	175.4	168.9	277.7
Refinance	4,676.7	3,993.0	4,161.9	1,982.5

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

Topic of the Week

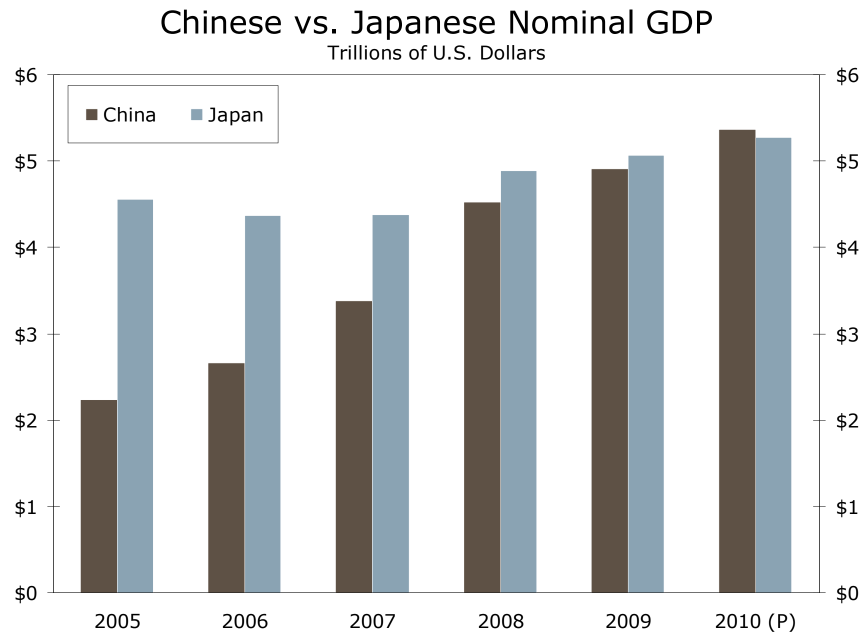
China Surpasses Japan. Is the U.S. Next?

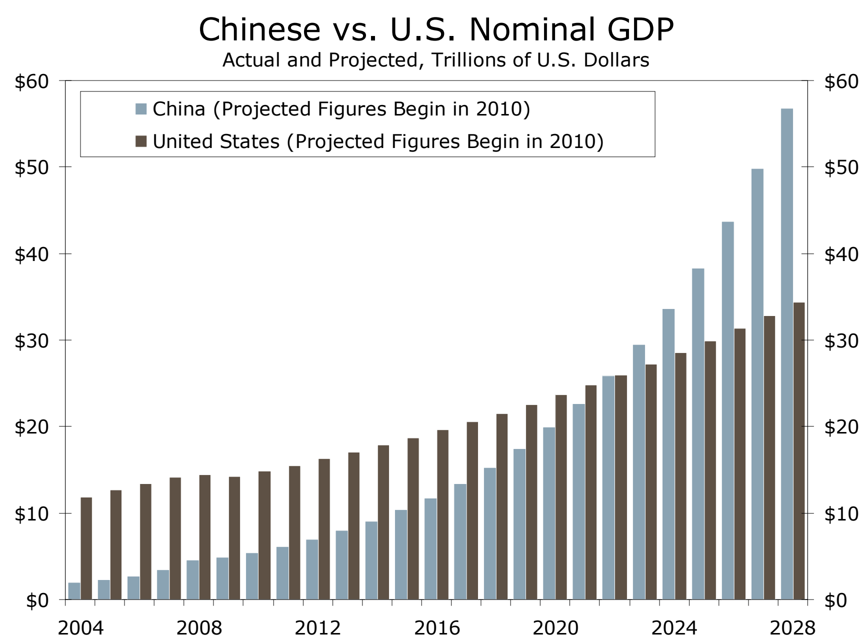
The media was abuzz early in the week with news that China had surpassed Japan as the world's second-largest economy, a position that the latter had held for roughly 40 years (top chart). The question that seemingly everyone is asking now is "when will China overtake the United States as the world's number one economy?"

When that date occurs depends largely on the growth rate assumptions that one is willing to make. Over the past 20 years, Chinese GDP (measured in dollars) has grown 14 percent per annum while the U.S. economy has grown roughly 5 percent per year. If we assume that those average growth rates will continue to hold over the next 20 or so years, then nominal GDP in China will surpass U.S. nominal GDP in the early years of the 2020s (bottom chart).

That said, making long-range forecasts is fraught with peril. Many smart people were saying in the mid-1980s that Japan would ultimately catch the United States, which obviously never happened. Economic growth in China is bound to slow as the country draws closer to the technological frontier, which would push out the date that China overtakes America as the world's largest economy. On the other hand, there is no guarantee that nominal GDP in the United States will grow 5 percent per annum either. It sure seems that it may be a few more years before the United States notches up another 5 percent growth rate. In addition, fluctuations in the yuan-dollar exchange rate could hasten or delay the day that China catches up in dollar terms.

Moreover, China is more than four times as populous as the United States. Even when (if) China catches up, the average American citizen will be four times better off in a material sense than the average Chinese citizen. For all its spectacular growth, China will remain a relatively poor country for quite some time. China may surpass the United States as the world's largest economy in the next 10 to 15 years, but it will take decades for the former to fully catch up to the latter in terms of per capita income.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/20/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.15	0.15	0.15
3-Month LIBOR	0.33	0.37	0.41
1-Year Treasury	0.26	0.29	0.40
2-Year Treasury	0.49	0.53	0.98
5-Year Treasury	1.41	1.45	2.41
10-Year Treasury	2.58	2.67	3.43
30-Year Treasury	3.62	3.85	4.24
Bond Buyer Index	4.03	4.06	4.58

Foreign Exchange Rates

	Friday 8/20/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.269	1.275	1.425
British Pound ($/£)	1.552	1.559	1.651
British Pound (£/€)	0.818	0.818	0.864
Japanese Yen (¥/$)	85.680	86.200	94.190
Canadian Dollar (C$/$)	1.048	1.042	1.087
Swiss Franc (CHF/$)	1.038	1.051	1.063
Australian Dollar (US$/A$)	0.888	0.893	0.831
Mexican Peso (MXN/$)	12.753	12.728	12.886
Chinese Yuan (CNY/$)	6.791	6.796	6.832
Indian Rupee (INR/$)	46.675	46.765	48.705
Brazilian Real (BRL/$)	1.764	1.772	1.844
U.S. Dollar Index	83.193	82.948	78.384

Foreign Interest Rates

	Friday 8/20/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.83	0.83	0.82
3-Month Sterling LIBOR	0.72	0.73	0.73
3-Month Canadian LIBOR	1.02	1.02	0.59
3-Month Yen LIBOR	0.24	0.24	0.39
2-Year German	0.62	0.66	1.28
2-Year U.K.	0.65	0.73	0.90
2-Year Canadian	1.31	1.38	1.26
2-Year Japanese	0.12	0.14	0.25
10-Year German	2.28	2.39	3.26
10-Year U.K.	2.98	3.12	3.61
10-Year Canadian	2.90	2.98	3.40
10-Year Japanese	0.94	0.99	1.35

Commodity Prices

	Friday 8/20/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	73.66	75.39	72.54
Gold ($/Ounce)	1226.85	1215.50	940.65
Hot-Rolled Steel ($/S.Ton)	545.00	545.00	465.00
Copper (¢/Pound)	326.70	325.15	273.80
Soybeans ($/Bushel)	10.05	10.26	10.03
Natural Gas ($/MMBTU)	4.15	4.33	2.94
Nickel ($/Metric Ton)	21,733	21,357	18,820
CRB Spot Inds.	502.02	496.63	443.19

Next Week's Economic Calendar

	Monday 23	Tuesday 24	Wednesday 25	Thursday 26	Friday 27
U.S. Data		**Exiting Home Sales** June 5.37M July 4.55M (W)	**Durable Goods Orders** June -1.2% July 2.0% (W) **Durable Ex Transp.** June -0.9% July 1.0% (W) **New Home Sales** June 330K July 338K (W)		**GDP** 2Q 2.4% 2Q S 1.6% (W)
Global Data	**Eurozone** **PMI Services** Previous (Jul) 55.8 **Eurozone** **PMI Manufacturing** Previous (Jul) 56.7	**Canada** **Retail Sales (MoM)** Previous (May) -0.2%	**Germany** **IFO- Business Climate** Previous (Jul) 106.2		**Japan** **Jobless Rate** Previous (Jun) 5.3% **Japan** **CPI (YoY)** Previous (Jun) -0.7%

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	(612) 667-0168	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

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