August 27, 2010

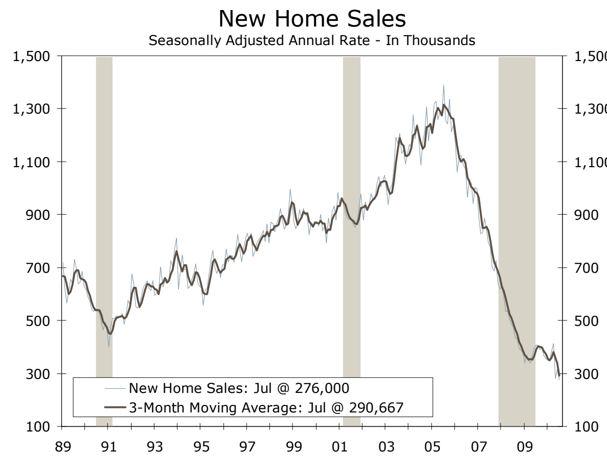
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

New Day Yesterday

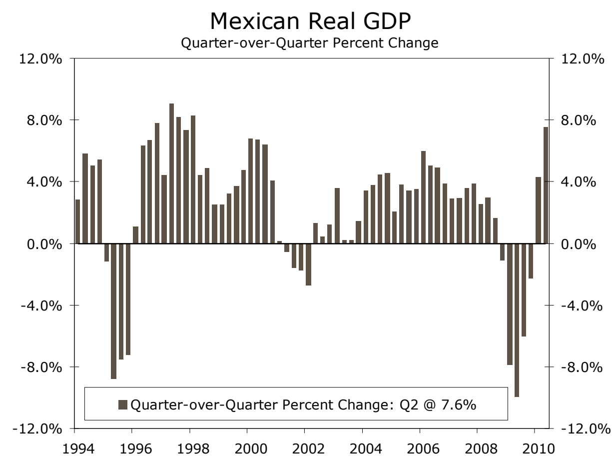
- Subpar recovery in housing had been our expectation but this week's existing and new home sales data reinforced that the old themes of consumer deleveraging and the long-term workout for the U.S. economy remain in place. Our outlook for the second half of this year is for sub 2 percent growth and housing continuing its slow workout.
- Disappointing durable goods orders are an issue, given our expectation that capital spending would be a major positive for growth this year.
- Real growth in the second quarter was revised down to 1.6 percent due to weaker trade and inventories.



Global Review

Latin America Is Holding Its Ground

- The Mexican economy posted a surprisingly strong performance during the second quarter, growing by 7.6 percent compared to the year-earlier period.
- The Mexican engine of growth during the recovery from last year's recession has been the auto manufacturing sector. Automobile production surged by almost 80 percent during the first half of the year.
- The story in South America is also very positive with Argentina's economy surging by 11.1 percent during June of this year after posting growth of 12.4 percent during the previous month.



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

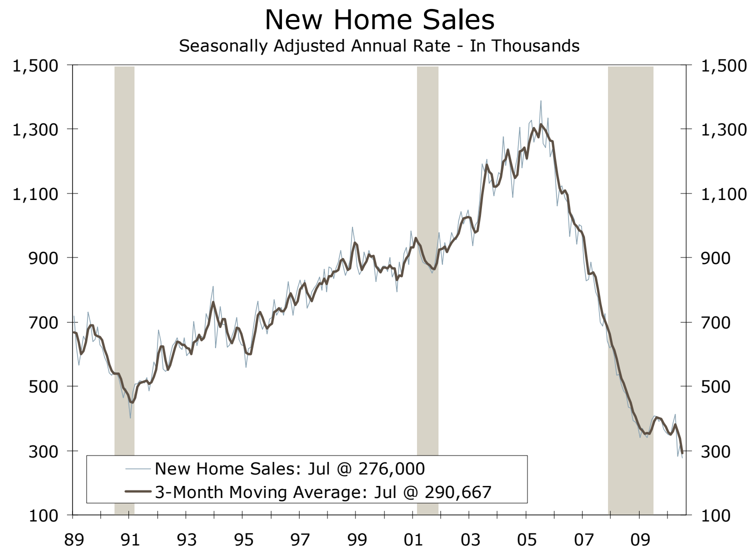
Forecast as of: August 11, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

Inside

U.S. Review

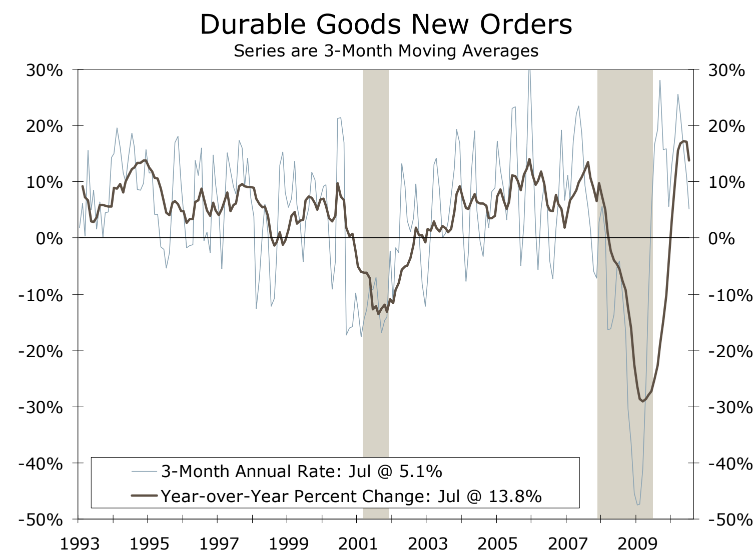
Old Day Now

Economic readjustment continues to dominate any upside momentum the economy may have, and this is especially true for housing. Existing home sales dropped 27.2 percent in July, which was well below expectations. The monthly decline was the largest on record. Payback from the tax credit is largely responsible for the sizable decline. High inventories, at 11.9 months for single-family homes, continue to dominate home prices and buyer expectations. Combined with weak job growth and low consumer confidence, the case remains for a slow workout from the housing boom. Meanwhile, new home sales fell 12.4 percent in July, which was well below the consensus estimate. Prior months' data were revised downward. The absolute level of sales dropped to a 276,000-unit pace, which is a record low. Unfortunately, median and average sales prices fell in July as well.



Nothing Is Easy

One element of strength we did see in the economic recovery was equipment and software spending, but the latest release for durable goods orders for July was up just 0.3 percent. Ex-transportation, new orders fell 3.8 percent—very disappointing. Some of our most reliable sources of recent strength, such as machinery and electrical equipment, showed weakness. Nothing appears easy about this economic recovery.



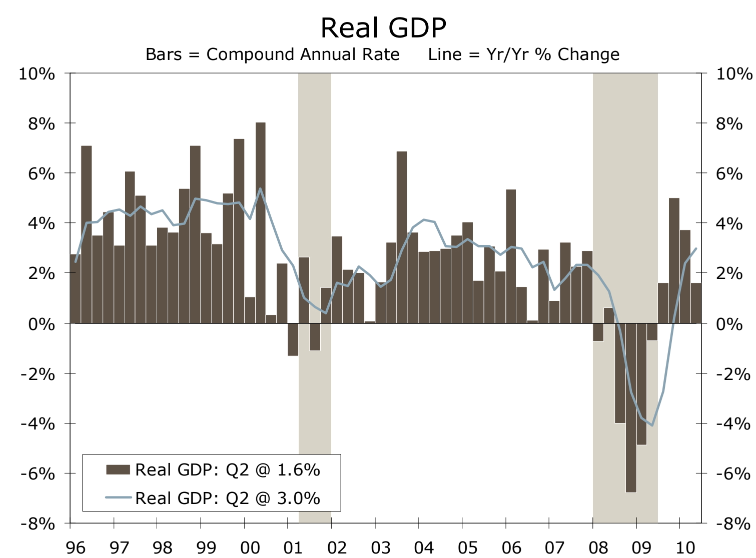
Skating Away on the Thin Ice of a New Day

Real economic growth was revised down to 1.6 percent for the second quarter with trade and inventories coming in weaker than first reported. Weakness appears to be the story for the second half of this year. Our outlook for growth is sub 2 percent with inflation, the consumer price index, coming in at below 1 percent. Compared to the first half of this year, real growth has slowed with moderation in consumer spending, equipment and software spending and government purchases. Structures continue to subtract from growth. For the second half, housing will actually subtract from growth in the third quarter and add a bit in the fourth quarter.

"While the worst of the storm has passed, our ship is still struggling against fierce winds." Annual Economic Outlook 2010

Looking back at our annual outlook published in December 2009, we had anticipated slow going in the second half of this year. Our consumer, equipment spending gains were on target. We had anticipated a continued decline in structures all year. We were too optimistic on housing, even though our numbers were at the low end of the Blue Chip forecast, and net exports subtracted more and inventories added less than we had expected.

Our theme of rebalancing the U.S. economy was on target and yet the extent of the rebalancing, in housing, for example, has been greater than we had expected. In addition, the wobbly legs of weak employment growth, no pricing power and slower profit growth ahead suggests that there is no convenient, easy policy handle that we can grab to shock the economy back to life.

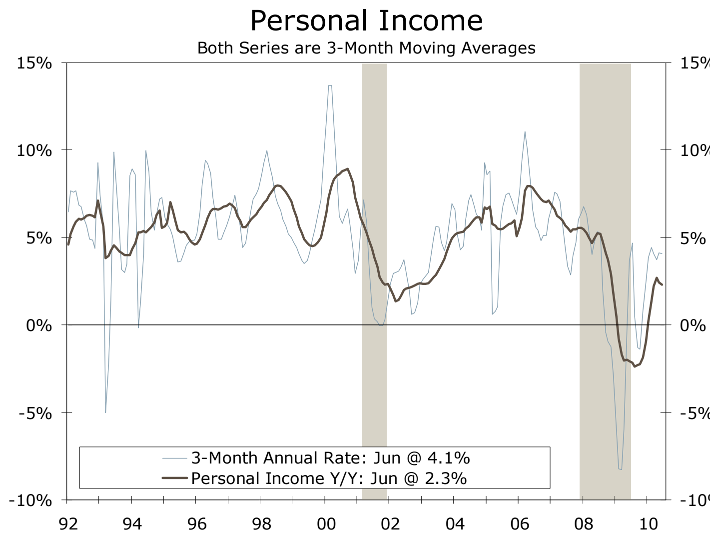


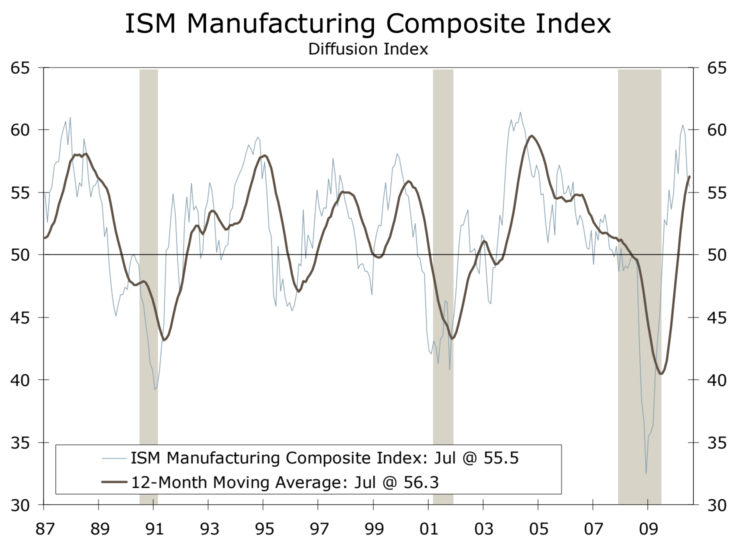
Personal Income • Monday

Personal income was unchanged in June, with weakness evident across most major categories. Wages and salaries fell 0.1 percent and proprietors' income fell 0.4 percent. Nearly all the drop in wages and salaries was in the private sector, where wages fell 0.1 percent. The rise in after-tax income combined with no change in consumer spending pushed the saving rate up to 6.4 percent. The rise in the saving rate is good news, because it means the adjustment to the negative wealth effect from falling home prices and the financial crisis is largely complete. Unfortunately, income growth appears to be decelerating. Early data for July suggest spending was fairly weak that month. The expiration of extended unemployment benefits likely cut into spending last month. We may get a bit of a bump in August, however, when benefits began flowing again and one-time catch-up payments were delivered.

Previous: 0.0% **Wells Fargo: 0.2%**

Consensus: 0.3%





ISM Manufacturing • Wednesday

The manufacturing rebound, which helped fuel the nascent recovery, is losing steam. The slower momentum in factory production is fairly typical at this stage of the business cycle as inventories are brought in line with demand. If previous recoveries provide any insight, the headline could slip to 50 by the end of the year, which will be well off its peak of 60.4 reached in April. Regional manufacturing surveys are also showing weakness. In particular, the Philadelphia Fed business index fell 12.8 points in August. The new orders index declined into negative territory, and the shipments and employees indices are now at zero. Consequently, we expect the ISM index to remain solidly in expansionary territory but slip to 54.8 in August

Previous: 55.5 **Wells Fargo: 54.8**

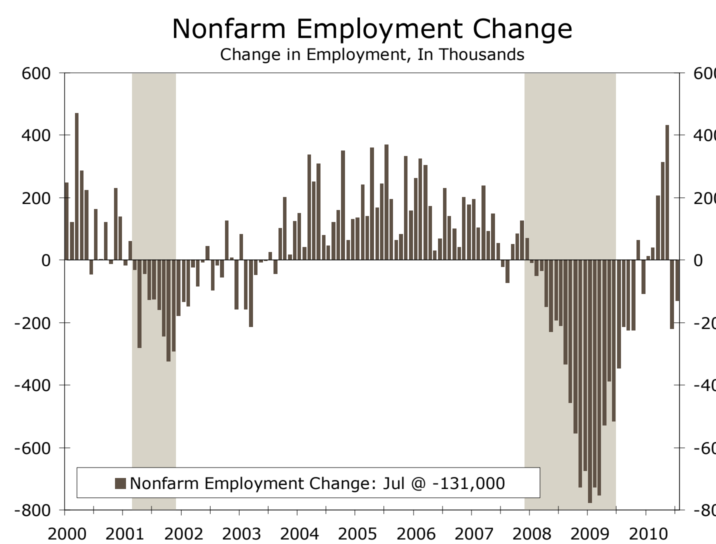
Consensus: 53.0

Nonfarm Employment • Friday

Private sector job growth continues to be the key to a sustainable economic recovery. The private sector added an average of just 50,000 jobs per month over the past three months. In August, we think the picture will moderate with the private sector adding roughly 20,000 jobs. Much of the softness will likely be payback from the increase in jobs caused by some auto plants remaining open during the typical retooling months. This moderation is sure to incite even more uncertainty and rhetoric about a double-dip recession. We continue to believe the probability of a double-dip recession remains low, but we are cautious. Census layoffs will also generate noise in the data with overall employment possibly falling by 133,000 jobs. While distortions will be evident, we can not dismiss underlying weakness in the labor market. We expect the unemployment rate to edge modestly higher to 9.6 percent.

Previous: -131K **Wells Fargo: -133K**

Consensus: -105K



Global Review

Mexico Is Contributing Its Share

As has been the case with many emerging market economies, the Mexican economy is also making its contribution to global economic growth. The Mexican economy posted a surprisingly strong performance during the second quarter of the year by growing 7.6 percent compared to the year-earlier period.

The engine of growth during the recovery from last year's recession has been the auto manufacturing sector. Automobile production surged by almost 80 percent during the first half of the year. This strong auto manufacturing recovery has pushed manufacturing GDP through the roof, increasing by 12.7 percent during the second quarter on a year-earlier basis. A large chunk of this increase in auto manufacturing has the U.S. market as its principal destination. This is the reason why we are concerned that Mexican economic growth may experience a strong slowdown during the second half of the year.

This can be seen by looking at the Economic Activity Index graph where it is clear that the economy started to slow down during the last month of the second quarter. Furthermore, with the latest news coming from the U.S. consumer market, it will not be very difficult to predict a considerable slowdown from current levels.

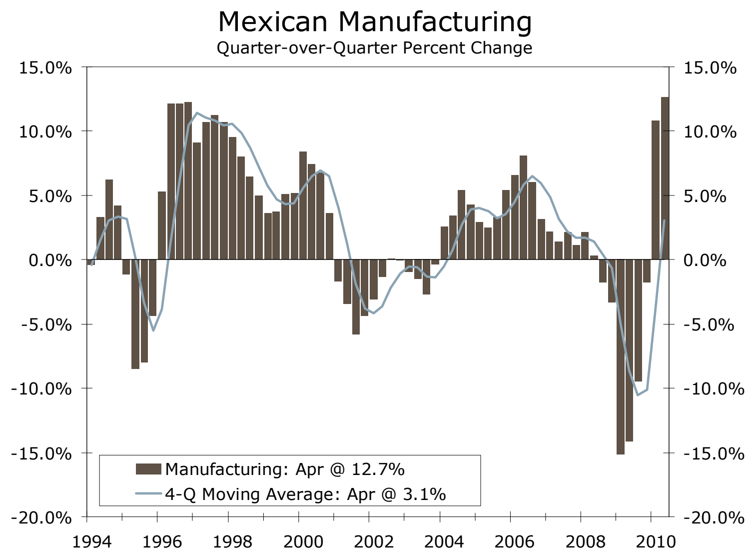
Meanwhile, an important sector of the Mexican economy, construction, has remained in recession, dropping by 2.0 percent during the second quarter of the year after falling 3.3 percent during the previous quarter. This was the seventh consecutive quarter of negative growth for the Mexican construction sector. Thus, this is a clear indication that lending conditions remain tight even though the central bank has kept an expansionary monetary policy during the past several years.

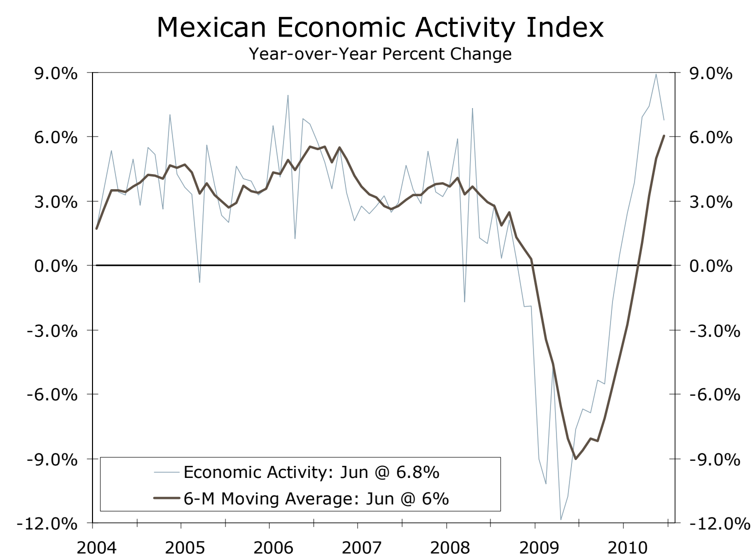
Even the Mexican tourism sector, which suffered one of its worst crises in decades during 2009, posted a strong recovery during the second quarter of the year. Temporary accommodations surged by 11.6 percent during the second quarter of the year compared to the year-earlier period, while the number of tourists coming into Mexico posted a surge of 36.1 percent in June measured as a three-month-moving average.

Argentina's Economy Is Also Surging

The story in South America is also positive with Argentina's economy surging by 11.1 percent during June of this year after posting growth of 12.4 percent during May, all compared to the year-earlier period and according to the Index of Economic Activity, a proxy for the performance of GDP.

While we foresee a slowdown of the economy during the second half of the year, the economy will retain some momentum due to still strong commodity prices and strong domestic consumption as the government continues to pour money into the economy in order to maintain its chances of winning the presidential elections next year. Our two biggest concerns are the acceleration in prices and the difficult political environment as elections approach.





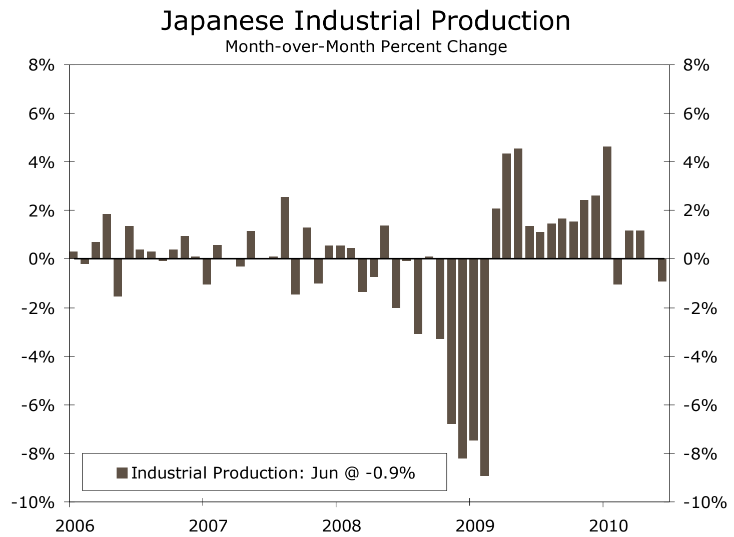
Japanese Ind. Production • Monday

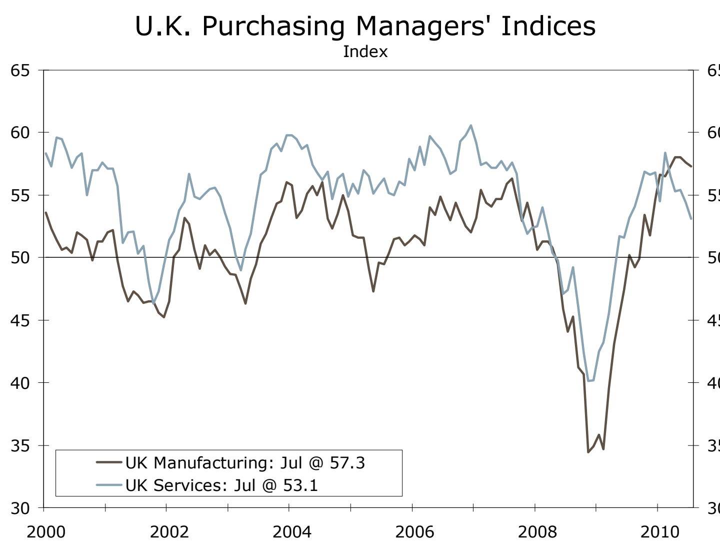
Japan is releasing industrial production numbers for July on Monday and markets are expecting a fairly flat performance after a drop of 1.1 percent during the previous month. The number has added importance, because another negative reading could be a prelude to further weakness coming from the export market and a weak start for the second half of the year.

The slowdown in economic activity in the second quarter after strong performances during the previous two quarters is a clear indication that all the measures put out by the Japanese government to minimize the effects of last year's worldwide crisis are coming to an end. If the private economy does not fill the void, then the Japanese economy will remain fragile. This is also happening in the rest of the countries that import from Japan, which will put further downward pressure on growth.

Previous: -1.1% (Month over month)

Consensus: 0.0% (Month over month)





U.K. PMI • Wednesday

The August U.K. manufacturing PMI release on Wednesday will give us a glimpse of how serious is the expected slowdown in economic activity due to the recent austerity measures taken by the government to try to put its house in order. While we are still looking for the U.K. economy to continue to expand during the second half of the year, the rate of expansion will be slower than the first half.

The consensus expects the manufacturing PMI to slow a bit in August from a relatively strong reading in July, but a higher-than-expected slowdown could put pressure on policymakers. Having said this, we expect the strong performance of GDP during the second quarter to carry some momentum into the third quarter and growth to remain relatively strong. However, we do expect the U.K. economy to slow down further during the fourth quarter.

Previous: 57.3

Consensus: 56.8

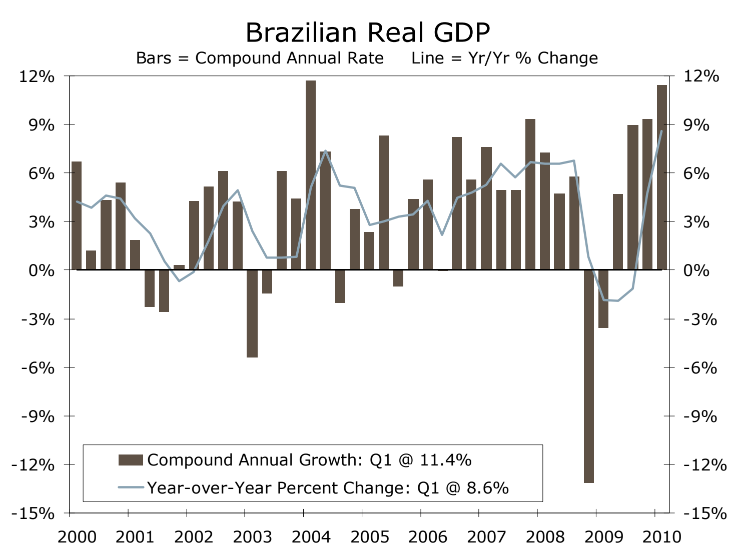
Brazilian GDP • Friday

While there is some indication that the Brazilian economy has started to slow down, we are expecting Brazilian GDP to come in at the high end of expectations, as policymakers have been successful in navigating last year's economic environment. This has carried into a strong recovery during this year.

We are expecting the Brazilian economy to have grown by almost 8.0 percent during the second quarter of the year after posting a brisk 8.6 percent growth rate during the first quarter. The latest supporting evidence that growth has remained brisk during the second quarter was the recent unemployment rate release, which came in at 6.9 percent, one of the lowest readings in many decades. Markets were expecting the rate of unemployment to remain at 7.0 percent. Thus, we should suspect that if there is a surprise, the surprise would be on the upside.

Previous: 9.0% (Year over year)

Consensus: 8.0% (Year over year)



Interest Rate Watch

What Do Lower Yields Portend?

Bond yields rallied most of the week before falling back a bit following the slightly better-than-expected revised second-quarter GDP report. Bond investors were apparently trying to get ahead of any plans the Fed might reveal about renewing securities purchases in order to help stave off a double-dip recession. Those expectations were deflated when Ben Bernanke delivered his speech at Jackson Hole, Wyo., where he reiterated the Fed's ability to ease further but left the impression that such a move was not yet necessary and still some time well off.

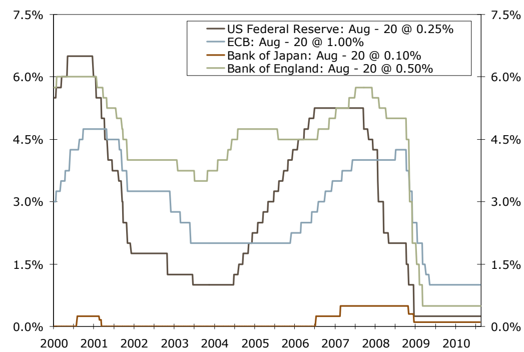
We were not surprise by Bernanke's statements. A second round of quantitative easing (QE2) would require either some sort of exogenous shock to the global or U.S. economy or a substantial further deceleration in economic activity. We still view the odds of a second round of quantitative easing as fairly high but do not think the Fed would make such a move before the November election.

There is clearly more at play than merely the anticipation of a second round of quantitative easing. Expectations for the federal funds rate have been ratcheted down significantly in recent weeks, with most forecasters now expecting the Fed to hold the funds rate at its current level through late 2011.

Expectations for inflation have also been significantly reduced. Both the core CPI and core PCE deflator are expected to end the year at 1 percent or less.

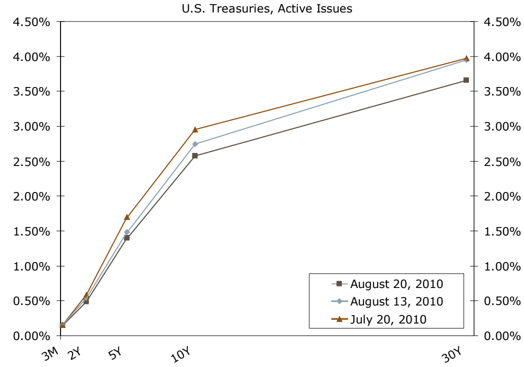
Bernanke's Jackson Hole speech outlined the moves that the Fed could potentially make, and gave a strong defense of the effectiveness of quantitative easing. He did not, however, reduce the Fed's forecast for economic growth for later this year or 2011. Such a move seems more than justified by recent economic data and from what we are hearing from corporate America. Reducing its forecast now might box the Fed into making a decision sooner than it would have liked. We expect the Fed's forecast will be reduced in coming months and feel a decision on QE2 might be needed by Thanksgiving.

Central Bank Policy Rates



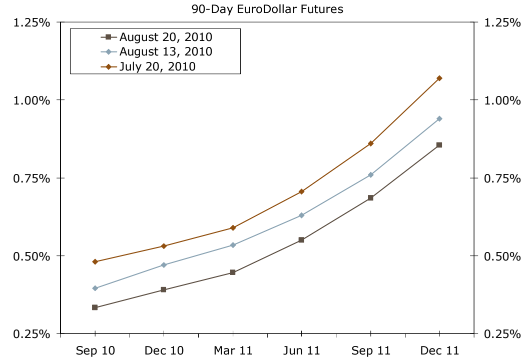
Yield Curve

U.S. Treasuries, Active Issues



Forward Rates

90-Day EuroDollar Futures



Consumer Credit Insights

The Good, the Bad and the Ugly

First, the good news. Delinquency rates for loans of all types fell in the second quarter from the first quarter, with credit cards seeing the most improvement. The credit card delinquency rate fell to 4.8 percent from 5.8 percent and is well below the peak of 6.6 percent in Q1 2009. One factor in the big decline is simply the fact that banks continue to charge off bad accounts, while tightening standards on new accounts. Unfortunately, another reason is that some homeowners are skipping mortgage payments and using the savings to pay down credit card balances.

The bad news is that, in order to shape up their financial situation, consumers have reined in spending, which has been virtually flat over the past four months. While higher savings will propel the economy down the road, in the interim, consumer frugality is contributing to the economy's ongoing weakness.

The ugly news is the big declines in July existing home sales, which fell to a 15-year low, and new home sales, which fell to the lowest on record. We expected a payback from the end of the homebuyer tax credit, but these declines were much worse than expected.

Of course, all of these items are related, with housing being the focal point. If the housing relapse continues, consumer confidence will decline, spending will slow, layoffs will accelerate and delinquencies could rebound. Stay tuned...

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.36%	4.42%	4.54%	5.14%
15-Yr Fixed	3.86%	3.90%	4.00%	4.58%
5/1 ARM	3.56%	3.56%	3.76%	4.67%
1-Yr ARM	3.52%	3.53%	3.64%	4.69%
MBA Applications				
Composite	870.3	829.7	720.6	566.4
Purchase	170.5	169.4	172.3	280.4
Refinance	4,944.7	4,676.7	3,918.1	2,233.5

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

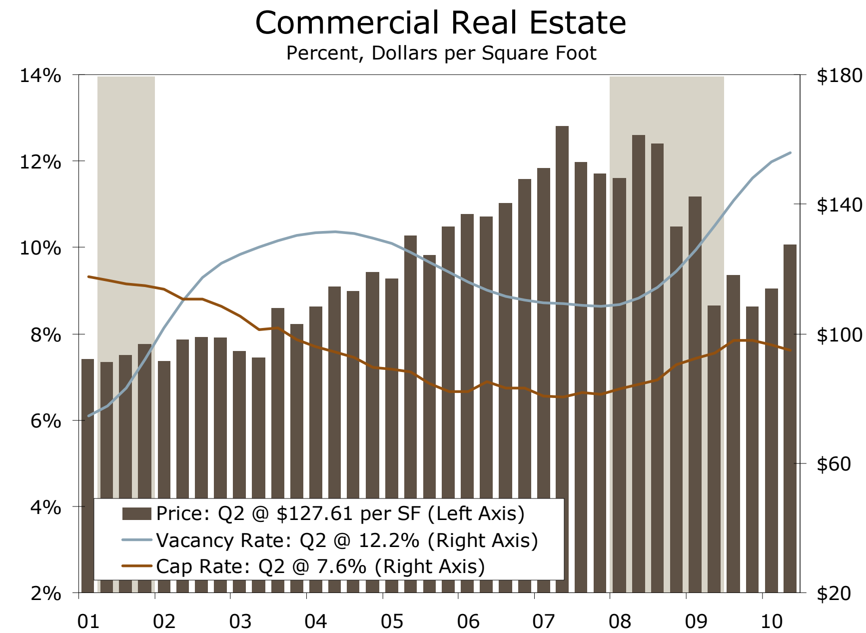
Topic of the Week

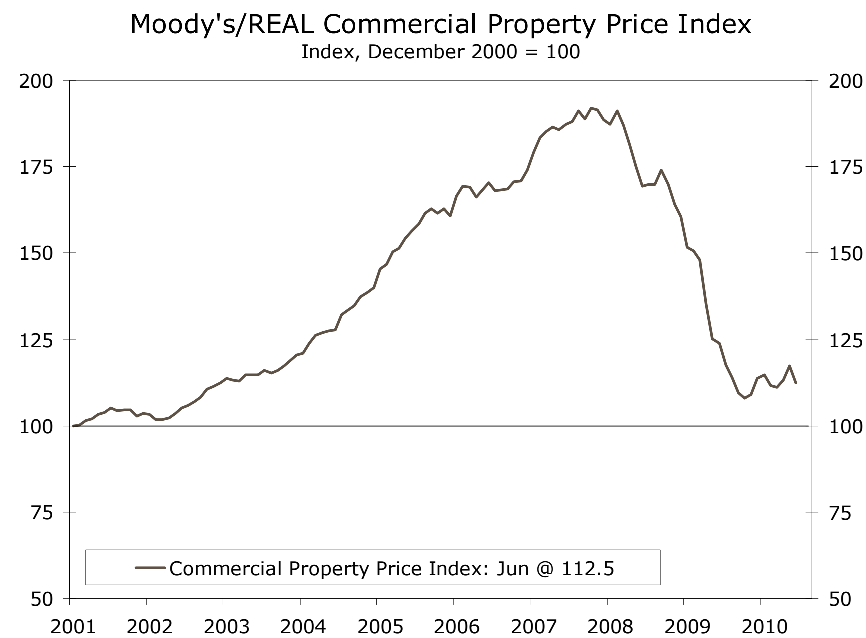
Commercial Real Estate—Resiliency, a Bottom, or Merely the Eye of the Storm?

Commercial real estate markets showed surprising resiliency during the second quarter, with property transactions rising solidly and leasing activity holding up better than expected. We remain cautious in our outlook for commercial real estate and construction. With the exception of a handful of markets, overbuilding was never really the issue that many made it out to be. The rise in delinquency rates in recent years was mostly caused by the sharp contraction in employment, retail sales and the rate of household formation growth. Even the modest rebound in real GDP growth and stabilization in nonfarm employment was not enough to arrest the increase in delinquency. The apparent improvement in demand may be overstated, as many firms are taking advantage of soft market conditions to upgrade space and locations. Moreover, economic growth slowed late in the second quarter and appears to be decelerating further in the second half of the year.

The larger immediate issues with commercial real estate continue to be the overhang of commercial real estate loans coming due over the next few years and the large number of development projects that have been partially completed or less, which continue to weigh on community bank portfolios.

After showing some resiliency earlier this year, commercial real estate prices fell sharply in June. Prices had risen during the two previous months, as buyers scrambled to pick up deals on higher-quality properties. June saw buyers take a step back and also saw a further pick up in distressed transactions. Prices fell 4 percent during June, effectively wiping out any gains from earlier in the year. Most of the decline was in distressed properties, which accounted for 28 percent of transactions in June and saw prices fall just above 7 percent during the month. Excluding distressed transactions, prices fell much less in June and have been roughly stable for much of this year.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/27/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.15	0.15	0.14
3-Month LIBOR	0.30	0.33	0.36
1-Year Treasury	0.25	0.26	0.38
2-Year Treasury	0.52	0.49	1.04
5-Year Treasury	1.41	1.45	2.47
10-Year Treasury	2.53	2.61	3.45
30-Year Treasury	3.56	3.66	4.22
Bond Buyer Index	3.88	4.03	4.53

Foreign Exchange Rates

	Friday 8/27/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.271	1.271	1.434
British Pound ($/£)	1.547	1.553	1.628
British Pound (£/€)	0.822	0.818	0.881
Japanese Yen (¥/$)	84.660	85.620	93.520
Canadian Dollar (C$/$)	1.063	1.048	1.088
Swiss Franc (CHF/$)	1.027	1.034	1.059
Australian Dollar (US$/A$)	0.888	0.894	0.839
Mexican Peso (MXN/$)	13.111	12.765	13.232
Chinese Yuan (CNY/$)	6.798	6.791	6.832
Indian Rupee (INR/$)	46.888	46.675	48.925
Brazilian Real (BRL/$)	1.757	1.756	1.867
U.S. Dollar Index	82.891	83.057	78.009

Foreign Interest Rates

	Friday 8/27/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.83	0.83	0.80
3-Month Sterling LIBOR	0.73	0.72	0.69
3-Month Canadian LIBOR	1.01	1.02	0.56
3-Month Yen LIBOR	0.23	0.24	0.39
2-Year German	0.61	0.61	1.26
2-Year U.K.	0.63	0.64	0.89
2-Year Canadian	1.26	1.31	1.29
2-Year Japanese	0.14	0.12	0.25
10-Year German	2.13	2.27	3.25
10-Year U.K.	2.86	2.98	3.56
10-Year Canadian	2.81	2.92	3.39
10-Year Japanese	1.01	0.94	1.31

Commodity Prices

	Friday 8/27/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	73.10	73.46	72.49
Gold ($/Ounce)	1235.50	1227.80	948.15
Hot-Rolled Steel ($/S.Ton)	545.00	545.00	465.00
Copper (¢/Pound)	332.60	329.10	284.55
Soybeans ($/Bushel)	9.90	10.05	10.42
Natural Gas ($/MMBTU)	3.79	4.12	2.84
Nickel ($/Metric Ton)	20,395	21,733	19,105
CRB Spot Inds.	500.87	502.02	443.95

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	30	31	1	2	3
U.S. Data	**Personal Income** June 0.0% July 0.2% (W) **Personal Spending** June 0.0% July 0.3% (W) **PCE Deflator** June 1.4% July 1.6% (W)	**Consumer Confidence** July 50.4 August 49.9 (W)	**ISM Manufacturing** July 55.5 August 54.8 (W) **Construction Spending** June 0.1% July -0.8% (W) **Total Vehicle Sales** July 11.56M August 11.5M (W)	**Nonfarm Productivity** 2Q -0.9% 2Q F -1.2% (W) **Nonfarm Productivity** 2Q 0.2% 2Q F 0.8% (W) **Factory Orders** June -1.2% July 0.4% (W)	**Nonfarm Payrolls** July -131K August -133K (W) **Unemployment Rate** July 9.5% August 9.6% (W) **ISM Non-Mfg** July 54.3 August 53.4 (W)
Global Data		**Canada** **GDP (QoQ)** Previous (1Q) 6.5% **Japan** **Industrial Prod. (MoM)** Previous (Jun) -1.1%	**UK** **PMI Manufacturing** Previous (Jul) 57.3		**UK** **PMI Services** Previous (Jul) 53.1 **Brazil** **GDP (YoY)** Previous (1Q) 9.0%

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

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