WELLS FARGO SECURITIES

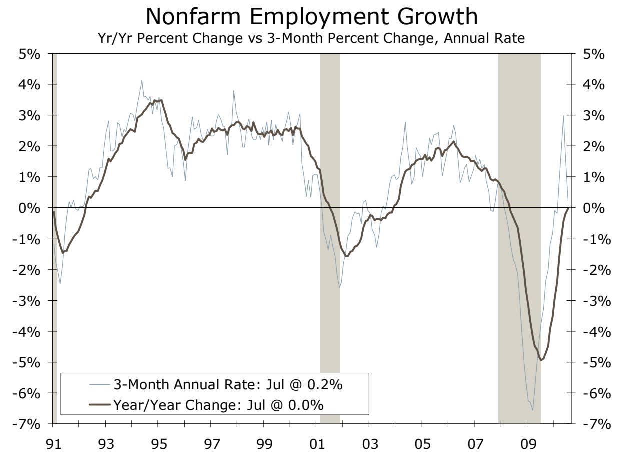
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Slower Growth Looks Certain, but Not a Double Dip

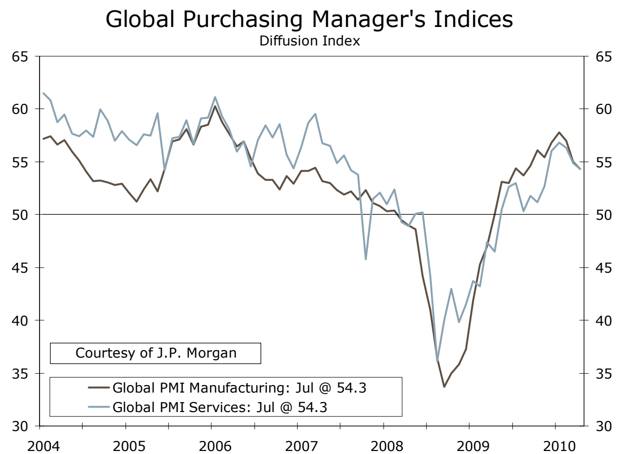
- While July's employment report was weaker than expected, it still showed solid, yet unspectacular, gains in private sector payrolls. The unemployment rate was unchanged, but only because the labor force continued to shrink.
- The ISM manufacturing index slipped 0.7 points in July to 55.5, indicating that manufacturing activity expanded at a slightly less robust pace during the month.
- Falling food and energy prices helped lift real personal income and spending 0.1 percentage point during July. The saving rate rose to 6.4 percent.



Global Review

Moderation in Growth for Global Economy as Well

- The global economy certainly appears to be slowing from the pace recorded during the first half, which is in line with our earlier forecasts. Although global growth should be slower in the second half of the year, we do not expect a double-dip recession.
- The Greek crisis seems to have been contained, at least for now. Barring any other surprise, the world financial system should continue to improve during the next several quarters, which will continue to support growth in the emerging markets that have become very important contributors to global economic growth.



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Wells Fargo U.S. Economic Forecast

	Actual 2009				Forecast 2010				Actual				Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2006	2007	2008	2009	2010	2011
Real Gross Domestic Product [1]	-6.4	-0.7	2.2	5.6	2.7	3.2	1.6	2.2	2.7	2.1	0.4	-2.4	2.9	2.3
Personal Consumption	0.6	-0.9	2.8	1.6	3.0	3.0	1.5	2.2	2.9	2.7	-0.2	-0.6	2.2	2.1
Inflation Indicators [2]														
"Core" PCE Deflator	1.7	1.6	1.3	1.5	1.4	1.2	1.2	1.2	2.3	2.4	2.4	1.5	1.2	1.6
Consumer Price Index	-0.2	-1.0	-1.6	1.5	2.4	1.8	0.9	0.6	3.2	2.9	3.8	-0.3	1.4	1.2
Industrial Production [1]	-17.6	-10.3	8.3	7.0	6.9	7.5	3.9	2.2	2.2	2.7	-3.3	-9.3	5.3	3.4
Corporate Profits Before Taxes [2]	-19.0	-12.6	-6.6	30.6	34.0	25.0	20.0	14.0	10.5	-4.1	-11.8	-3.8	22.6	7.1
Trade Weighted Dollar Index [3]	83.2	77.7	74.3	74.8	76.1	77.3	80.0	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	9.8	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	0.52	0.60	1.81	1.34	0.90	0.55	0.58	0.85
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	1.00
Conventional Mortgage Rate	5.00	5.42	5.06	4.93	4.97	4.58	4.50	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	3.00	3.20	4.71	4.04	2.25	3.85	3.20	4.00

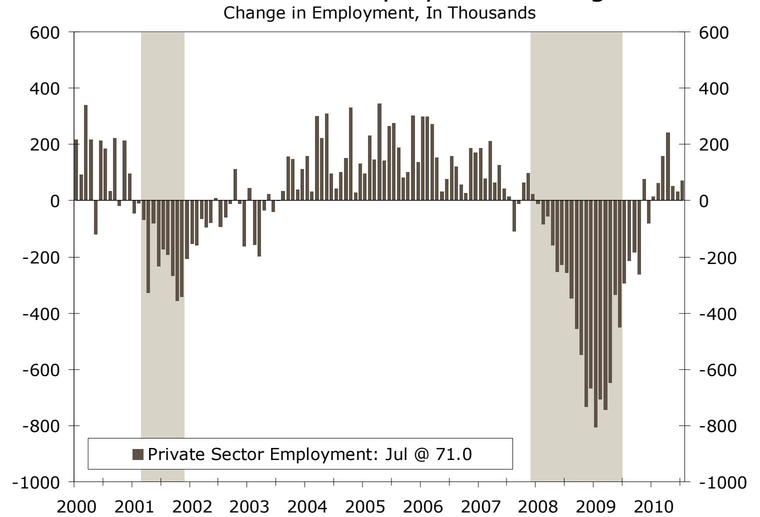
Forecast as of: July 7, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

Together we'll go far

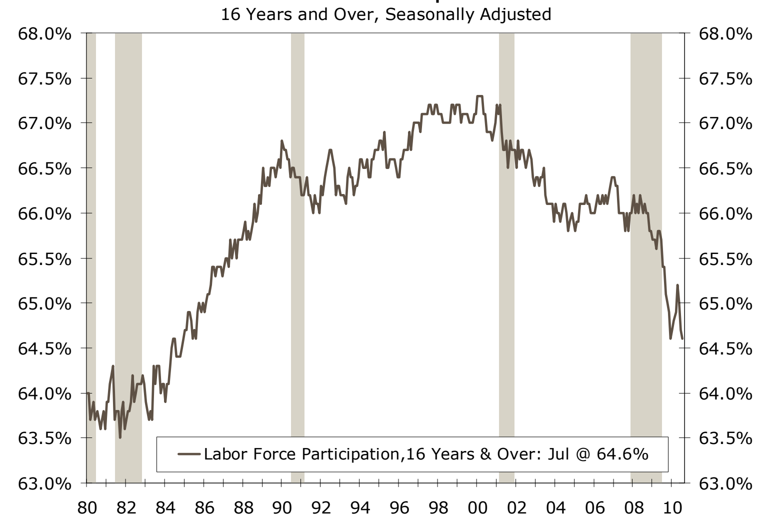
U.S. Review

Growth Will Slow but we see no Double Dip

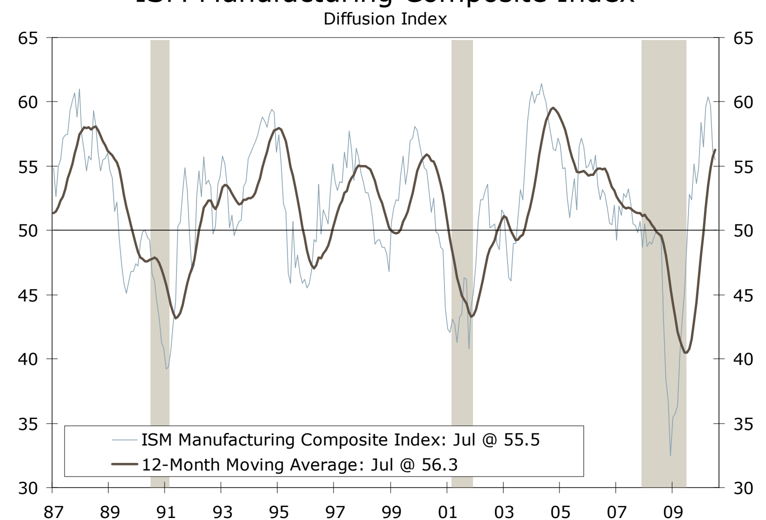
This week's economic news went a long way toward alleviating fears about an imminent double-dip recession. While a second downturn cannot be totally dismissed, we see the probability as very low and expect the economy to again show surprising resiliency. Expectations for a slowdown are built around five basic principals: the winding down of massive government stimulus, less of a boost from inventory rebuilding, slower global economic growth, cutbacks at state and local governments, and further gains in household saving. All five of these look certain to restrain growth during the next few quarters, but we expect business fixed investment, exports and consumer spending to remain solidly positive. In addition, inventories are likely to bounce back further than many people expect, as many industries are reporting bottlenecks throughout their supply chain.



Nonfarm employment fell by 131,000 jobs in July, and jobs losses during June were significantly worse than first reported. The monthly numbers continue to be buffeted by the ups and downs of the Census hiring. Employment for the Census fell by 143,000 in July, which was exactly in line with expectations. One of the surprises was that private sector hiring was less robust than previously thought. Private sector payrolls rose by just 71,000 in July, following a downwardly revised 31,000 in June. The average gain for the past three months is right at 51,000 jobs. Another key takeaway from this past month's numbers is that state and local cutbacks are likely to produce a significant drag on the headline numbers well into the second half of 2010. The recent package of $26 billion in aid to state and local governments to help reduce layoffs of teachers will help reduce this drag but will not eliminate it.



One of the most troubling aspects of this morning's employment report was the continued decline in the civilian labor force, which fell 181,000 in July and has declined by 1.155 million over the past three months. The drop has helped keep the unemployment rate steady at 9.5 percent, even though civilian employment has fallen by 661,000 jobs over this time period. Normally at this stage of an economic recovery, the labor force would be rising as jobseekers returned to the labor market. The large drop over the past three months suggests that jobseekers see little prospect of landing a job and have simply given up searching. The implications for the economy are far-reaching and are evident in the recent weak consumer confidence data and disappointing chain store sales figures reported this week.



The manufacturing sector continues to be one of the biggest positive surprises. The ISM manufacturing survey held up better than expected in July, and manufacturing payrolls increased by 36,000 jobs. The ISM index fell 0.7 points to 55.5 in July, which is consistent with solid gains in the factory sector. Inventory rebuilding has accounted for a large proportion of the improvement in factory output over the past year, and there are signs that the impact from restocking is beginning to lose some steam. The new orders component fell 5 points in July to 53.5 and is down 12.2 points over the past two months.

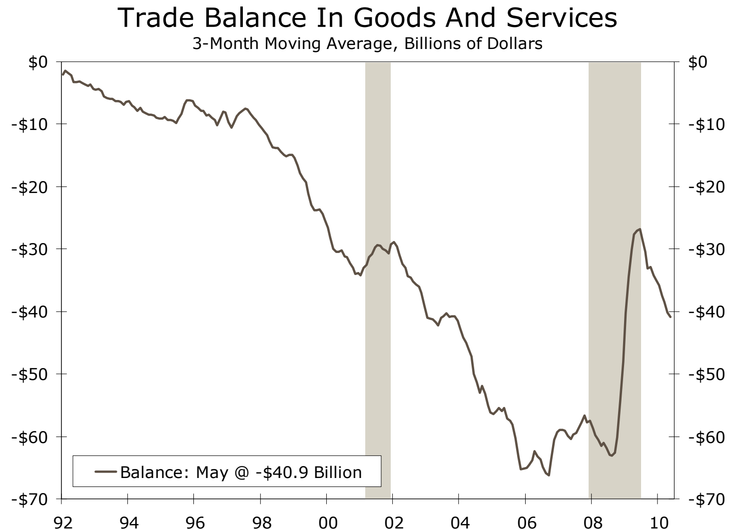
International Trade • Wednesday

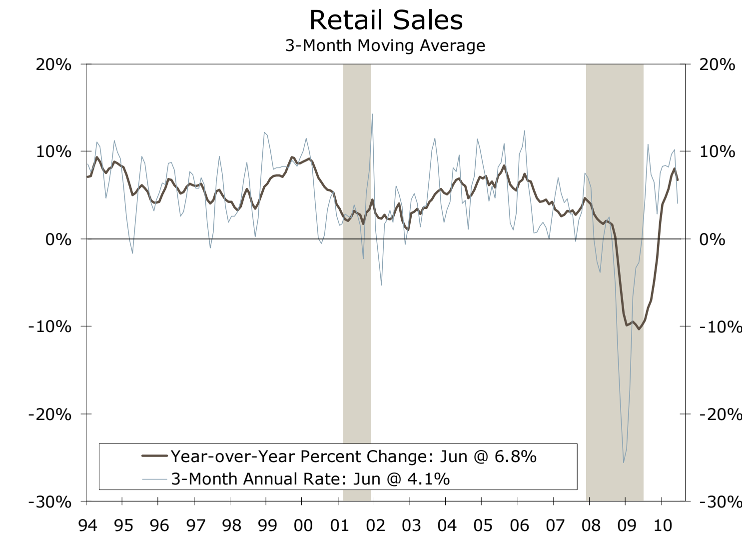
The trade deficit has widened over the past year or so as oil prices have risen and as non-oil import growth has rebounded. Indeed, the $42.3 billion deficit that the country incurred in May was the most red ink in the trade accounts since November 2008. Although we forecast a modest narrowing in the deficit in June, due in part to our expectation of lower petroleum imports, we project that the deficit will widen somewhat between now and the end of the year as import growth outstrips export growth.

The trade data will also be important because it has implications for upcoming revisions to the GDP data for the second quarter. When it made its first estimate of GDP growth, the BEA assumed that the trade deficit had widened by nearly $4 billion in June from the previous month. If the deficit widens by less, let alone narrows, then GDP growth in the second quarter would be revised higher.

Previous: -$42.3 billion **Wells Fargo: -$41.5 billion**

Consensus: -$42.1 billion





Retail Sales • Friday

Retail sales fell slightly more than expected in June, with overall sales dropping 0.5 percent and sales excluding motor vehicles declining 0.1 percent. The weakness was not totally unexpected as several weekly sales measures had been posting declines for much of the previous two months and consumer confidence and buying plans both fell sharply in June. On Friday of next week, we will get a look at retail sales in the month of July. After back-to-back monthly declines, the consensus is looking for a 0.5 percent jump in July sales. We are a bit less optimistic. Considering the fact that consumer confidence deteriorated further in July, we are looking for a more modest increase of 0.2 percent. Much of the rise in the headline number will likely be fueled by auto sales. Sales to dealerships picked up to an 11.5 million unit pace in July.

Previous: -0.5 % (Month-over-month) **Wells Fargo: 0.2%**

Consensus: 0.5%

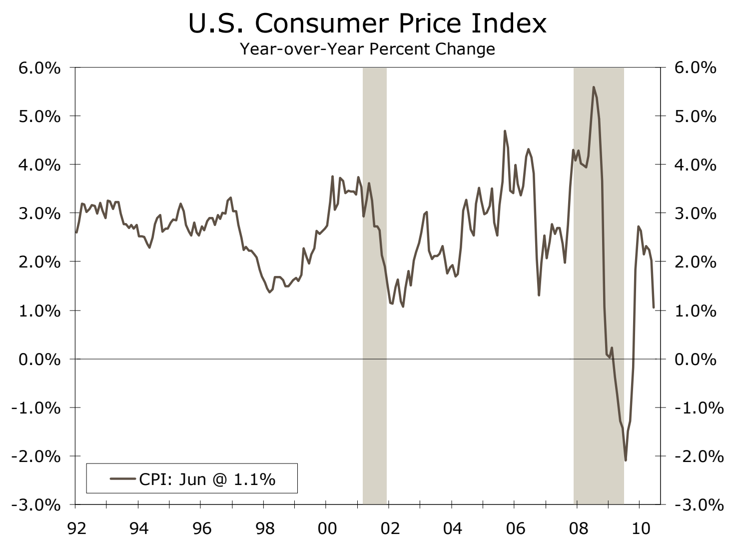
Consumer Price Index • Friday

The consumer price index is taking on added significance lately given the maelstrom of discussion about deflation kicked off recently by St. Louis Federal Reserve President James Bullard. (See our topic of the week on page 7 for more on deflation.) If there is a real risk of deflation, it is not likely to manifest itself yet. Most economists are looking for modest gains in prices when July data hit the wire on Friday. Average gasoline prices picked up modestly in the month of July, and wheat costs nearly doubled as concerns about drought in some parts of the world jolted prices.

We expect inflation to remain in check, giving the Fed plenty of room to keep rates and policy accommodative. Deflation may eventually become a concern, but we do not think major price drops are imminent.

Previous: 1.1% (Year-over-year) **Wells Fargo: 1.0%**

Consensus: 1.2%



Global Review

Expect Moderation in Growth, but no Double-Dip

The global economy certainly appears to be slowing from the pace recorded during the first half, which is in line with our earlier forecasts. Although global growth should be slower in the second half of the year, we do not expect a double-dip recession.

This slowdown in growth will come from Europe, the United States and the developing world, including China. From Europe, we expect second-quarter GDP growth to come in relatively strong during next week's release, but we also expect the Eurozone's economy to slow down as the recent fiscal tightening starts taking hold in some of the region's economies.

This was clear from looking at the weakness in July car sales in Spain due to increases in taxes as well as the end of all of the subsidies put in place across the region to smooth out last year's plunge in demand. Thus, we should expect more weakness in consumer demand all across the affected countries in the coming months.

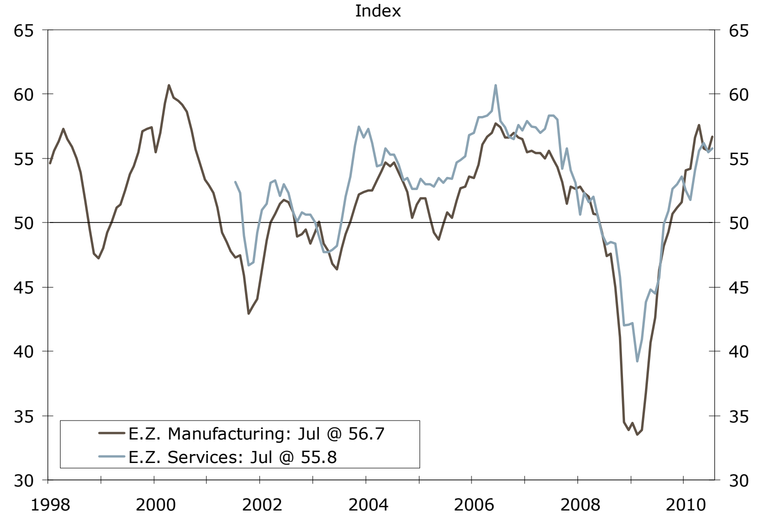
However, in some countries—especially in Germany—indicators still point to a very strong end to the second quarter of the year and continuing strength during the first month of the third quarter. Thus, growth in the third quarter could surprise on the upside if markets exaggerate the expectations for the slowdown in German economic activity.

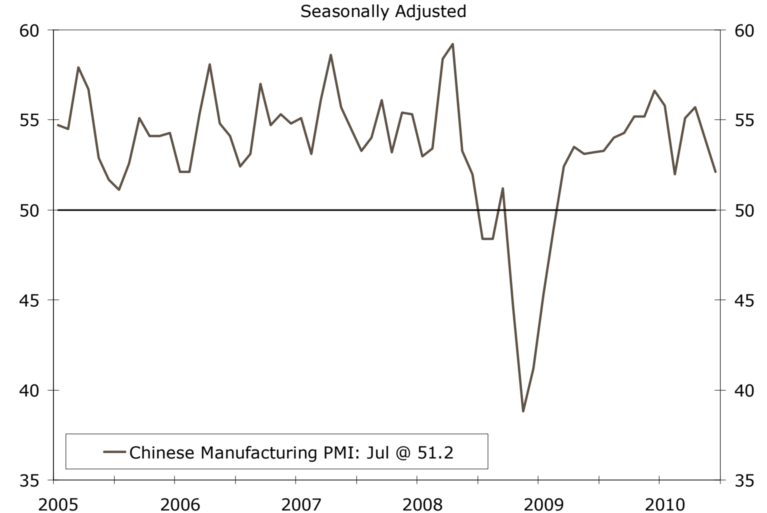
Meanwhile, Chinese indicators are also pointing to a slowdown in economic activity, but we already know what a slowdown in China means compared to the rest of the world. That is, even if the Chinese economy slows down, we should expect growth to remain at rates north of 8 percent per year. And while this may be "low" by Chinese growth standards, it certainly is far from recession territory. Furthermore, we also have to look at growth in the rest of Asia, which generally remains solid at present.

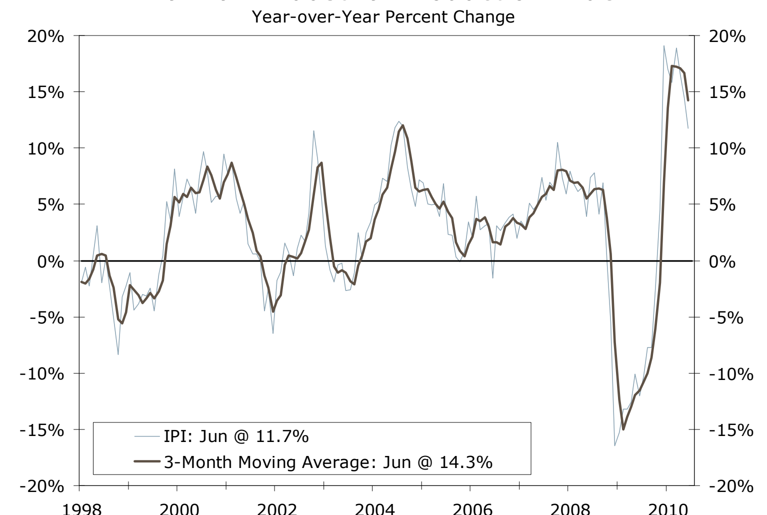
Even the Latin America region is still posting some interesting growth rates. Mexico, a laggard in this recovery process, has stepped up its growth during the past several months and is going to contribute to overall global growth, while the Brazilian economy slowed from the torrid pace it recorded during the first quarter of the year. Even with all of its energy scarcity issues affecting the productive sector, Argentina's economy has accelerated considerably during the past several months.

And as if this was not enough, it is clear that central banks across the world are very comfortable with current interest rate levels, even if some central bankers are talking about a potential exit strategy. However, even if a few central banks increase interest rates over the next several months, most officials across the region seem to be at ease with current policy.

The Greek crisis seems to have been contained, at least for now. Barring any other surprise, the world financial system should continue to improve during the next several quarters, which will continue to support growth in the emerging markets that have become very important contributors to global economic growth.







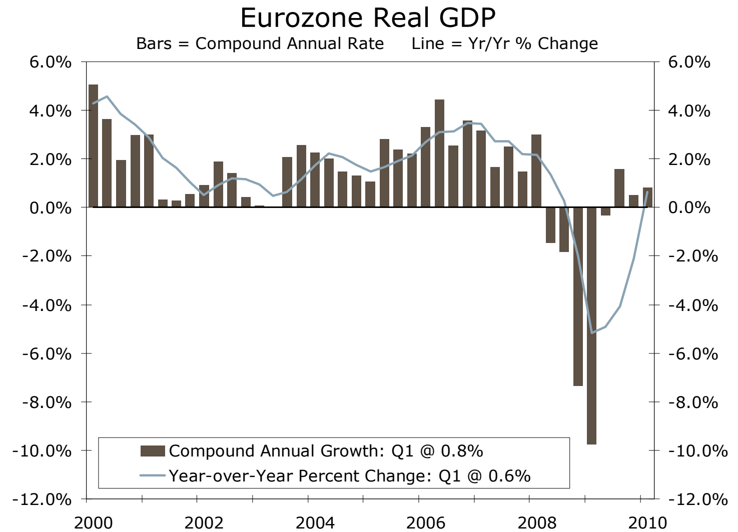
Eurozone GDP • Friday

Eurozone economic growth should come in relatively strong for the second quarter of the year, with the consensus looking for a 0.7 percent increase. It appears that the Greek crisis, while intense, was not able to pull the region down as many were expecting earlier in the cycle. However, this does not mean that we are not expecting some of these effects to be reflected in the numbers for the third quarter of the year.

Fiscal tightening, due to the crisis across the region, will put downward pressure on domestic consumption, and while external demand (i.e., exports) should remain relatively strong outside the Eurozone region, it will probably not be enough to prevent a slowdown in economic activity during the third and fourth quarters of the year.

Previous: 0.2% (not annualized)

Consensus: 0.7%



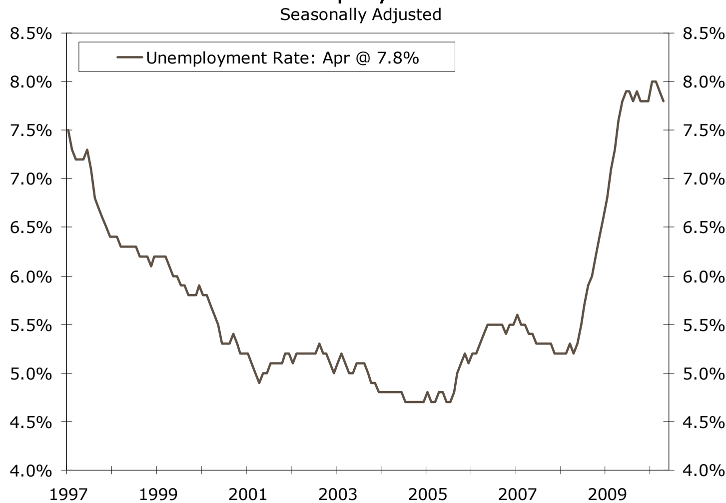
U.K. Unemployment Rate • Wednesday

It will be interesting to see if the relatively strong performance of GDP during the second quarter of the year continued to help the U.K. labor market during the last month of the quarter. Employment had been improving during the past several months, which has caused the unemployment rate to edge down to 7.8 percent.

Markets are expecting the rate of unemployment to have remained unchanged at 7.8 percent, but a surprise drop in that rate could signal a continuation of economic growth that could help the economy in the third quarter of the year. While the U.K. economy is not out of the woods yet, an upbeat labor market report could help to boost consumer confidence and retail spending.

Previous: 7.8%

Consensus: 7.8%



Chinese Industrial Production • Tuesday

Tuesday's release of the July industrial production index in China should shed some light on whether the recent measures to slow down growth in one of the largest and fastest-growing economies of the world is producing the intended results. Although some of the measures have been geared toward curtailing the growth in lending in the housing market rather than on the country's export sector, industrial production should reflect some slowdown in production linked to the construction industry in the country.

We do not expect industrial production to plummet as it did during the aftermath of the worldwide financial crisis of 2008—just to slow down compared to the almost breakneck pace at which industrial production has been growing since it recovered from the "soft-patch" induced by the financial crisis.

Previous: 13.7% (Year-over-year)

Consensus: 13.4%

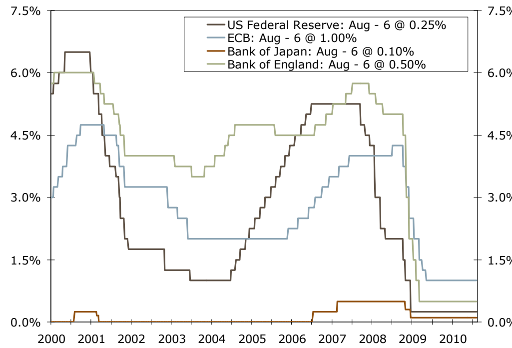
Interest Rate Watch

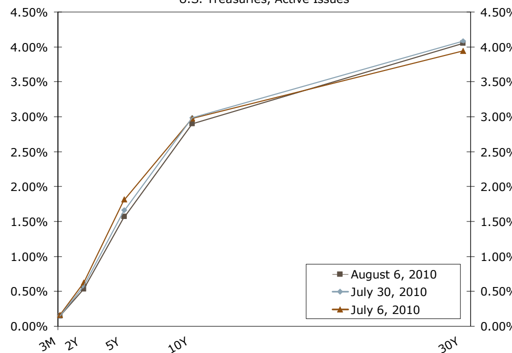
All Eyes on the Fed

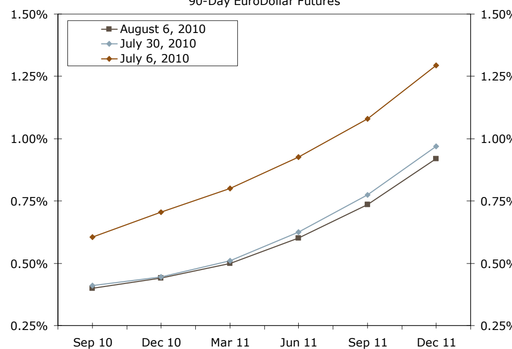
The Federal Open Market Committee (FOMC) is meeting on Monday and Tuesday next week with a rate decision and statement expected at 2:15 EDT on Tuesday. There is more market interest around this statement than usual, given the renewed signs of an economic slowdown in the U.S. and more guarded statements on the economic outlook of late from Ben Bernanke and others on the FOMC.

Of particular note, James Bullard, president of the St. Louis Fed, a voting member on the FOMC and a well-known inflation hawk, speculated on the need to restart asset purchases should a negative shock hit growth. Bottom line, if the inflation hawks are losing their nerve on the strength and sustainability of this recovery without additional monetary stimulus, it could mean a decidedly more dovish statement from the FOMC as soon as this month. A recent downgrade in the Fed's forecast for growth and last month's Beige Book report that showed a sluggish economic recovery will likely force the Fed to downgrade its language on the economy yet again. But the statement's language around inflation could be even more telling. Should the Fed raise the specter of further deflationary price pressures, it would increase the odds that, in a few months' time, the Fed will either be back making additional asset purchases, or at the very least, rolling over the MBS securities that are maturing, rather than letting them retire without replacement.

Markets have already begun to price in a more dovish path for interest rates. The implied probability (based on the Fed Funds futures market) that the FOMC cuts the Fed funds target rate to zero as soon as next week is 38.0 percent. The implied probability that the FOMC cuts the rate to zero by next January is now 32.2 percent, up from only a 17.5 percent probability a month ago. On the other hand, the probability that the Fed will increase the Fed Funds target rate by January of next year is now only 9.8 percent, down from a probability of 28.8 percent one month ago. It is little surprise that mortgage rates are currently probing cyclical lows.







Consumer Credit Insights

How Sustainable Is Our Debt?

It has been well documented, including in this space, that consumer debt levels as a share of disposable income or GDP remain extremely high by historical standards, though off a few percentage points from the peak in 2008. This begs the questions: how sustainable is that debt and how does it affect consumer spending and the demand for credit going forward? Analyzed in isolation, higher debt levels as a share of income, especially when they are out of whack with historical norms, should have a negative effect on the demand for future credit and spending, as consumers repair their balance sheets and reduce their leverage to bring the debt back in line with fundamentals.

Yet consumers don't operate in a vacuum, and the Fed can have a powerful effect on consumer and lending behavior. At this time, the Fed is making it as attractive as possible for consumers to maintain their debt levels, or even take on some more if they think they can swing the interest payments. That is why many economists focus more on the debt service burden, or the ratio of debt payments to income, to analyze the potential drag that consumer debt can have on household spending and the demand for new credit. Thanks to the Fed's interest rate cuts, consumers can now carry higher levels of debt before they have to cut back on spending and pay it down. According to the Federal Reserve Board, the household debt service ratio is now back down to its 2000 levels.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.49%	4.54%	4.57%	5.22%
15-Yr Fixed	3.95%	4.00%	4.07%	4.63%
5/1 ARM	3.63%	3.76%	3.75%	4.73%
1-Yr ARM	3.55%	3.64%	3.75%	4.78%
MBA Applications				
Composite	730.2	720.6	721.5	517.3
Purchase	174.9	172.3	168.6	264.4
Refinance	3,969.0	3,918.1	3,944.6	1,996.7

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

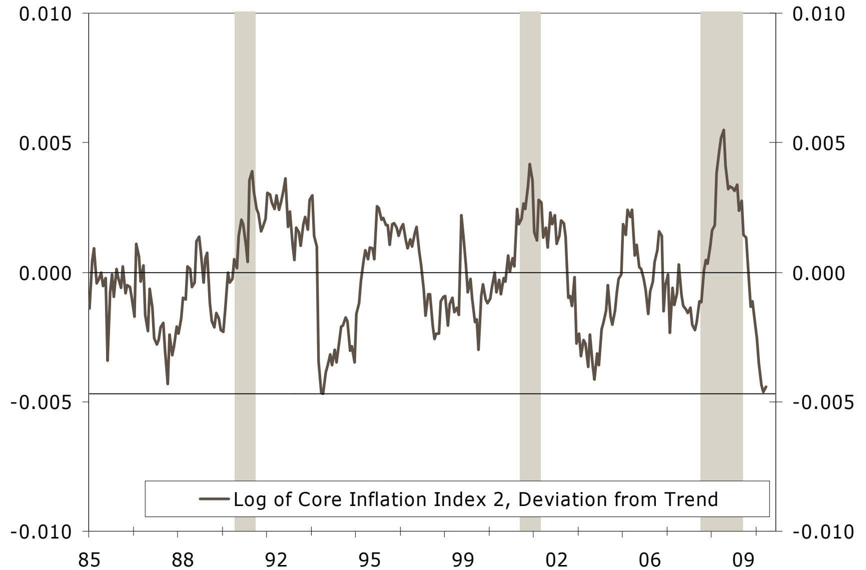
Topic of the Week

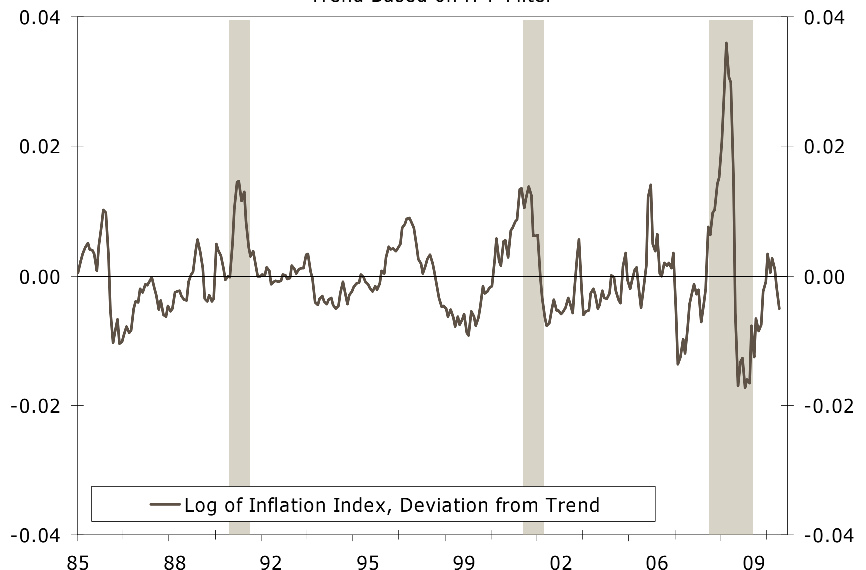
Understanding the Risk of Deflation

Deflation and its likelihood will be the hot topics of discussion over the next few weeks. The risks of a destabilizing deflation, while still relatively low, have increased and will likely increase further during the second half of the year, when economic growth is widely expected to slow and inflationary pressures are expected to ease even further. In some sense, deflation is already here in that the two most widely followed price indices, the Consumer Price Index and the Producer Price Index, have both declined for the past three months. These declines, while noteworthy, are not the persistent, destabilizing deflation the Fed is worried about. Still, these declines bring the year-to-year change in inflation into a zone where monetary policy will in all likelihood have to become much more proactive and aggressive.

The reason monetary policy will need to be more proactive today is that the potential risks from a persistent, destabilizing deflation are much greater than the potential long-term costs that inflation might accelerate. Moreover, the economy may already be at the point where we are only one more negative shock away from a problematic deflation. Inflation is already lower today than it was in November 2002, when then Fed Governor Ben Bernanke delivered his widely cited speech on the subject titled, Deflation: Making Sure "It" Doesn't Happen Here. Unfortunately, the current list of potential stumbling blocks is uncomfortably long. While predicting Black Swans is hazardous, notable tripping points include the European sovereign debt crisis, the precarious position of many state and local governments in the United States, and the growing resistance to additional fiscal stimulus in Europe and the United States amid what appears to be slower global economic growth. If economic conditions deteriorate, monetary policy will need to be more aggressive because the Fed's other unconventional easing measures have largely run their course.

To see our full report, please go to the "Special Reports" section of our website.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 8/6/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.13	0.14	0.17
3-Month LIBOR	0.41	0.45	0.46
1-Year Treasury	0.28	0.32	0.58
2-Year Treasury	0.51	0.55	1.20
5-Year Treasury	1.49	1.60	2.71
10-Year Treasury	2.82	2.91	3.75
30-Year Treasury	4.00	3.99	4.53
Bond Buyer Index	4.16	4.21	4.65

Foreign Exchange Rates

	Friday 8/6/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.330	1.305	1.435
British Pound ($/£)	1.597	1.569	1.678
British Pound (£/€)	0.832	0.832	0.855
Japanese Yen (¥/$)	85.120	86.470	95.460
Canadian Dollar (C$/$)	1.027	1.030	1.078
Swiss Franc (CHF/$)	1.035	1.041	1.065
Australian Dollar (US$/A$)	0.917	0.904	0.840
Mexican Peso (MXN/$)	12.634	12.645	13.032
Chinese Yuan (CNY/$)	6.769	6.775	6.831
Indian Rupee (INR/$)	46.160	46.408	47.670
Brazilian Real (BRL/$)	1.760	1.755	1.842
U.S. Dollar Index	80.193	81.539	78.065

Foreign Interest Rates

	Friday 8/6/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.83	0.83	0.84
3-Month Sterling LIBOR	0.74	0.75	0.87
3-Month Canadian LIBOR	1.01	0.99	0.60
3-Month Yen LIBOR	0.24	0.24	0.41
2-Year German	0.75	0.78	1.46
2-Year U.K.	0.77	0.78	1.29
2-Year Canadian	1.46	1.54	1.46
2-Year Japanese	0.15	0.16	0.28
10-Year German	2.51	2.67	3.37
10-Year U.K.	3.22	3.33	3.73
10-Year Canadian	3.07	3.18	3.56
10-Year Japanese	1.06	1.07	1.45

Commodity Prices

	Friday 8/6/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	81.67	78.95	71.94
Gold ($/Ounce)	1206.75	1181.00	963.25
Hot-Rolled Steel ($/S.Ton)	545.00	565.00	465.00
Copper (¢/Pound)	333.90	330.70	274.75
Soybeans ($/Bushel)	10.37	10.17	11.75
Natural Gas ($/MMBTU)	4.60	4.92	3.74
Nickel ($/Metric Ton)	21,809	20,606	20,390
CRB Spot Inds.	493.09	485.80	441.33

Next Week's Economic Calendar

	Monday 9	Tuesday 10	Wednesday 11	Thursday 12	Friday 13
U.S. Data		**Nonfarm Productivity** 1Q 2.8% 2Q 0.6% (W) **Unit Labor Cost** 1Q -1.3% 2Q -0.7% (W) **FOMC Rate Decision** Previous 0.25% Expected 0.25% (W)	**Trade Balance** May -$42.3B June -$41.5B (W)	**Import Price Index** June -1.3% July 0.0% (W)	**Retail Sales** June -0.5% July 0.2% (W) **CPI** June -0.1% July 0.0% (W) **Business Inventories** May 0.1% June 0.3% (W)
Global Data	**China** **Industrail Prod. (YoY)** Previous (Jun) 13.7% **Japan** Machine Orders (MoM) Previous (May) -9.1%	**Germany** **CPI (YoY)** Previous (Jun) 1.1% **Canada** **Housing Starts** Previous (Jun) 192.8K	**UK** **Unemployment Rate** Previous (May) 7.8%	**Euro-zone** **Industrail Prod. (YoY)** Previous (May) 9.6%	**Euro-zone** **GDP (QoQ)** Previous (1Q) 0.2%

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

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