February 12, 2010

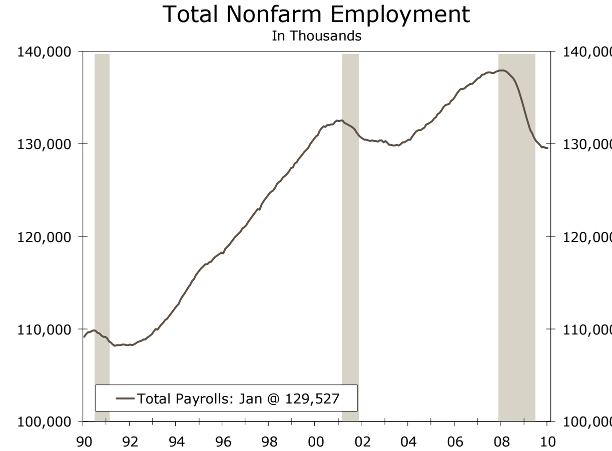
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

So Much Growth, Yet So Few Jobs

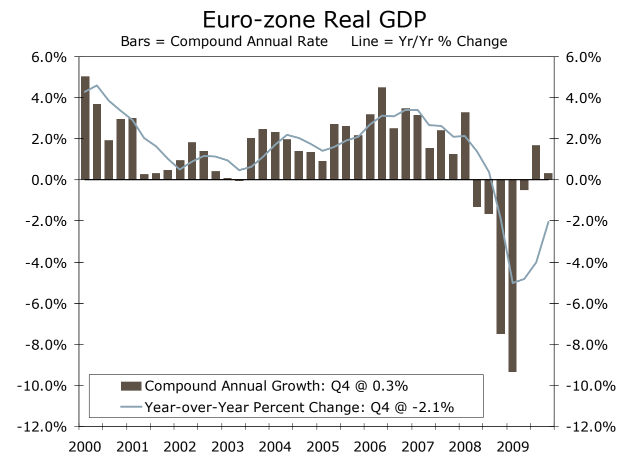
- Seldom have the interdependencies of markets been so obvious to practitioners and yet so opaque to policymakers. Struggles in the labor market have been evolving for years, in both expansions and recessions, and yet policymakers romanticize about the past and leave the American worker ill prepared for the future.
- Meanwhile, the gains in business investment are accumulating, suggesting both a change in the way we produce goods and services as well as the continued pressures for global competitiveness.



Global Review

Slow Growth in the Euro-zone

- Real GDP growth in the Euro-zone was barely positive in the fourth quarter. Until consumer spending starts to strengthen, any recovery that takes hold in the euro area is bound to remain tentative.
- The weak GDP data underscore the difficulty that the Greek government will have stabilizing its debt-to-GDP ratio. Other EU governments pledged support to Greece this week, at least in principle. However, these governments may need to pony up some actual euros before this crisis completely passes.



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	5.7	3.7	1.7	1.9	2.3	2.7	2.1	0.4	-2.4	2.9	2.4
Personal Consumption	0.6	-0.9	2.8	2.0	1.9	0.8	1.3	1.5	2.9	2.6	-0.2	-0.6	1.6	1.7
Inflation Indicators [2]														
"Core" PCE Deflator	1.7	1.6	1.3	1.4	1.3	1.2	1.2	1.3	2.3	2.4	2.4	1.5	1.2	1.7
Consumer Price Index	-0.2	-0.9	-1.6	1.5	2.6	2.6	2.1	1.7	3.2	2.9	3.8	-0.3	2.2	2.1
Industrial Production [1]	-19.0	-10.4	6.9	7.0	6.8	3.9	3.4	6.5	2.3	1.5	-2.2	-9.7	4.7	5.7
Corporate Profits Before Taxes [2]	-19.0	-12.6	-6.6	24.0	22.0	16.0	10.0	8.5	10.5	-4.1	-11.8	-5.1	13.8	8.0
Trade Weighted Dollar Index [3]	83.2	77.7	74.3	74.7	74.0	74.9	76.0	78.5	81.5	73.3	79.4	74.7	78.5	82.3
Unemployment Rate	8.2	9.3	9.6	10.0	9.8	9.9	10.2	10.1	4.6	4.6	5.8	9.3	10.0	9.7
Housing Starts [4]	0.53	0.54	0.59	0.55	0.59	0.64	0.67	0.70	1.81	1.34	0.90	0.55	0.65	0.76
Quarter-End Interest Rates														
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	5.25	4.25	0.25	0.25	0.50	3.25
Conventional Mortgage Rate	5.00	5.42	5.06	4.88	5.40	5.70	5.80	5.80	6.14	6.10	5.33	4.88	5.80	6.10
10 Year Note	2.71	3.53	3.31	3.85	3.70	3.80	4.00	4.10	4.71	4.04	2.25	3.85	4.10	4.50

Forecast as of: February 10, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

Inside

U.S. Review

Triangulation Does not Work in Economics

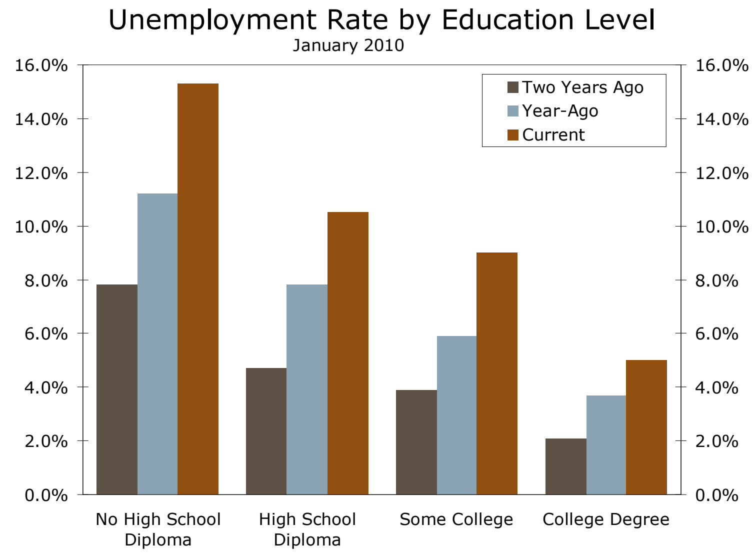
Sequential attempts to deal with particular problems in our economy have not solved any problems since the recession began. Instead, we have simply pushed the economic pressures in the economy, as if it were a child's balloon, to another part of the balloon. Almost four years ago we published an article on the domestic implications of a global labor market (Business Economics, July 2006). Three themes were paramount and we can see them repeated today. First, prior labor market benchmarks are outmoded by the emergence of a global labor market. Second, the U.S. labor market has become an increasingly dual labor market where service and goods workers face increasingly different economic forces and that the workers in each sector find it increasingly difficult to move between sectors. This has given rise to significantly different unemployment rates for workers across sectors and with varied educational backgrounds. Finally, participation rates for all workers and especially for teenagers are heavily influenced by changing household preferences as well as regulations such as the minimum wage.

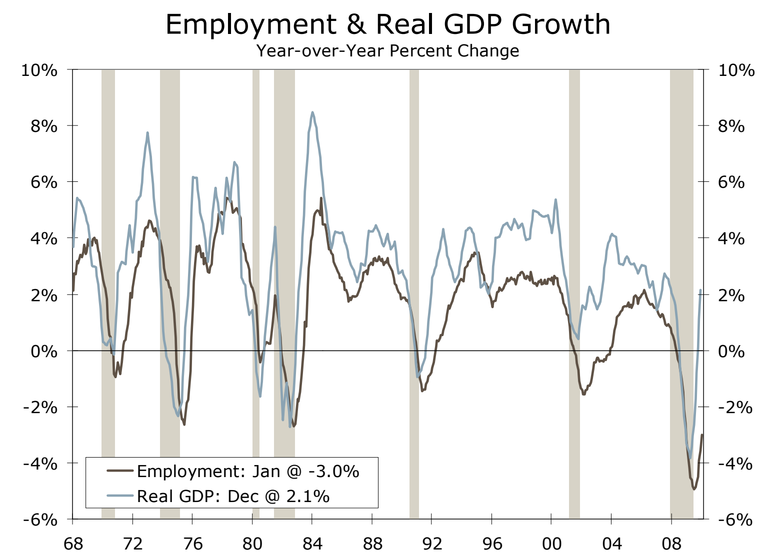
As a result, stronger real GDP growth has not translated into commensurate employment gains. Nonfarm employment fell during the fourth quarter and is expected to average 60,000 for the first half of this year. In its Economic Report of the President, the Obama Administration estimates job gains on average of 95,000 for this year with the unemployment rate at 9.8 percent at the end of this year. We find this employment outlook refreshingly realistic. Businesses are still concerned about the staying power of the recovery and are also uncertain as to what the outcome of the health care legislation will be. Cap and trade is also out there as well as the likelihood of higher income and wealth taxation.

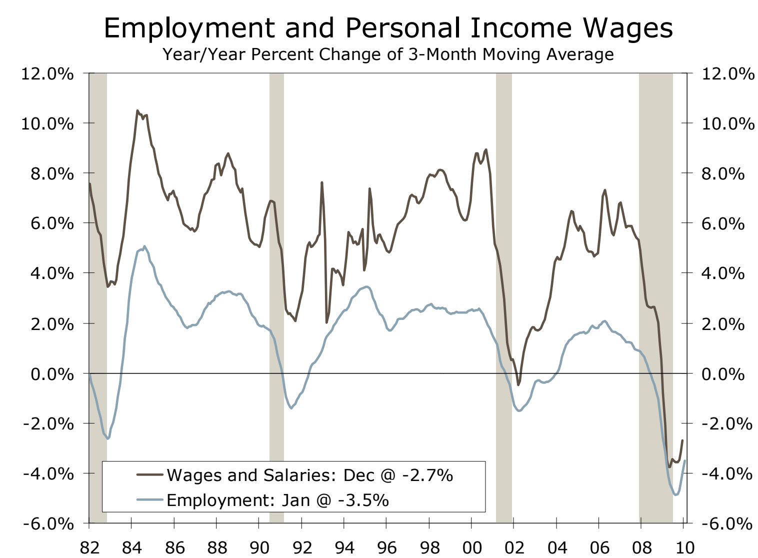
Interdependence: "Don't Touch Anything"

Anyone who has seen an Indiana Jones movie knows this admonition is based upon the belief that any change in one area leads to unforeseen changes in another area. Certainly this continues to be true for the U.S. economy. Weak employment conditions continue to restrain income and spending. Meanwhile, weak employment also suggests a longer workout of consumer credit problems, and therefore persistently high delinquency rates for consumer credit. This suggests caution by both lenders and borrowers—especially on residential real estate and therefore a longer-than-usual, weaker-than-usual housing recovery. Weaker income and housing gains will put continued pressure on state and local budgets which will, in turn, put further upward pressure on taxes and downward pressure on income support programs. Economics is a study in interdependence among markets and countries.

Spending for equipment and software continues to improve as business firms and individual entrepreneurs employ capital to improve their competitiveness. Moreover, the addition of capital reflects the ongoing substitution of capital for labor to restrain costs in a globally competitive environment.





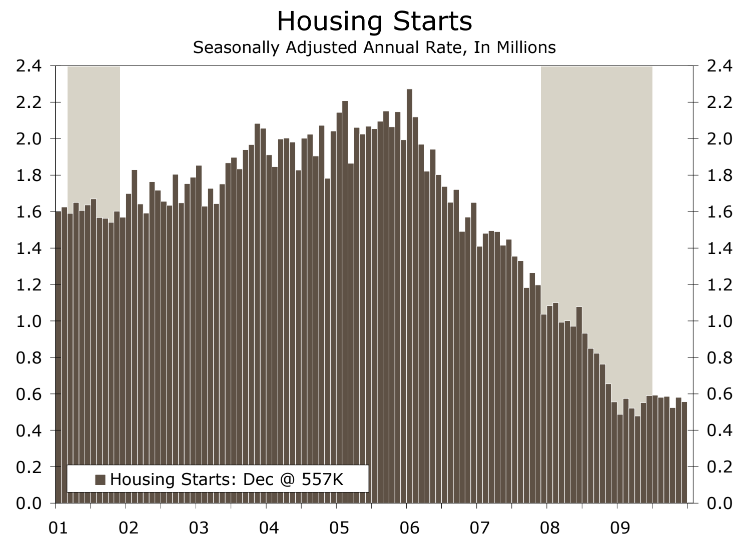


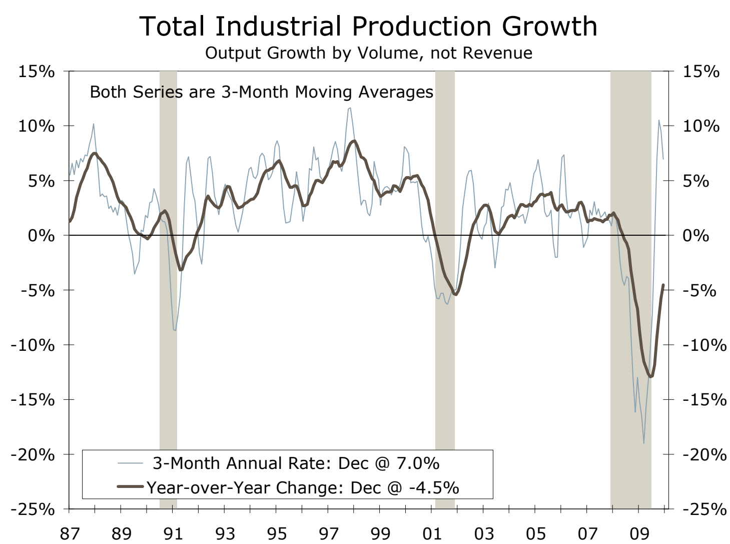
Housing Starts • Wednesday

Housing starts fell 23,000 units to an annual pace of 557,000 from the previous month. While starts were weak in December, they have remained within a range that has held for more than a year. Moreover, single-family permits continue to run ahead of starts, which suggests starts are sustainable at current levels. Total housing permits are now running 15.8 percent above year ago rates with single-family permits running 37.3 percent above last year's rates. We expect starts will increase by 8 percent to an annual pace of 601,000 in January. Permits will likely have another big increase in January as builders attempt to start houses to build inventories. Record high rental vacancy rates, however, will likely continue to keep residential construction constrained. Our 2010 outlook is for just 650,000 housing starts—not the 1.3 million of 2007.

Previous: 557K **Wells Fargo: 601K**

Consensus: 580K





Industrial Production • Wednesday

Industrial production rose 0.6 percent in December, the sixth consecutive monthly increase. The string of increases dating back to July is consistent with our view that the recession likely ended in June. While manufacturing is clearly in recovery, much of December's headline increase was due to an outsized gain in utilities. Cold weather will likely continue to boost utility output in January. The headline ISM manufacturing index came in at 58.4 in January driven by gains in new orders and production, which suggests more upside momentum. Consequently, industrial production likely rose 0.6 percent in January. Capacity utilization, which peaked in 2006 at 81.2 percent, will likely continue its upward trajectory, but is rising from very depressed levels. We expect capacity utilization will likely rise to 72.6 percent in January, but at such historic low levels, pricing power will remain minimal.

Previous: 0.6% **Wells Fargo: 0.6%**

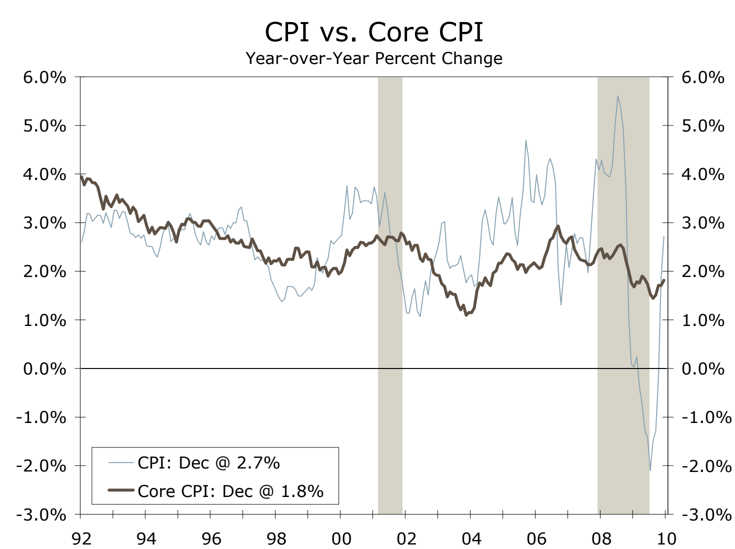
Consensus: 0.7%

CPI • Friday

Both the headline and core Consumer Price Indexes (CPI) rose 0.1 percent in December. The overall CPI is now up 2.7 percent year to year, while the core CPI is up just 1.8 percent. With housing in obvious oversupply, rent and owners' equivalent rent should continue to moderate in coming months keeping core consumer prices relatively tame. Goods prices, however, are continuing to rise faster than services prices. Goods prices were up 3.0 percent over the past year in December, the largest increase since the early 1990s. Core goods prices are being pulled up by stronger global economic growth, while weak domestic demand continues to restrain core services prices. Higher retail gasoline prices will likely also push the headline higher. We expect headline CPI to increase 0.3 percent in January and core CPI will likely register a modest increase of 0.2 percent.

Previous: 0.1% **Wells Fargo: 0.3%**

Consensus: 0.3%



Global Review

Euro-zone Economy Barely Growing at Present

Data released this morning showed that real GDP in the Euro-zone edged up 0.1 percent (0.4 percent at an annualized rate) in the fourth quarter. Over the past two quarters, real GDP has grown only 0.5 percent, hardly a dent in the 5 percent peak-to-trough decline it recorded during the recession. Moreover, the fourth quarter ended on a weak note as industrial production fell 1.7 percent in December, more than erasing the 1.4 percent increase registered in November.

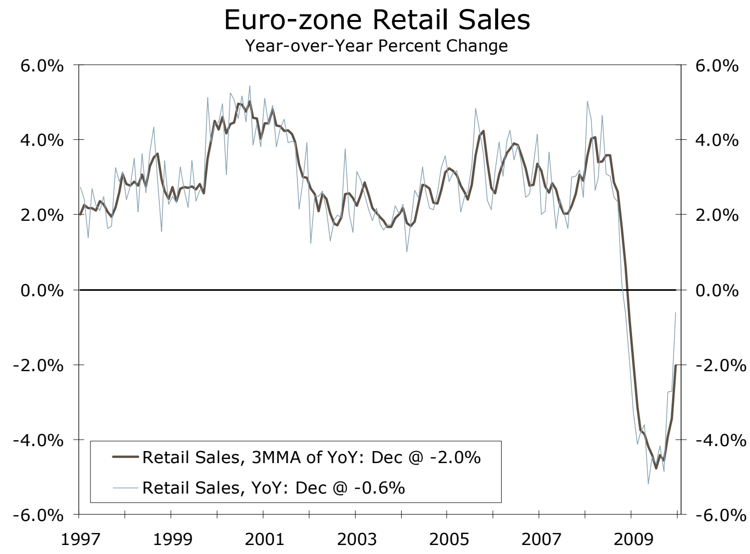
Not every individual country in the 16-member Euro-zone has reported figures for the fourth quarter yet. In addition, we do not have a breakdown of the overall GDP data into its underlying demand components, so conclusions are only tentative at this point. However, monthly data show where some of the underlying weakness in economy is at present.

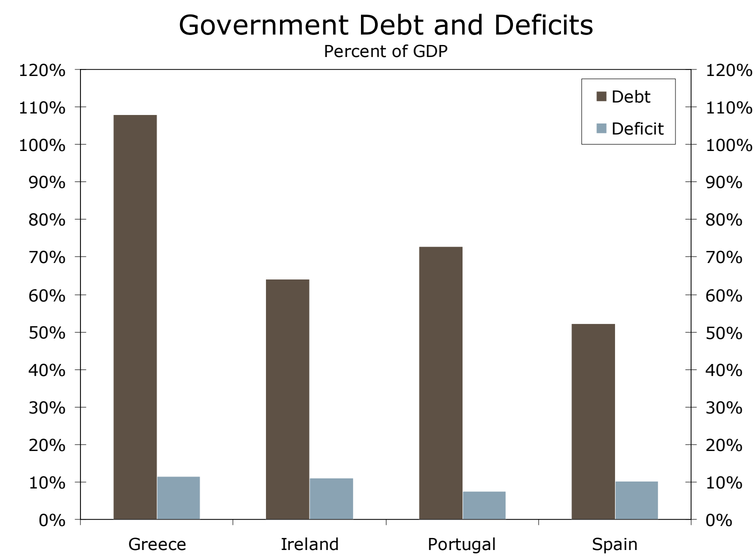
Start with the consumer. Retail sales in the overall euro area were off 0.2 percent (not annualized) in the fourth quarter relative to the previous quarter. On year-over-year basis, growth in retail sales in the Euro-zone is still negative (top chart). Although there are some countries in which consumer spending is starting to grow again—France is a notable example—retail spending in most countries remains weak. For example, retail sales in Germany were down 2.5 percent in December (year-over-year) while Greek sales are off about 10 percent. Until consumer spending starts to strengthen, overall economic growth in the euro area likely will remain weak. Indeed, we project that the recovery in the Euro-zone will remain very sluggish throughout most of 2010.

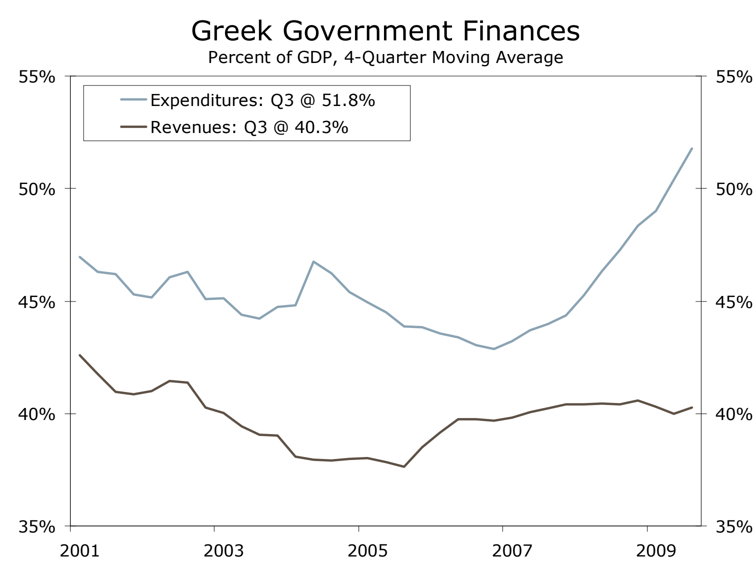
Greece is in a World of Pain

Speaking of the Hellenic Republic, real GDP in Greece contracted 0.8 percent in the fourth quarter, which underscores the difficulty that the government will have in addressing its fiscal issues. As we explained in a recent special report, nominal GDP growth in Greece needs to rebound to help stabilize the debt-to-GDP ratio. (See “The Long Road Ahead for Greece (and Others)”, which is posted on our website.) However, the deep fiscal correction that is required in Greece, especially if it is implemented quickly, tends to depress economic growth, at least in the near term. How is Greece supposed to pull off a major fiscal retrenchment while at the same time jumpstarting economic growth?

The answer lies in outside support to help smooth out the adjustment process. In that regard, other members of the European Union pledged support to the Greek government this week. Although few specific details were announced, other EU governments have, in principle, agreed to help Greece. It seems that these governments are hoping that merely their pledges of support will convince private investors that it is OK to lend to the Greek government. However, the drumbeat of weak economic news out of the Euro-zone will keep investors nervous regarding the finances of the Greek government. In our view, the EU (and perhaps the IMF) may actually need to pony up some money in the near future to Greece and perhaps some other indebted government (e.g., Portugal and Spain).







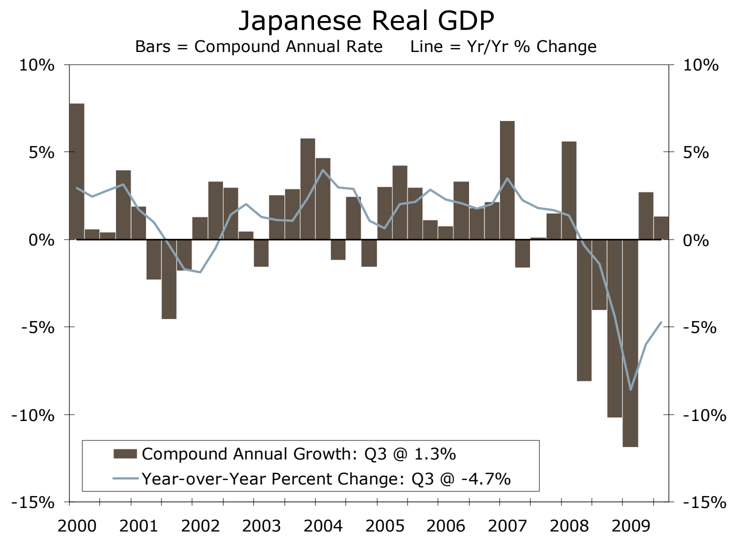
Japanese GDP • Monday

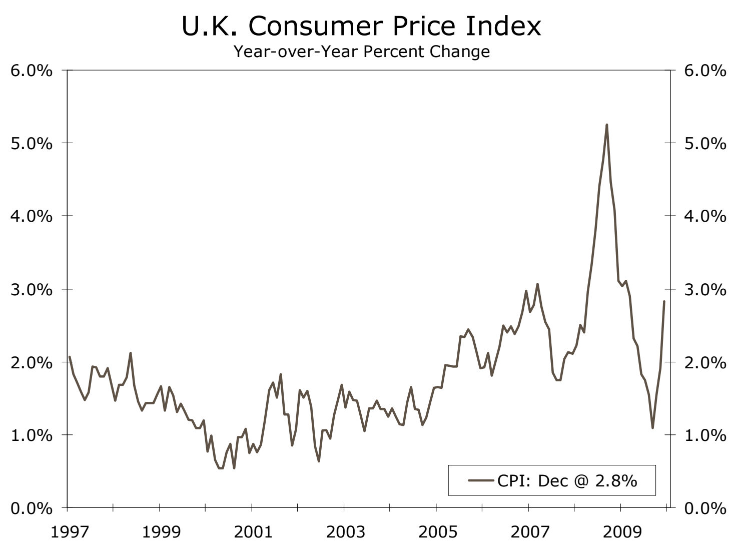
Real GDP in Japan has risen for two consecutive quarters, and most analysts look for another positive number when data for the fourth quarter print on Monday. Indeed, industrial production grew at an annualized rate of 20 percent in the fourth quarter relative to the third quarter due, at least in part, to robust growth in export volumes. It also appears that capital spending is starting to pick up a bit, but growth in consumer spending appears to have weakened somewhat in the fourth quarter.

The Bank of Japan also holds its monthly policy meeting next week. There is very little chance that the BoJ will change its main policy rate from only 0.10 percent, where it has been maintained since December 2008, but its monthly report may contain some useful information regarding the BoJ's current thinking.

Previous: 1.3% (annualized) Wells Fargo: 3.0%

Consensus: 3.6%





British CPI• Tuesday

British CPI is set to breech 3 percent, which will prompt a public letter from the Governor of the Bank of England to the Chancellor of the Exchequer explaining why inflation is more than 1 percentage point above the Bank's target of 2 percent. Part of the explanation lies in the re-imposition of the VAT that took effect on January 1. That said, there generally has been more inflation in the United Kingdom than one would expect from an economy that has suffered a 6 percent contraction in real GDP. The minutes from the Bank's recent policy meeting, which will be released on Wednesday, may provide some insights into the Bank's current assessment of the economy.

There are other important economic indicators on the docket next week including the labor market report for January (Wednesday) and retail spending last month (Friday).

Previous: 2.9% (year-over-year) Wells Fargo: 3.6%

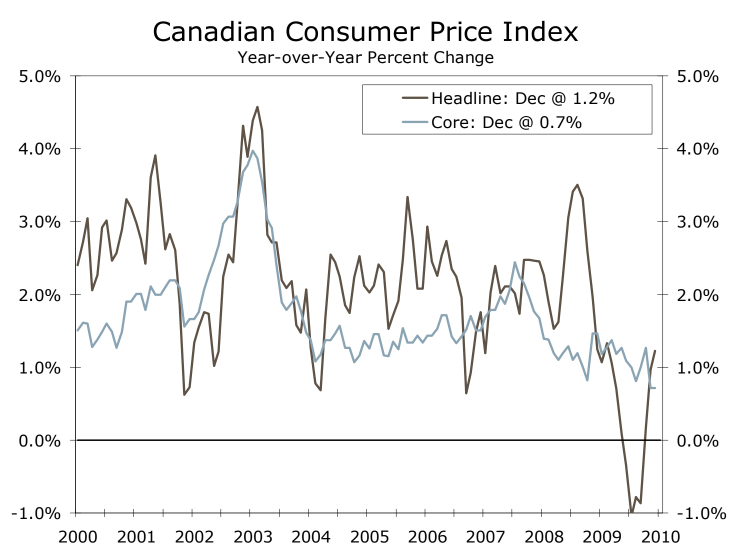
Consensus: 3.7%

Canadian CPI • Friday

The Bank of Canada (BoC) conducts its monetary policy with the explicit goal of keeping inflation as close as possible to the midpoint of a range between 1 and 3 percent. Because monetary policy can only go so far in controlling short-run changes in the price of commodities like gasoline and food, the BoC is primarily concerned with core CPI which excludes the most volatile components of CPI. In its most recent monetary policy statement the BoC noted that while CPI was rising faster than expected, "considerable excess supply remains." That gives the bank cover to keep rates at their current low level. The bank's official forecast does not anticipate Inflation hitting the 2 percent target level until the third quarter of 2011. By then we suspect the Canadian economic recovery will be self-sustaining and less dependent on monetary stimulus.

Previous: 1.3% (year over year) Wells Fargo: 1.6%

Consensus: 1.9%



Interest Rate Watch

Exit Strategy Out of an Untested Fire Escape

Tough enough for the fire warden to herd everyone out the fire escape as practice, but how about in real time on an untested fire escape? This week Chairman Bernanke gave advanced notice that the Fed will take us out this untested fire escape at some point in the future. What will signal their move? What will be the price of the exit?

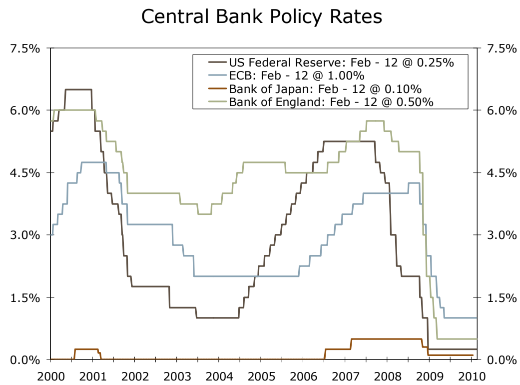
We will watch jobs and housing to gauge the timing of the exit. First, sustained improvement in the monthly jobs figures will be required. The Fed is a political institution and is unlikely to pull in the credit reigns until it is clear the unemployment rate has peaked and job gains are in tow. We expect this signal by the second quarter. Second, given the Fed's exposure to mortgage backed securities, it is likely to also wait for sustained gains in housing starts.

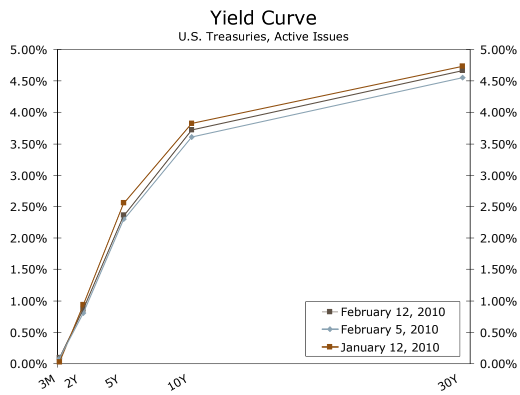
The price of the exit will be higher interest rates on the short-end of the yield curve as well as tighter credit for a sustained period of time. Essentially, the discussion of interest on reserves, reverse repos and term deposit auctions boils down to tying up reserves and raising the cost of funds for the banking system. As the availability of free reserves drops and the cost of funds rises, open-market interest rates on all forms of short-term credit will rise.

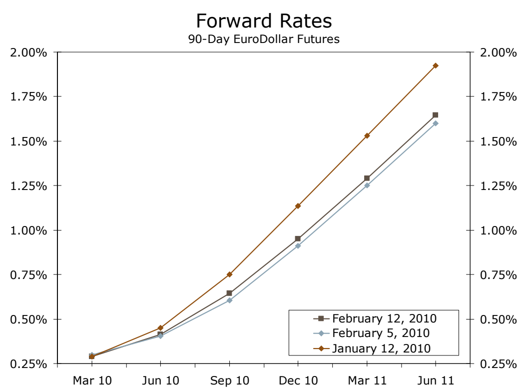
Certainly the Fed will go slow at the start but we also know the capital markets are forward looking and unlikely to patiently wait to exit the fire escape. Once the market senses interest rates are a one-way bet upward the likely moves will be quick and will anticipate the next Fed move.

In this environment, interest rate volatility will likely rise and the attempt by some firms to move from cheap short-term credit to locking in long-term financing will generate additional volatility.

Home buyers and firms that are dependent on short-term credit will also move quickly to lock in financing where possible. For the markets, the likely path for short-rates will be upward with higher volatility. While the path is ambiguous, the ultimate destination, higher rates, is crystal clear.







Consumer Credit Insights

Retail Sales Signal Increased Credit Demand

This week's improved retail sales data suggest that consumers are likely to increase their use of credit going forward. Two factors may be driving this spending. First, for many households there have been job gains, certainly for public sector workers, but also for private sector service workers as well. In addition, the latest monthly employment report suggests there are also job gains in the manufacturing sector. Second, we may also be seeing more spending from households whose job prospects have improved (note the Conference Board's improve reading of "jobs easy to get") which may have prompted a "relief" rally in consumer spending. Households may be attempting to reestablish their normal spending patterns and the retail sales data may be suggestive of that.

On the credit side, we have seen gains in consumers' use of non-revolving credit (autos, vacation and student loans) as households attempt to reestablish their long-run intentions on auto and education spending preferences. Meanwhile, revolving credit remains weak. Yet the latest three-month gain in general merchandise store sales of 4.9 percent suggests that consumers may be turning the corner on their use of revolving credit (credit cards).

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.97%	5.01%	5.06%	5.16%
15-Yr Fixed	4.34%	4.40%	4.45%	4.81%
5/1 ARM	4.19%	4.27%	4.32%	5.23%
1-Yr ARM	4.33%	4.22%	4.39%	4.94%
MBA Applications				
Composite	613.1	620.7	528.1	600.6
Purchase	221.2	237.8	213.7	235.9
Refinance	2,893.9	2,854.8	2,407.2	2,722.7

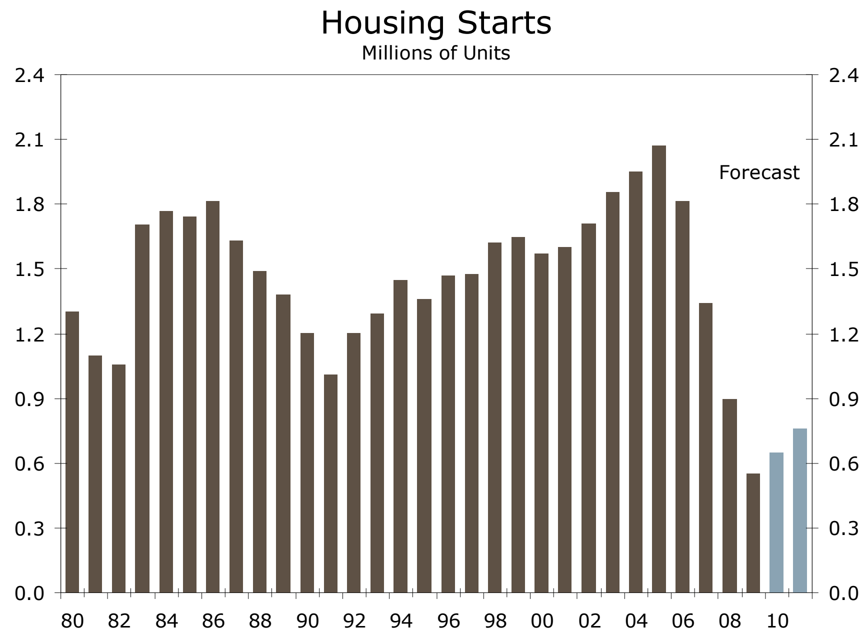
Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

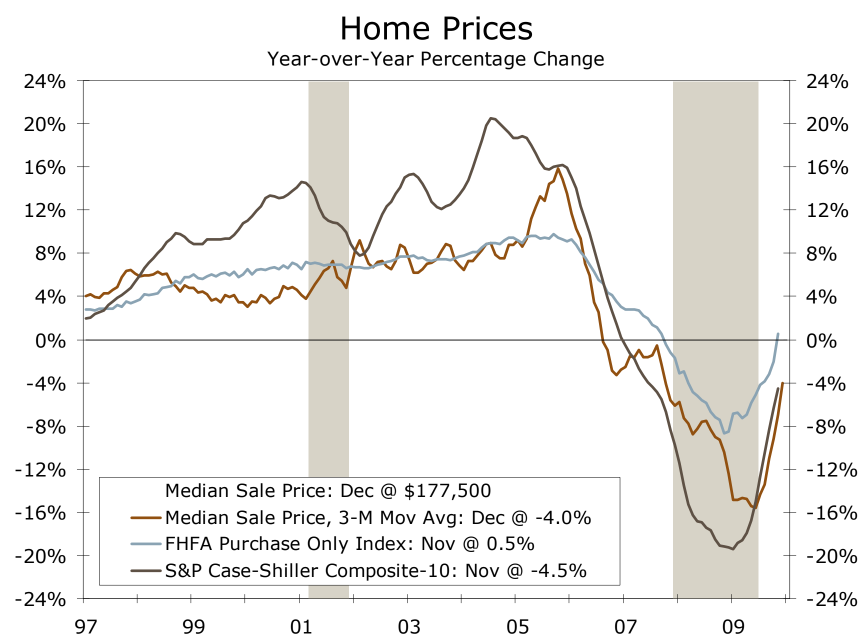
Topic of the Week

What Happens After the Stimulus Ends?

Low mortgage rates and incentives for first-time homebuyers helped arrest the long slide in home sales, housing starts, and home prices during 2009. Sales of both new and existing homes perked up toward the end of last year and house prices, as measured by the three most popular indices, stabilized during the second half of the year. New home construction also picked up modestly, and a number of homebuilders actually returned to profitability, again with the help of tax refunds from operating-loss carry backs. Foreclosure activity remains high, but lenders, at the urging of government regulators, are making extraordinary efforts to reduce foreclosures and are also showing restraint in unloading foreclosed homes into the already bloated resale market. With so much of the recovery tied to some sort of stimulus, and much of that stimulus set to end in the coming months, the natural question is what happens to the housing market after the stimulus ends?

Home sales and new home construction will recover less rapidly than the pace for which many would hope. We see new home sales rising close to 20 percent on an annual average basis and look for existing home purchases to climb 9 percent. While those increases sound impressive, much of the improvement has already taken place as 2009 ended on such a strong note. Sales likely got off to a slow start in 2010 because of unusually harsh weather in January and February, which are two of the seasonally weakest months of the year. Demand should pick up in March and April as new home sales, which are recorded at the time a contract is signed, would need to be booked by the end of April in order to close on new homes by June 30. Existing home sales, which are recorded at closing, will likely ramp up in May and June. Our expectation is that home sales and new construction will gradually grind higher, reflecting a modest improvement in employment conditions, record-high housing affordability and a slight relaxation in lending requirements in parts of the country. Please see our *Housing Chartbook* for our complete analysis.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 2/12/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.09	0.09	0.29
3-Month LIBOR	0.25	0.25	1.23
1-Year Treasury	0.34	0.26	0.45
2-Year Treasury	0.82	0.76	0.91
5-Year Treasury	2.32	2.23	1.76
10-Year Treasury	3.68	3.57	2.78
30-Year Treasury	4.64	4.52	3.52
Bond Buyer Index	4.34	4.36	4.89

Foreign Exchange Rates

	Friday 2/12/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.361	1.368	1.286
British Pound ($/£)	1.564	1.564	1.427
British Pound (£/€)	0.870	0.875	0.901
Japanese Yen (¥/$)	90.000	89.250	90.940
Canadian Dollar (C$/$)	1.056	1.072	1.244
Swiss Franc (CHF/$)	1.079	1.073	1.163
Australian Dollar (US$/A$)	0.882	0.868	0.652
Mexican Peso (MXN/$)	12.986	13.141	14.472
Chinese Yuan (CNY/$)	6.833	6.827	6.834
Indian Rupee (INR/$)	46.500	46.254	48.695
Brazilian Real (BRL/$)	1.862	1.879	2.307
U.S. Dollar Index	80.397	80.441	86.547

Foreign Interest Rates

	Friday 2/12/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.60	0.60	1.96
3-Month Sterling LIBOR	0.64	0.62	2.07
3-Month Canadian LIBOR	0.41	0.43	1.45
3-Month Yen LIBOR	0.25	0.26	0.64
2-Year German	0.98	0.99	1.30
2-Year U.K.	1.16	1.15	1.21
2-Year Canadian	1.34	1.26	1.15
2-Year Japanese	0.17	0.17	0.41
10-Year German	3.19	3.12	3.08
10-Year U.K.	4.05	3.88	3.48
10-Year Canadian	3.46	3.36	2.90
10-Year Japanese	1.34	1.39	1.26

Commodity Prices

	Friday 2/12/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	72.99	71.19	33.98
Gold ($/Ounce)	1085.45	1066.30	946.75
Hot-Rolled Steel ($/S.Ton)	545.00	545.00	475.00
Copper (¢/Pound)	303.50	285.40	152.95
Soybeans ($/Bushel)	9.28	8.97	9.71
Natural Gas ($/MMBTU)	5.49	5.52	4.49
Nickel ($/Metric Ton)	18,377	17,652	10,329
CRB Spot Inds.	474.98	468.11	340.55

Next Week's Economic Calendar

	Monday 15	Tuesday 16	Wednesday 17	Thursday 18	Friday 19
U.S. Data		**Empire Manufacturing** January 15.92 February 17.70 (C)	**Housing Starts** December 557K January 601K (W) **Industrial Production** December 0.6% January 0.6% (W) **Import Price Index** December 0.0% January 0.9% (W)	**PPI** December 0.2% January 0.9% (W) **Core PPI** December 0.0% January 0.1% (W) **Leading Indicators** December 1.1% January 0.1% (W)	**CPI** December 0.1% January 0.3% (W) **Core CPI** December 0.1% January 0.2% (W)
Global Data	**Japan** **GDP (QoQ)** Previous (3Q) 1.3%	**UK** **CPI (YoY)** Previous (Dec) 2.9%	**UK** **Unemployment Rate** Previous (Nov) 7.8%	**Canada** **CPI (YoY)** Previous (Dec) 1.3%	**UK** **Retail Sls Ex Auto Fuel** Previous (Dec) 0.3% **Canada** **Retail Sales (MoM)** Previous (Nov) -0.3%

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

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