January 22, 2010

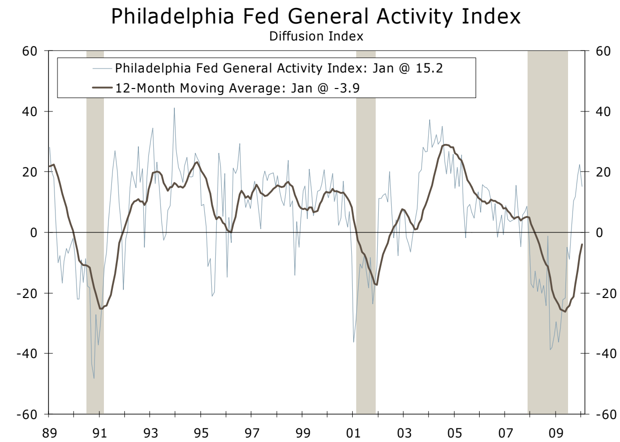
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Disappointing Economic Data Continue in January

- The economic data this week largely disappointed equity investors and missed analyst expectations.
- Homebuilder confidence has ebbed as new home sales remain sluggish and buyer traffic has dropped since September.
- A pull-back in the January Philly Fed index has raised concerns about the strength of the economic recovery in the first quarter.
- Expect slower economic activity in January following robust improvement in the fourth quarter.



Global Review

China Strengthened Further in the Fourth Quarter

- In the fourth quarter of 2009 the Chinese economy grew at its fastest pace in two years and CPI inflation rose to a one-year high. The Chinese government also made news by taking steps to rein in credit growth.
- In our view, the government is taking back some of the emergency measures that were put in place a year ago because they are not longer appropriate. Although we expect that growth will slow somewhat over the coming quarters, we think that the probability of a "hard landing" in China is rather low.

Inside

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]	-6.4	-0.7	2.2	5.6	2.3	2.2	2.4	2.3	2.7	2.1	0.4	-2.4	2.7	2.5
Personal Consumption	0.6	-0.9	2.8	1.4	1.2	1.3	1.4	1.5	2.9	2.6	-0.2	-0.6	1.4	1.8
Inflation Indicators [2]														
"Core" PCE Deflator	1.7	1.6	1.3	1.4	1.3	1.1	1.2	1.3	2.3	2.4	2.4	1.5	1.2	1.6
Consumer Price Index	-0.2	-0.9	-1.6	1.5	2.7	2.7	2.2	1.8	3.2	2.9	3.8	-0.3	2.3	2.1
Industrial Production [1]	-19.0	-10.4	6.1	6.1	5.8	4.2	3.8	7.3	2.3	1.5	-2.2	-9.8	4.3	5.9
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	73.6	73.4	75.0	77.1	81.5	73.3	79.4	74.7	77.1	82.5
Unemployment Rate	8.2	9.3	9.6	10.0	10.2	10.2	10.5	10.5	4.6	4.6	5.8	9.3	10.4	10.1
Housing Starts[4]	0.53	0.54	0.59	0.56	0.60	0.65	0.68	0.71	1.81	1.34	0.90	0.55	0.66	0.80
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	5.50	5.90	6.00	6.10	6.14	6.10	5.33	4.88	6.10	6.50
10 Year Note	2.71	3.53	3.31	3.85	3.80	4.00	4.20	4.40	4.71	4.04	2.25	3.85	4.40	4.90

Forecast as of: January 13, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

U.S. Review

Reality Bites

Political upheaval in Washington with the election of Republican Scott Brown to the Senate turned conventional wisdom on healthcare reform and financial sector reform on its head this week. Regulatory risk has risen against the banking industry as the Obama Administration tries to score political points off of popular anger over bank bailouts and executive compensation and bonuses. At the same time, the economic data released this week pointed to weaker expansion as the first quarter gets underway.

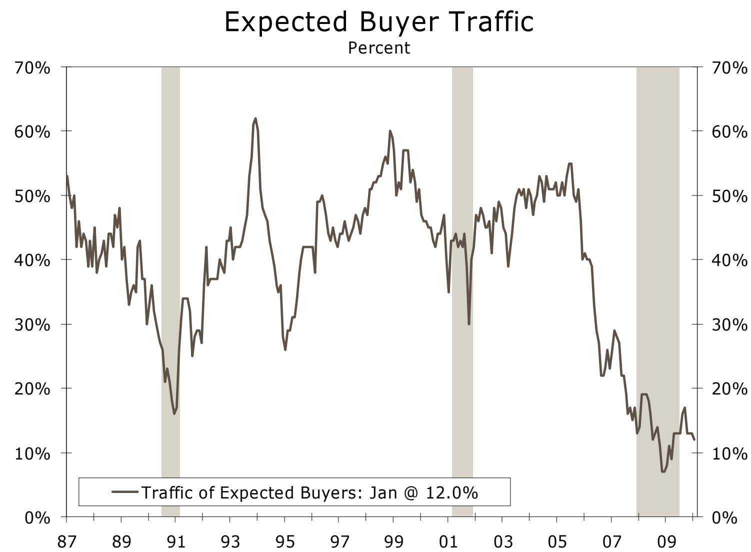
The NAHB/Wells Fargo builders' sentiment index dropped another point in January to 15 from a post-bubble peak of 19 last September. The index is still seven points above where it was a year ago. Prospective buyer traffic has dropped five points since September's first time homebuyer credit surge. Regionally, the biggest declines in the housing market index since September have come from the Midwest followed by the Northeast and South. The regional index in the West has been comparatively steady.

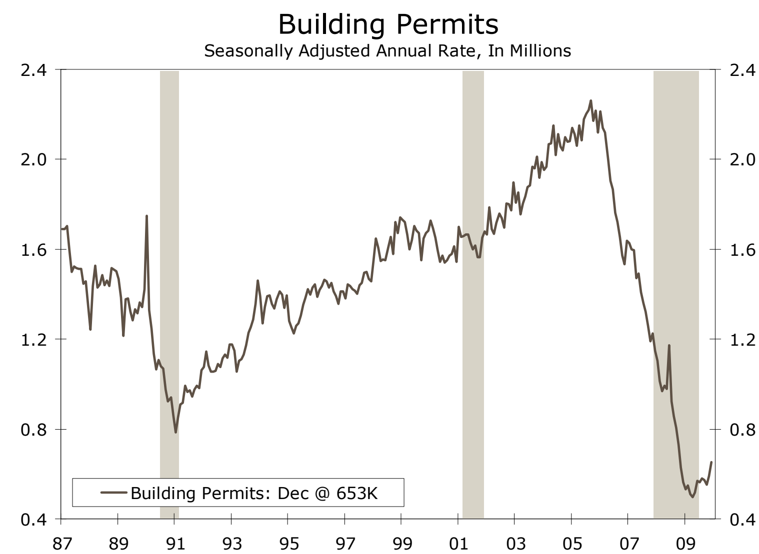
Housing starts took a step backward in December dropping 4.0 percent as rough weather seems to have hampered single-family starts, which dropped 6.9 percent. On a more encouraging note, multi-family starts jumped another 12.2 percent in December after a steep 70 percent increase in November. The permits data continue to point toward a sustainable recovery in housing activity. Housing permits have risen for two consecutive months, gaining another 10.9 percent in December. Total housing permits are now running 15.8 percent above year ago rates with single-family permits running a whopping 37.3 percent above last year's rates.

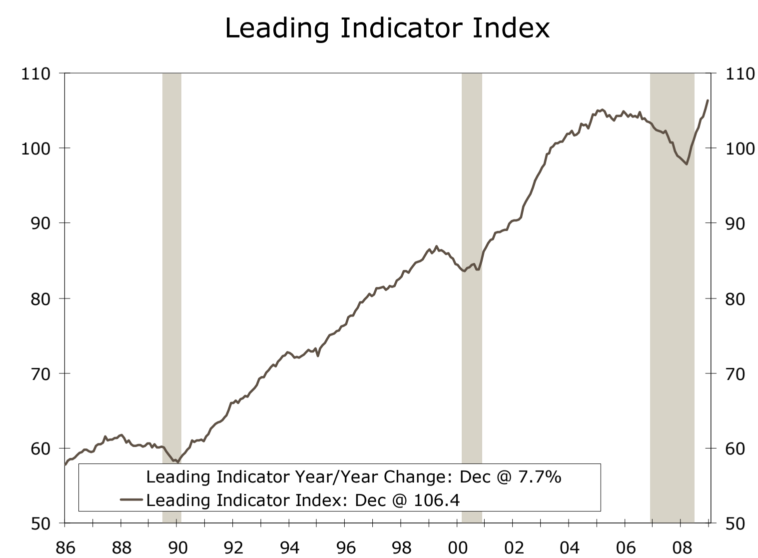
Manufacturing activity in the mid-Atlantic region slipped to 15.2 in January from 22.5 in December, according the Philly Fed index. Manufacturing expansion continues, but at a slower pace. The new orders component has moderated substantially since November while labor market components have strengthened visibly, both the number of employees and average workweek measures.

A welcome sign of continuing expansion came from the Conference Board's Leading Economic Indicators (LEI), which provided the most encouraging data point this week. The LEI rose 1.1 percent in December after gaining 1.0 percent in November, signaling continued expansion and perhaps some acceleration in growth in the second half of 2010. The December reading at 106.4 was a new record high for this measure. The widening interest rate spread, falling initial jobless claims, and robust building permit gains lead the advance in this measure.

Producer prices for December proved somewhat stronger than expected, rising another 0.2 percent on the month despite a large 3.2 percent decline in wholesale gasoline prices. Food prices jumped 1.4 percent, putting some further upward pressure on the headline index. Core PPI was unchanged in December, and has only increased 0.9 percent over the past twelve months.





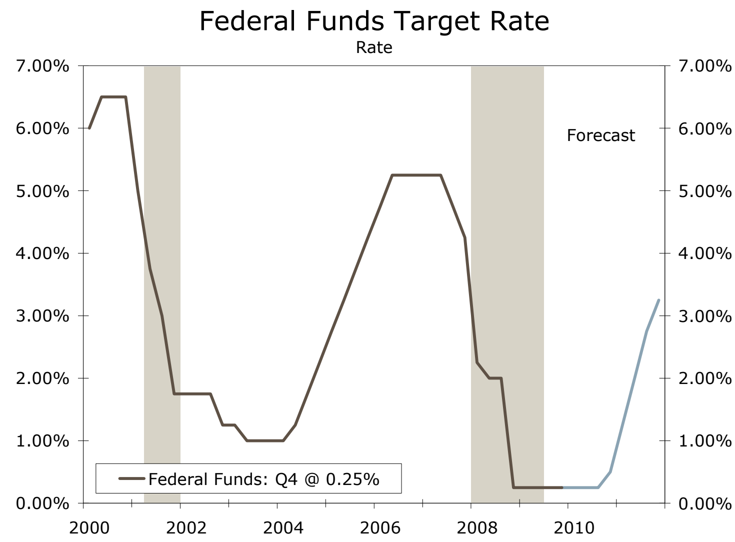


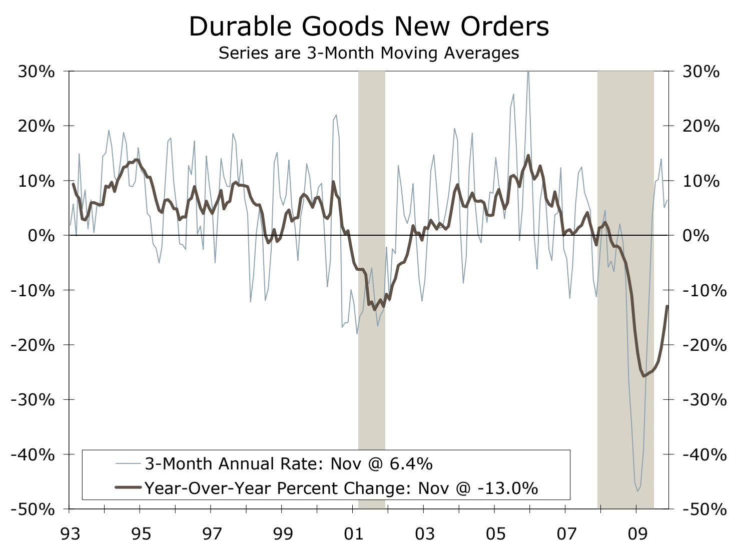
FOMC • Wednesday

The Federal Reserve is expected to keep its federal funds target rate at its current level at the January meeting. In a speech earlier this month, Federal Reserve Vice Chairman Donald Kohn reiterated the stance of the FOMC on monetary policy by stating, "...its expectations for the stance of monetary policy depend on economic conditions, including resource utilization, inflation, and inflation expectations." He also mentioned, "...the judgment as to when to begin initiating steps to withdraw stimulus will depend on the outlook for these variables." Our outlook continues to suggest that resource utilization should remain low through the end of 2010 with the unemployment rate peaking at around 10.5 percent. Moreover, the fed has historically not raised rates while the unemployment rate is rising. Further, core inflation and inflation expectations should also remain subdued.

Previous: 0.25% **Wells Fargo: 0.25%**

Consensus: 0.25%





Durable Goods Orders • Thursday

New orders for durable goods rose 0.2 percent in November and were restrained by a significant decline in nondefense aircraft orders. While the "headline" tends to be extremely volatile on a month-to-month basis, the three-month annual rate of new nondefense capital goods orders excluding aircraft is a better gauge of manufacturing activity. That figure has remained positive for six consecutive months. While the industrial production manufacturing index fell slightly in December, durable goods manufacturing rose modestly with increases in fabricated metal products, machinery, computers and electronics and primary metals. Recent gains in the ISM Manufacturing Index also suggest a similar trend in new durable goods orders in December. Moreover, civilian aircraft orders will likely get a substantial boost in December as Boeing reported their order log rose significantly. Consequently, we expect new orders rose 1.1 percent in December.

Previous: 0.2% **Wells Fargo: 1.1%**

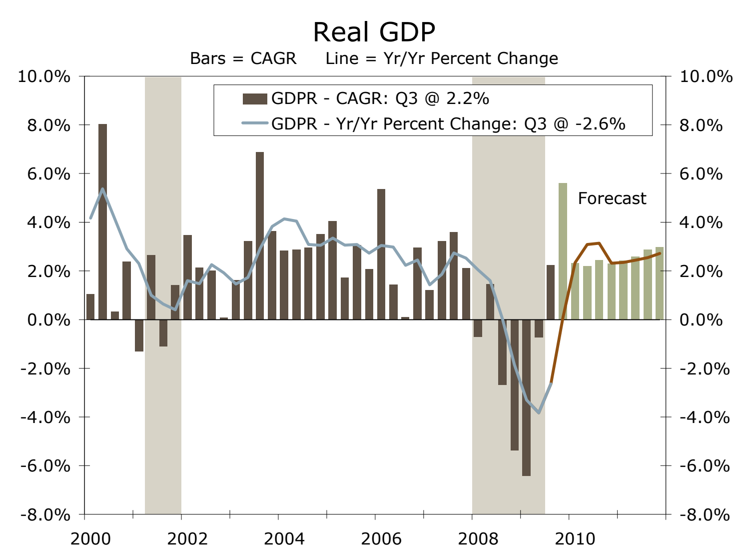
Consensus: 1.6%

GDP • Friday

Our estimate for fourth quarter real GDP has been raised significantly due in large part to stronger inventory numbers released in recent months. We expect the slower pace of inventory liquidations will add around 4 percentage points to real GDP growth, which should boost the headline up to a 5.6 percent annual pace. The contribution from inventories, however, will be short-lived as businesses bring inventory levels into alignment with final sales. Real final sales will likely only increase at a modest pace of around 1.6 percent in 2010. Personal consumption and residential investment should also contribute to real GDP, but much of the increase here was likely derived from temporary tax credit programs. Spending on equipment and software will also likely show improvement. Structure outlays will likely continue to contract from real GDP growth through 2010.

Previous: 2.2% **Wells Fargo: 5.6%**

Consensus: 4.5%



Global Review

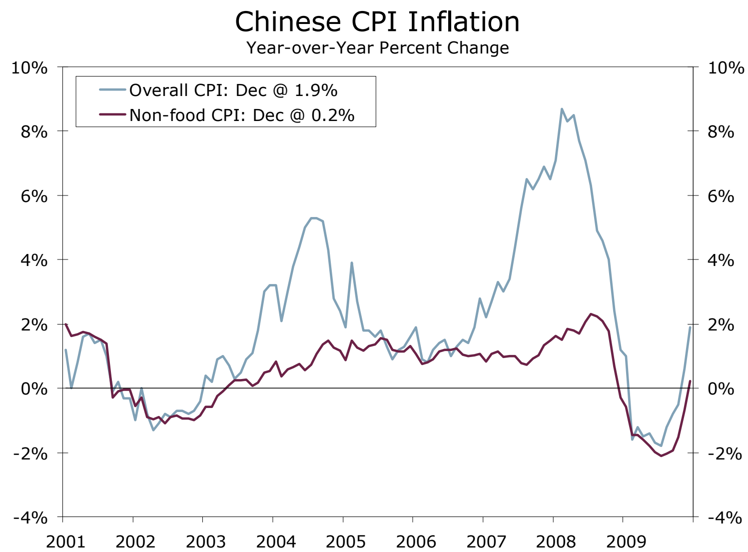
Chinese Economy Continues to Strengthen

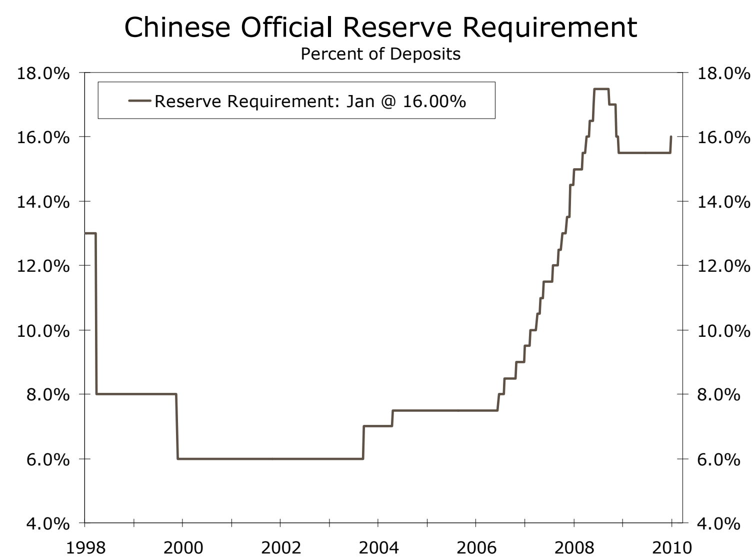
The Chinese economy was headline news this week for a number of reasons. First, data released this week showed that real GDP growth rose from 9.1 percent in the third quarter to 10.7 percent in the fourth quarter, the strongest year-over-year growth rate in two years (see graph on front page). A breakdown of the GDP data into its underlying demand-side components is not available, but it appears that consumers helped to do their part. That is, growth in the value of retail spending strengthened from 15.4 percent in the third quarter to 16.5 percent in the fourth quarter. Fixed investment spending rose 30 percent last year, and the value of China's exports appear to have risen significantly in seasonally-adjusted terms in the fourth quarter. In sum, most major categories of demand strengthened in the fourth quarter.

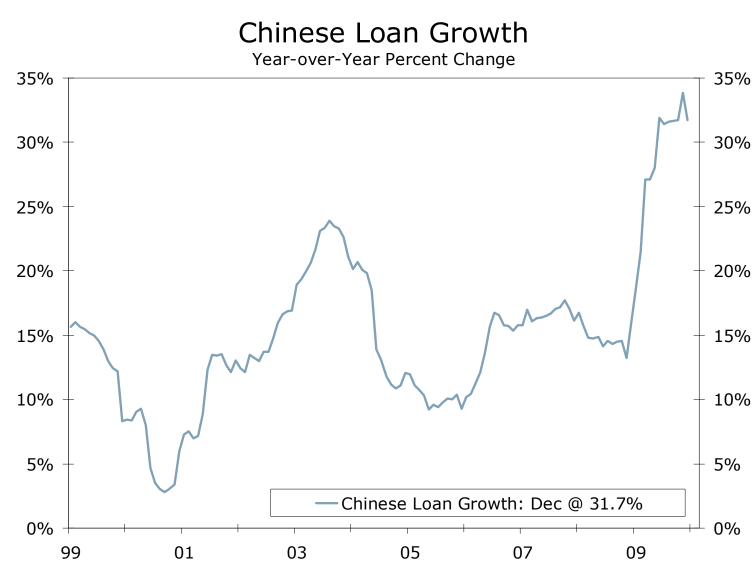
This week's data also showed that the overall rate of CPI inflation jumped from 0.6 percent in November to 1.9 percent in December, the highest year-over-year rate of inflation in more than a year (top chart). Yes, the overall rate of inflation in December may have been distorted by a low base—prices were falling rapidly in late 2008 in the wake of the global financial crisis—and the recent rise in food prices, which account for one-third of the index, has also helped to lift the overall CPI. That said, non-food price inflation turned positive in December, and the recent rise in producer prices suggest that consumer prices many continue to drift higher in the months ahead.

Because growth has been strong and mild inflation is starting to reappear, the Chinese government has taken steps to scale back some of the emergency stimulus measures that were put in place more than a year ago. In order to sop up some of the excess liquidity in the financial system, the central bank two weeks ago raised reserve requirements by 50 bps to 16 percent (middle chart). This week, the Chinese government helped to send equity markets into a tizzy by announcing that it is directing the nation's banks to scale back the pace of new lending. Is the government about to engineer a dramatic slowing in the pace of Chinese economic growth?

In our view, the government is simply attempting to reverse some of the emergency stimulus measures that were put in place in late 2008/early 2009 because the Chinese economy no longer needs them. In 2003 when global growth was very slow, the government directed the banks to increase lending to stimulate the economy (bottom chart). Subsequently, the directive was reversed in mid-2004 when the global economy began to recover and it became apparent that excessive lending was no longer appropriate. Today, the government is hoping to pull off a "soft" landing à la 2004. In the months ahead, the government likely will raise reserve requirements further, probably hike interest rates and slow loan growth. Markets could remain on edge as investors fret that the government may end up slamming on the brakes. We look for the year-over-year growth rate to slow from 10.7 percent at present to roughly 9 percent by late this year/early next year, which would represent a slowdown but not really a "hard landing."







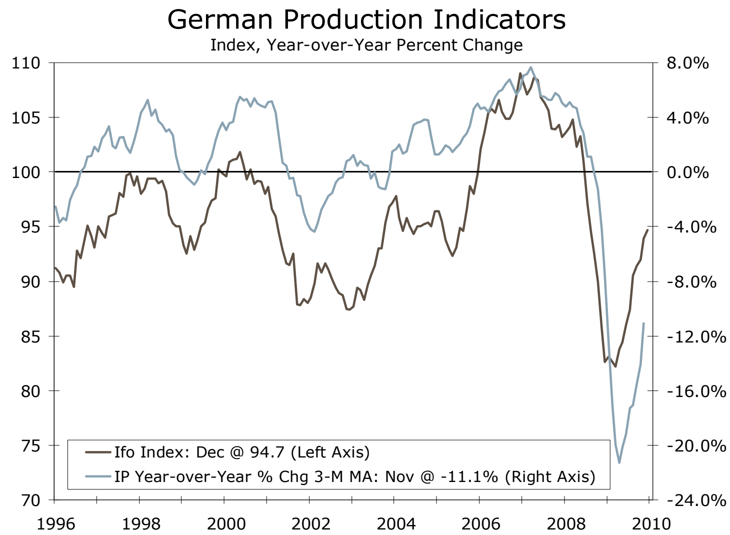
German Ifo Index • Tuesday

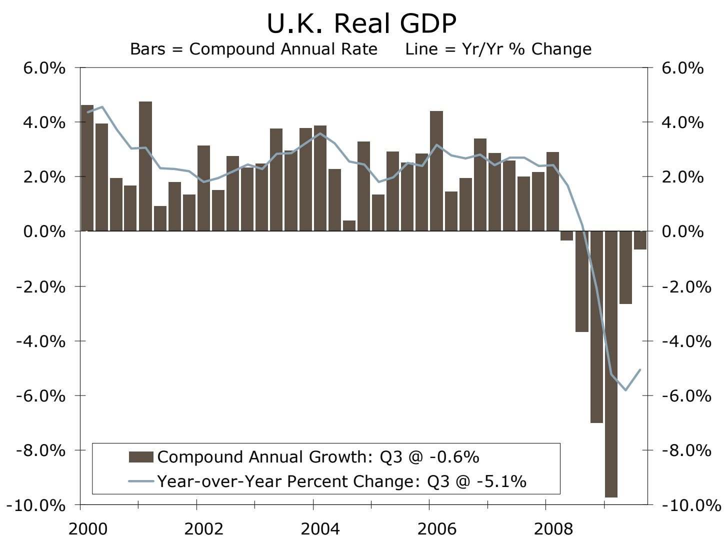
The Ifo index of German business sentiment is widely watched because it is highly correlated with industrial production growth in Germany, the largest economy in the euro area. The rise in the Ifo index since its low in March is consistent with the increase in industrial production (IP) that has occurred. Although German IP remains more than 15 percent below its peak in early 2008, it has rebounded about 9 percent since its nadir last spring. The consensus forecast looks for another modest rise in the Ifo index in early January.

Although the Ifo index should be the highlight of the week, other data will give investors some insights into the current state of the Euro-zone economy. Data on consumer spending in France and Italy will be released on Tuesday, and business confidence indices in both countries will also print next week.

Previous: 94.7

Consensus: 95.1





U.K. GDP • Tuesday

Real GDP in the United Kingdom has declined for six consecutive quarters, dropping 6 percent on a peak-to-trough basis. However, monthly indicators suggest that the overall economy started to grow again in the fourth quarter. We are in line with the consensus forecast, which anticipates that real GDP rose 0.4 percent (not annualized) in the fourth quarter relative to the previous quarter. A breakdown of the GDP data into its underlying demand-side components will not be available for a few more weeks, so we will not yet know how much of the anticipated lift in GDP is due to a temporary inventory swing and how much reflects final sales.

Speaking of sales, survey data on retail spending in January will be released on Wednesday. Did the increase in the VAT on January 1 lead to a weakening of retail spending? Consumer confidence data also print next week.

Previous: -0.2% (not annualized) **Wells Fargo: 0.4%**

Consensus: 0.4%

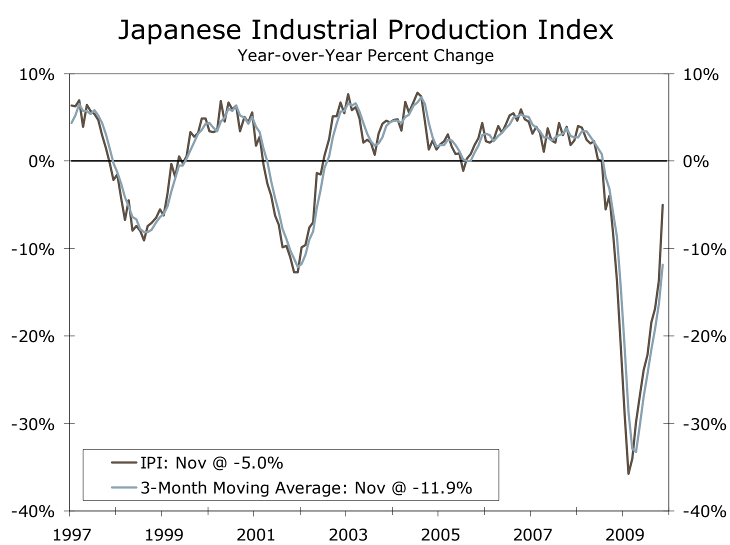
Japanese Industrial Production • Friday

Industrial production (IP) in Japan plunged more than 35 percent between February 2008 and February 2009. Although IP remains 20 percent below its peak, it has risen for nine consecutive months and most analysts look for another sizeable increase when December data are released on Friday.

The Japanese economy has benefitted from strong exports over the past few quarters. Indeed, the year-over-year rate of export growth is expected to turn positive in December for the first time since September 2008. However, retail spending generally remains soft. Indeed, the consensus forecast looks for a modest decline in retail sales in December when the data print on Friday. CPI data on the consumer price index are expected to show that the Japanese economy remains afflicted by a mild case of deflation.

Previous: 2.2% (month-on-month change)

Consensus:2.5%



Interest Rate Watch

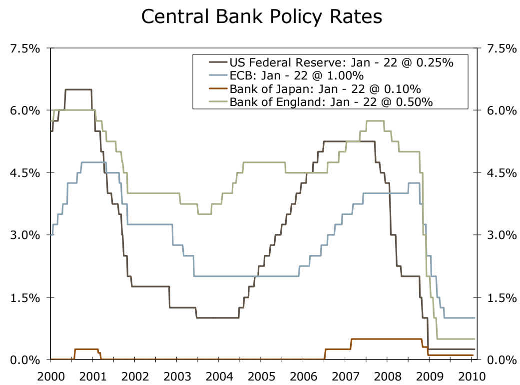
Still Waiting For Sustained Growth

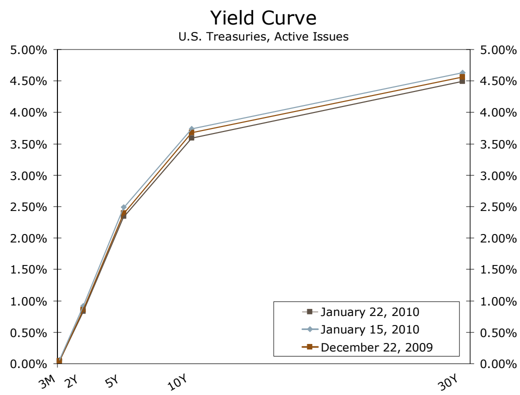
Next week's Federal Open Market Committee (FOMC) meeting will likely keep in place the Fed's current policy of a target federal funds rate at the 0-25 basis point range for an "extended period." This stance remains consistent with our most recent outlook which looks for the Fed to maintain its current policy at least through the first half of this year. Like our call, the consensus view remains that the Fed will hike rates by the end of the year.

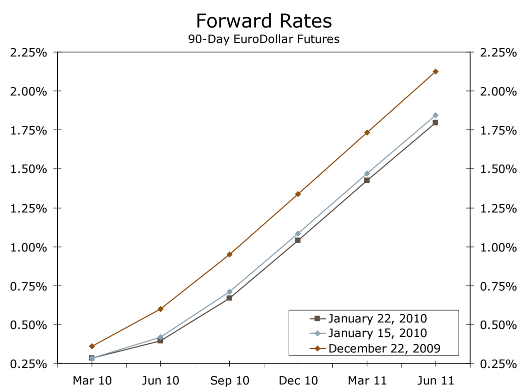
A couple factors continue to support the FOMC's position at this time. First, we agree with the FOMC that economic activity has "continued to pick up." In fact, we anticipate fourth quarter real GDP growth should exceed 5 percent given the inventory adjustment and better than expected holiday sales which helped lift total retail sales at a 7.0 percent annual rate in the fourth quarter. We also agree with the FOMC that household spending "appears to be expanding" and while ending the year on a soft note, the housing sector "has shown signs of improvement" as evidenced by the strong jump in December building permits.

Second, inflation, as expressed by the FOMC, "will remain subdued for some time" given its reason that "substantial" resource slack remains as indicated by "elevated" unemployment and low capacity utilization (which remains 10 percentage points below the long-term average). While we have recently lifted our inflation outlook based on our higher GDP forecast, we still believe the core personal consumption deflator, the Fed's favorite inflation measure, will remain below 2 percent next year while the unemployment rate will remain above 10 percent.

As the economic recovery proceeds and the Treasury Department continues to issue debt, interest rates should rise at the long end of the curve. We recently increased our 10-year Treasury yield forecast to 4.40 percent by year's end from the previous forecast of 3.60 percent. The real test for policy and the markets will be if/when the Fed ends mortgage-backed securities purchases currently scheduled for March 31st.







Consumer Credit Insights

FHA Makes Changes

Earlier this week, the Federal Housing Administration (FHA) announced a change in its lending requirements to tighten credit standards on what had been some of the easiest mortgages to qualify for with the lowest down payments in today's marketplace. While the FHA's role in the mortgage market had been minimized at the peak of the housing boom insuring just 3 percent of mortgage loans in 2007, today they have nearly a 30 percent market share. An FHA backed loan is one of the few options in the post subprime mortgage era for a low down payment loan. FHA loans require as little as 3.5 percent down. In exchange borrowers pay an upfront insurance premium and annual premiums to the FHA. Changes this week include an increase in the upfront insurance fee from 1.75 percent to 2.25 percent of the loan amount. In addition, borrowers with credit scores below 580 will no longer be eligible for the smallest down payment options. The FHA is also seeking to increase the annual premiums that borrowers are charged but will need Congressional approval. Just a few years ago changes to FHA requirements would have been of little consequence to the broader market with so few borrowers looking to the agency for credit. However, today with nearly 30 percent of the market, FHA changes could be far more influential. Still these changes are fairly minor and the long-term health, solvency and stability of the FHA warrant prudent risk management.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.99%	5.06%	5.05%	5.12%
15-Yr Fixed	4.40%	4.45%	4.45%	4.80%
5/1 ARM	4.27%	4.32%	4.40%	5.24%
1-Yr ARM	4.32%	4.39%	4.38%	4.92%
MBA Applications				
Composite	575.9	528.1	595.8	1,195.3
Purchase	223.0	213.7	213.3	303.1
Refinance	2,663.8	2,407.2	2,889.9	6,491.8

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

Topic of the Week

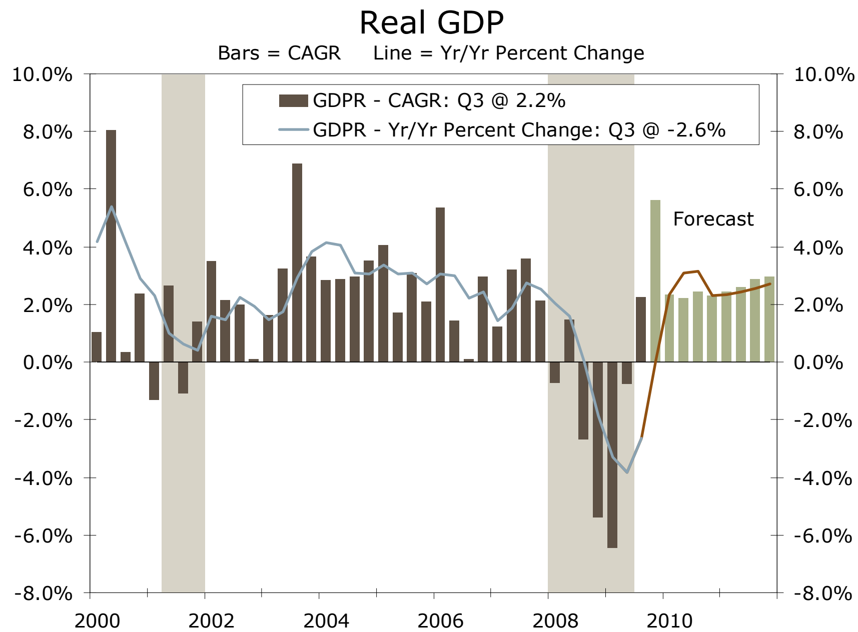
The Recovery that Looks Better than it Feels

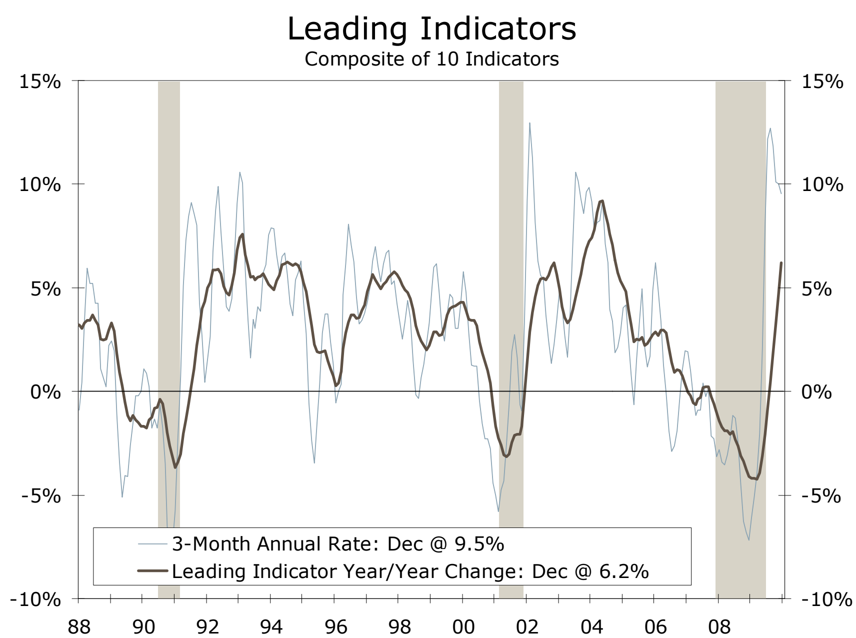
In public remarks made in September, Ben Bernanke said that "from a technical perspective the recession is very likely over at this point," but he also acknowledged, "it is still going to feel like a very weak economy for some time." Recent economic data certainly support the view that the recession is in the rear-view mirror. Third quarter real GDP was positive and our forecast looks for growth to pick up substantially on a sequential basis in the fourth quarter, registering a torrid pace of more than 5 percent. Meanwhile, forward-looking measures that portend how growth may take shape in the future are looking up as well. The Leading Economic Index (LEI) has posted gains in each of the last nine months, and the composite has already returned to pre-recession highs.

A blistering pace of growth in the fourth quarter, and a leading index that is all green lights for the road ahead must signal the "all clear," right? Not exactly. The growth in the fourth quarter is largely made possible by a slower pace of inventory liquidations which will add nearly 4 percentage points to real GDP growth in the fourth quarter. We are not seeing a huge spike in consumer spending, nor are we seeing businesses engaging in big business fixed investment spending. Businesses are not yet hiring in earnest either, which is the most troubling aspect of this recovery for the 10.0 percent of Americans who cannot find work.

Similarly, the gains in the LEI in recent months are more reflective of government efforts to kick start the economy (yield spread, increase in the money supply) than they are of strong domestic demand.

While GDP and LEI may seem to overstate the strength of the U.S. economy, recovery is gradually taking hold. A bottom seems to have formed in the residential construction sector, industrial production is picking up steam, the consumer is starting to loosen purse strings, and jobless claims are coming down on trend. While the recovery may look better than it feels, it is a recovery nonetheless. Our growth outlook: slow and steady.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates	Friday 1/22/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.04	0.05	0.10
3-Month LIBOR	0.25	0.25	1.16
1-Year Treasury	0.23	0.30	0.35
2-Year Treasury	0.83	0.86	0.72
5-Year Treasury	2.36	2.42	1.60
10-Year Treasury	3.61	3.67	2.59
30-Year Treasury	4.50	4.58	3.26
Bond Buyer Index	4.30	4.31	5.13

Foreign Exchange Rates	Friday 1/22/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.411	1.439	1.300
British Pound ($/£)	1.610	1.626	1.388
British Pound (£/€)	0.876	0.885	0.937
Japanese Yen (¥/$)	90.120	90.770	88.915
Canadian Dollar (C$/$)	1.057	1.029	1.255
Swiss Franc (CHF/$)	1.042	1.025	1.152
Australian Dollar (US$/A$)	0.902	0.923	0.655
Mexican Peso (MXN/$)	12.997	12.697	14.065
Chinese Yuan (CNY/$)	6.827	6.827	6.837
Indian Rupee (INR/$)	46.155	45.775	49.162
Brazilian Real (BRL/$)	1.828	1.772	2.321
U.S. Dollar Index	78.322	76.732	85.520

Foreign Interest Rates	Friday 1/22/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.61	0.63	2.25
3-Month Sterling LIBOR	0.61	0.61	2.20
3-Month Canadian LIBOR	0.45	0.45	1.52
3-Month Yen LIBOR	0.25	0.26	0.70
2-Year German	1.09	1.14	1.44
2-Year U.K.	1.23	1.21	1.46
2-Year Canadian	1.18	1.29	1.14
2-Year Japanese	0.17	0.17	0.37
10-Year German	3.19	3.26	3.11
10-Year U.K.	3.91	3.94	3.51
10-Year Canadian	3.39	3.50	2.76
10-Year Japanese	1.33	1.33	1.24

Commodity Prices	Friday 1/22/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	75.83	79.39	43.67
Gold ($/Ounce)	1089.63	1130.93	857.00
Hot-Rolled Steel ($/S.Ton)	545.00	505.00	475.00
Copper (¢/Pound)	328.50	338.75	141.90
Soybeans ($/Bushel)	9.37	9.73	10.06
Natural Gas ($/MMBTU)	5.75	5.59	4.68
Nickel ($/Metric Ton)	18,873	18,228	10,865
CRB Spot Inds.	494.90	496.69	336.24

Next Week's Economic Calendar

	Monday 25	Tuesday 26	Wednesday 27	Thursday 28	Friday 29
U.S. Data	**Existing Home Sales** November 6.54M December 5.4M (W)	**Consumer Confidence** December 52.9 January 54.4 (W)	**FOMC Rate Decision** Previous 0.25% Expected 0.25% (W) **New Home Sales** November 355K December 349K (W)	**Durable Goods Orders** November 0.2% December 1.1% (W) **Durables Ex Transp.** November 2.0% December 0.4% (W)	**GDP** 3Q 2.2% 4Q 5.6% (W) **Employm. Cost Index** 3Q 0.4% 4Q 0.3% (W)
Global Data		**UK** **GDP (QoQ)** Previous (3Q) -0.2% **Germany** **IFO-Business Climate** Previous (Dec) 94.7		**Gemany** **Unemployment Rate** Previous (Dec) 8.1%	**Japan** **Industrial Prod. (MoM)** Previous (Nov) 2.2% **Japan** **Jobless Rate** Previous (Nov) 5.2%

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

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