July 16, 2010

WELLS FARGO SECURITIES

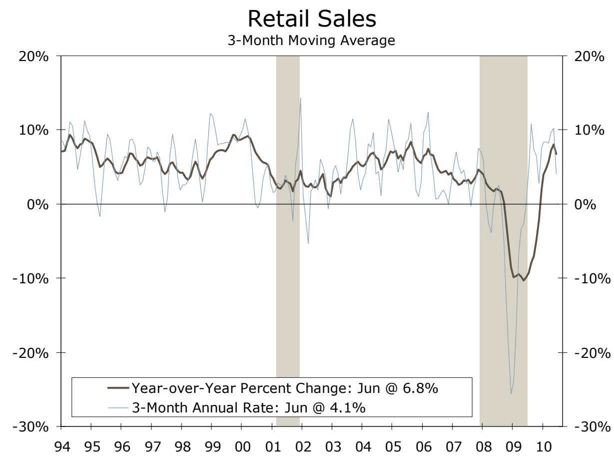
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Slower Growth, Low Inflation with Big Budget Deficits

- Retail sales and industrial production set the tone for the economic outlook as momentum has slowed to a three month pace of 4 percent compared to a 7 percent year-over-year gain. This slowdown outlook was reinforced by comments by the Federal Reserve.
- Inflation, meanwhile, measured by the Consumer Price Index, is now up just 1.1 percent over the past year. Substantial slack in the economy will likely continue to put downward pressure on core CPI inflation. Slow growth and low inflation suggests big federal fiscal budgets persist for the outlook horizon.



Global Review

Chinese Economy Starts to Slow

- After a sharp rebound, the year-over-year rate of GDP growth in China slowed in the second quarter relative to the first quarter. The lending restrictions that the government directed banks to take a few months ago appear to have had their desired effects.
- Although we look for further slowing in the quarters ahead, we do not look for a "hard landing" in China. Indeed, recent declines in equity and housing prices and benign inflation may cause the government to ease up on the brakes somewhat.

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

Inside

U.S. Review

Moderate Paced Recovery with Low Inflation

A Dose of Reality from the Fed: *Participants generally anticipated that, in light of the severity of the economic downturn, it would take some time for the economy to converge fully to its longer-run path as characterized by sustainable rates of output growth, unemployment, and inflation consistent with participants' interpretation of the Federal Reserve's dual objectives; most expected the convergence process to take no more than five to six years.*

Recent data suggest economic momentum has slowed. Retail sales slowed to a three-month pace of 4 percent compared to a 7 percent year-over-year gain. This slowdown was reinforced by comments made by the Federal Reserve at the June meeting. The Fed suggested that the economic recovery was proceeding at a moderate pace in the second quarter but that the unemployment rate remained elevated. Yet, aggregate hours worked by employees on private nonfarm payrolls rose substantially through May suggesting continued forward momentum.

Reinforcing the Fed's view, industrial production figures this week indicated moderation over the past three months especially for consumer goods including autos. In contrast, business equipment production, including computer and electronic products, remains solid. Exports, business inventory rebuilding and the longer-run imperative of global competition have provided forward momentum to industrial production. Our July outlook is for 1-2 percent growth in GDP in the second half of 2012, with positive contributions from consumer spending, business equipment investment and government purchases.

Inflation: CPI Moderation at a Low Level

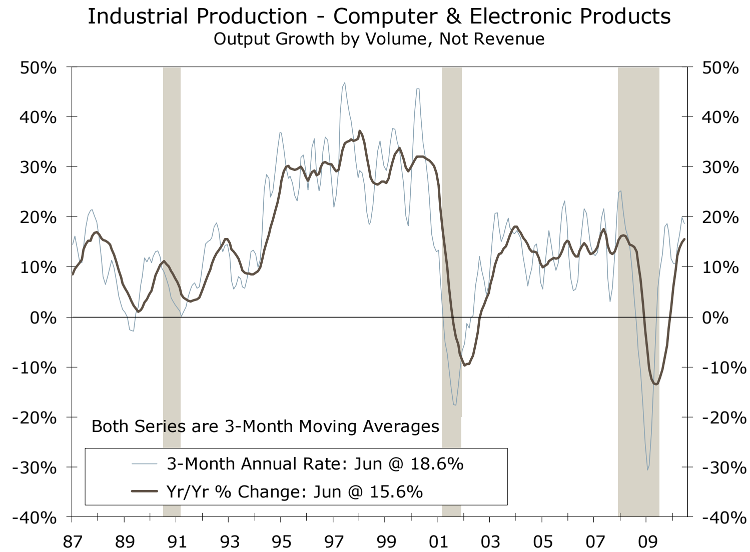
On the inflation front, falling energy prices held down headline consumer prices in June, with overall CPI now at 1.1 percent year over year, while core consumer prices are at just 0.9 percent.

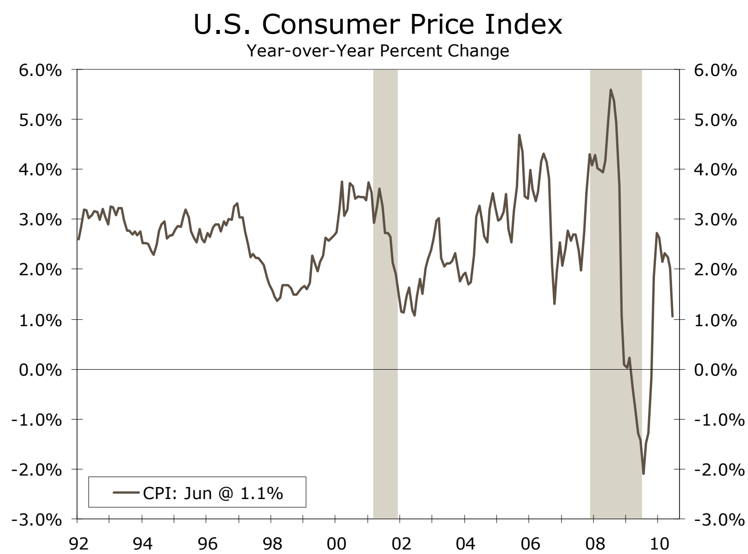
Fed: *Nonetheless, the possibility that inflation expectations might start to decline in response to persistently low levels of actual inflation and the potential effects of continued weakness of the economy on price trends were seen by a few participants as posing some downside risks to the inflation outlook.*

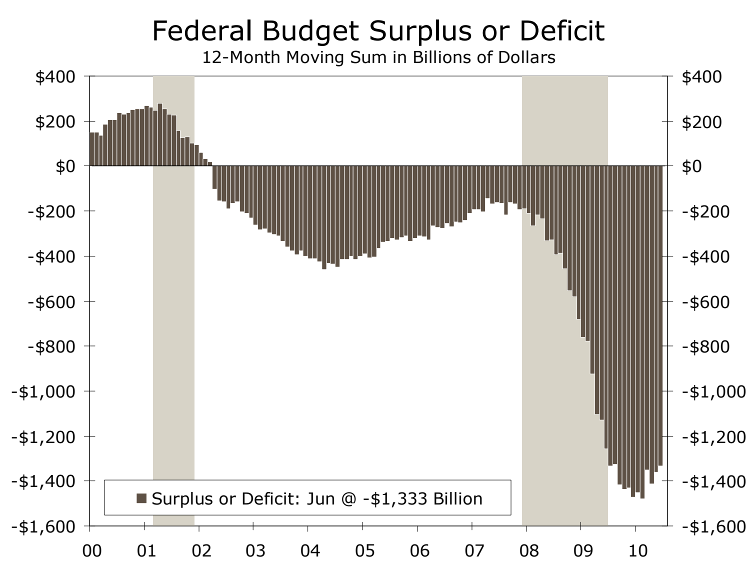
Clearly there is little pricing power for suppliers as it appears that keeping market share is the driving force. Our July outlook is for overall CPI to stay in the 1 percent range for the rest of this year.

The Federal Budget Outlook and Our Foreign Friends

The fiscal year-to-date deficit reached more than $1.0 trillion in June, and we estimate the deficit-to-GDP ratio will finish this year above 9 percent. The slight reduction of the deficits in recent months has been due to better economic growth so the recent slowdown in growth expectations is a negative signal for the deficit moving into the next fiscal year. Our outlook is for fiscal deficits to come in at $1.3 trillion on average for fiscal 2010 and 2011. Ominously, net foreign purchases of Treasury bonds and notes fell in May. Foreign official purchases of short-term securities also declined.







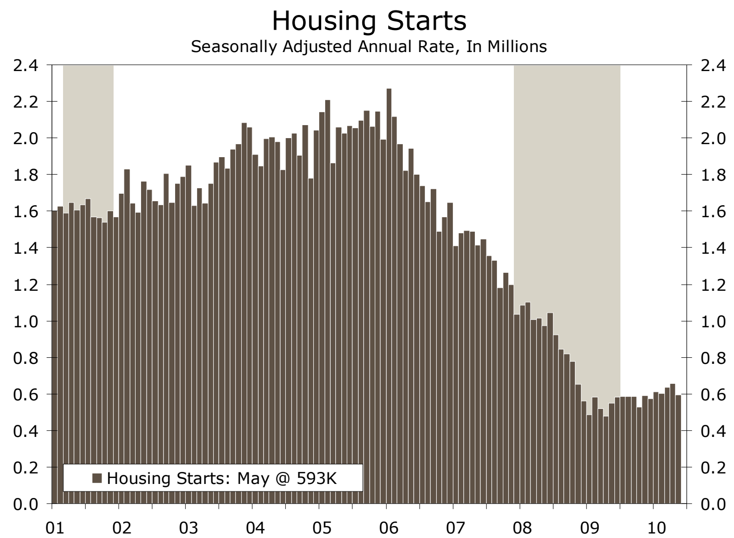
Housing Starts • Tuesday

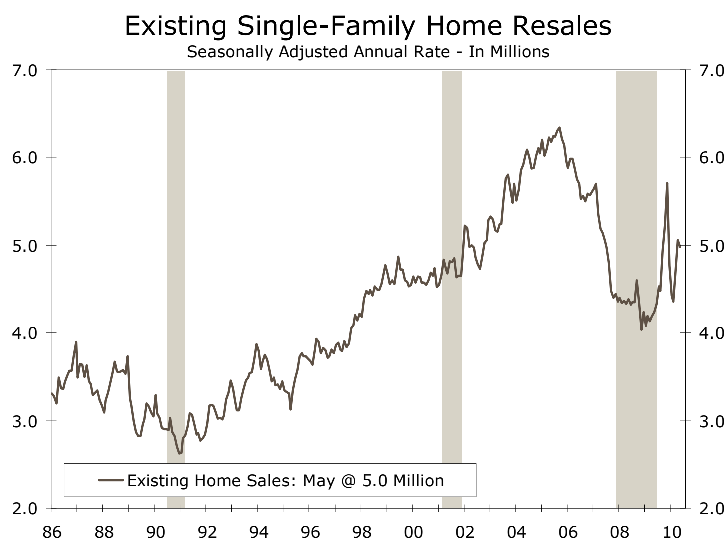
Housing starts are expected to remain within the range that has been maintained since the beginning of 2009. The market still has an oversupply of homes, and builders do not yet have a reason to add to it—demand is still soft, particularly in the wake of the first-time homebuyers' tax credit. The pullback seen in May could continue in June as sales have been extremely weak without government support, making builders exceptionally cautious.

The dismal labor market has also weighed on demand. Our expectation that the housing industry will be in the doldrums for some time was confirmed in May's reading of building permits, down 9.9 percent, and we anticipate weakness continued in June. Residential construction will likely detract from third quarter GDP growth.

Previous: 593K **Wells Fargo: 580K**

Consensus: 581K





Existing Home Sales • Thursday

Existing home sales turned in a 2.2 percent decline in May, and we expect another weak result in June. The expiration of the first-time homebuyers' tax credit means that demand will be determined in the market without government influence for the first time in months. However, the effect of the tax credit was to pull demand forward for eligible buyers, so underlying demand is likely even lower than it otherwise would have been without the tax credit. The market will likely spend the summer finding its new sales pace, and our expectations are quite low.

Low mortgage rates are a bright spot for the housing market, which may entice certain buyers into the market; however, stricter lending standards limit the pool of qualified buyers.

Previous: 5.66M **Wells Fargo: 4.85M**

Consensus: 5.20M

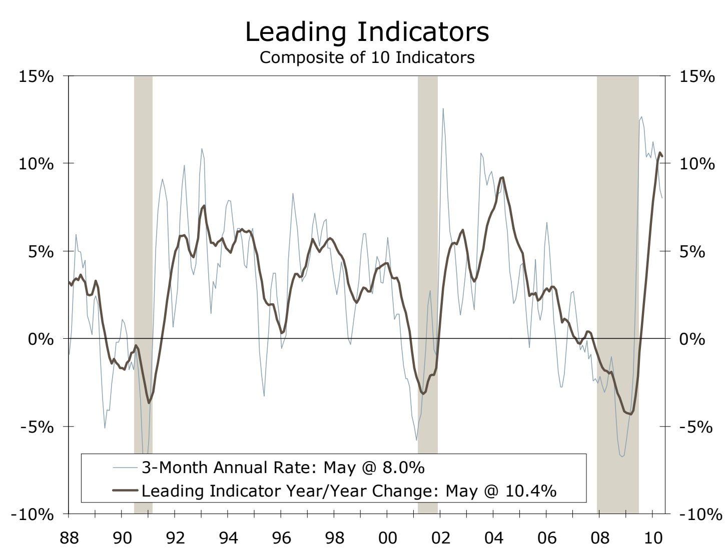
Leading Economic Index • Thursday

Despite a steady string of positive readings since March 2009, it appears that the run has ended for the Leading Economic Index. We expect a slight drop to -0.1 percent, though the swing variable could very well be the building permits number, which prints on July 20 and is an important component of the index.

Slowing supplier deliveries, as seen in many recent surveys of the factory sector, as well as weakness in stocks in the month of June will detract from the index. The disappointing labor market, which has become a motif of late, will also weigh on the headline. While the leading index is paring its recent gains, we do not anticipate a double-dip recession; instead, a slower pace of growth in the second half is the most likely outcome.

Previous: 0.4% **Wells Fargo: -0.1%**

Consensus: -0.3%



Global Review

Chinese Economy Starts to Slow

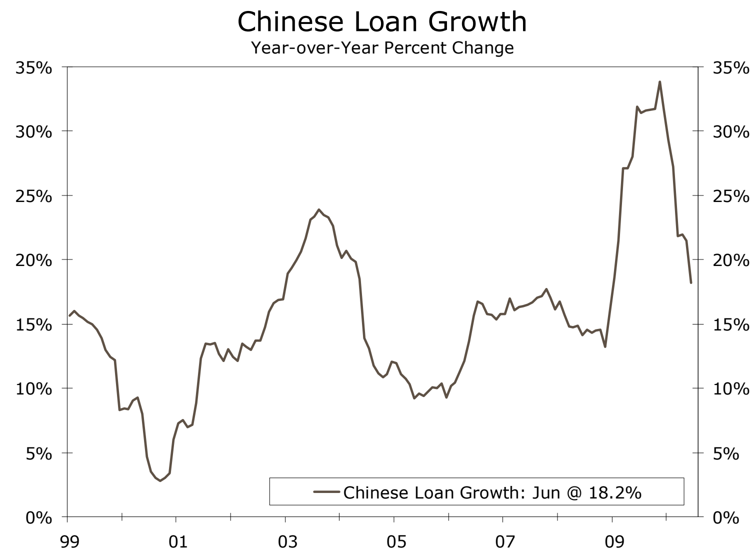
Recent data show that real GDP growth in China slowed to 10.3 percent in the second quarter from 11.1 percent in the first quarter of 2010 (see graph on front page). Some of the slowdown in the year-over-year rate of economic growth reflects base effects. The first quarter of 2009 marked the nadir of the global downturn, making a strong year-over-year growth rate in the first quarter of this year easy to achieve. That said, it appears that economic growth slowed on a sequential basis as well in the second quarter due, at least in part, to a deliberate attempt by authorities to take some steam out of the economy.

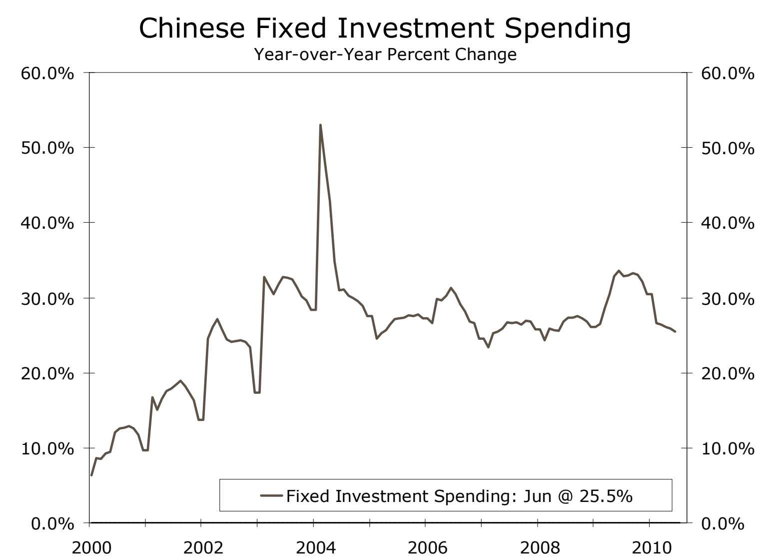
In the midst of the global downturn, Chinese officials encouraged banks to ramp up lending in order to support the domestic economy. When it became apparent earlier this year that the global economy was on the mend, China no longer needed economic stimulation. Indeed, sharp rises in house prices in some cities indicated that tighter economic policies were appropriate. Therefore, the government directed banks to rein in lending and a sharp slowdown in loan growth ensued (top chart). The directives were largely targeted at excessive real estate investment, and the recent slowdown in fixed-investment spending suggests that the measures are having their desired effects (middle chart). In that regard, growth in the value of construction spending edged down in the second quarter and further deceleration seems likely.

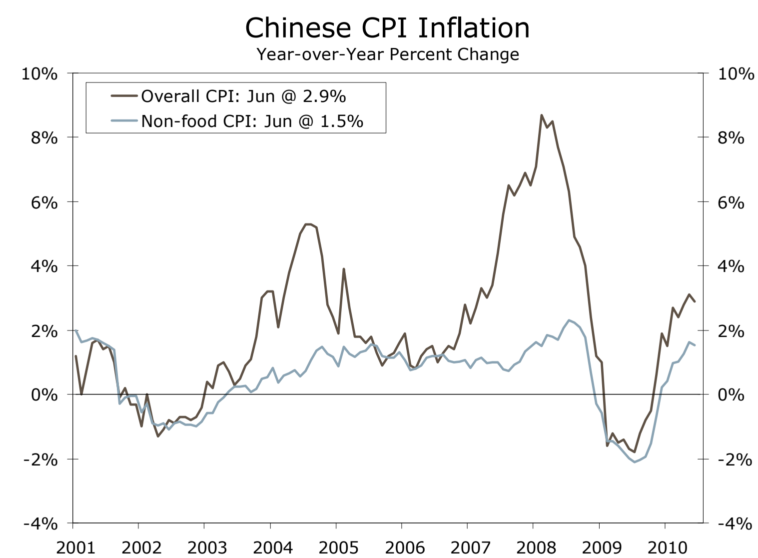
Is the Chinese economy destined for a "hard landing"? Probably not. Outside of the construction sector there are few apparent signs of significant slowing, at least not yet. The year-over-year growth rate in retail spending continues to clip along around 18 percent, and export growth picked up to 40 percent in the second quarter from 30 percent in the first quarter. Although we expect export growth to slow in coming quarters, another downturn in exports seems unlikely unless the global economy falls back into a recession, which we do not expect.

Moreover, the recent behavior of prices, both in terms of assets and goods and services, means that the government may be able to somewhat ease up on the brakes. The stock market (as measured by the Shanghai Composite index) is off about 25 percent since mid-April, and the widely followed 70-city index of house prices edged down in June for the first time in more than a year. In addition, the year-over-year rate of CPI inflation declined to 2.9 percent in June from 3.2 percent in May (bottom chart). Although deceleration in food prices contributed to the decline in the overall rate of CPI inflation, non-food price inflation also edged lower in June. In other words, there is less evidence today to support the view that the Chinese economy is overheating than there was a few months ago.

Although the government may ease up on the brakes somewhat in terms of monetary policy, we expect its renewed willingness to allow some flexibility in the exchange rate to continue. The currency strategy group projects that the dollar will weaken about 5 percent versus the renminbi over the next 12 months or so.







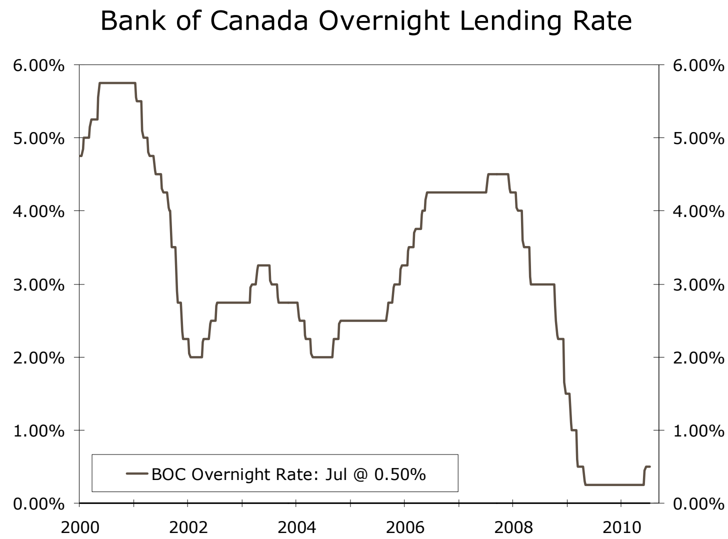
Bank of Canada Policy Meeting • Tuesday

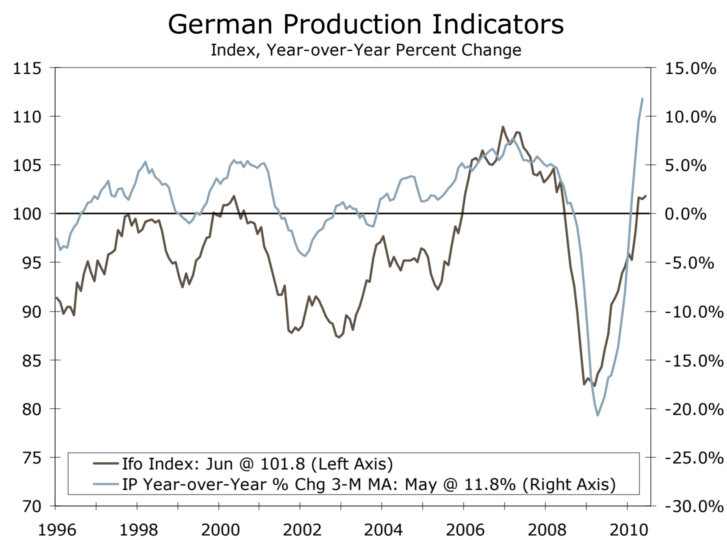
At its policy meeting on June 1, the Bank of Canada (BoC) raised its target for the overnight lending rate to 0.50 percent from 0.25 percent, the first rate hike in nearly three years. In its statement announcing the rate hike, the BoC noted that "considerable monetary stimulus" is still in place. Given the recent strength in the labor market, we concur with the consensus forecast that the BoC will hike rates by another 25 bps.

Data on retail sales in May and CPI inflation in June will also be released next week, but the BoC probably won't have the luxury of seeing the data before its rate decision. Retail sales are expected to have bounced back in May from their unexpected decline in April, and CPI inflation should remain benign. That said, inflation could rise over the medium term if abnormally low interest rates excessively stimulate the economy.

Current Rate: 0.50 percent **Wells Fargo: 0.75 percent**

Consensus: 0.75 percent





German Ifo Index • Friday

It appears that industrial production (IP) in Germany strengthened considerably in the second quarter. Indeed, IP in the April/May period shot up nearly 5 percent relative to the first quarter, and the high level of the Ifo index in June suggests that IP remained solid during the final month of the second quarter. The Ifo index for July will offer investors some insights into the state of the German economy thus far in the third quarter.

Elsewhere in the Euro-zone, data on French consumer confidence and consumer spending are slated for release next week as well. Italy prints data on industrial orders and sales, consumer confidence, and retail sales. The "flash" estimates of the Euro-zone manufacturing and service sector PMIs are also on the docket next week.

Previous: 101.8

Consensus: 101.5

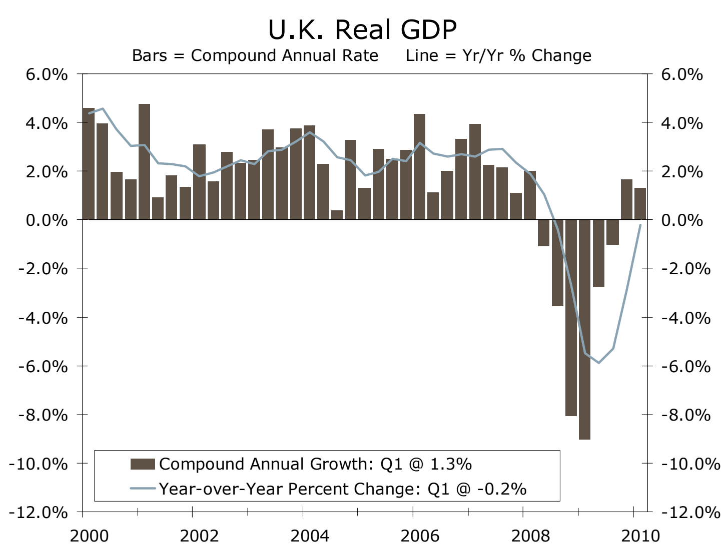
British GDP • Friday

Positive growth has returned to the U.K. economy, but the rate of recovery has been slow, at least through the first quarter. However, monthly indicators suggest that growth strengthened somewhat in the second quarter. For example, industrial production in the April/May period was up 1.1 percent relative to the first quarter. Therefore, most analysts, including us, look for an increase in the rate of GDP growth when the figures for the second quarter print on Friday.

Other data released earlier in the week will give investors further insights into the state of the British economy at present. A widely-followed business survey will shed some light on business sentiment, and retail sales data will show how consumer spending fared in June.

Previous: 0.3% (not annualized) **Wells Fargo: 0.5%**

Consensus: 0.5%



Interest Rate Watch

FOMC Provides Guidance

Like a good corporate investor relations head, the FOMC has given us guidance on interest rates and, like a good equity analyst, we pay attention.

The FOMC modestly lowered its projection for growth and inflation for the next two years. Growth in 2010 is now at 3.0-3.5 percent, which is slightly above our number. The FOMC cited tighter financial conditions resulting from spillover effects from Europe, while we would add that housing is not bouncing back as some expected after the first-time homebuyers' tax credit was discontinued. Unemployment also has been higher than the FOMC expected. We expect unemployment rates to stay in the 9.5 percent plus range this year. The FOMC also lowered its inflation outlook for core PCE prices for 2010 and 2011 as well.

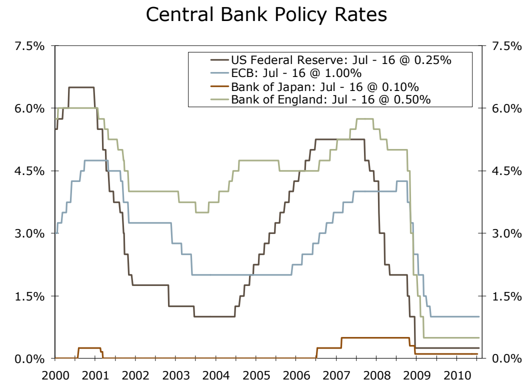
Downside risk to the outlook for inflation was also discussed and the risk of deflation was cited by a few (more than one) participants.

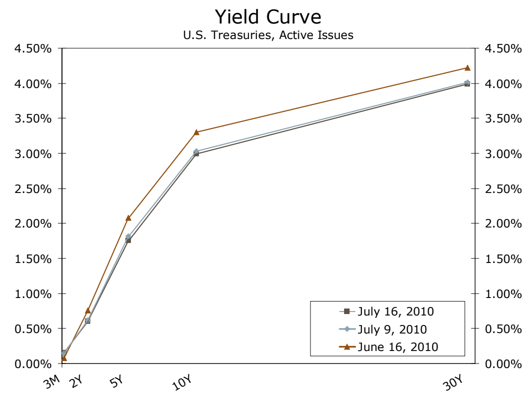
Given such guidance, our expectation is that the FOMC is unlikely to move the funds rate this year or through the first quarter of next year. Only some upside growth/inflation surprise is likely to get any movement.

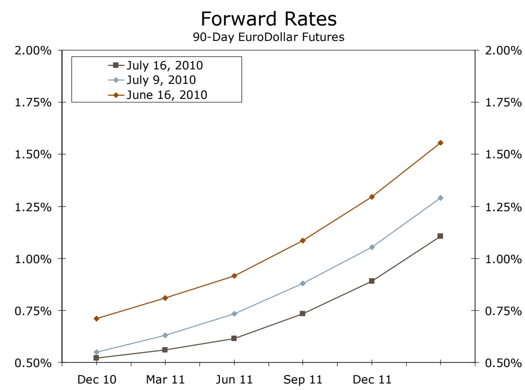
Long Rates: Growth, Inflation, the Euro and Federal Deficits

Meanwhile our expectations are for five- and 10-year Treasury rates to remain around the 2 and 3 percent levels for the rest of this year. Two big positives for Treasury rates this year have been less than consensus expectations for both growth and inflation. Throw in a little flight-to-safety from the Euro and you get lower Treasury yields.

Risk remains in the large fiscal deficits and the dependence of the United States on foreign investors. As reported earlier this week, foreign demand for long-term U.S. assets fell in May as net purchases of Treasury bonds and notes fell significantly. Growth and inflation dominate but the delicate financing balance remains a concern.







Consumer Credit Insights

An Increasingly Bifurcated Economy

This week, FICO reported that as of April, 25.5 percent of consumers now have a credit score of 599 or below, a significant jump from the pre-recession average of 15.0 percent. On the other hand, the share with a score of 800 or higher has risen to 17.9 percent versus a pre-recession average of 13.0 percent. The ranks of those with moderate credit scores between 650 and 699 have dropped to 11.9 percent from a pre-recession average of 15.0 percent. The reasons for the increase in the lower credit score range are numerous, including over-indebtedness, missed payments, job losses and foreclosures. But what accounts for the increase in the top score range? Those individuals who are lucky enough to have a job are likely putting more of their income toward paying down debt. Similarly, those who are lucky enough to still have equity in their homes are refinancing at record-low mortgage rates. Both of these actions can help to improve credit scores by either reducing debt or debt service burdens. This speaks to a bifurcated economy, one where those who are doing well are getting really good deals and shoring up their balance sheets, while those who are already going through difficult times are finding things getting even worse. With credit conditions tight across the economy, even those with good credit are still finding it challenging to get a loan, while those with bad credit are finding credit nearly impossible to obtain. This imbalance between supply and demand does not bode well for lenders.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.57%	4.57%	4.75%	5.14%
15-Yr Fixed	4.06%	4.07%	4.20%	4.63%
5/1 ARM	3.85%	3.75%	3.89%	4.83%
1-Yr ARM	3.74%	3.75%	3.82%	4.76%
MBA Applications				
Composite	700.3	721.5	659.9	514.4
Purchase	163.3	168.6	180.0	258.8
Refinance	3,831.2	3,944.6	3,461.5	2,009.4

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

Topic of the Week

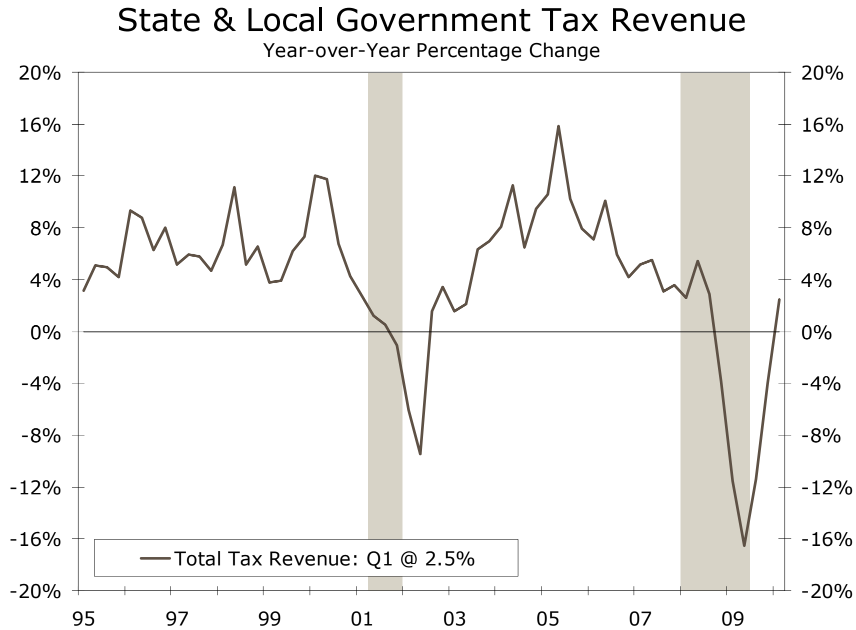
States struggle to balance budgets

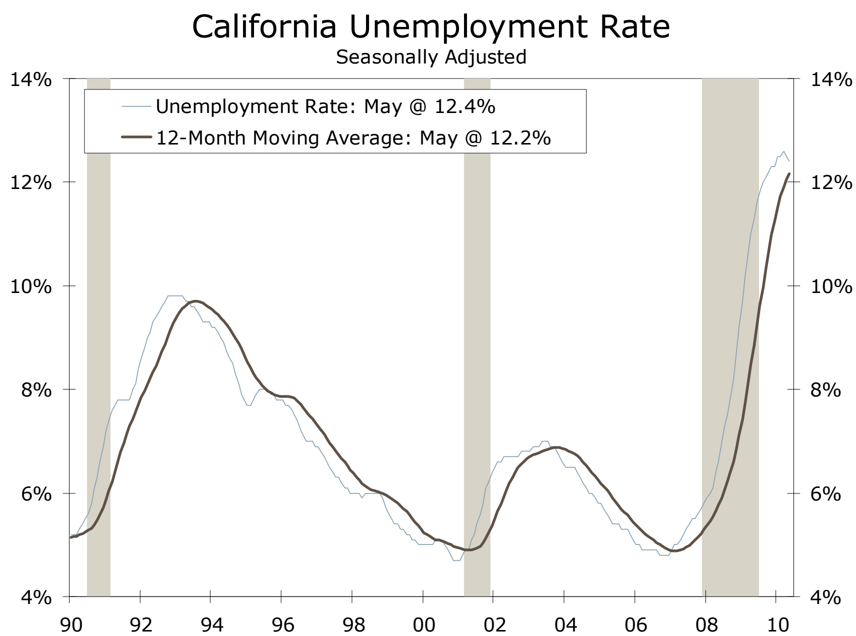
July 1 marked the beginning of fiscal-year 2011 for most states, and state officials are faced with tough decisions concerning their budgets. Slow economic growth coupled with the legal obligation to balance budgets forces states to continue to raise taxes and/or cut spending.

Record high unemployment levels have increased demand for state spending as more people qualify for assistance programs. States have projected total budget deficits of $127 billion in 2011. While less than the shortfalls of the past two years, this deficit will prove more difficult to close. Under the stimulus program enacted in 2009, the federal government was able to plug 30-40 percent of state budget shortfalls in 2009 and 2010. However, the funding will run out in December and Congress has yet to show any signs of extending assistance.

Two states facing significant financial woes, Arizona and California, show that states are looking to make considerable spending cuts. Arizona projects a structured shortfall of $1.69 billion. The budget solution consists of a 26 percent reduction in spending, cutting back on temporary cash assistance eligibility, as well as Medicaid services for more than 1 million Arizonans. The state imposed a 1.1 percent rise in the sales tax rate, creating the expectation of a 4.3 percent rise in base revenues. However, the boycotts some cities are calling against Arizona over its immigration laws may impact tourism and lead to lower-than-expected fiscal revenues.

Last year, California was able to close its budget gap of $60 billion, draining most of its rainy day fund, yet the state faces a $19.1 billion gap again this year. To help close the gap, California will reduce expenditures by $12.4 billion. Still facing unprecedented unemployment levels of 12.4 percent, California is looking at a rough road ahead. The cuts in state spending will continue to counterweight the federal stimulus and place a drag on the slow growing economy.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 7/16/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.15	0.15	0.17
3-Month LIBOR	0.52	0.53	0.51
1-Year Treasury	0.35	0.03	0.46
2-Year Treasury	0.58	0.63	0.98
5-Year Treasury	1.69	1.84	2.45
10-Year Treasury	2.94	3.05	3.57
30-Year Treasury	3.95	4.04	4.45
Bond Buyer Index	4.37	4.36	4.68

Foreign Exchange Rates

	Friday 7/16/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.293	1.264	1.415
British Pound ($/£)	1.533	1.506	1.644
British Pound (£/€)	0.844	0.839	0.861
Japanese Yen (¥/$)	86.370	88.620	93.930
Canadian Dollar (C$/$)	1.055	1.034	1.117
Swiss Franc (CHF/$)	1.046	1.058	1.073
Australian Dollar (US$/A$)	0.872	0.878	0.806
Mexican Peso (MXN/$)	12.876	12.769	13.551
Chinese Yuan (CNY/$)	6.775	6.773	6.831
Indian Rupee (INR/$)	46.773	46.664	48.703
Brazilian Real (BRL/$)	1.778	1.755	1.932
U.S. Dollar Index	82.439	83.947	79.216

Foreign Interest Rates

	Friday 7/16/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.79	0.76	0.96
3-Month Sterling LIBOR	0.73	0.73	0.97
3-Month Canadian LIBOR	0.88	0.85	0.60
3-Month Yen LIBOR	0.24	0.25	0.43
2-Year German	0.78	0.77	1.22
2-Year U.K.	0.76	0.74	1.13
2-Year Canadian	1.61	1.72	1.21
2-Year Japanese	0.15	0.15	0.27
10-Year German	2.61	2.63	3.34
10-Year U.K.	3.35	3.33	3.77
10-Year Canadian	3.19	3.23	3.43
10-Year Japanese	1.10	1.16	1.34

Commodity Prices

	Friday 7/16/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	75.71	76.09	62.02
Gold ($/Ounce)	1192.80	1211.60	937.34
Hot-Rolled Steel ($/S.Ton)	625.00	625.00	405.00
Copper (¢/Pound)	293.50	304.45	238.00
Soybeans ($/Bushel)	10.27	10.01	10.56
Natural Gas ($/MMBTU)	4.57	4.40	3.67
Nickel ($/Metric Ton)	19,336	19,343	15,861
CRB Spot Inds.	471.29	472.21	406.40

Next Week's Economic Calendar

	Monday 19	Tuesday 20	Wednesday 21	Thursday 22	Friday 23
U.S. Data		**Housing Starts** May 593K June 580K (W)		**Leading Indicators** May 0.4% June -0.1% (W) **Existing Home sales** May 5.66M June 4.85M (W)	
Global Data		**Canada** **Bank of Canada Rate** Previous 0.50% **Italy** **Indus. Orders (MoM)** Previous (Apr) 4.7%		**U.K.** **Retail Ex Auto Fuel** Previous (May) 0.5% **France** **Business Confidence** Previous (Jun) 95	**U.K.** **GDP (QoQ)** Previous (1Q) 0.3% **Germany** **IFO-Business Climate** Previous (Jun) 101.8

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

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