July 23, 2010

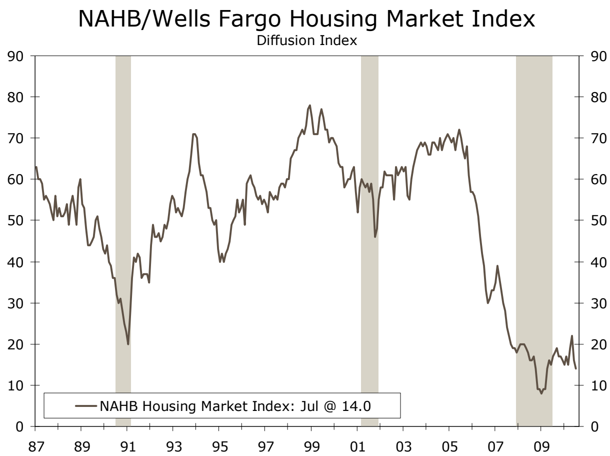
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Home Is Where the Economy's Heart Is

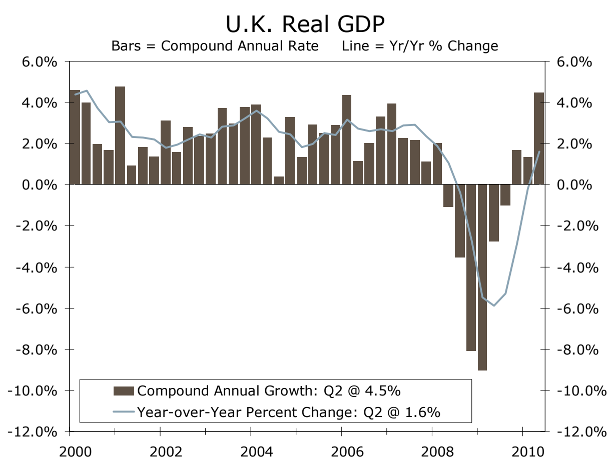
- Housing starts and existing home sales declined in June, reflecting the winding down of homebuyer tax credits.
- Building confidence fell to 14 in July, and June's numbers were revised down slightly.
- The effect from the unwinding of various economic stimulus programs is evident in other data, with the leading indicators declining 0.2 percent and weekly first-time unemployment claims bouncing back to 464,000.
- Bernanke's midyear report to Congress outlined possible future steps the Fed may take to boost economic growth.



Global Review

U.K. Economy Breaks into a Sprint, but Will It Last?

- The U.K. became the first major economy to report GDP growth for the second quarter. Expectations were blown away as growth expanded at the fastest clip in nearly a decade. But, given the fiscal deficit problems and upcoming cuts in government spending, does the U.K. economy really have the legs to keep up this pace?
- Fiscal tightening is not the only concern in the United Kingdom. The overall rate of CPI inflation is well above the Bank of England's target of 2 percent, and the January increase in the value-added tax complicates the outlook for inflation.



Inside

Wells Fargo U.S. Economic Forecast

	Actual 2009 1Q	2Q	3Q	4Q	Forecast 2010 1Q	2Q	3Q	4Q	Actual 2006	2007	2008	2009	Forecast 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

U.S. Review

We Have Got to Get in Shape

If the state of the nation's housing market is at the center of the economy's near-term prospects, then we have got to get in shape. Nearly all of the major housing indicators reported this past week showed more weakness than was widely expected, suggesting that the payback from the homebuyer tax credit program will be a bit deeper and longer lasting than many had hoped. One of the most disconcerting pieces of news was housing starts, which fell 5 percent in June, following a downwardly revised 14.9 percent drop in May. A slight 2.1 percent rise in building permits initially took some of the sting out of the headline number, but all of that gain was in the volatile multi-family unit series. Permits for new single-family homes fell 3.4 percent, following 10.3 percent drops in both May and April

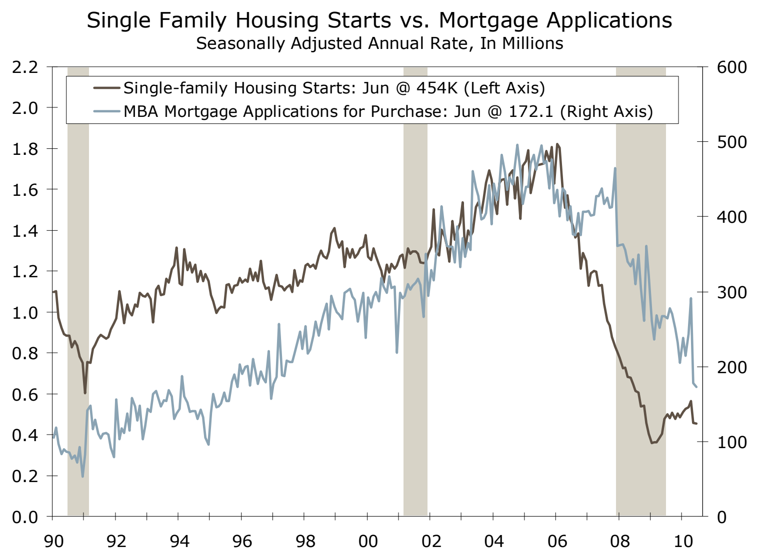
Single-family permits are now running at just a 421,000-unit pace, well below the recent trend in starts. When you couple this with July's decline in the Wells Fargo/NAHB homebuilders' index, there is no reason to expect housing starts to increase in July, and we may not see a gain in August either. With demand flat and credit for homebuilders still extremely tight, there is no incentive for builders to get out ahead of demand.

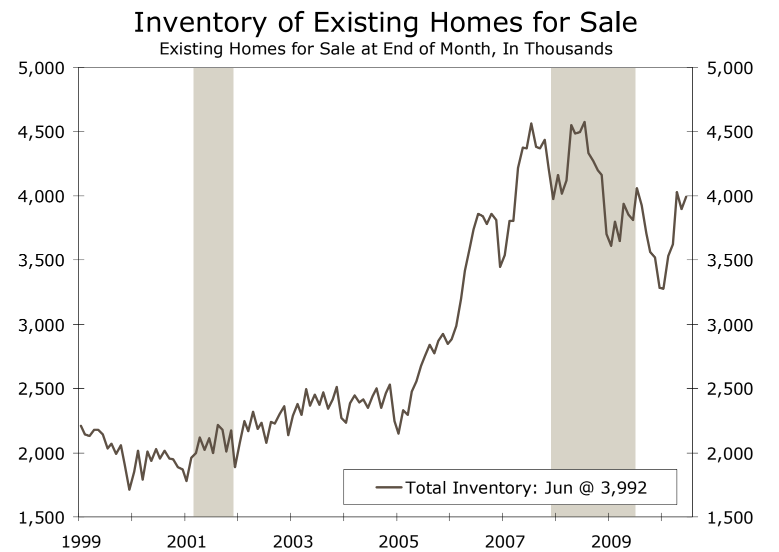
Existing home sales actually fell less that expected, but the trend remains unfavorable. Existing home sales have been harder to read because of the extension of the closing deadline for homebuyer tax credits from June 30 to September 30. The net effect of the deadline extension will be to moderate the slide in existing home sales over the new few months.

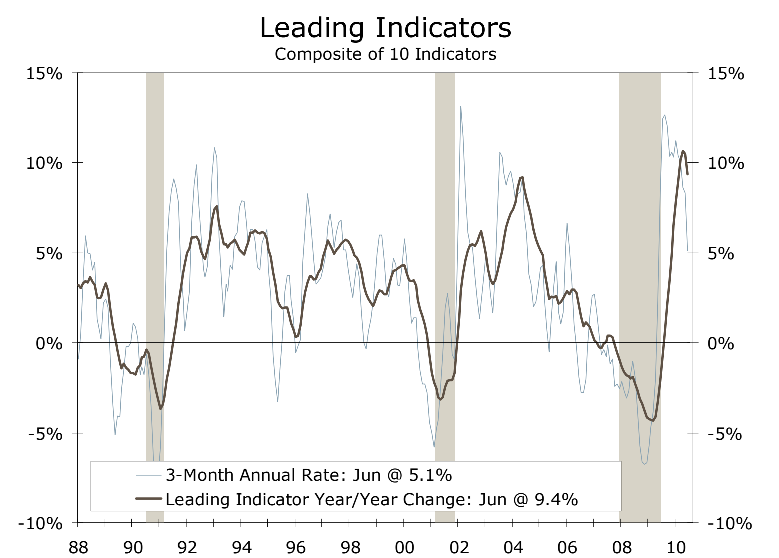
The latest data from the National Association of Realtors (NAR) shows that first-time homebuyers accounted for 43 percent of home sales, about the same as the prior month. Distressed transactions, which include foreclosures and short sales, accounted for 32 percent of existing home sales in June, and investor purchases accounted for 13 percent. One of the more worrisome aspects of the report is that the number of homes on the market increased in June and remains relatively high. There is currently a 10.6-month supply of condominiums on the market and 8.7-month supply of single-family homes.

There were also a couple of pieces of encouraging news. The median price of an existing home rose 1.0 percent from last June to $183,700. The NAR also noted that home prices rose in 10 of the 19 MSAs that report monthly, and sales increased in 12 of those 19 areas. In addition, mortgage applications for the purchase of a home rose 3.4 percent, as the lowest mortgage rates on record are beginning to pull some buyers back into the market.

Fed Chairman Bernanke delivered his midyear report to Congress this week and basically reiterated the forecast released in the minutes of the June FOMC meeting. The markets were initially bewildered that the Fed chairman did not focus more on the deterioration in economic activity and growth prospects that has occurred since that forecast was put together. He redeemed himself, however, by focusing on what steps the Fed could take to further stimulate economic activity.

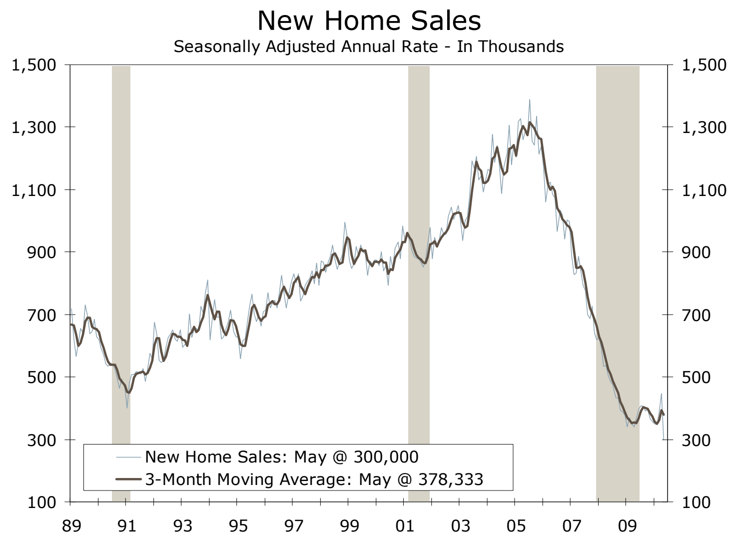






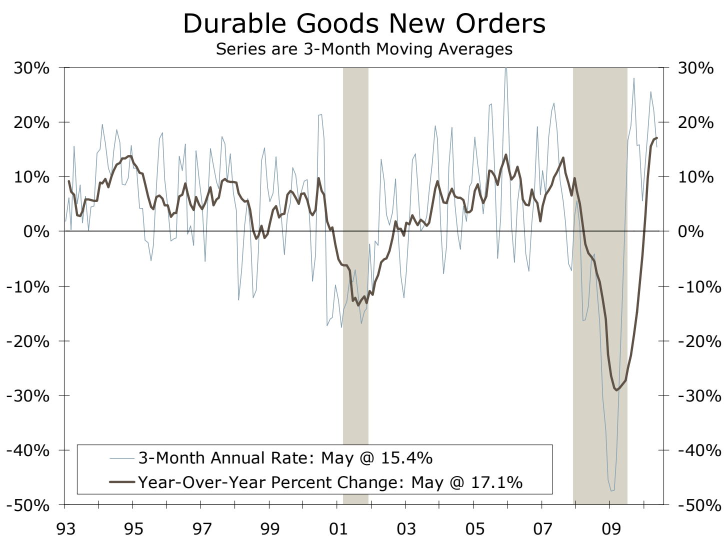
New Home Sales • Monday

Giving back two months of solid gains, new home sales plummeted 32.7 percent in May to a 300,000-unit pace, the lowest level on record. Demand for new homes was pulled forward due to the homebuyers' tax credit, which required buyers to sign a contract by April 30. With mortgage applications for purchase declining 14.8 percent in June, we expect at least one more month of payback. New home sales will likely fall 3.3 percent in June to a 290,000-unit pace, setting a new record low. Moreover, the downward trend in other indicators such as builder sentiment, permits, and starts continue to suggest weakness in the housing market. With new home sales at such depressed levels, a modest recovery in sales could be imminent following the tax credit payback, but any rebound in housing will likely be painfully slow.



Previous: 300K **Wells Fargo: 290K**

Consensus: 320K



Durable Goods • Wednesday

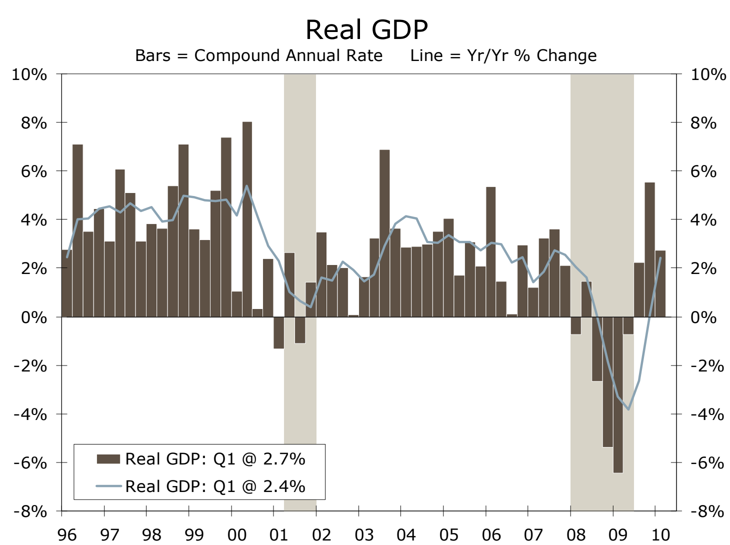
Advance orders for durable goods fell 1.1 percent in May, driven largely by a 29.6 percent drop in nondefense aircraft orders. The decline in aircraft bookings was mostly payback from a 215.7 percent surge in April. The underlying components of the report were far more sanguine than the headline suggested, with machinery, primary metals and computers and electronics bookings all increasing on the month. New orders excluding the volatile transportation sector were up 0.9 percent in May and will likely continue to improve in coming months, but at a modest pace. Moderating its positive momentum, the ISM manufacturing index pulled back for the second consecutive month in June, likely suggesting slower manufacturing activity in the second half of the year. We expect headline durable goods to increase 1.2 percent in June, with orders excluding transportation rising 0.8 percent.

Previous: -1.1% **Wells Fargo: 1.2%**

Consensus: 0.8%

GDP • Friday

The economic recovery that likely began a little more than a year ago is beginning to lose momentum. Much of the slowdown can be attributed to the fading of fiscal stimulus programs and the ending of the inventory cycle. Moreover, recently released economic data on retail sales and foreign trade also suggest the economic recovery is moderating. Core retail sales, which excludes auto dealers, gasoline stations and building material stores, rose only 0.2 percent in June and posted negative readings in April and May. This component of retail sales closely parallels personal consumption and suggests another quarter of weak consumer demand. International trade could also weigh down economic growth. The trade deficit widened in May and may shave 1.0 percentage point from second quarter GDP growth. Consequently, we expect real GDP likely grew at a 2.4 percent pace in the second quarter.



Previous: 2.7% **Wells Fargo: 2.4%**

Consensus: 2.5%

Global Review

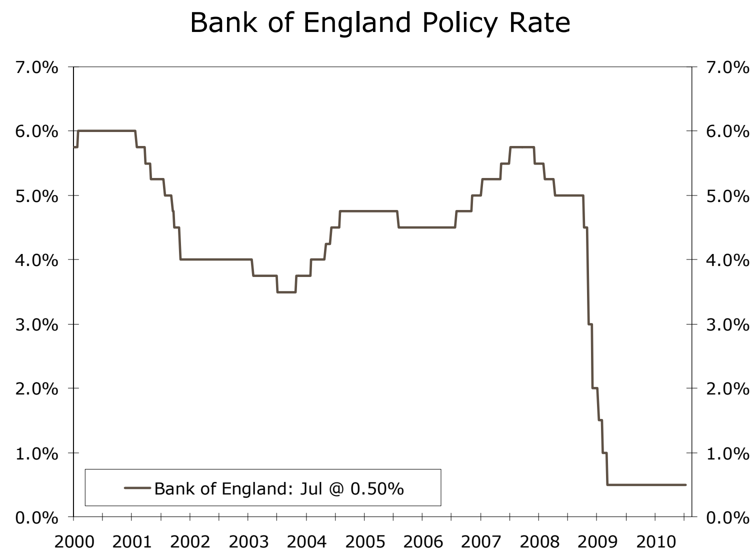
Strong Growth Will Face Headwinds in the U.K.

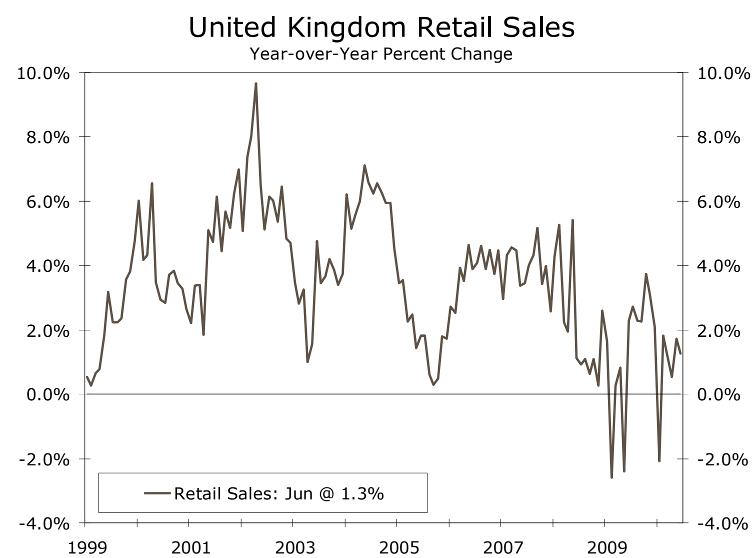
During the global recession, the U.K. economy was among the hardest hit in terms of major developed economies, with real GDP falling more than 6 percent. Since then, a tepid recovery has taken hold and, until very recently, sequential economic growth has been weak even with the benefit of low base effects. But developments in the United Kingdom this week including a decent retail sales report and a stellar GDP print for the second quarter might seem to suggest something different. Is the U.K. economy finally catching the wind in its sails? Unfortunately, we suspect the sequential growth rate in the second quarter will likely be the high-water mark for the next several quarters and the expansion will slow somewhat as fiscal tightening and deficit reduction programs sap economic growth in coming quarters.

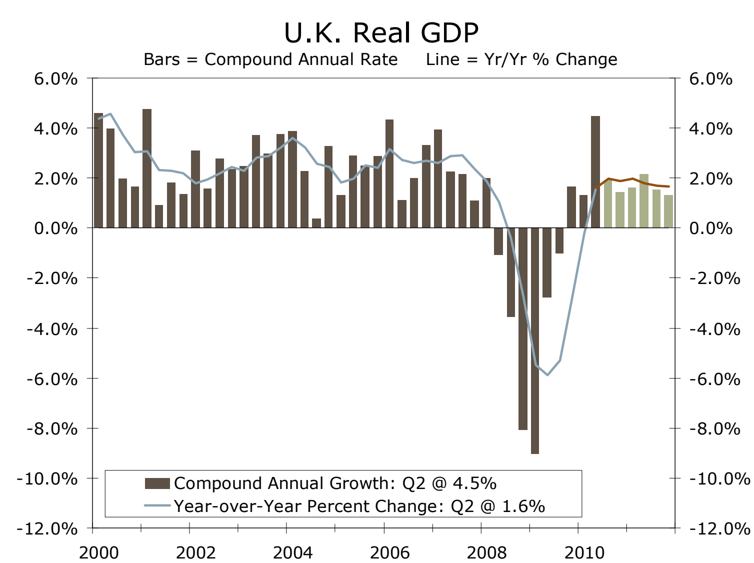
The Bank of England's (BoE) Monetary Policy Committee (MPC) on Wednesday released the minutes from its meeting earlier this month. As was widely expected, the MPC left rates at the very stimulative present level of 0.50 percent. There is clearly a divergence among the members of the MPC as to the timing of dialing back stimulus from the U.K. economy. Even as one member voted for a hike in the target benchmark rate, the minutes revealed that the "committee considered arguments in favour of a modest easing in the stance of monetary policy." While the recovery appears to be building up steam, the overall rate of CPI inflation is well above the Bank of England's target of 2 percent at present. Adding to inflation concerns, the MPC agreed that, in the near term, "inflation was likely to be higher." Our view is that fiscal tightening will exert headwinds on growth over the next few quarters, and there seems to be support for that position among the MPC members. That is why we are not forecasting a rate hike until the second half of 2011. The value-added tax hike in January may keep the overall rate of CPI inflation elevated, but underlying inflationary pressures should remain benign.

Thursday's retail sales report for June showed that sales climbed 0.7 percent in the month and, excluding the volatile auto fuel component, sales climbed 1.0 percent. Month-to-month changes in retail sales are notoriously choppy, and it should be noted that retail sales have been tepid so far in this recovery; the jump in June may also reflect a temporary boost in spending related to England's participation in the World Cup.

Finally, at the end of the week, the United Kingdom became the first major developed economy to report second quarter GDP. U.K. GDP grew at a 4.5 percent pace in the second quarter after increasing at a mere 1.3 percent pace in the previous quarter. We do not yet have a breakdown of GDP into its various components, but preliminary details suggest a jump in construction sector spending. There was also an increase in government services output, an area where support will likely be absent in coming quarters as government spending is scaled back. Going forward, we do not expect the U.K. economy to match this pace of growth as it struggles to overcome headwinds from fiscal tightening.





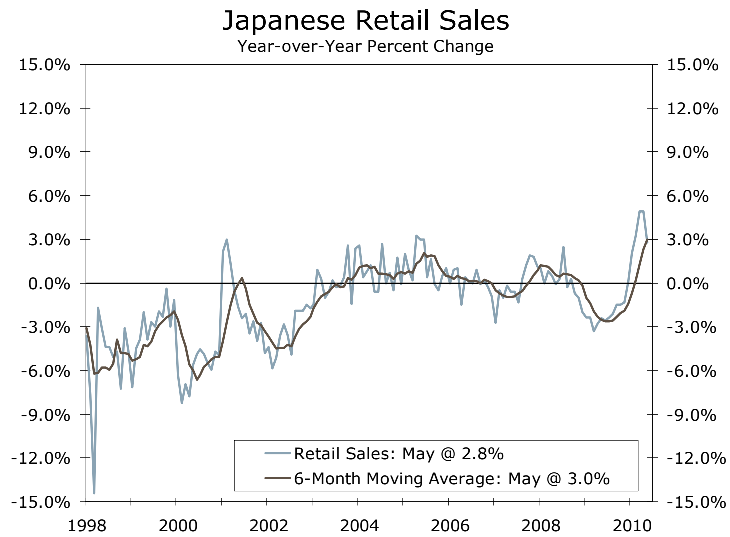


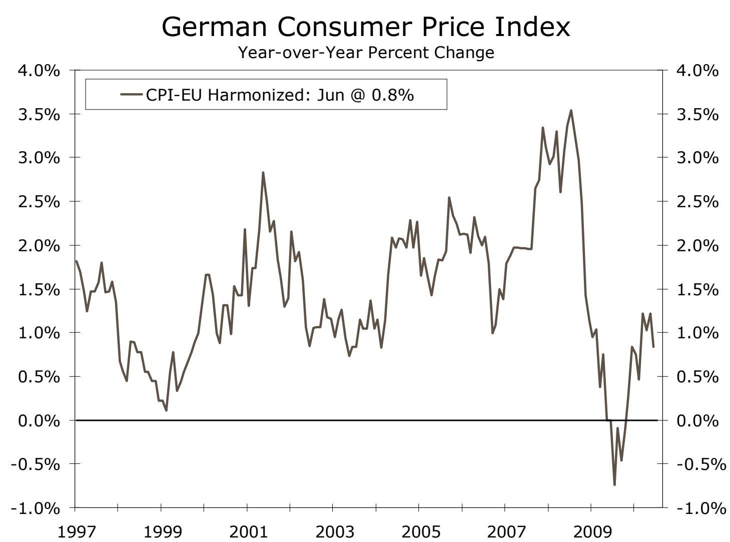
Japanese Retail Sales • Tuesday

The Japanese economy has expanded in each of the past four quarters, and total real GDP has retraced roughly half of the ground lost in the recession. Part of the recovery story in Japan has had to do with surprising strength in domestic demand. Indeed, retail sales climbed steadily in every month of the year through April before falling 2.0 percent in May. This moderation is consistent with our outlook for slower growth in the second half of the year. On Tuesday, retail sales data for June will become available. The June measure of consumer confidence surged to its highest level since 2007, which may suggest shoppers in Japan returned to the stores in June, but we do not expect strong consumer spending to last. Also out next week in Japan are data on housing starts and construction orders on Friday, which will shed light on the housing situation.

Previous: 2.8%

Consensus: 3.2%





German CPI • Wednesday

As the largest economy in the Euro-zone, economic trends in Germany can influence decisions made by the European Central Bank (ECB). In ordinary times, the ECB targets an inflation rate of just under 2 percent. The year-over-year harmonized inflation rate for Germany slipped to 0.8 percent in June. A July CPI figure is expected on Wednesday of next week. A modest recovery in oil prices during the month could help lift the year-over-year rate somewhat, but inflation pressures will likely remain benign for the near future. This gives the ECB cover to keep its target rate at 1.00 percent, and to continue its other unconventional methods of stimulating the economy such as providing a nearly limitless supply of credit to banks. In addition to usual concerns like balancing growth and inflation, the ECB has the additional consideration of keeping the sovereign debt situation from spinning out of control.

Previous: 0.8%

Consensus: 1.1%

Euro-zone Unemployment Rate • Friday

The unemployment rate in the Euro-zone held steady at 10 percent in May—the highest level of joblessness in more than 11 years. When the ECB recently dialed back its growth outlook for the second half of the year, ECB President Jean-Claude Trichet noted “weak labor market prospects” as one of the bank’s primary worries.

The June unemployment number will hit the wire on Friday and will give financial markets a sense of whether hiring is picking up. We suspect employers across the Euro-zone will be sitting on their hands, holding back on big expansions or mass hiring until they become convinced that the sovereign debt situation is under control and until they get a better sense of how growth will be shaping up in the second half of the year.

Previous: 10.0%

Consensus: 10.0%

Interest Rate Watch

The Fed Still Has Some Bullets Left

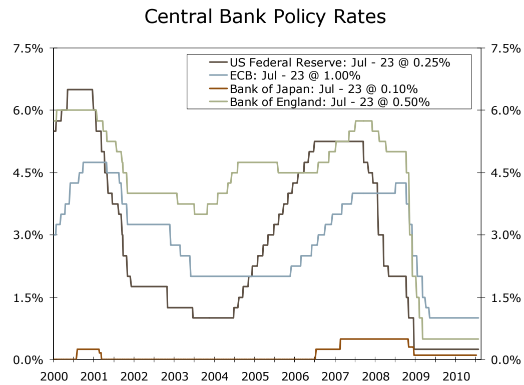
Fed Chairman Ben Bernanke broke precious little new ground in his midyear report to Congress and essentially reiterated the forecast issued in the minutes of the June FOMC meeting. The problem with that is economic conditions have clearly deteriorated since the Fed last met, and many forecasts for second quarter growth have been scaled back by a full percentage point or more. With conditions widely thought to have deteriorated further, many of the questions the Fed chairman faced were whether the Fed had any bullets left if the recovery should falter.

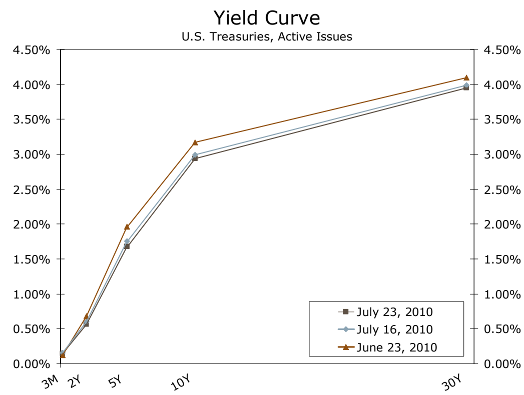
Bernanke outlined the steps the Fed could take to provide more stimulus if conditions warranted. He stated the Fed could change its policy statement to indicate that short-term interest rates would remain near zero for an even longer period. The Fed could also reduce the interest rate it pays on excess reserves. In addition, it could reinvest the proceeds of maturing mortgage backed securities or buy more securities.

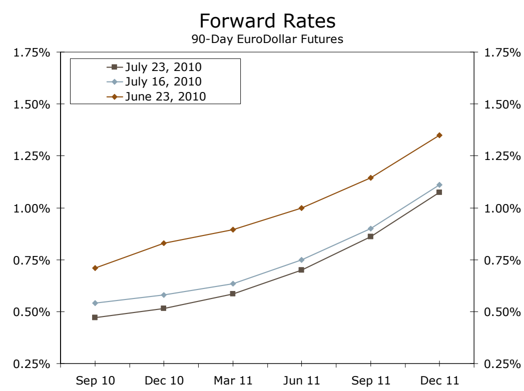
While Bernanke's reasoning is perfectly sound, the first option already appears to have been played out. The financial markets have already pushed the first Fed tightening all the way out into late 2011. Announcing that the extended period had been extended further would seem anticlimactic at this point.

We believe the Fed is putting on a brave front. While he stood by the Fed's forecast, Bernanke also noted there are downside risks to the forecast and also spent considerable time lamenting the problems with persistently high unemployment. We expect the Fed to reduce its forecast later this year.

A second round of quantitative easing was always a long shot unless we saw severe deterioration in the economic outlook or some sort of exogenous shock. That said, the Fed would be wise to keep its powder dry. There are still huge unresolved issues with the sovereign debt crisis in Europe and municipal finances in the U.S.







Consumer Credit Insights

A New Credit Paradigm

Consumer spending as a share of real gross domestic product (GDP) has risen from 60 percent in the early 1950s to 70 percent today. These were the heydays of American consumer might. These were the days when if you wanted something, you bought it, with little thought to if you could afford it. This was fueled by a post-war economy that continued to innovate, expand and grow. More recently, this was accompanied by a severe lack of concern for the credit quality of borrowers, which led to a credit explosion. Even the Great Recession didn't stop this trend, as the peak of consumers' share of real GDP was reached in the third quarter of 2009. But the U.S. economy is going through a structural shift, characterized by a new credit paradigm.

With the passage of the Financial Regulation (FINREG) Bill, as the banks warned, credit is likely to be more scarce than it already is. The new rules will force banks to hold more capital, which could restrain loan growth. In addition, due to the reduction in interchange fees and other stipulations in the bill, banks will need to find new sources of revenue. All of this will likely lead to less reliance on credit, a more frugal consumer and a smaller consumer contribution to GDP. But maybe this isn't such a bad thing. After all, diversification is a good thing, right? Maybe it's time to focus more on trade. Increasing exports would support economic growth, likely create more jobs and would help to reduce the current account deficit.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.56%	4.57%	4.69%	5.20%
15-Yr Fixed	4.03%	4.06%	4.13%	4.68%
5/1 ARM	3.79%	3.85%	3.84%	4.74%
1-Yr ARM	3.70%	3.74%	3.77%	4.77%
MBA Applications				
Composite	753.5	700.3	621.2	528.9
Purchase	168.9	163.3	177.9	262.1
Refinance	4,161.9	3,831.2	3,208.5	2,089.7

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

Topic of the Week

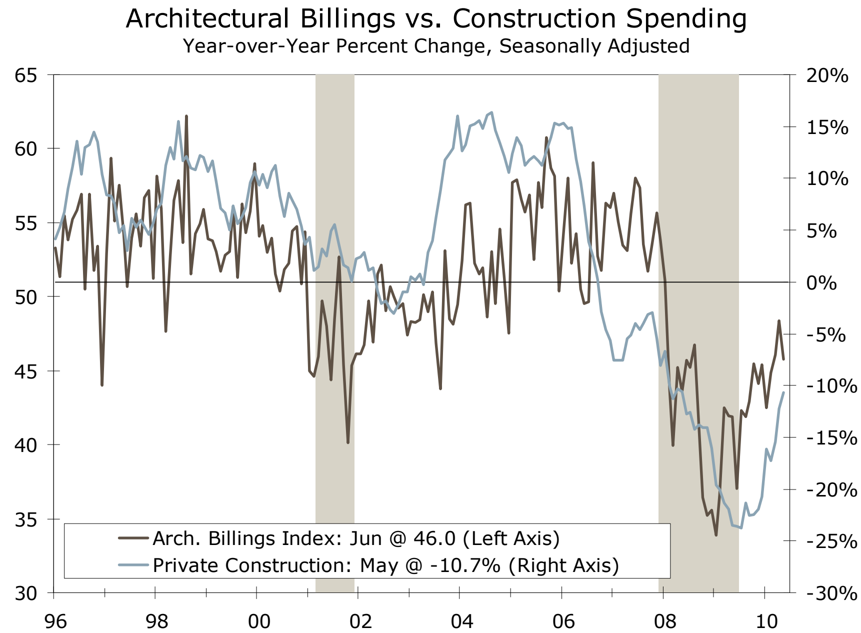
A Glimmer of Hope in the Construction Outlook

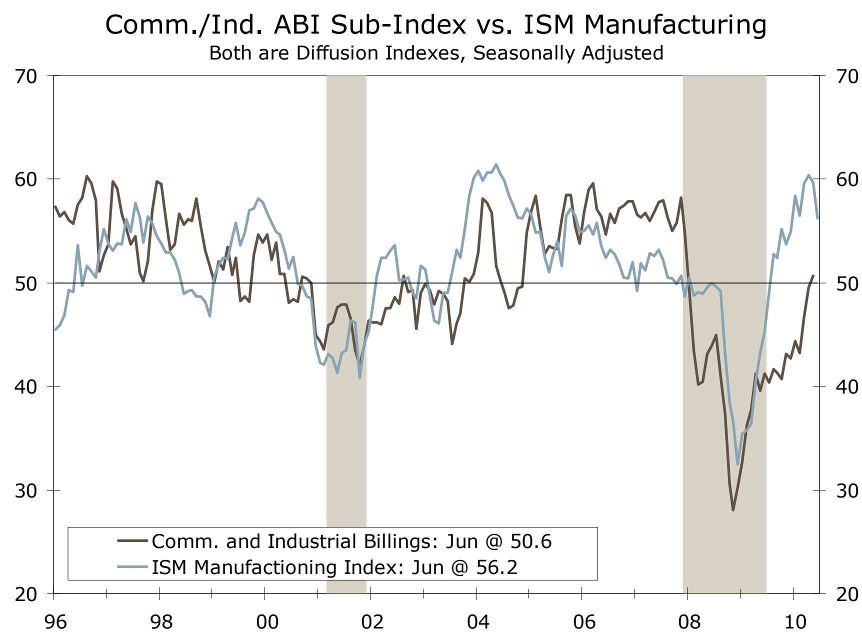
The Architectural Billings Index (ABI) is a monthly diffusion index that can serve as a leading economic indicator for nonresidential construction spending. The American Institute of Architects surveys around 300 architecture firms across the country where participants are asked whether their billings increased, decreased, or stayed the same. In June, the ABI posted a reading of 46.0, remaining below the breakeven of 50 for nearly two and a half years. The score continues to suggest further weakness ahead for nonresidential outlays.

All is not doom and gloom, however. The ABI, although still below the threshold of 50, has risen significantly since reaching its record low of 33.9 in January 2009. Despite May's subpar reading, a closer look at its components sheds some light on the future of the nonresidential construction industry. Billings for architecture firms with a commercial/industrial specialization posted a score of 50.6 in June, putting the sub-index in expansionary territory for a second consecutive month. Commercial and industrial construction spending can lag the commercial/industrial sub-index up to 11 months, which suggests better times could be less than a year away in this sector.

The ISM Manufacturing Index, which also closely parallels the commercial/industrial sub-index, has been in expansionary territory for nearly a year and could also portend future growth in the commercial and industrial sector.

It is still too early to predict what will come of the sector and nonresidential construction spending overall, however. Sure, the commercial/industrial sub-index surpassed the breakeven of 50, but two months in positive territory is not nearly enough evidence to prove a recovery. Moreover, while the index provides valuable insight, it is a diffusion index, which can only accurately portray the breadth and not the depth of the industry's strength. We expect nonresidential construction outlays will continue to fall well into 2010.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 7/23/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.14	0.15	0.18
3-Month LIBOR	0.49	0.52	0.50
1-Year Treasury	0.31	0.35	0.36
2-Year Treasury	0.56	0.58	1.01
5-Year Treasury	1.68	1.67	2.53
10-Year Treasury	2.95	2.92	3.66
30-Year Treasury	3.96	3.94	4.55
Bond Buyer Index	4.26	4.37	4.69

Foreign Exchange Rates

	Friday 7/23/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.283	1.293	1.414
British Pound ($/£)	1.538	1.530	1.648
British Pound (£/€)	0.834	0.845	0.858
Japanese Yen (¥/$)	87.250	86.570	94.920
Canadian Dollar (C$/$)	1.041	1.058	1.089
Swiss Franc (CHF/$)	1.051	1.051	1.075
Australian Dollar (US$/A$)	0.892	0.869	0.812
Mexican Peso (MXN/$)	12.788	12.935	13.245
Chinese Yuan (CNY/$)	6.780	6.775	6.831
Indian Rupee (INR/$)	46.945	46.773	48.453
Brazilian Real (BRL/$)	1.765	1.782	1.899
U.S. Dollar Index	82.871	82.486	78.803

Foreign Interest Rates

	Friday 7/23/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.82	0.79	0.90
3-Month Sterling LIBOR	0.74	0.73	0.93
3-Month Canadian LIBOR	0.94	0.88	0.60
3-Month Yen LIBOR	0.24	0.24	0.42
2-Year German	0.74	0.78	1.30
2-Year U.K.	0.85	0.75	1.35
2-Year Canadian	1.56	1.58	1.31
2-Year Japanese	0.15	0.15	0.28
10-Year German	2.70	2.61	3.46
10-Year U.K.	3.42	3.33	3.97
10-Year Canadian	3.21	3.16	3.53
10-Year Japanese	1.08	1.09	1.39

Commodity Prices

	Friday 7/23/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	78.83	76.01	67.16
Gold ($/Ounce)	1197.90	1193.00	949.15
Hot-Rolled Steel ($/S.Ton)	565.00	625.00	405.00
Copper (¢/Pound)	317.50	292.35	251.90
Soybeans ($/Bushel)	10.19	10.27	10.38
Natural Gas ($/MMBTU)	4.61	4.52	3.55
Nickel ($/Metric Ton)	20,182	19,336	16,172
CRB Spot Inds.	474.40	471.29	415.95

Next Week's Economic Calendar

	Monday 26	Tuesday 27	Wednesday 28	Thursday 29	Friday 30
U.S. Data	**New Home Sales** May 300K June 290K (W)	**Consumer Confidence** June 52.9 July 50.6 (W)	**Durable Goods Orders** May -0.6% June 1.2% (W) **Durables Ex Transp.** May 1.6% June 0.8% (W)		**GDP** 1Q 2.7% 2Q 2.4% (W) **Employment Cost** 1Q 0.6% 2Q 0.6% (W)
Global Data		**Japan** **Retail Trade (YoY)** Previous (May) 2.8%	**Germany** **CPI (YoY)** Previous (Jun) 0.8% **Japan** **Industrial Prod. (YoY)** Previous (May) 20.4%	**Germany** **Unemployment Rate** Previous (Jun) 7.7% **Japan** **Housing Starts (YoY)** Previous (May) -4.6%	**Euro-zone** **Unemployment Rate** Previous (May) 10.0%

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

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(612) 667-0168	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economist	(704) 374-4407	tim.quinlan@wellsfargo.com
Kim Whelan	Economic Analyst	(704) 715-8457	kim.whelan@wellsfargo.com

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