June 18, 2010

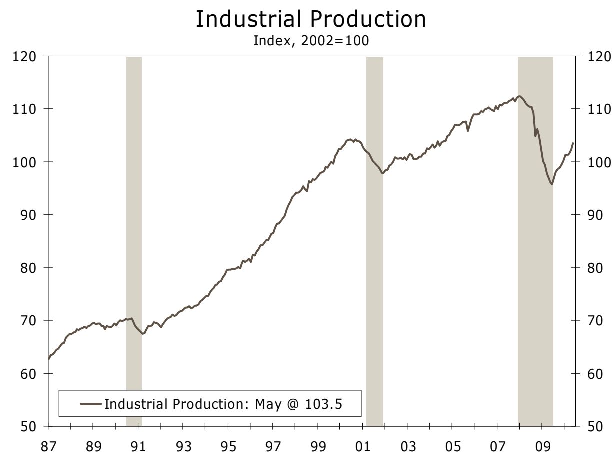
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Production Seems to Be Running Ahead of Demand

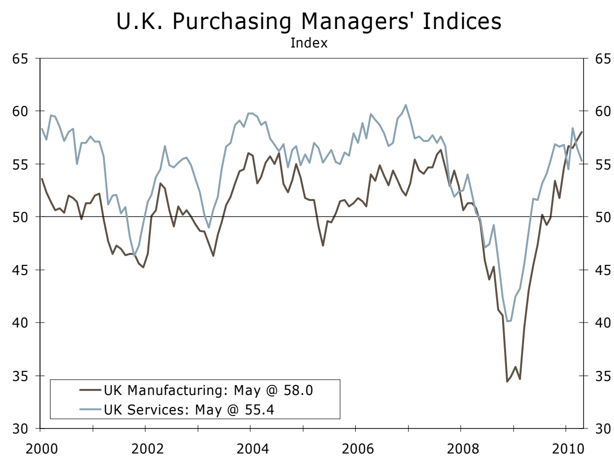
- The production side of the economy remains red hot, with industrial production rising at a 9.3 percent pace over the past three months. By contrast, final demand appears to be cooling a bit, with retail sales tumbling 1.2 percent in May.
- The weakness in final demand and falling energy prices have kept consumer prices well contained. The CPI fell 0.2 percent in May and is down at a 0.7 percent annual rate over the past three months.



Global Review

U.K. Economy Probably Accelerated in Q2

- Following a very deep recession the British economy is expanding again, although the pace of recovery has been slow. That said, available monthly indicators suggest that real GDP growth strengthened in the second quarter.
- Unfortunately, economic growth likely will slow again later this year due, at least in part, to fiscal tightening. Budget cuts have already been announced for the current fiscal year, and Chancellor Osborne is expected to announce further measures on June 22.



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	3.0	3.4	1.9	2.1	2.7	2.1	0.4	-2.4	3.0	2.2
Personal Consumption	0.6	-0.9	2.8	1.6	3.5	3.2	1.6	2.2	2.9	2.6	-0.2	-0.6	2.4	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	1.3	1.6
Consumer Price Index	-0.2	-1.0	-1.6	1.5	2.4	1.9	1.0	0.7	3.2	2.9	3.8	-0.3	1.5	1.2
Industrial Production [1]	-19.0	-10.4	6.4	6.9	7.8	5.4	2.6	2.2	2.3	1.5	-2.2	-9.7	4.8	3.2
Corporate Profits Before Taxes [2]	-19.0	-12.6	-6.6	30.6	31.0	26.0	21.0	15.0	10.5	-4.1	-11.8	-3.8	22.7	7.2
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	9.8	10.0	10.0	4.6	4.6	5.8	9.3	9.9	9.6
Housing Starts [4]	0.53	0.54	0.59	0.56	0.62	0.59	0.56	0.62	1.81	1.34	0.90	0.55	0.60	0.84
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	2.00
Conventional Mortgage Rate	5.00	5.42	5.06	4.93	4.97	4.80	4.80	5.00	6.14	6.10	5.33	4.93	5.00	6.00
10 Year Note	2.71	3.53	3.31	3.85	3.84	3.20	3.20	3.40	4.71	4.04	2.25	3.85	3.40	4.40

Forecast as of: June 9, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

Inside

U.S. Review

Is Production Getting too Far Ahead of Demand?

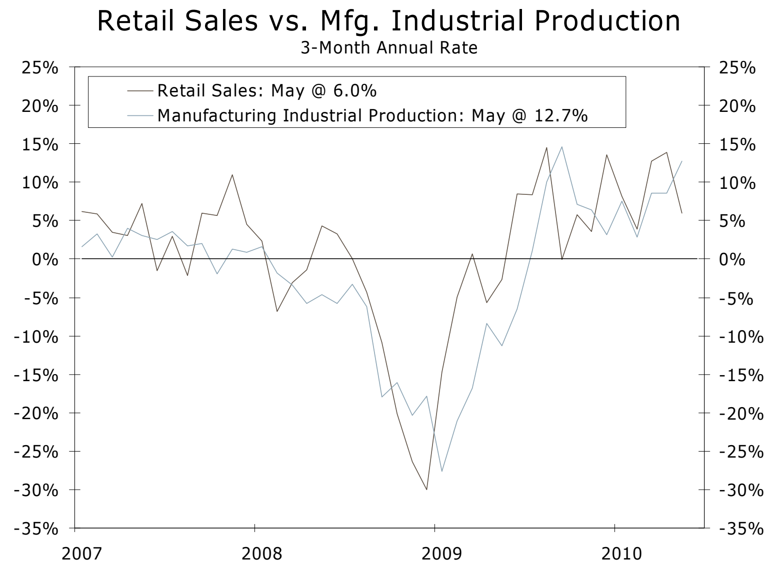
Unusually warm temperatures across much of the country during May helped pull utility use up 4.8 percent during the month, which led to an outsized 1.2 percent jump in industrial production during May. Output in the factory sector rose only slightly less, climbing 0.9 percent in May and at a 12.7 percent annual rate over the past three months.

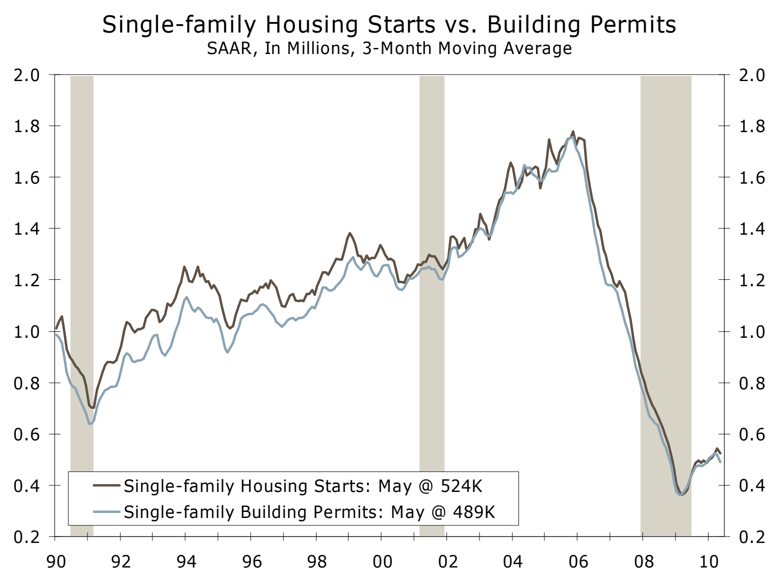
While a 5.5 percent jump in motor vehicle output helped pace May's increase, solid gains were also evident across most other major industrial categories. Output excluding the motor vehicle sector rose 0.6 percent in May, following gains of 1.0 percent and 1.2 percent in April and March, respectively. Production appears to be getting a lift from stronger sales of household appliances, due to the tax incentives. The mini boom in home construction has also led to a pick up in production of building supplies, which surged at a 27.4 percent pace over the past three months.

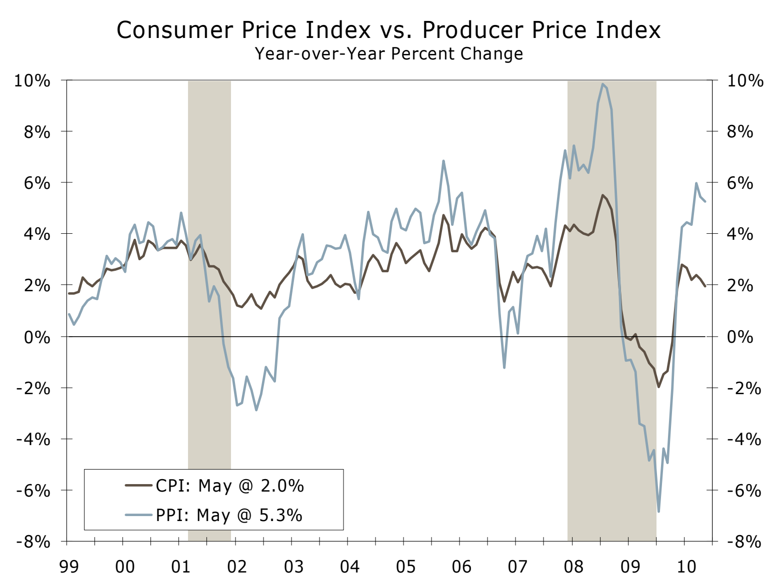
With the recent gains, industrial production now appears to be running ahead of demand. Home construction is beginning to wind down now that home-buyer tax incentives are ending. Incentives to purchase more energy efficient appliances have also ended or are winding down. The impact on consumer spending is already evident. Retail sales tumbled 1.2 percent in May, with a huge decline in sales at home improvement centers accounting for much of the drop. Sales of motor vehicles also weakened in May, while our measure of core retail sales, which excluding motor vehicles, gasoline and building materials, rose at just a 0.1 percent pace. The net result is production of goods is now rising twice as fast as consumption, which means inventories are likely building at a faster-than-desired rate. This could set up a sharper pull back in output later this year.

One area where production is already weakening is housing, where starts fell 10 percent in May and permits are down nearly 18 percent over the past two months. May's drop in housing starts and most of the decline in permits over the past two months was in single-family homes, which had been benefitting from home buyer tax incentives. We expect housing starts to slide for another couple of months, which should pull residential construction outlays and production of building materials lower during the third quarter. Mortgage applications for the purchase of a home, which fell roughly 32 percent from early April to the recent low in early June, provide a strong clue as to how far the pullback in home sales and new home construction is likely to be.

The weakness in final demand and continued strength in production is also evident in the inflation data. The Consumer Price Index has fallen for two months in a row and is now up just 2.0 percent over the past year. By contrast, the continued strength in industrial output has helped support commodity prices. Producer prices for finished goods, which also fell during each of the past two months, have moderated less than expected and remain up 5.3 percent over the past year. The inability of firms to pass along their higher costs to their end consumers should put some pressure on profit margins in coming quarters.





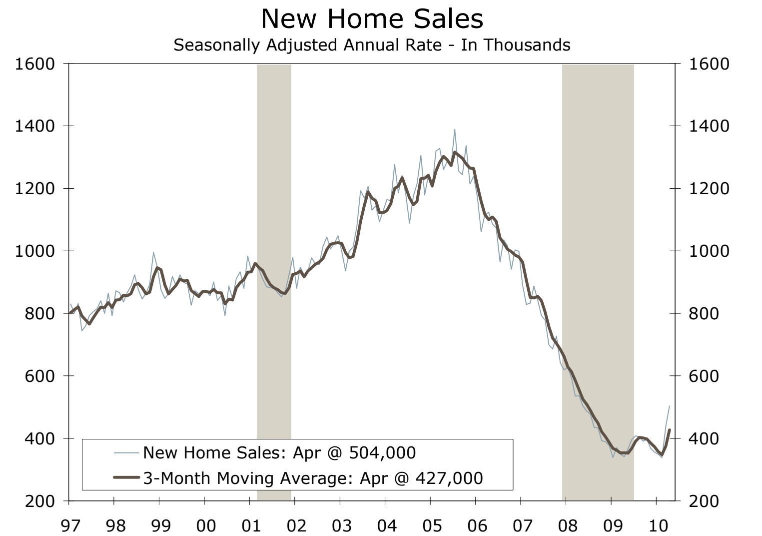


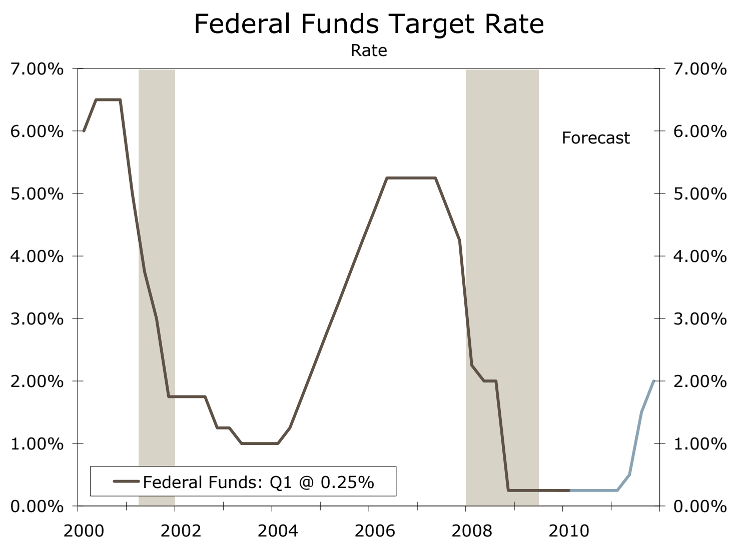
New Home Sales • Wednesday

New home sales jumped 14.8 percent in April to a 504,000-unit pace, the highest level since May 2008. With tax credits expiring, we expect sales to slide back near their early 2010 lows. The seasonal adjustment process will likely exaggerate the extent of the slowdown in May and June. We expect new home sales, which are based on contract signings to slip 24.6 percent in May to a 380,000 unit pace. Existing home sales, which are based on closings, however, will likely post another solid gain as homebuyers' rush to meet the June 30 tax credit deadline. Existing home sales will likely increase 9.2 percent to a 6.3 million unit pace in May.

Previous: 504,000 **Wells Fargo: 380,000**

Consensus: 431,000





FOMC Rate Decision • Wednesday

The Federal Reserve is expected to keep its federal funds target rate at its current level at the June meeting. Economic conditions, including low rates of resource utilization, subdued inflation trends and stable inflation expectations, suggest the Fed will likely remain on hold much longer. Moreover, Euro-zone uncertainty adds another dimension of caution. Our outlook continues to suggest that resource utilization should remain low through the end of 2010 with the unemployment rate peaking at around 10.0 percent. We have tentatively pushed the first rate hike into next spring. Consistent with the past three FOMC meetings, we expect Kansas City Fed President Thomas Hoenig to dissent based on the view that continued usage of the "extended period" language could lead to "future imbalances" and "risks to longer run macroeconomic and financial stability", which could limit the Fed's flexibility.

Previous: 0 – 0.25% **Wells Fargo: 0 – 0.25%**

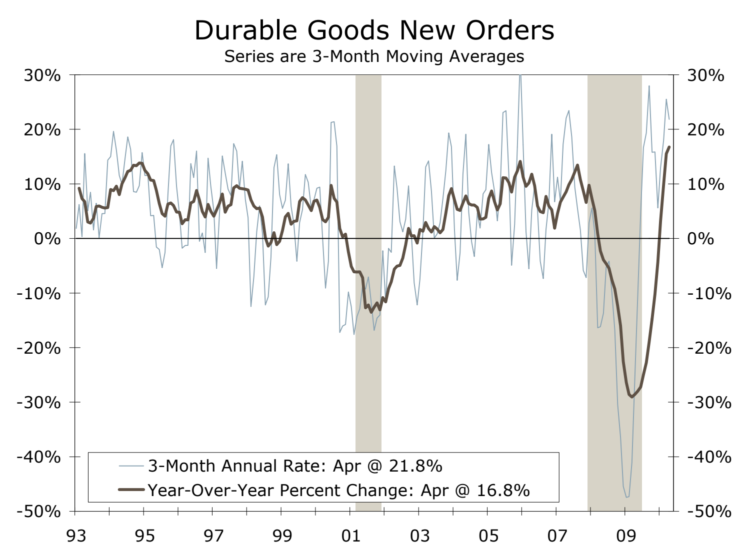
Consensus: 0 – 0.25%

Durable Goods • Thursday

Advance orders for durable goods rose 2.9 percent in April, driven by a 228.0 percent surge in nondefense aircraft orders. This trend is not sustainable, however, and the gain will likely be retraced in May. We expect a modest pullback of 0.2 percent. While the forward-looking series on nondefense capital goods orders (excluding aircraft) was down 2.4 percent on the month, the trend is more promising. On a three-month annualized basis, nondefense capital goods orders (excluding aircraft) were up 21.5 percent suggesting further gains in business equipment spending. Reflecting improving global demand and domestic inventory restocking, both the ISM Manufacturing Index and industrial production also suggest continued positive momentum for the manufacturing industry.

Previous: 2.9% **Wells Fargo: -0.2%**

Consensus: -1.0%



Global Review

U.K. Economy Probably Accelerated in Q2

As measured by changes in real GDP, the U.K. economy emerged from recession in the fourth quarter of 2009. However, the pace of growth in the first two quarters of the recovery was lackluster, and the level of economic activity remains well below the pre-recession peak. Real GDP plunged more than 6 percent between Q 1 2008 and Q3 2009, and it has retraced only 0.7 percent over the past two quarters.

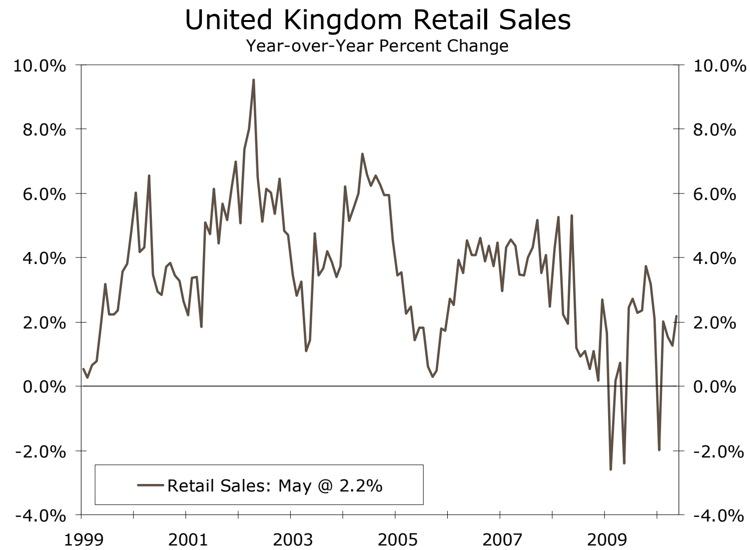
However, there are indications that the economy accelerated in the second quarter. For starters, the 1.9 percent increase in industrial production (IP) in March relative to the previous month meant that the manufacturing sector entered the quarter with strong momentum. Although IP fell back a bit in April, the high level of the manufacturing PMI in May suggests that the factory sector continues to expand (see graph on front page).

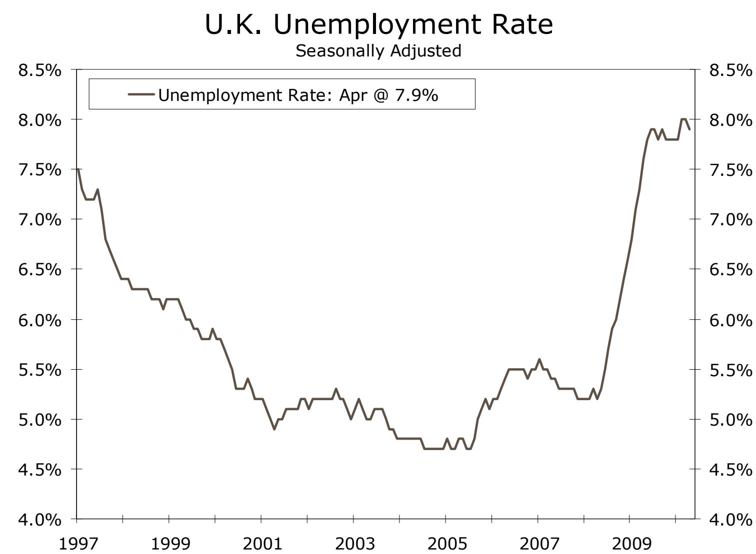
Although 50 percent of British exports go to the Euro-zone, where the pace of overall economic growth has been quite slow, export volumes appear to have edged up relative to the first quarter. In addition, retail spending also appears to have strengthened in the second quarter as the volume of sales in the April–May period was 1.0 percent higher than in the first quarter (top chart). These data, along with the high level of the service sector PMI in the first two months of the second quarter, suggest that real consumer expenditures expanded at a solid pace.

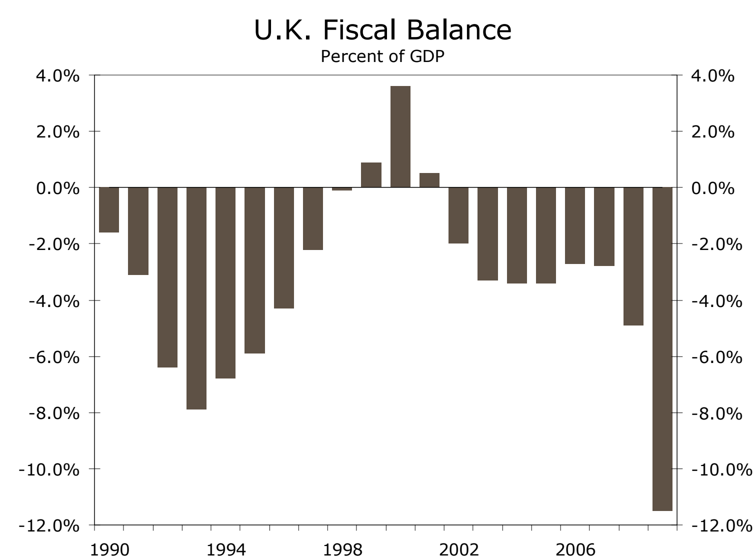
In addition, the labor market appears to be strengthening. Over the past four months, the number of people claiming unemployment compensation has declined by nearly 136,000, which has caused the unemployment rate to edge down to 7.9 percent from 8.0 percent earlier this year. Another indication of a strengthening labor market is the pick-up in wage growth. In the first three months of 2010, wages (excluding bonuses) rose 1.7 percent relative to the same period in 2009, up from the 1.4 percent rate of increase just a few months prior. In sum, we estimate that real GDP grew at an annualized pace of roughly 3 percent in the second quarter on a sequential basis.

Although we project that the U.K. economy will continue to expand, we also forecast that the sequential rate of growth will slow somewhat over the next few quarters due, at least in part, to fiscal tightening. The deficit-to-GDP ratio of the U.K. government currently exceeds 11 percent, among the highest in the world (bottom chart). The newly elected government has already announced £6.25 billion (0.4 percent of GDP) worth of spending cuts for the current fiscal year, and much steeper reductions are expected to be announced on June 22 by Chancellor of the Exchequer Osborne when he presents budget plans for the years ahead.

Another piece of good news recently was the lower-than-expected CPI inflation rate, which fell from 3.7 percent in April to 3.4 percent in May. With inflation expected to decline further in the months ahead and with the economy not likely to boom, there is little reason for the Bank of England to change its policy rate from only 0.50 percent anytime soon.







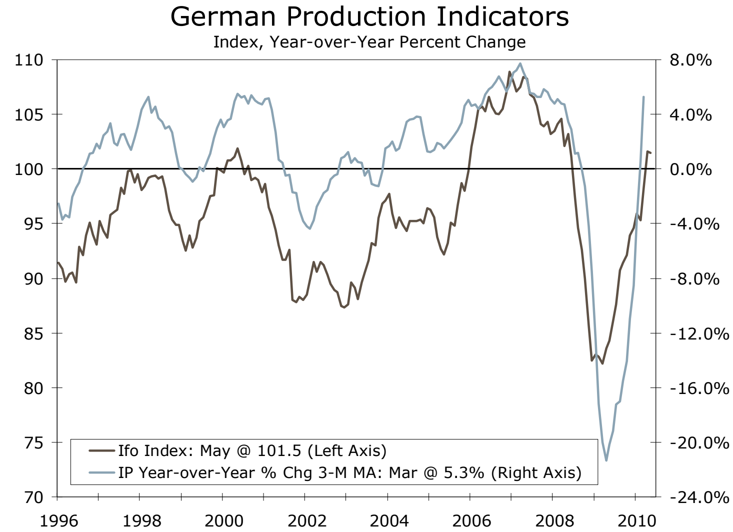
German Ifo Index • Tuesday

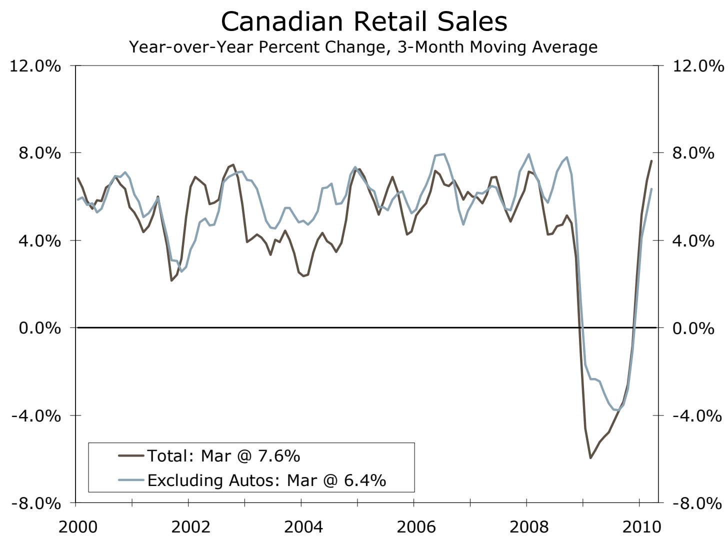
The sharp rebound in the Ifo index of German business sentiment that began in mid-2009 heralded the subsequent upturn in German industrial production (IP). However, the Ifo index edged a bit lower in May, and most analysts look for a further modest decline in June. Although the index is still at a level that is consistent with positive IP growth, production likely will decelerate a bit in the months ahead. The manufacturing and service sector PMIs for the broader Euro-zone are also to be released next week, and consensus forecasts anticipate some modest declines in these indices as well.

Moving from the industrial sector to the consumer sector, data on Italian retail sales in April and French consumer spending in May also are on the docket next week. In general, growth in European consumer spending has turned positive again, but the pace of growth remains sluggish.

Previous: 101.5

Consensus: 101.0





Canadian Retail Sales • Wednesday

The Canadian central bank became the first of the G-7 nations to raise rates when it lifted the overnight rate to 0.50 percent earlier this month. The BoC's biggest obstacle is the sovereign debt crisis in Europe. Canadian GDP is within spitting distance (less that 1 percent) of pre-recession levels. With the economy snapping back so quickly, the BoC will need to gradually increase rates to temper the pace of recovery and curb inflation. The April retail sales report, a major yardstick for domestic spending activity, is released on Wednesday and will give some indication of how second quarter growth is shaping up. The G-20 meets in Toronto at the end of the week. BoC Governor Carney has pushed for "radical" resolutions to help shore up the European financial system. After applauding measures already taken, Carney said, "I don't think anybody is of the view that more will not be required."

Previous: 2.1% month-over-month

Consensus: N/A

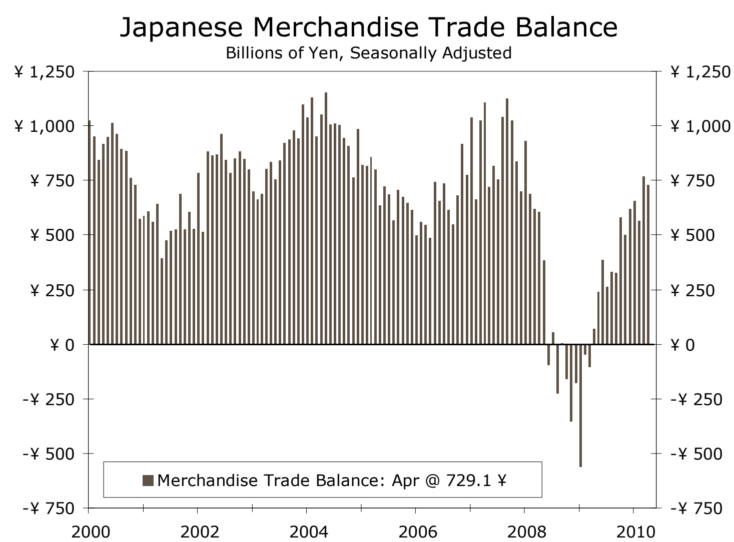
Japanese Trade Balance • Friday

The Japanese trade balance swung into deficit in late 2008/early 2009 as global trade collapsed. However, black ink in the trade accounts has returned as growth in Japanese exports has exceeded growth in imports over the past year or so. Indeed, net exports have made a positive contribution to Japanese GDP growth in the past four quarters. The surplus fell a bit in April, and the consensus forecast anticipates a further modest decline in May. Consequently, net exports may not be providing as much boost to the economy as previously. Data on the May trade balance print on Thursday.

Data on Japanese consumer prices are on the docket on Friday. Due to falling prices over the past 15 months, the Japanese CPI has returned to its 2007 level. In our view, Japan will continue to experience a mild case of deflation through, at least, the end of this year.

Previous: ¥729.1 billion

Consensus: ¥723.5 billion



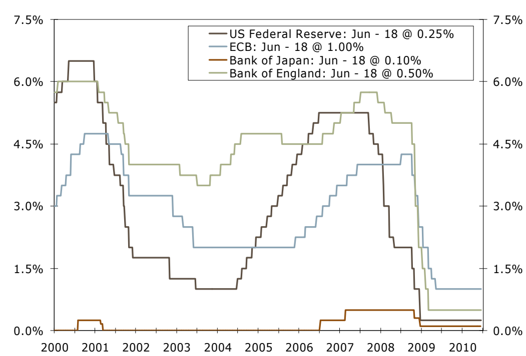
Interest Rate Watch

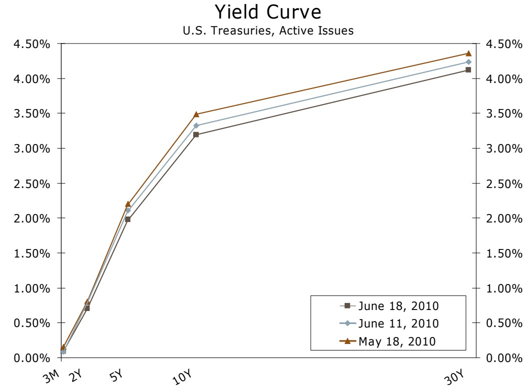
What's Next for the Fed?

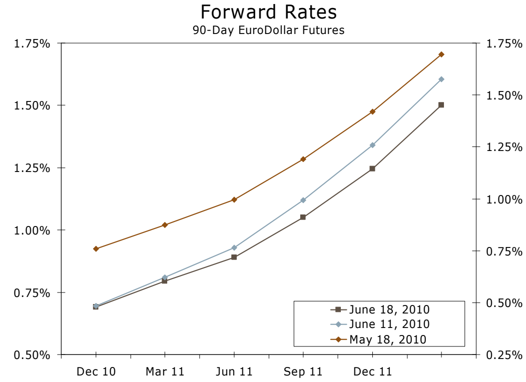
The financial markets zeroed in on a research note from the Federal Reserve Bank of San Francisco, which examined changes in Fed policy relative to changes in the unemployment rate. The San Francisco Fed note modified its Taylor Rule-like analysis for the Fed's massive securities purchases. The net result of the analysis is that even with a nearly zero federal funds rate and $1.7 trillion in securities purchases, monetary policy actually remains too tight relative to the current and projected levels of unemployment and inflation. One implication of this research note is that it could take longer for the Fed to raise short-term interest rates.

President Obama recently nominated three people to fill vacancies on the seven member Federal Open Market Committee, including Janet Yellen, who is currently president of the Federal Reserve Bank of San Francisco. The other two nominees are Peter Diamond from MIT and Sara Raskin, a banking regulator from Maryland. These upcoming changes to the Federal Reserve board will likely make the board of governors sympathetic to some variation of the Taylor Rule-like analysis outlined in the San Francisco Fed report. As a result, we would expect more forecasters to push out the timing of the Fed's first tightening move.

We currently have the Fed's first rate hike occurring around the middle of next year, even though we see little to no improvement in the unemployment rate and only a modest increase in core inflation. Our thinking has been that the Fed is ultra sensitive to claims it left interest rates too low for too long during the last recovery and would like to move the funds rate up from its near zero level as soon as the financial markets stabilize. While this would be difficult to do with the unemployment rate near 10 percent, the Fed might be able to justify an earlier hike in the funds rate if it resumes its quantitative easing. A resumption of securities purchases may be needed to offset the waning effects of fiscal stimulus and the government's sudden rush to austerity ahead of the November elections.







Consumer Credit Insights

Debt-Income Ratios Falling, But...

Just prior to the housing boom, the household debt-income ratio stood at 91.0 percent in Q1 2000. The mortgage debt ratio was 62.8 percent, while the consumer debt ratio was 22.1 percent. Other loans and leases accounted for the remainder. The debt-income ratio peaked at 130.6 percent in Q1 2008. While the consumer ratio had only risen to 24.4 percent, the mortgage ratio had soared to 99.5 percent. Since then, the debt-income ratio has fallen to 122.5 percent as of Q4 2009, the latest data available. The belief was that consumers were finally starting to realize their debt levels were unsustainable and were putting a higher priority on paying down their loans. But last week we found this is likely not the case.

From Q1 2008 to Q4 2009 mortgage debt outstanding fell $290 billion. However, $111 billion, or about 40 percent of the decline, was due to charge-offs. Similarly, consumer debt outstanding fell $103 billion, with $86 billion due to charge-offs, a whopping 83 percent! Total household debt fell $394 billion, with charge-offs accounting for $198 billion, about 50 percent. In addition, these charge-off amounts were only for loans at commercial banks, so total charge-offs were obviously higher. The denominator in the ratio, personal disposable income, has increased $440 billion, which is good news. However, the decline in the numerator, household debt, has come substantially from charge-offs, rather than a focus on deleveraging.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.75%	4.72%	4.84%	5.38%
15-Yr Fixed	4.20%	4.17%	4.24%	4.89%
5/1 ARM	3.89%	3.92%	3.91%	4.97%
1-Yr ARM	3.82%	3.91%	4.00%	4.95%
MBA Applications				
Composite	659.9	560.9	569.2	514.4
Purchase	180.0	167.8	192.1	261.2
Refinance	3,461.5	2,859.5	2,783.0	1,998.1

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

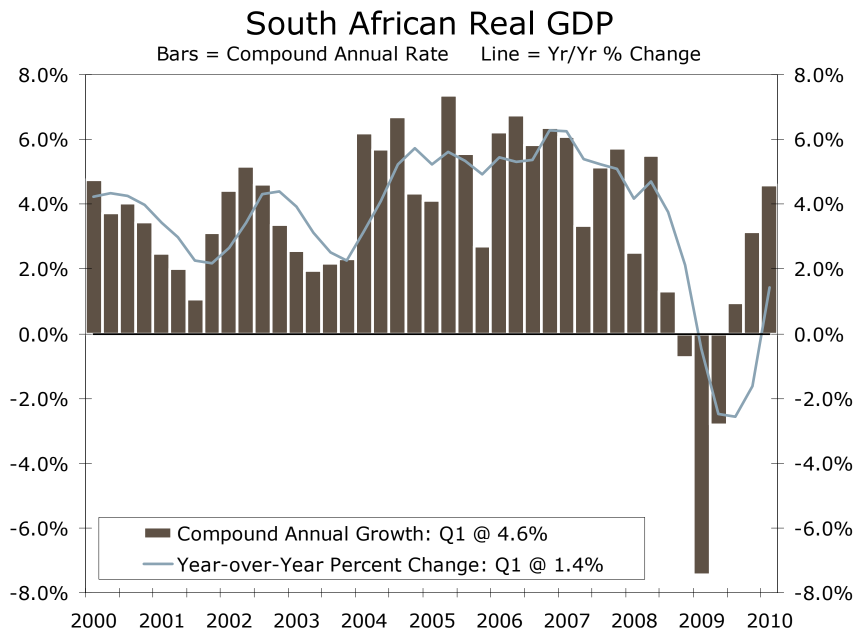
Topic of the Week

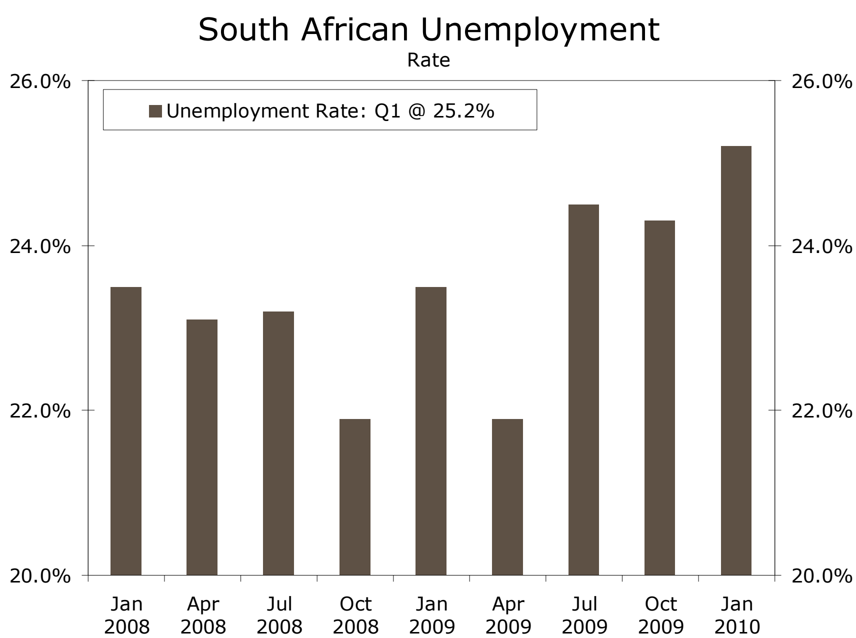
World Cup Effect on South African Economy

In the first quarter of 2010, the South African economy posted its third consecutive quarter of economic expansion, growing at a 4.6 percent annualized pace. After a nasty recession in 2009, the economy is rebounding. Finance Minister Gordhan recently noted the money spent by fans at the World Cup will "circulate throughout the economy, spreading benefits much wider than just the hospitality and transport industries." Will hosting the 2010 World Cup provide a boost to South African GDP growth?

To get a sense of how an economy may benefit from hosting the tournament, we considered looking at the effect of the 2006 World Cup on Germany, but the $3.3 trillion German economy is the fourth largest in the world and far too large to be affected in a measurable way by hosting the tournament. Greece, on the other hand, is a $330 billion economy, roughly comparable with the $287 billion South African economy. As host of the 2004 Olympics, Greece was in a position to benefit economically from the Summer Games. In our analysis of IMF current account data, we were not able to find a discernable jump in spending for either personal or business travel, nor did we notice an above trend rate of growth in other major sectors. However, one category did stand out: "Other Services: Personal, Cultural and Recreational." This series showed a spike in spending that was more than $600 million dollars higher than average in 2004. That comprises roughly 2 percent of the overall economy, a big number to be sure, but the impact faded the following year. So, any lift from hosting the games is only temporary.

South Africa has one of the highest unemployment rates in the world, so anything that spurs job creation is certainly welcome news, and on that basis the World Cup certainly does some good. But we do not expect the South African economy to take off because of it. Perhaps the greatest gain to South Africa is one that is harder to quantify: the honor and prestige in the eyes of the world for hosting the most-watched event in world sport.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 6/18/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.09	0.07	0.17
3-Month LIBOR	0.54	0.54	0.61
1-Year Treasury	0.16	0.22	0.31
2-Year Treasury	0.72	0.73	1.25
5-Year Treasury	2.01	2.03	2.84
10-Year Treasury	3.20	3.23	3.83
30-Year Treasury	4.12	4.15	4.60
Bond Buyer Index	4.40	4.37	4.86

Foreign Exchange Rates

	Friday 6/18/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.237	1.211	1.390
British Pound ($/£)	1.480	1.455	1.633
British Pound (£/€)	0.835	0.832	0.851
Japanese Yen (¥/$)	90.670	91.650	96.470
Canadian Dollar (C$/$)	1.028	1.032	1.132
Swiss Franc (CHF/$)	1.111	1.149	1.086
Australian Dollar (US$/A$)	0.868	0.850	0.798
Mexican Peso (MXN/$)	12.570	12.655	13.390
Chinese Yuan (CNY/$)	6.826	6.833	6.835
Indian Rupee (INR/$)	46.174	46.845	48.215
Brazilian Real (BRL/$)	1.778	1.811	1.972
U.S. Dollar Index	85.739	87.507	80.609

Foreign Interest Rates

	Friday 6/18/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.66	0.65	1.23
3-Month Sterling LIBOR	0.73	0.73	1.25
3-Month Canadian LIBOR	0.81	0.79	0.62
3-Month Yen LIBOR	0.24	0.24	0.49
2-Year German	0.55	0.46	1.52
2-Year U.K.	0.86	0.82	1.37
2-Year Canadian	1.75	1.80	1.33
2-Year Japanese	0.16	0.16	0.38
10-Year German	2.69	2.57	3.55
10-Year U.K.	3.52	3.46	3.85
10-Year Canadian	3.32	3.41	3.51
10-Year Japanese	1.21	1.24	1.46

Commodity Prices

	Friday 6/18/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	75.84	73.78	71.37
Gold ($/Ounce)	1257.90	1226.70	933.06
Hot-Rolled Steel ($/S.Ton)	625.00	645.00	335.00
Copper (¢/Pound)	286.00	289.95	226.70
Soybeans ($/Bushel)	9.47	9.30	12.04
Natural Gas ($/MMBTU)	5.17	4.78	4.09
Nickel ($/Metric Ton)	19,731	18,885	14,758
CRB Spot Inds.	478.14	472.61	400.66

Next Week's Economic Calendar

	Monday 21	Tuesday 22	Wednesday 23	Thursday 24	Friday 25
U.S. Data		**Existing Home Sales** April 5.77M May 6.3M (W)	**New Home Sales** April 504K May 380K (W) **FOMC Rate Decision** Previous 0.25% Expected 0.25% (W)	**Durable Goods Orders** April 2.9% May -0.2% (W) **Durables Ex Transp.** April -1.0% May 1.6% (W)	**GDP** 1Q: 2nd 3.0% 1Q: 3rd 3.1% (W)
Global Data		**Germany** **IFO - Business Climate** Previous (May) 101.5 **Canada** **CPI (MoM)** Previous (Apr) 0.3%	**Euro-zone** **PMI Manufacturing** Previous (May) 55.8 **Canada** **Retail Sales (MoM)** Previous (Mar) 2.1%	**Japan** **Trade Balance** Previous (Apr) ¥729.1B	**Japan** **CPI (YoY)** Previous (Apr) -1.2%

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

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