March 19, 2010

Economics Group

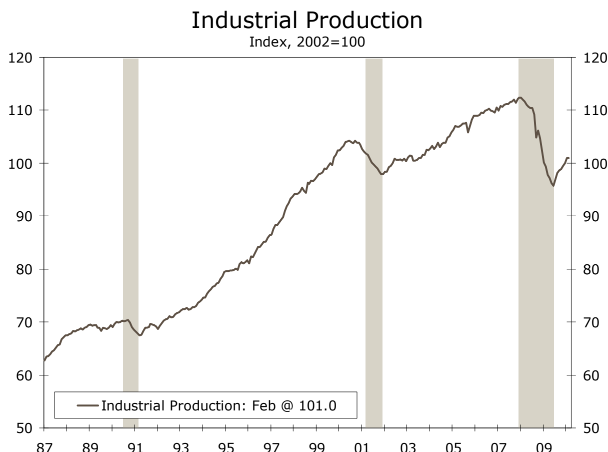
WELLS FARGO SECURITIES

Weekly Economic & Financial Commentary

U.S. Review

Continued Economic Recovery, Low Inflation

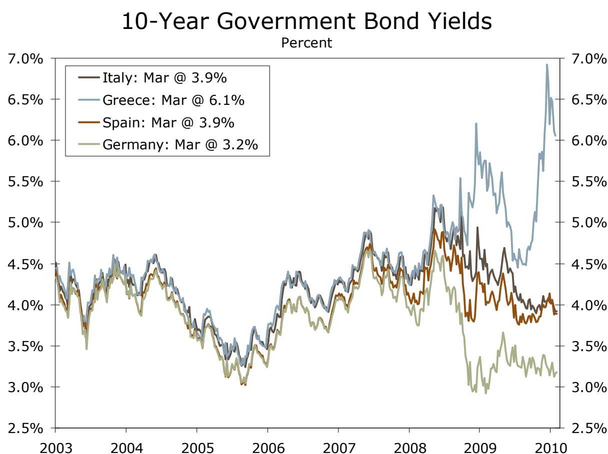
- Three economic releases this week—industrial production, the Philadelphia Fed index and the leading economic index—all support the view of continued economic growth. Meanwhile the housing starts data suggest that this recovery will be more modest than other recoveries.
- Inflation remains low as measured by the Consumer Price Index. The details of this report highlight the slow pace of inflation, which partly reflects the ongoing housing correction. Medical price inflation continues to outpace the overall price index.



Global Review

Greece Not Out of the Woods Yet

- Although euro-zone finance ministers offered a few more details this week, a lending package for Greece is still woefully short on specifics. We still don't know how much money other countries are willing to pony up. "Bailing out" Greece is unpopular in most countries, so politicians are reluctant to discuss details at this point.
- In our view, the crisis will continue to simmer on the backburner for some time. Until a concrete lending program is announced or economic growth strengthens significantly, investors likely will remain worried about Greek fiscal prospects.



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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	5.9	3.4	2.0	2.0	2.3	2.7	2.1	0.4	-2.4	2.9	2.5
Personal Consumption	0.6	-0.9	2.8	1.7	2.2	1.0	1.4	1.6	2.9	2.6	-0.2	-0.6	1.6	1.7
Inflation Indicators [2]														
"Core" PCE Deflator	1.7	1.6	1.3	1.5	1.4	1.2	1.2	1.2	2.3	2.4	2.4	1.5	1.3	1.7
Consumer Price Index	-0.2	-1.0	-1.6	1.5	2.5	2.4	1.9	1.6	3.2	2.9	3.8	-0.3	2.1	2.1
Industrial Production [1]	-19.0	-10.4	6.4	6.6	8.3	3.9	3.4	6.5	2.3	1.5	-2.2	-9.7	4.9	5.7
Corporate Profits Before Taxes [2]	-19.0	-12.6	-6.6	24.0	22.0	16.0	10.0	8.5	10.5	-4.1	-11.8	-5.1	13.8	8.0
Trade Weighted Dollar Index [3]	83.2	77.7	74.3	74.7	75.4	76.8	78.5	80.1	81.5	73.3	79.4	74.7	80.1	83.6
Unemployment Rate	8.2	9.3	9.6	10.0	9.7	9.8	10.1	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	0.59	0.64	0.67	0.70	1.81	1.34	0.90	0.55	0.65	0.76
Quarter-End Interest Rates														
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	5.25	4.25	0.25	0.25	0.50	3.25
Conventional Mortgage Rate	5.00	5.42	5.06	4.88	5.40	5.70	5.80	5.80	6.14	6.10	5.33	4.88	5.80	6.10
10 Year Note	2.71	3.53	3.31	3.85	3.70	3.80	4.00	4.10	4.71	4.04	2.25	3.85	4.10	4.50

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

U.S. Review

Continued Economic Recovery, Low Inflation Remain Consistent with the Annual Outlook

In our 2010 annual outlook we forecasted a growth rate of 2 percent plus for 2010 and overall consumer inflation of around 2 percent as well. This week's economic releases support that outlook.

On the real economy side, three economic releases this week—industrial production, the Philadelphia Fed index and the leading economic index—all support the view of continued economic growth. Over the last three months, industrial production has grown six percent plus with continued solid gains in information processing equipment. Cold weather—isn't it always cold in February?—pushed up utility output for a third straight month. Taking a different slice of the data, consumer goods and business equipment have been up over the last three months while construction supplies continue to decline.

Meanwhile the Philadelphia Fed index improved but the pace of gains in new orders and shipments, while still positive, has slowed. Leading indicators continued to improve led by gains in the financial indicators—money and the yield curve.

Yet, the housing starts release suggests that this recovery will be more modest and of a different character than other recoveries. Starts have stabilized in the 550-600K range (annual rate) for now. The stabilization is due in part to the homebuyer tax credits. However, the level of starts remains low as the overhang of existing inventory persists and builder confidence remains very low according to the NAHB/Wells Fargo Housing Market Index.

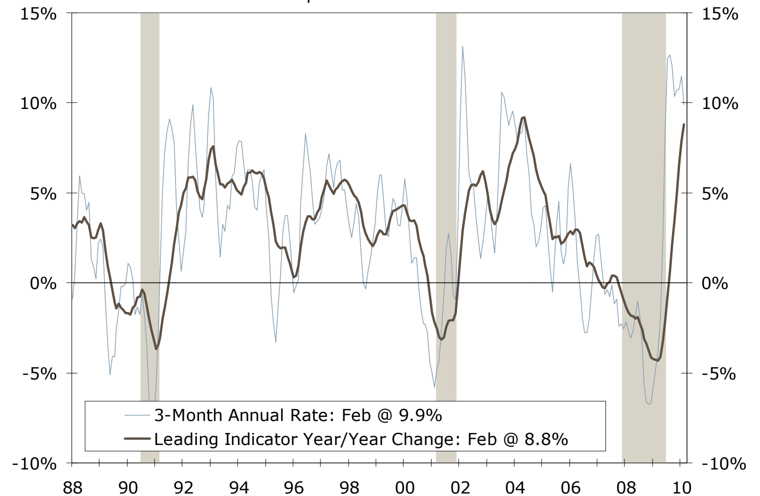
Inflation: Low But Be Careful What You Wish For!

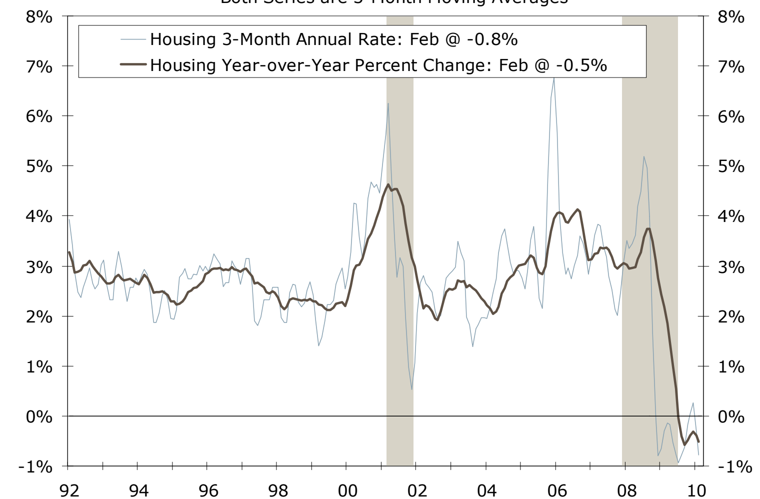
Inflation remains low as measured by the Consumer Price Index. The details of this report highlight that the slow pace of inflation reflects, in part, the ongoing housing correction. Shelter costs are down compared to a year ago and owner's equivalent rent is flat. Both these results are the product of an ongoing housing correction. Public policy is focused on restarting the housing market and that would likely swing the inflation data to the upside.

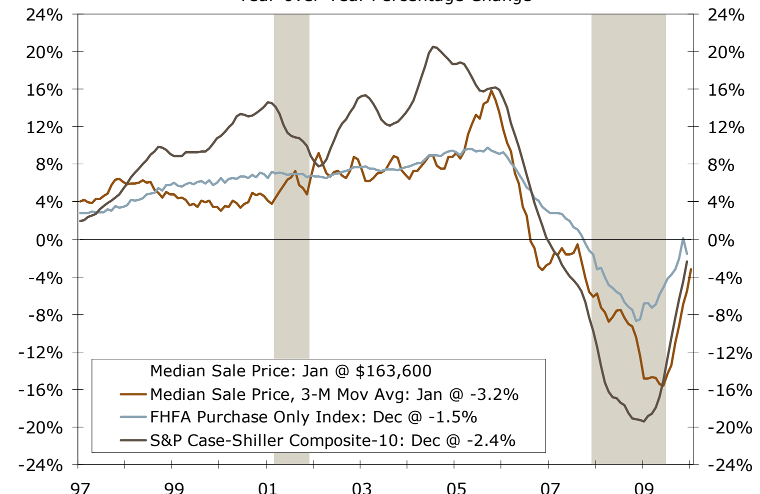
Meanwhile, medical price inflation continues to outpace the overall price index. Medical care prices are up 3.5 percent compared to a year ago while the overall CPI is up 2.1 percent.

Outlook Revisited: Recovery Yes but Just Not Enough to Bring Joy

In many recent meetings with clients we have sensed the frustration that the pace of recovery still leaves us with a weak housing and job market. Housing prices in many areas are still declining and in other areas where home prices *are* rising, the pace of improvement leaves many homeowners under water. Unemployment remains high. Our outlook remains as it has since last year—9 percent plus unemployment and even higher for lesser-educated workers. The U.S. economy continues to adapt to an excess supply of houses and workers. Meanwhile, there is a growing tension that the cyclical stimulus is morphing into a structural problem for the long-run.





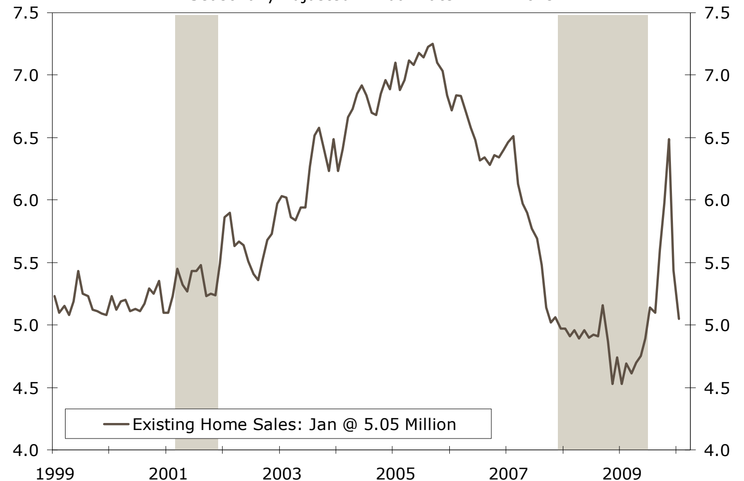


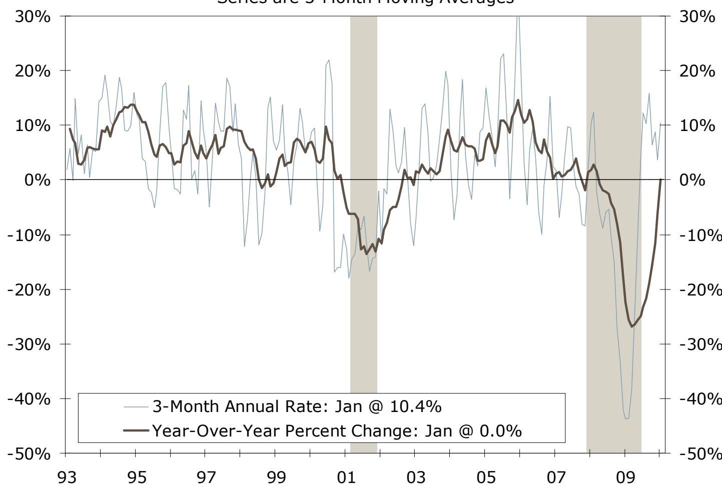
Existing Home Sales • Tuesday

Existing home sales are expected to reveal another drop in February. Harsh winter weather in the South and Northeast probably contributed to recent weakness. A decline in existing home sales in February would make this the third consecutive month of declining sales, which have now dropped back to levels last seen in June 2009. Still, sales remain above the lows plumbed immediately following the collapse in global financial markets. The sizable buildup in sales we saw in the months prior to the original November deadline for the first-time homebuyer tax credit does not appear to be materializing for the new April deadline. The end of Fed MBS purchases this month, which could push mortgage rates somewhat higher, and the end of the home buyer tax credit at the end of April are emerging headwinds for a rebound in housing demand and existing sales.

Previous: 5.05 M **Wells Fargo: 4.90 M**

Consensus: 5.00 M





Durable Goods • Wednesday

Durable orders are expected to rise again in February after strong gains in December and January. January durable goods orders rose 2.6 percent on the month and were 9.3 percent higher than a year ago. Aircraft and defense orders led the gains in January. But here too there could be some effects from the winter storms in February. The snow storms in February appeared to weigh on manufacturing hours worked and the durable component of industrial production. Manufacturing hours worked dropped 1.0 percent, while the durable component of industrial production fell 0.3 percent in February. One bright spot may be civilian aircraft orders, since Boeing orders surged to 47 planes from only 10 in January. On the other hand, vehicle sales appear to be leveling out after strong gains from the bottom, which could weigh on new car orders.

Previous: 0.7% **Wells Fargo: 2.6%**

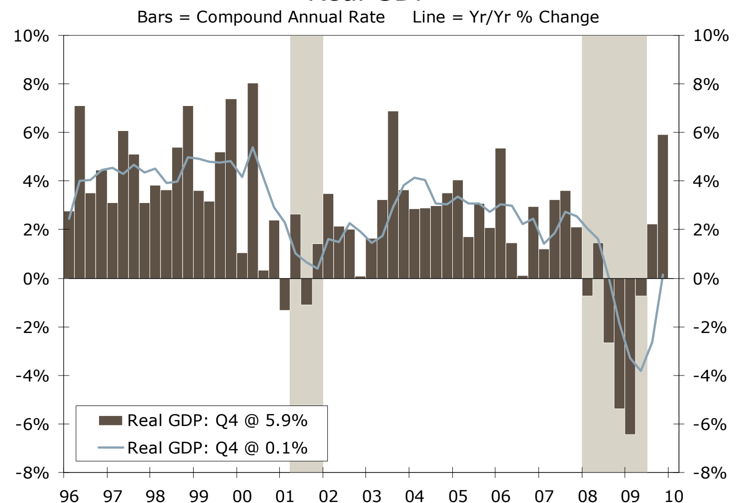
Consensus: 0.5 %

Q4 GDP Final Release • Friday

The third release of Q4 GDP should reveal little to no change from the 5.9 percent rate previously reported. The fourth quarter growth was the largest quarterly increase for U.S. GDP since 2003. Recent data for construction and inventories will probably prompt a net downward revision in Q4 GDP, though there will likely be an upward bump in Q4 trade data to offset this. In the second release inventories and fixed investment were revised higher, while trade, consumption and government spending were revised lower. Inventories accounted for the majority of the growth in Q4 as liquidation slowed to just $17 billion from $139 billion in the previous quarter. Still, equipment and software spending jumped at a 16 percent pace and consumption rose 1.7 percent.

Previous: 5.9% **Wells Fargo: 5.9%**

Consensus: 5.9%



Global Review

Greece Stabilized, For Now

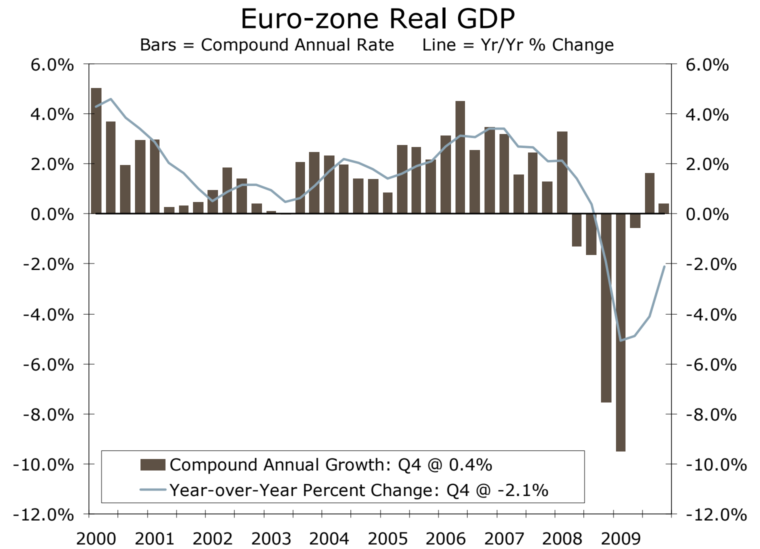
Finance ministers from Euro-zone countries met early this week to discuss solutions to the Greek government debt crisis. Following last month's announcement that euro-area countries are in principle willing to offer financial assistance to Greece, statements released this week gave a few more details regarding their willingness to support the Hellenic Republic. Instead of offering loan guarantees, the assistance would take the form of bilateral inter-governmental loans. Although a few more specifics were forthcoming this week, the public statements still lacked important concrete details. For example, we still do not know how much money euro area governments are willing to cough up to support Greece. Would all euro-zone countries be willing to participate, or only a subset? Under what conditions would funds be made available?

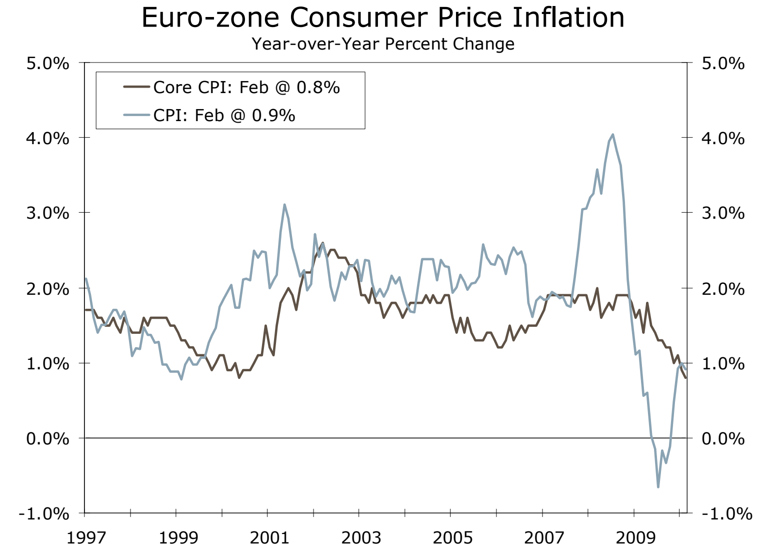
The yield on the 10-year Greek government bond peaked in late January before other euro-zone governments offered their support. Although the yield is down about 100 bps from its peak, it remains well above rates that prevailed before the crisis struck (see graph on front page). In our view, the relative lack of detail about any lending program for Greece is helping to keep long-term rates high due to elevated risk premia.

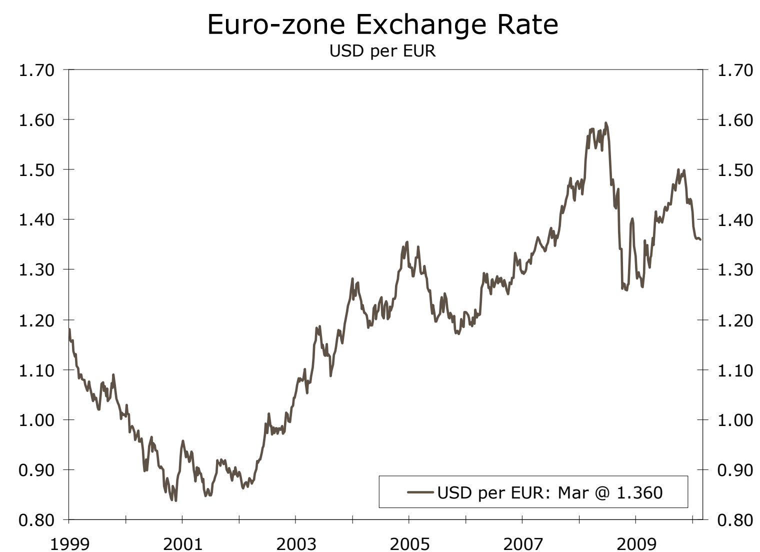
So why are euro-zone finance ministers unwilling to fully step up to the plate and offer more details? The answer appears to be that "bailing out" Greece is deeply unpopular in most euro-zone countries. Therefore, politicians are attempting to navigate a middle path. That is, they are willing to offer vague claims of assistance that may prevent the crisis from worsening. However, they are unwilling to offer specific details, at least up to this point, to avoid angering voters back home. Although the worst of the crisis may be past, at least for now, it likely has not fully gone away either.

In our view, it will probably continue to simmer on the backburner for some time. Growth in the overall euro area is very weak at present (top chart), and the Greek economy continues to contract. Indeed, real GDP in Greece declined 0.8 percent (not annualized) in the fourth quarter, the fifth consecutive sequential decline. Moreover, as we have pointed out in two recent special reports (both posted on our Web site), it will be difficult for Greece to grow its way out of its debt problems. Fiscal policy needs to be tightened, and monetary policy in the Hellenic Republic is the domain of the European Central Bank not the Bank of Greece. In addition, export growth is constrained because 60 percent of Greece's exports go to other euro-zone economies. Until a concrete lending program is announced or economic growth strengthens significantly, investors likely will be kept on edge about Greek fiscal prospects.

At least Greece does not need to worry about the ECB tightening policy anytime soon. Data released this week showed that the core rate of inflation in the euro area fell to only 0.8 percent in February, the lowest rate in at least two decades. Steady ECB policy should help to keep the short end of the Greek yield curve anchored. The Greek government also needs to hope that the euro, which has depreciated about 5 percent versus the dollar so far this year, continues to weaken. Although the majority of Greece's exports go to other euro-zone economies, a weaker euro would help Greek economic prospects at the margin.







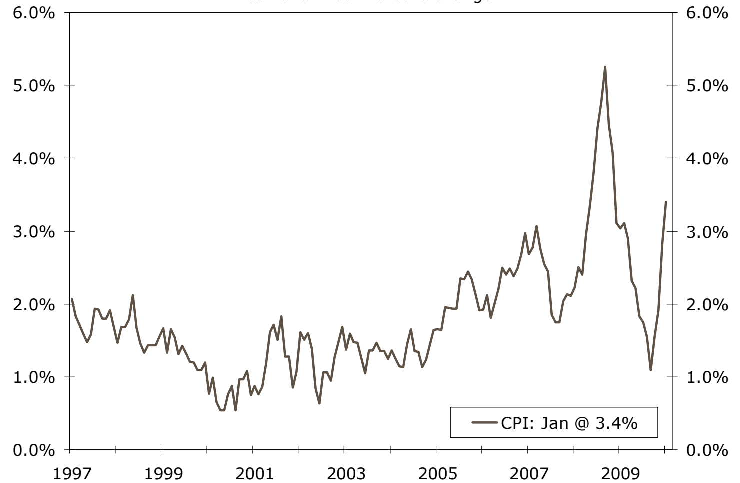
British CPI • Tuesday

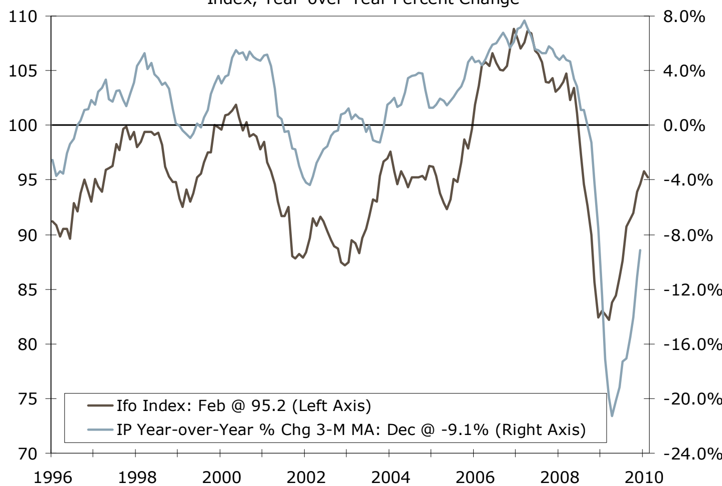
As mandated by law, the Bank of England is tasked with maintaining the CPI inflation rate at 2 percent over the "medium term." However, the inflation rate shot above 3 percent in January, which necessitated the Governor of the Bank of England to write an open letter to the Chancellor of the Exchequer explaining why inflation was more than a full percentage point above target. Part of the jump in the overall CPI inflation rate reflects the increase in the value-added tax that took effect. In addition, higher energy prices have also been pushing the inflation rate higher. In any event, we look for CPI inflation to recede in the months ahead due to weakness in the economy.

Retail sales data for February will be released on Thursday. Some bounce-back from the VAT-induced decline in January seems likely.

Previous: 3.5 % (year-over-year) Wells Fargo: 3.0%

Consensus: 3.1%





German Ifo Index• Wednesday

The Ifo index of German business sentiment is widely followed because it is highly correlated with growth in industrial production. The Ifo index edged lower in February, the first decline in ten months, but it remains at a level that historically has been consistent with positive growth in industrial production. Other "soft" data, in the form of the euro-zone manufacturing and service sector PMIs, will also be released on Wednesday. These indicators should give investors useful insights into the state of the euro-zone economy in March.

"Hard" data for key economies in the euro area will print next week as well. January data on factory orders in the overall euro area are slated for release on Wednesday, and French data on consumer spending in February print on Thursday.

Previous: 95.2

Consensus: 95.6

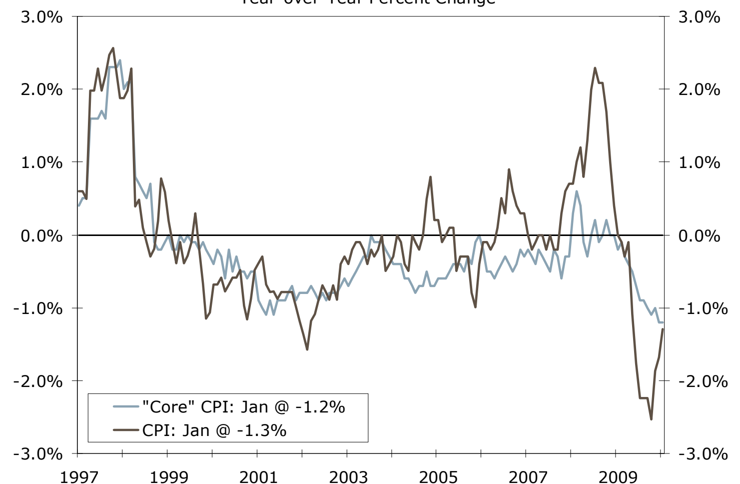
Japanese CPI Inflation• Friday

The surge in energy prices in 2008 and the subsequent collapse in 2009 has caused overall CPI inflation in Japan to fluctuate widely over the past two years. As measured by the core rate of inflation, however, the best characterization of the price environment in Japan would be one of mild deflation. Indeed, the deflationary environment led the Bank of Japan this week to extend an unconventional lending program in hopes of bringing about an inflationary environment again. In our view, consumer prices will continue to trend lower throughout 2010.

February sales data from department stores and convenience stores, which will print on Tuesday, should offer some insights into the current state of consumer spending in Japan. Data on the trade balance in February will be released on Wednesday.

Previous: -1.3% (year-over-year) Wells Fargo: -1.5%

Consensus: -1.1%



Interest Rate Watch

FOMC Maintains "Extended Period"

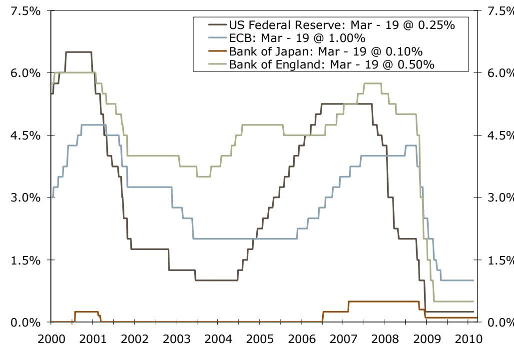
As expected, the Federal Open Market Committee kept the "extended period" language when referring to the level of the federal funds rate. Top-line readers are reassured that policy remains unchanged.

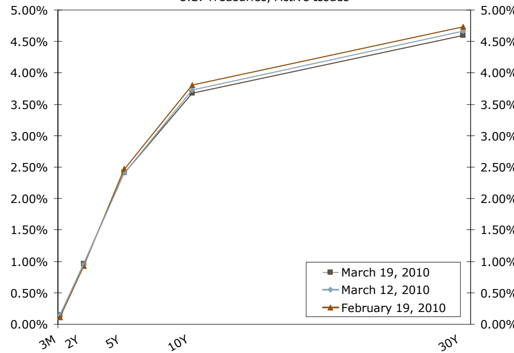
Yet, beneath the headlines it is becoming clear that market pricing will begin to change very soon. First, the Fed is likely to begin draining or sterilizing reserves by raising the interest rate on excess reserves. Both the Federal Reserve and the marketplace know that there is excess liquidity in the markets. President Hoenig's dissent makes public what everyone discusses behind the scenes. The excess reserves in the system are a financial imbalance that increases risks to long-run macroeconomic and financial stability.

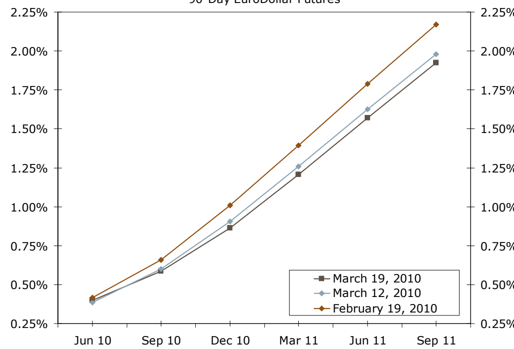
Markets are forward looking and therefore short rates will begin to discount a higher level of rates in anticipation of any possible Fed move this Fall. Comments by Chicago Fed President Evans suggests that "extended period" carries over into August at least. Therefore, six-month and longer-dated instruments should be discounting higher rates.

U-turn Ahead on Long Rates?

Longer out the curve, the challenge for decision-makers is the potential U-turn in Fed policy. For now the Fed indicates that its purchases of agency mortgage-backed securities are nearing completion. However, the FOMC leaves open the possibility that they may return to the marketplace depending on market and economic conditions. This potential U-turn has three negative implications. First, it suggests that housing/mortgage finance has become a new benchmark for setting Fed policy. How does housing's importance balance against inflation? Second, if the market pricing on MBS does not match the Fed's objectives, this suggests private market pricing is inconsistent with the Fed's real side economic goals. Finally, further Fed intervention into the MBS market suggests a bigger balance sheet and this contradicts the Fed actions at the short end. There appears to be much to lose at this U-turn.







Consumer Credit Insights

Consumers Still Impaired

On March 12, The Commerce Department reported a 0.3 percent increase in retail sales for February, much better than the 0.2 percent decline expected. That was the good news. The bad news was that January's 0.5 percent increase was revised down to a much weaker 0.1 percent gain.

Thus, while consumers have been spending a little more freely recently, their ability to spend remains impaired. Retail sales growth has actually slowed from November's pace. This rather mirrors the recent trends in housing as home sales have pulled back over the last few months, while starts remain just above cyclical lows.

With housing still quite weak, home equity borrowing continues the downward trend that started about this time a year ago. In March of 2009, home equity loans were still rising at a 20 percent year-on-year clip, but the latest reading shows a 0.3 percent year-on-year decline for the week of March 3, the first negative reading in more than a decade. Consumer loans continue to contract as well, down 8.1 percent year-on-year as household deleveraging continues.

With the rush of cash-for-clunkers behind us, holiday gift-card redemptions wrapping up and consumer credit contracting, we expect consumer spending growth to remain below average. There is little room politically or financially for new fiscal stimulus plans to bolster consumer spending; better job growth will be needed to keep the consumer alive and well.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.96%	4.95%	4.93%	4.98%
15-Yr Fixed	4.33%	4.32%	4.33%	4.61%
5/1 ARM	4.09%	4.05%	4.12%	4.98%
1-Yr ARM	4.12%	4.22%	4.23%	4.91%
MBA Applications				
Composite	620.9	633.1	600.5	876.9
Purchase	221.5	226.8	212.3	257.1
Refinance	2,955.9	3,007.2	2,860.1	4,497.6

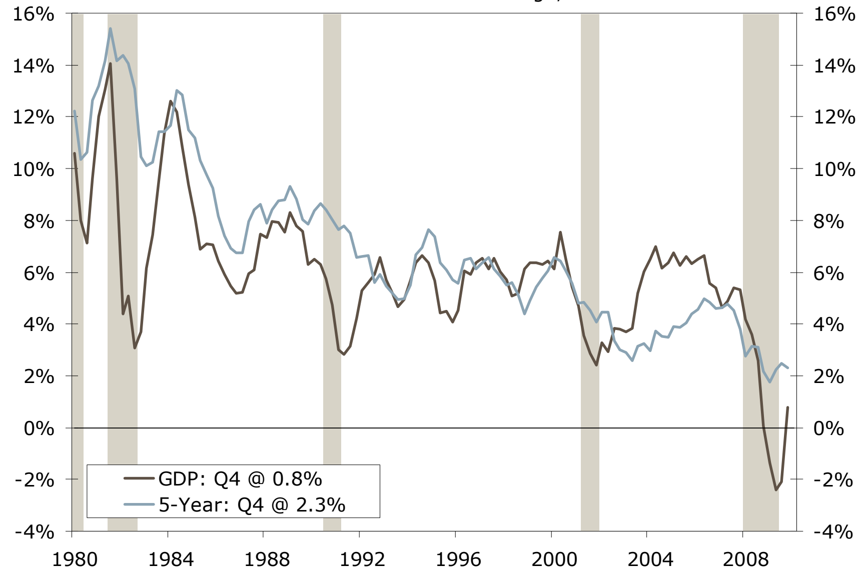
Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

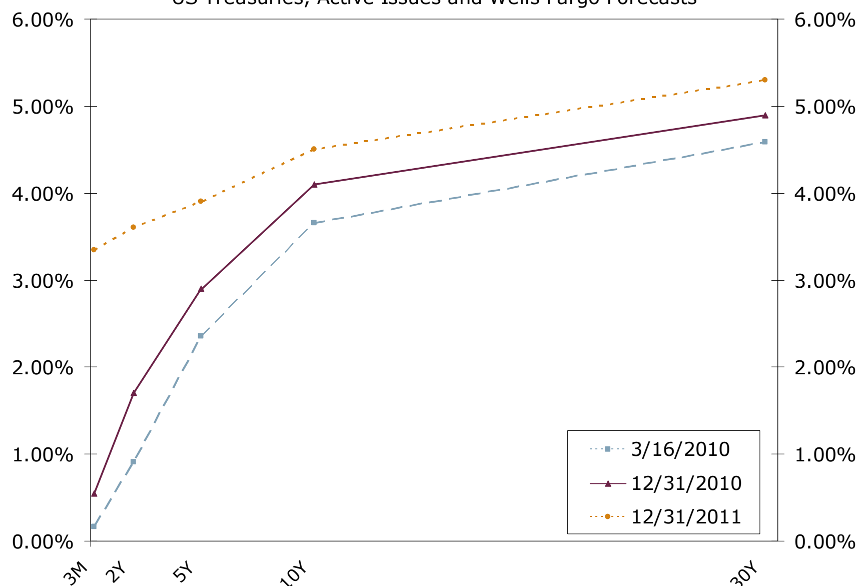
Topic of the Week

A Closer Look at Treasury Rates

During expansions, five-year Treasury rates have historically tracked fairly closely to nominal growth, that is, growth not adjusted for inflation. In the long run, nominal growth and long-term rates tend to converge. While the correlation between the two is far from perfect, particularly in the short run, nominal growth expectations can provide a general guideline for our rate projections. Given the dismal levels of growth notched during the depth of the recession, our forecast is comparatively quite robust. It follows that rates ought to increase significantly over the same time horizon. Indeed, the 10-year Treasury yield will likely double from the lows of the recession to the end of 2011, due at least in part to much improved economic growth. The path of GDP growth has traversed across an extremely broad swath of territory, which is common when transitioning between economic cycles. Rates have done the same. Extremely low as the flight to safety trade was in play, they have since begun to normalize. At the same time growth has returned to the U.S. economy. The recovery in the fourth quarter of 2009 and the first quarter of this year has been stronger than expected, at least on the headline. One of the many follow-on effects of this increased stability and outright growth is higher Treasury rates.

Higher Treasury rates, and consequently higher private borrowing rates, could have a chilling effect on the economic recovery if they come too soon or are too large. If rates rise in line with our current expectations, they will prove to be a modest drag on economic activity into 2011. Among other things, higher rates will hold growth slightly below trend next year and will help contain inflation expectations for the medium to long run. At the same time, a move higher in rates could give dollar denominated assets a relative advantage in global capital markets. If the Federal Reserve pushes short-term rates higher before other central banks, as we currently expect, it should prove modestly positive for the value of the dollar. Relative interest rates will likely favor dollar-dominated assets for the rest of this year and into 2011. For our complete report, Treasury Outlook: A Closer Look, please visit our Web site.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 3/19/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.15	0.14	0.19
3-Month LIBOR	0.28	0.26	1.23
1-Year Treasury	0.40	0.42	0.51
2-Year Treasury	0.96	0.95	0.86
5-Year Treasury	2.42	2.41	1.64
10-Year Treasury	3.67	3.70	2.60
30-Year Treasury	4.58	4.62	3.63
Bond Buyer Index	4.32	4.33	4.98

Foreign Exchange Rates

	Friday 3/19/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.353	1.377	1.367
British Pound ($/£)	1.509	1.520	1.451
British Pound (£/€)	0.896	0.906	0.942
Japanese Yen (¥/$)	90.470	90.560	94.510
Canadian Dollar (C$/$)	1.014	1.019	1.240
Swiss Franc (CHF/$)	1.062	1.058	1.124
Australian Dollar (US$/A$)	0.916	0.915	0.685
Mexican Peso (MXN/$)	12.551	12.532	14.240
Chinese Yuan (CNY/$)	6.827	6.826	6.828
Indian Rupee (INR/$)	45.497	45.445	50.390
Brazilian Real (BRL/$)	1.794	1.762	2.256
U.S. Dollar Index	80.699	79.833	83.129

Foreign Interest Rates

	Friday 3/19/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.58	0.59	1.58
3-Month Sterling LIBOR	0.65	0.64	1.76
3-Month Canadian LIBOR	0.40	0.40	1.10
3-Month Yen LIBOR	0.24	0.25	0.62
2-Year German	0.99	1.05	1.39
2-Year U.K.	1.25	1.23	1.39
2-Year Canadian	1.62	1.59	0.99
2-Year Japanese	0.15	0.15	0.40
10-Year German	3.11	3.17	3.05
10-Year U.K.	3.96	4.10	3.03
10-Year Canadian	3.45	3.54	2.70
10-Year Japanese	1.37	1.35	1.27

Commodity Prices

	Friday 3/19/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	81.58	81.24	51.61
Gold ($/Ounce)	1112.66	1101.90	959.85
Hot-Rolled Steel ($/S.Ton)	615.00	575.00	465.00
Copper (¢/Pound)	339.30	336.95	179.80
Soybeans ($/Bushel)	9.45	9.15	9.20
Natural Gas ($/MMBTU)	4.10	4.40	4.17
Nickel ($/Metric Ton)	22,722	21,222	9,791
CRB Spot Inds.	503.52	500.06	325.29

Next Week's Economic Calendar

	Monday 22	Tuesday 23	Wednesday 24	Thursday 25	Friday 26
U.S. Data		**Existing Home Sales** January 5.05M February 4.90M (W)	**Durable Goods Orders** January 2.6% February 0.7% (W) **Durables Ex Transp.** January -1.0% February 0.6% (W) **New Home Sales** January 309K February 320K (W)		**GDP (QoQ)** 4Q: 2nd 5.9% 4Q: 3rd 5.9% (W)
Global Data		**UK** **CPI (YoY)** Previous (Jan) 3.5%	**Euro-zone** **PMI Manufacturing** Previous (Feb) 54.2 **Germany** **IFO-Business Climate** Previous (Feb) 95.2	**France** **Consumer Spending** Previous (Jan) -2.7% **UK** **Retail Sales (MoM)** Previous (Jan) -1.8%	**Japan** **CPI (YoY)** Previous (Jan) -1.3%

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	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
Adam G. York	Economist	(704) 715-9660	adam.york@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economic Analyst	(704) 374-4407	tim.quinlan@wellsfargo.com
Kim Whelan	Economic Analyst	(704) 715-8457	kim.whelan@wellsfargo.com
Yasmine Kamaruddin	Economic Analyst	(704) 374-2992	yasmine.kamaruddin@wellsfargo.com

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