May 14, 2010

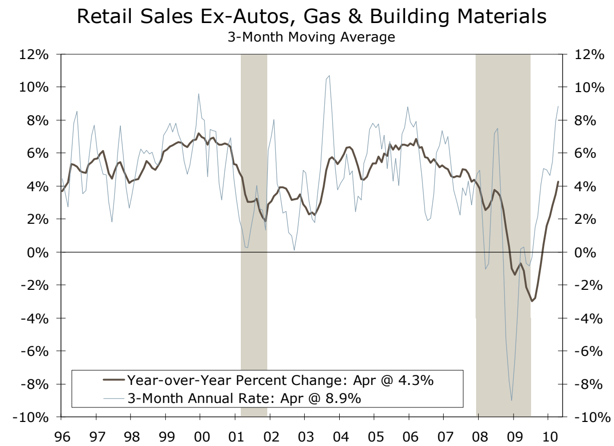
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Consumer Spending Still Contributing to the Recovery

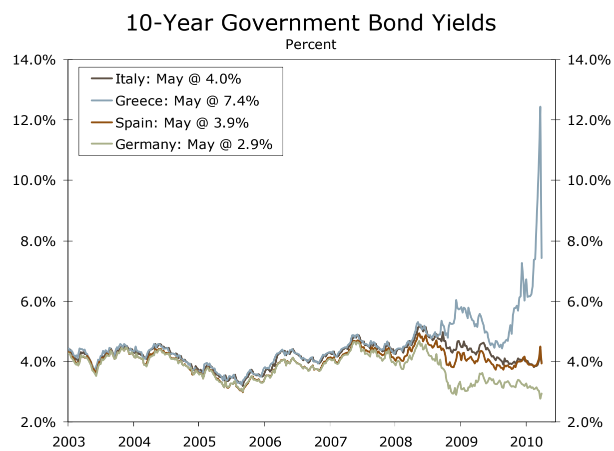
- Following a solid first-quarter contribution, consumer spending remained expansionary as retail sales continued to gain ground in April. Despite a slip in core retail sales, consumer spending should continue to propel the recovery forward.
- The manufacturing sector's V-shaped recovery remains intact. Led by improving global demand and domestic inventory restocking following an unusually long drawdown, total industrial production expanded further in April.



Global Review

With All Eyes on Greece, U.K. Economy Falling into Line

- At the start of the week, global financial markets cheered news of a European Union-led plan to halt the sovereign debt crisis that was spiraling out of control in Greece and threatening the broader European economy. Government borrowing costs came back down to a more normal level. See our special commentary, "European Union Moves to Put Out Greek Fire," on our Website.
- With all eyes on Europe, significant developments across the English Channel went somewhat unnoticed. After a disappointing first quarter for economic growth, it appears prospects for the U.K. economy are looking up.



Inside

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	3.2	3.6	2.0	2.1	2.7	2.1	0.4	-2.4	3.1	2.5
Personal Consumption	0.6	-0.9	2.8	1.6	3.6	3.1	1.8	2.2	2.9	2.6	-0.2	-0.6	2.5	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	2.2	1.7	1.4	3.2	2.9	3.8	-0.3	1.9	1.8
Industrial Production [1]	-19.0	-10.4	6.4	6.9	7.8	4.2	4.2	4.9	2.3	1.5	-2.2	-9.7	4.9	4.7
Corporate Profits Before Taxes [2]	-19.0	-12.6	-6.6	30.6	22.0	15.0	20.0	-1.0	10.5	-4.1	-11.8	-3.8	13.4	6.0
Trade Weighted Dollar Index [3]	83.2	77.7	74.3	74.8	76.1	78.0	79.0	81.0	81.5	73.3	79.4	74.8	81.0	87.0
Unemployment Rate	8.2	9.3	9.6	10.0	9.7	9.9	10.0	10.0	4.6	4.6	5.8	9.3	9.9	9.5
Housing Starts [4]	0.53	0.54	0.59	0.56	0.62	0.64	0.67	0.71	1.81	1.34	0.90	0.55	0.66	0.82
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	2.75
Conventional Mortgage Rate	5.00	5.42	5.06	4.93	4.97	5.70	5.60	5.60	6.14	6.10	5.33	4.93	5.60	6.10
10 Year Note	2.71	3.53	3.31	3.85	3.84	3.80	3.80	3.90	4.71	4.04	2.25	3.85	3.90	4.50

Forecast as of: May 12, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

U.S. Review

Despite Euro-zone Uncertainty, the U.S Economic Recovery Is Still on Pace

Economic indicators released during the week were mixed, but continue to suggest the recovery is under way. The nominal U.S. trade deficit for goods and services widened slightly in March to $40.4 billion with broad-based increases in both exports and imports. Both increases reflect the economic recovery that is occurring in both the U.S. and the global economy.

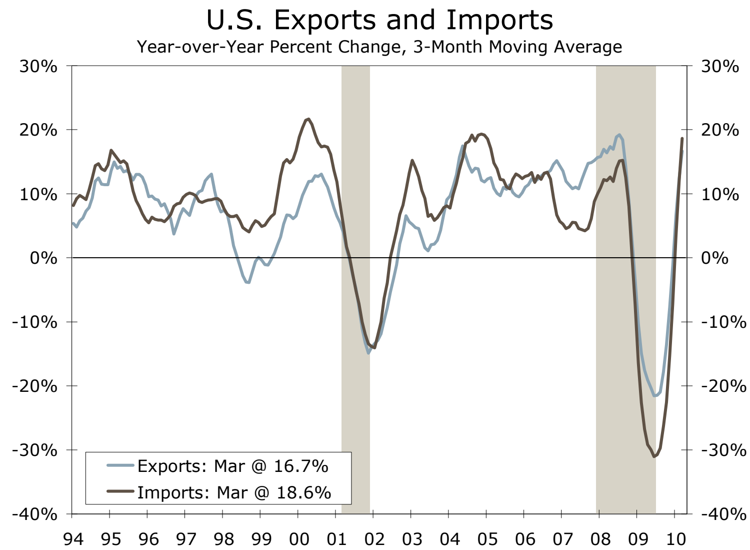
While trade data released this week continued to support an upward trend in exports, some market participants suggest turmoil in Europe and dollar strength will likely be deleterious for U.S. exports in the long run. Indeed, slow growth in Europe will result in somewhat slower growth in U.S. exports, but at around 20 percent of the total market share, it is simply not large enough to change the upward trajectory in U.S. exports if the rest of the world continues to grow.

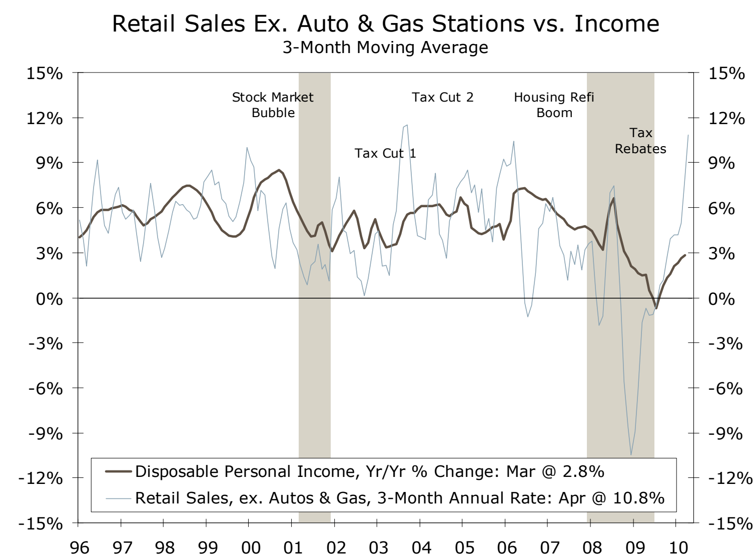
Retail sales grew 0.4 percent in April due largely to the third consecutive increase in building materials, which grew 6.9 percent on the month. Core retail sales, which excludes autos, gasoline and building material sales, is now up 9 percent on a three-month annualized basis. While the Easter holiday helped boost first-quarter consumer spending, we still expect the second quarter to grow at around a 3.1 percent annual rate. With spending currently outpacing income growth, however, the rebound in consumer spending will likely lose some momentum in the second half of the year.

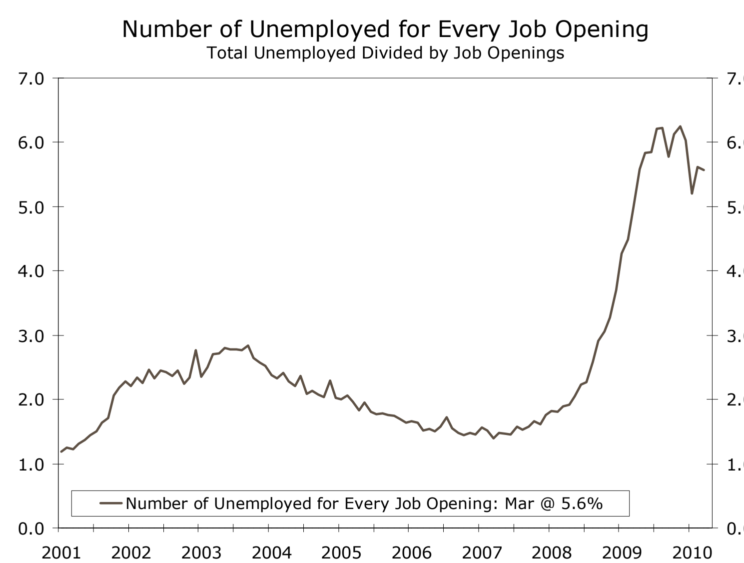
Data from the manufacturing sector continue to show strength with industrial production posting a 0.8 percent gain in April. Much of the gain was due to a 1 percent increase in manufacturing output. While capacity utilization increased sixth-tenths of a percentage point to 73.7 percent, it remains low by historical standards and continues to suggest surplus capacity exists in the economy.

Labor market indicators released this week remain fairly positive. Initial jobless claims fell by 4,000, to 444,000, from an upward revised 448,000. On a trend basis, the four-week moving average fell by 9,000, to 451,000. While claims are moving in the right direction, the level is still too high to be consistent with sustained underlying strength in payroll growth. We expect temporary census hiring will likely help boost payrolls in the coming months. Thereafter, we should see a retracement in temporary and government employment through September. By the fourth quarter, the effects of the census should be behind us and payroll gains should reflect underlying strength in the private sector.

The Job Openings and Labor Turnover Survey also showed some improvement in the labor market with the number of job openings continuing to trend higher since the most recent trough of 2.3 million in July 2009. The number of job openings in March remained at 2.7 million with the ratio of unemployed to job openings consistent at 5.5 workers per job opening. Even the NFIB Small Business Optimism Survey pointed to slightly better news but plans to hire remain weak.







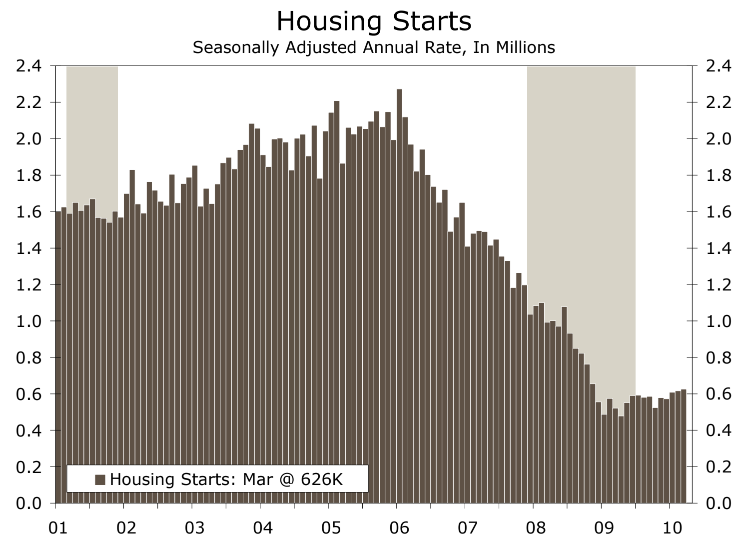
Housing Starts • Tuesday

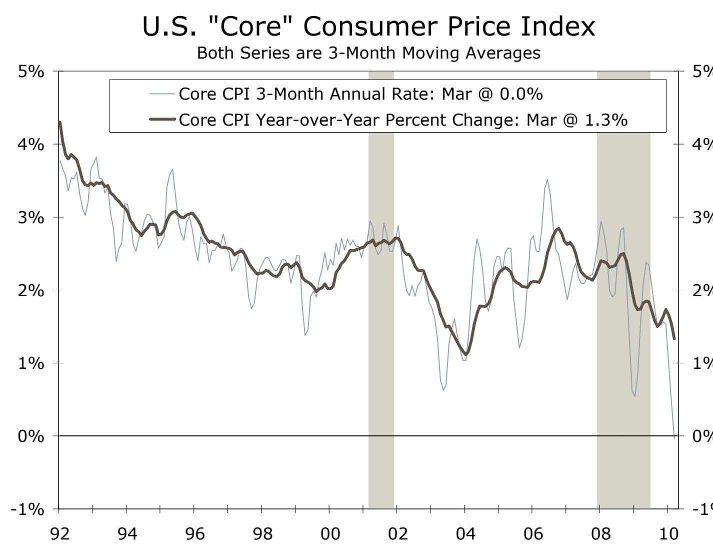
Since the start of the year, housing starts have eclipsed the 600,000-unit level and continue to make modest improvement. Favorable weather conditions, improved homebuilder sentiment and the pending expiration of the first-time homebuyer tax credit suggest we should see a sizable increase in April to an annualized pace of 665,000 units.

As the year progresses, we expect residential construction to make small but growing contributions to growth. However, the housing market will not return to a position of strength until late next year or in 2012.

Previous: 626K **Wells Fargo: 665K**

Consensus: 650K





Consumer Price Index • Wednesday

The Consumer Price Index (CPI) rose 0.1 percent in March. The overall CPI is now up 2.3 percent year over year, while the core CPI is up just 1.1 percent. With housing in obvious oversupply, rent and owners' equivalent rent should continue to moderate in coming months keeping core consumer prices relatively tame. Goods prices, however, are continuing to rise faster than services prices. Goods prices were up 1.9 percent over the past year, but the pace is slowing. Core goods prices are being pulled up by stronger global economic growth, while weak domestic demand continues to restrain core services prices. Substantial slack in the economy, as measured by the unemployment rate, capacity utilization and the output gap should continue to put downward pressure on core consumer prices. Benign consumer price increases should allow the Fed to keep short-term interest rates low.

Previous: 0.1% **Wells Fargo: 0.2%**

Consensus: 0.1%

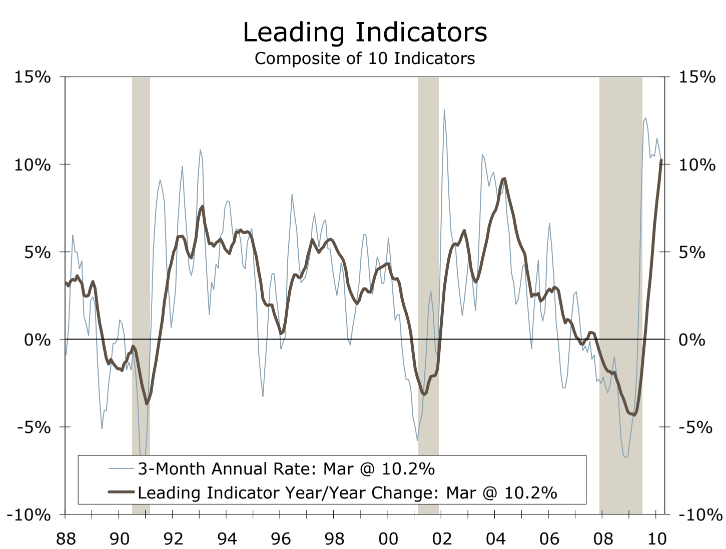
Leading Economic Indicator • Thursday

The Leading Economic Indicator (LEI) jumped 1.4 percent in March, bringing the year-over-year gain in the index to a 26-year high. Gains were broad-based as seven of the 10 components rose. While we expect a modest increase in April, contributions will likely only come from the yield spread, stock prices and average weekly hours. Six components are expected to subtract from the headline index, highlighted by substantial declines in the money supply and supplier deliveries.

Real GDP is expected to grow at a 3.6 percent annual pace during the first quarter and a 3.1 percent annual pace for 2010. The strength of the LEI suggests that the probability of a double-dip recession later this year has fallen significantly.

Previous: 1.4% **Wells Fargo: 0.1%**

Consensus: 0.2%



Global Review

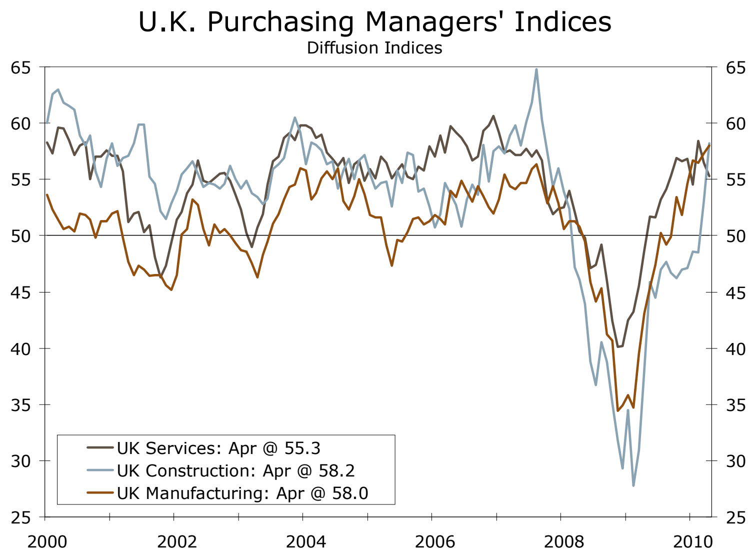
Is an Upward Revision to U.K. GDP Growth on the Way?

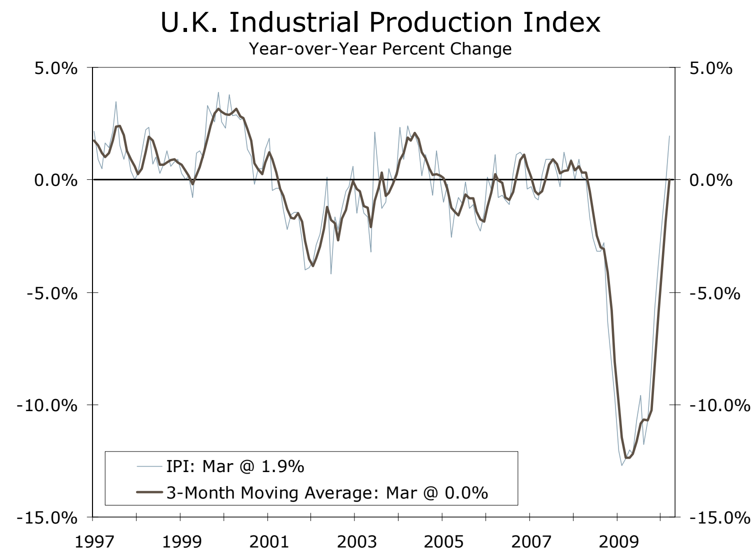
Going into this week, we already knew that the U.K. economy expanded at a mere 0.8 percent annualized rate in the first quarter. The turnout had been a disappointment to analysts who had been expecting roughly twice that rate of growth. Two out of three of the U.K.'s monthly Purchasing Managers' Indexes (PMIs) have been in expansion territory (above 50) for months, so the hopeful expectations were at least somewhat justified.

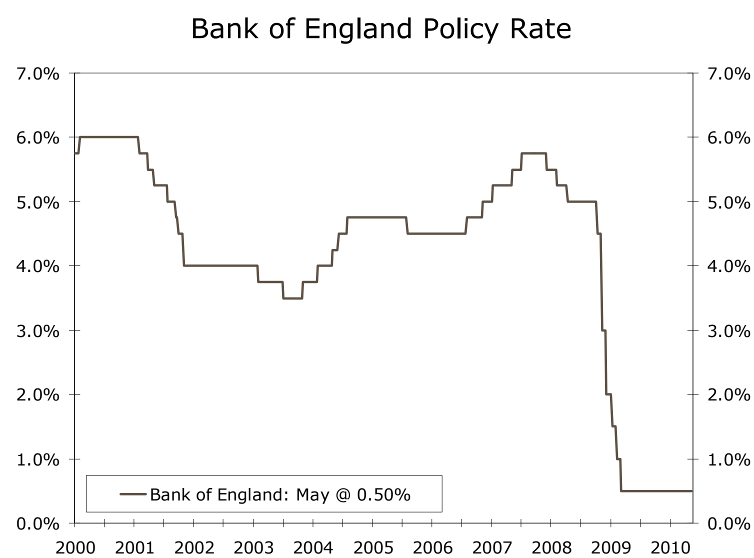
Market-watchers were taken off-guard again this week, however this time it was a positive surprise. Industrial Production (IP) in the United Kingdom jumped 2.0 percent in March, with manufacturing output sky-rocketing 2.3 percent since February. The surge in manufacturing activity was more than five times the consensus expectations and the largest monthly jump since 2002. Recent sterling weakness has made British manufactured goods more affordable to foreign buyers. While that may explain part of the strength, the fact of the matter is that the economy may have grown at a faster rate than previously thought. By our estimate, the March IP growth alone would lift the sequential growth rate in the fourth quarter by about one-tenth of a percent, which would translate into a revised GDP number for the first quarter of a growth rate of roughly 1.2 percent. And it appears that the momentum could be carried into the start of the second quarter. Indeed, earlier in the week a widely followed estimate of monthly GDP growth estimated growth of 0.5 percent in April alone. If that turns out to be the case, it would match the fastest monthly growth rate since before the recession began.

In the wake of the recent indecisive parliamentary election, a formal coalition between political parties has come together with David Cameron as its new prime minister. One of the key policy decisions to come out of the fledgling government was the announcement to move forward with £6 billion in public spending cuts in the current fiscal year. While this amount is too small to make any kind of difference, it signals the intentions of the new government to move in a more fiscally conservative direction. The Bank of England (BoE) was supportive of the maneuver.

The BoE's Monetary Policy Committee published its quarterly inflation report this week. Markets watch this publication for clues to monetary policy bias. The report modestly raised the outlook for CPI inflation from 1.2 percent to 1.4 percent. With the bank's growth outlook and risk assessment essentially unchanged, we conclude that the BoE will retain its dovish bias and we still do not expect rate increases out of the BoE for the remainder of the current year. Our confidence in that call is reinforced somewhat by the recently proposed austerity measures, which would tighten the reigns just as effectively as a rate hike—at least in the near term. As mentioned earlier, another major takeaway from the Inflation Report was the bank's explicit endorsement of the incoming government's proposed public spending cuts in the current fiscal year. Tighter fiscal policies give the bank cover to keep rates low, at least for now.





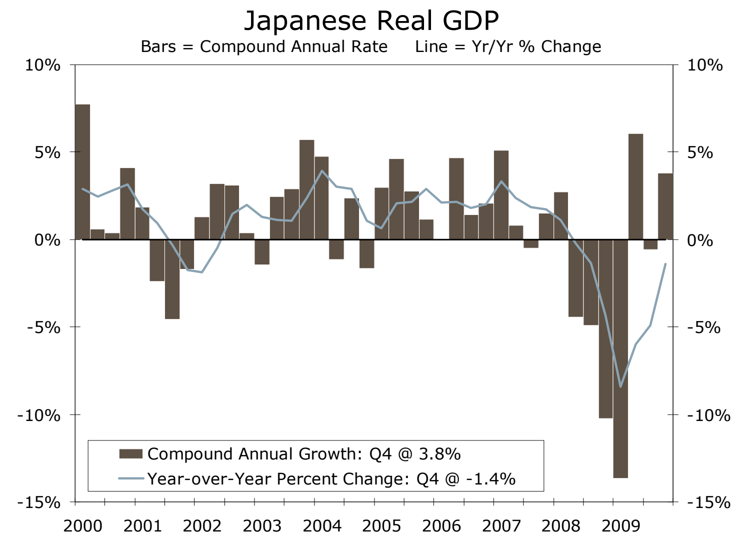


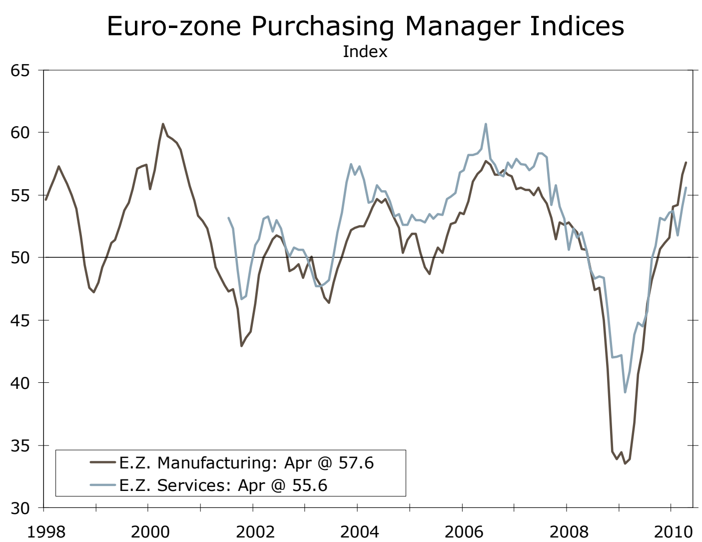
Japanese Machine Orders • Thursday

The Japanese economy is gradually recovering from a nasty recession. On a peak-to-trough basis, real GDP in Japan contracted more that 8 percent before bottoming in the first quarter of 2009. Since then, the economy has grown by a little more than 2 percent. On Monday, a report on March machine orders should give us a final clue about business spending before first-quarter GDP numbers are released on Thursday. The consensus is looking for a jump in machine orders to offset the decline in February. Given recent stronger economic data coming out of Japan, expectations are running high for first-quarter GDP, an annualized growth rate north of 5 percent is in the cards. Recent sovereign debt issues in Europe have begun to put pressure on Japanese policy-makers to reign in debt. A strong GDP print this week could help the debt/GDP ratio and ease that pressure somewhat.

Previous: 3.8%

Consensus: 5.5%





Euro-zone PMIs • Friday

The plan to help stabilize debt-trapped European economies allows markets to look past sovereign debt issues—for now—and look instead at the pace of recovery across the rest of the Euro-zone. Among the most widely followed leading indicators for the Euro-zone are the purchasing managers' indexes (PMIs). Both the manufacturing and the services PMI have been in expansion territory for months and while the consensus expects these measures to continue to signal expansion, the indexes may not gain at the same pace as they did coming out of the recession. Even if these measures were to stabilize at current levels, that would still be supportive of economic growth.

Also out next week in the Euro-zone is CPI inflation data for April. The data will likely show that prices remain in check and will likely give the ECB cover to keep rates accommodative.

Previous: 57.6 for Manufacturing, 55.6 for Services

Consensus: 57.4 for Manufacturing, 55.6 for Services

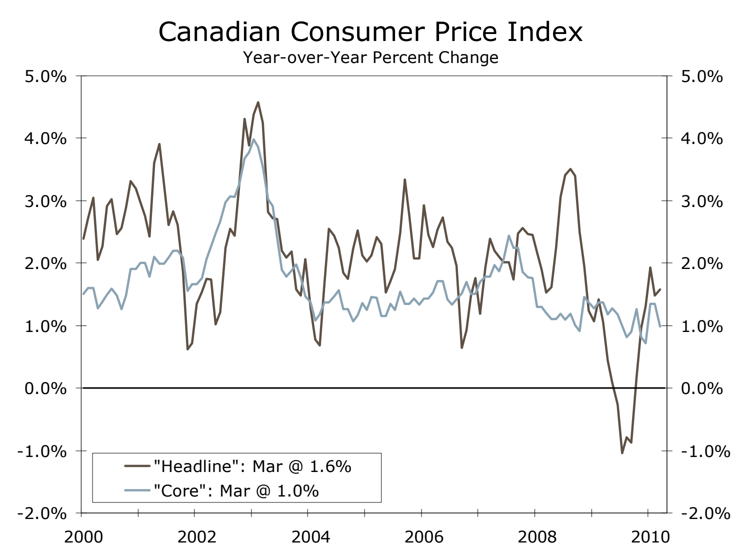
Canadian CPI • Friday

The Bank of Canada (BoC) recently backed away from its conditional intention to leave the target rate unchanged through the second quarter of 2010. Though the core rate of inflation remains near the bottom of BoC's target range of 1 to 3 percent, the vigorous pace of economic recovery and the stellar April jobs number likely mean a 25-bp hike when the BoC meets in June.

With GDP data for January and February already reported, it appears the Canadian economy likely grew at a more than 5 percent pace in the first quarter of 2010. We will get the consumer data for the last month of the quarter when March retail sales data are reported on Friday. Stores rang up higher sales in each of the past three months, and the consensus expects a pause in the gains in retail sales, but the swiftly recovering job market may be bolstering consumer sentiment, providing an upside risk.

Previous: 1.6%

Consensus: 1.7%



Interest Rate Watch

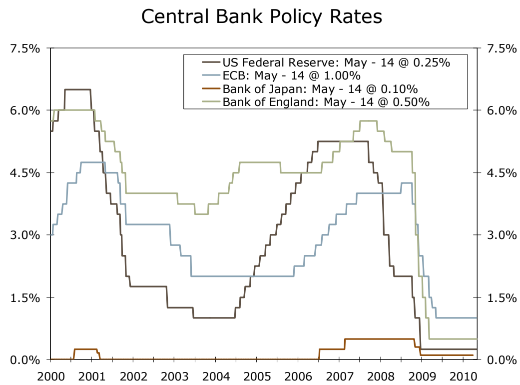
Global Capital Markets and the Normalization of Deviance

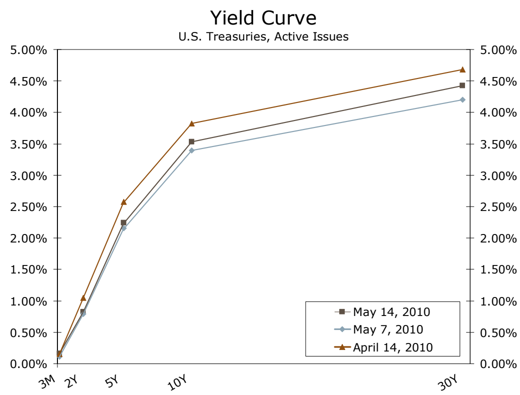
Another installment of the Greek Tragedy this week has brought heightened uncertainty into the capital markets, and this, in turn, has distorted the prices of financial assets. The flight-to-safety premium for Treasuries has certainly altered benchmark rates.

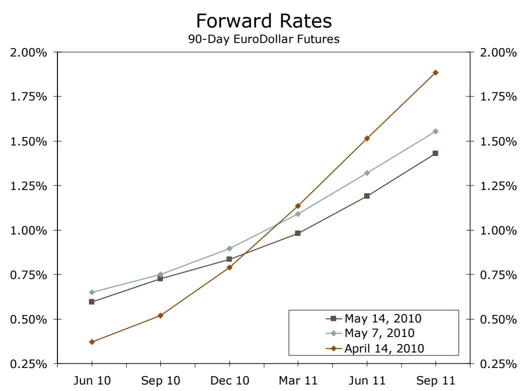
The Greek debt/euro problems reflect a typical pattern we have witnessed before in the housing/mortgage crisis. Deviations from the euro's targets for debt and deficit ratios have been persistent for years for many countries. Over time, these deviations have become accepted as the norm as did spectacular increases in home prices in California and Florida. The normalization of these deviances was accepted as long as investors would accept at face value the credits of the underlying securities—sovereign debt or mortgage-backed securities.

But at some point, usually in spectacular fashion, investor sentiment shifts and we get a wholesale failure of market pricing, a revulsion against the underlying credit, and a volatile trading environment where rumors and recrimination replace rational analysis.

Such is today's volatile pricing environment. From the start, we should recognize that capital markets are trading at nonmarket prices as they have been for some time (See our special commentary, "An Economy at Non-Market Prices," October 2009). For starters, today's Federal Funds rate is too low to be sustainable over time with a Fed balance sheet and U.S. fiscal imbalance that strongly dictates significant inflationary risk over time. Second, Treasury benchmark rates are pricing in a one-dimensional bet on avoiding default risk today, while underpricing the risk of future inflation and significant Treasury debt issuance going forward. For example, median inflation expectations for the 5–10 year period ahead (2.7 percent) now exceed the five-year Treasury yield (now 2.6 percent) even before future taxes are taken into account. Such mispricing, when unwound, is quick and painful.







Consumer Credit Insights

Nonrevolving Credit Growing

Consistent with reports of easing credit standards, particularly at large banks, consumer credit outstanding jumped 1.0 percent at an annual rate, or $2 billion in March. The gain was a surprise to the consensus, which had expected a second straight decline. February's reported decline was not as severe, confirming that borrowing, at least the nonrevolving portion, has picked up on trend. Declining utilization of revolving credit is unsurprising, given the mindset and circumstances of the typical U.S. consumer at present. Job growth has begun, but the level of payrolls remains well below the prior peak. Confidence is returning slowly and income gains have been tepid, reliant in part on transfer payments from government. Consumers are still saving somewhat with 3 percent of income being reserved for this purpose. Daily spending on core needs is being met increasingly through cash and checks, in a partial return to fiscal conservatism. Revolving credit will likely increasingly be drawn upon only when necessary, as wary spenders keep tabs on budgets. While the use of revolving credit has continued to decline, nonrevolving credit has gained traction. March saw a jump of 6.7 percent in auto sales, which is partly responsible for growth here, but future gains will likely be tempered. Given the unsatisfying pace of job growth and income gains, credit demand will reflect that reality even as standards gradually loosen.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.93%	5.00%	5.07%	4.86%
15-Yr Fixed	4.30%	4.36%	4.40%	4.52%
5/1 ARM	3.95%	3.97%	4.08%	4.82%
1-Yr ARM	4.02%	4.07%	4.13%	4.71%
MBA Applications				
Composite	578.1	556.2	484.6	895.6
Purchase	263.6	291.3	218.0	265.7
Refinance	2,430.8	2,117.3	2,047.1	4,588.6

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

Topic of the Week

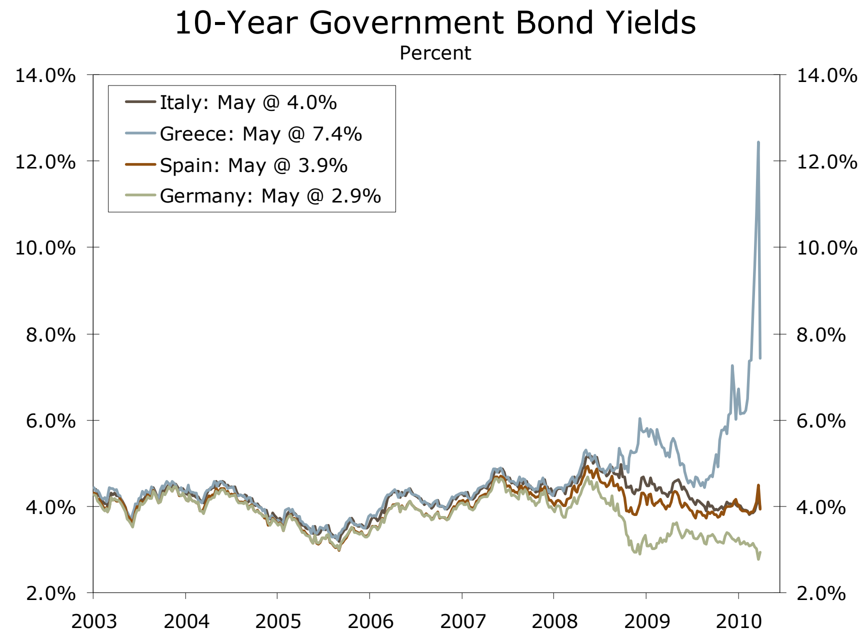
A Fix for European Sovereign Debt Crisis

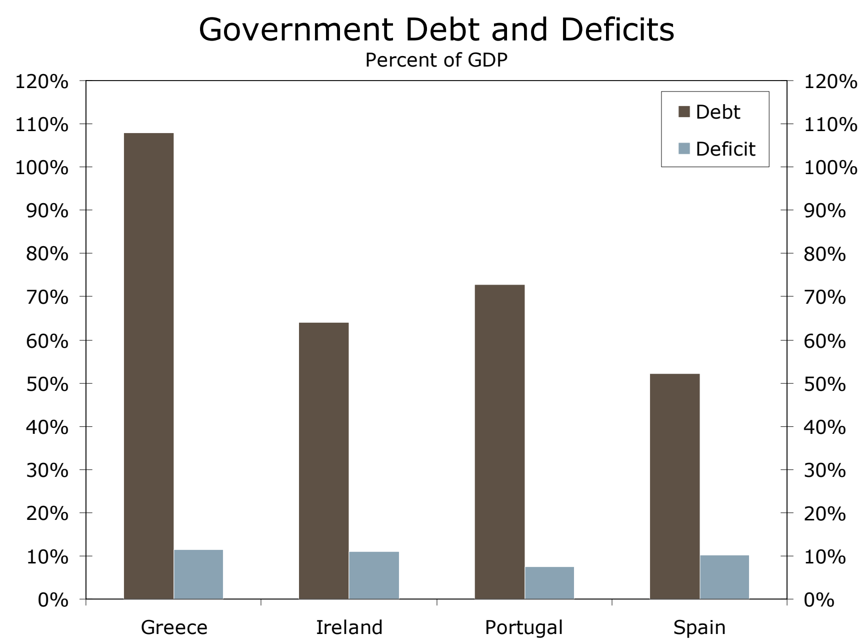
Financial markets went into a tailspin last week on concerns that the bad debt woes of the Greek government were about to go global. The realization that another global financial crisis was looming spurred the leaders of the European Union into action over the weekend forming a rescue plan with three components, the first of which is a lending facility that totals €750 billion (nearly $1 trillion). If needed, individual countries in the European Union would contribute up to €440 billion in bilateral loans as well. The European Commission will establish a €60 billion emergency fund, and the International Monetary Fund will top off the lending facility with a €250 billion commitment.

The second component is action by the world's central banks. The European Central Bank (ECB) announced that it would "conduct interventions...to ensure depth and liquidity in those market segments which are dysfunctional." To bring liquidity back to the fixed-income markets, the ECB will buy bonds, at least on a temporary basis. The ECB also announced that it would take measures to sterilize the government bond purchase to prevent inflationary pressure.

In the wake of the Lehman Brothers collapse, the Fed opened up swap lines with some other major central banks to provide dollar funding to their respective banking systems. The Fed let the swap lines expire earlier this year, because they were no longer needed. However, the swap lines between the Federal Reserve, the European Central Bank, the Bank of Canada, the Bank of England and the Swiss National Bank have been reauthorized through January 2011.

Third, highly indebted governments, including those in Portugal and Spain have announced that they will take further steps to bring their gaping deficits under control. Specifically, each country has committed to reduce its respective deficit in 2010 and 2011 by a 0.5 percentage point to a full percentage point more than previously promised. Last week, the Greek parliament passed an onerous austerity plan worth about 10 percent of GDP over the next few years. In our view, the decisive response of European leaders will likely bring the crisis to an end, at least for now.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 5/14/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.15	0.12	0.15
3-Month LIBOR	0.45	0.43	0.85
1-Year Treasury	0.22	0.15	0.25
2-Year Treasury	0.77	0.81	0.84
5-Year Treasury	2.13	2.16	1.96
10-Year Treasury	3.42	3.43	3.09
30-Year Treasury	4.30	4.27	4.05
Bond Buyer Index	4.32	4.29	4.54

Foreign Exchange Rates

	Friday 5/14/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.239	1.276	1.364
British Pound ($/£)	1.455	1.480	1.524
British Pound (£/€)	0.851	0.861	0.895
Japanese Yen (¥/$)	91.940	91.590	95.800
Canadian Dollar (C$/$)	1.035	1.044	1.169
Swiss Franc (CHF/$)	1.131	1.108	1.104
Australian Dollar (US$/A$)	0.888	0.888	0.760
Mexican Peso (MXN/$)	12.583	12.870	13.199
Chinese Yuan (CNY/$)	6.827	6.826	6.825
Indian Rupee (INR/$)	45.205	45.478	49.785
Brazilian Real (BRL/$)	1.805	1.838	2.086
U.S. Dollar Index	86.123	84.450	82.279

Foreign Interest Rates

	Friday 5/14/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.63	0.63	1.26
3-Month Sterling LIBOR	0.70	0.70	1.37
3-Month Canadian LIBOR	0.54	0.50	0.80
3-Month Yen LIBOR	0.25	0.24	0.54
2-Year German	0.55	0.53	1.26
2-Year U.K.	0.92	1.08	1.02
2-Year Canadian	1.81	1.81	1.10
2-Year Japanese	0.17	0.17	0.38
10-Year German	2.85	2.80	3.31
10-Year U.K.	3.74	3.83	3.48
10-Year Canadian	3.41	3.50	3.09
10-Year Japanese	1.31	1.28	1.44

Commodity Prices

	Friday 5/14/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	71.43	75.11	58.62
Gold ($/Ounce)	1233.33	1208.40	926.50
Hot-Rolled Steel ($/S.Ton)	645.00	645.00	375.00
Copper (¢/Pound)	312.30	313.10	203.50
Soybeans ($/Bushel)	9.50	9.32	11.33
Natural Gas ($/MMBTU)	4.29	4.02	4.29
Nickel ($/Metric Ton)	22,701	21,985	12,370
CRB Spot Inds.	492.05	497.33	378.41

Next Week's Economic Calendar

	Monday 17	Tuesday 18	Wednesday 19	Thursday 20	Friday 21
U.S. Data		**PPI** March 0.7% April 0.2% (W) **Core PPI** March 0.1% April 0.1% (W) **Housing Starts** March 626K April 665K (W)	**CPI** March 0.1% April 0.2% (W) **Core CPI** March 0.0% April 0.1% (W)	**Leading Indicators** March 1.4% April 0.1% (W)	
Global Data	**Japan** **Machine Orders (MoM)** Previous (Feb) -5.4%	**Germany** **ZEW Survey** Previous (Apr) 53.0 **UK** **CPI (YoY)** Previous (Mar) 3.4%		**Janpan** **GDP (QoQ)** Previous (4Q) 0.9% **Germany** **PPI (YoY)** Previous (Mar) -1.5%	**Canada** **CPI (YoY)** Previous (Mar) 1.4% **Euro-zone** **PMI Services** Previous (Apr) 55.6

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

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