May 28, 2010

Economics Group

Weekly Economic & Financial Commentary

U.S. Review

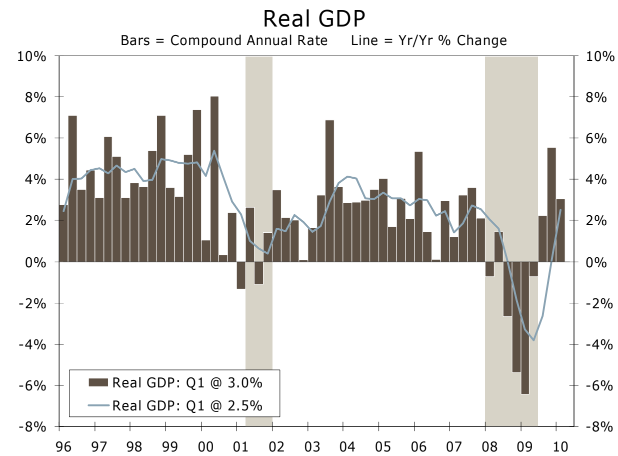
Some Good and Not So Good Data This Week

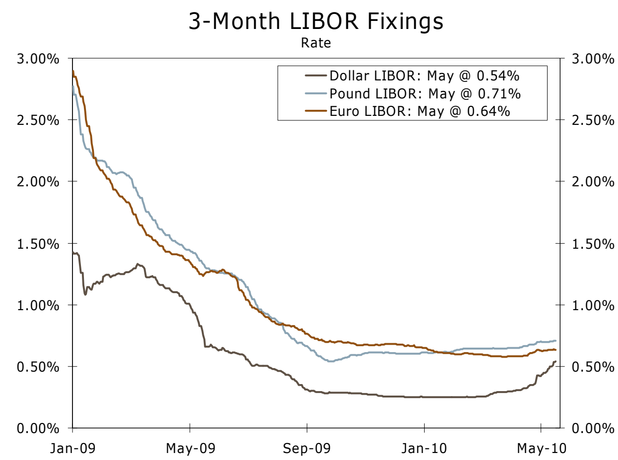
- The panic that gripped global markets over the past two weeks appears to be easing a bit. It helps that the economic data coming out of the United States suggest a sustainable recovery is now well underway. On the positive side, consumer confidence rose more than expected in May. The April durable goods orders and the May Richmond Fed survey confirmed that the U.S. manufacturing expansion continues to gain traction.
- Less good was the slight and unexpected downward revision in Q1 U.S. GDP growth, and U.S. home price data that reveal home prices beginning to roll over again.

Global Review

Euro-zone Issues Lead to Tighter Financial Conditions

- There are two ways by which sovereign debt issues in Europe can affect the U.S. economy. First, fiscal tightening in Europe will likely restrain U.S. export growth. However, exports to the euro area represent a relatively small proportion of U.S. GDP.
- The more pernicious effect is via the tightening in bank funding markets as exhibited by the recent increase in LIBOR rates. Another credit crunch, should one occur, would have a very negative effect not only on the U.S. economy, but on the global economy as well.





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	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

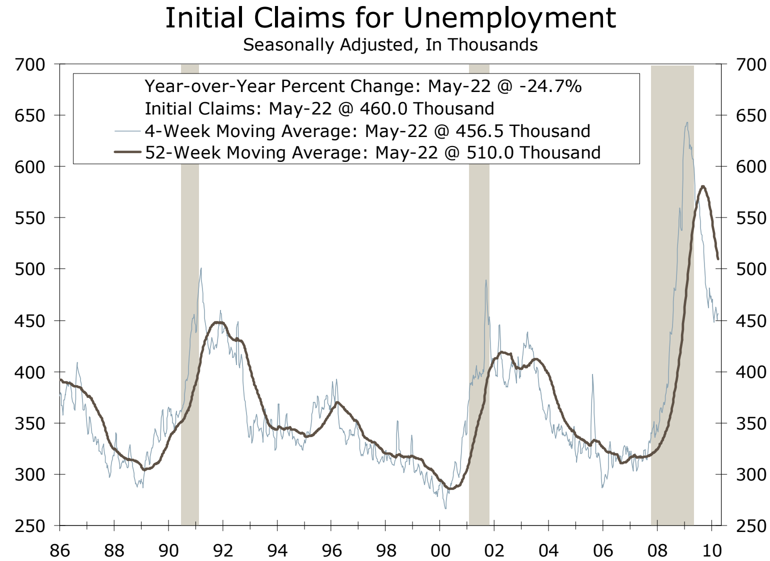
Two-Speed Recovery Continues

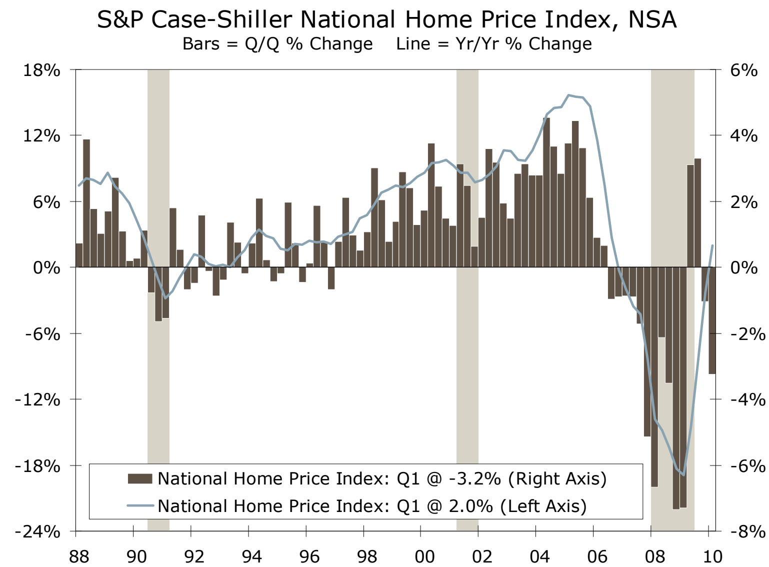
The U.S. economic recovery continues to show its Dr. Jekyll and Mr. Hyde sides. Perhaps that is a factor behind the schizophrenic stock market behavior of late. An “unbalanced” or “two-speed” recovery remains the current state of affairs. This is disappointing to the bulls that have been rampaging on Wall Street since March 2009, trumpeting the strong return of corporate earnings, while whispering the recovery is looking stronger than the consensus had expected. There were plenty of reminders this week that the bulls’ case for a normal or robust recovery from deep recession remains a long shot.

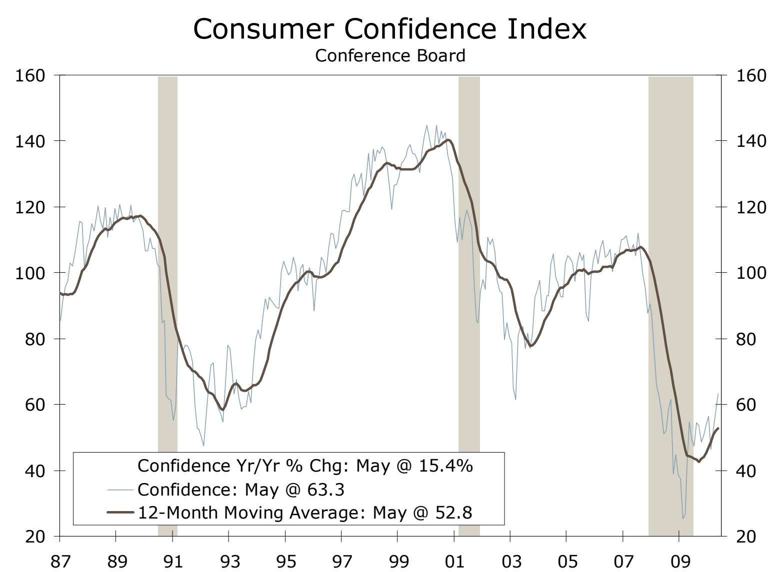
On the labor market front, initial jobless claims refuse to drop to levels that would suggest a swift return of a normal private sector payroll growth during an economic recovery. The four-week moving average of initial jobless claims, a more stable indicator of job trends than the weekly number, has risen for two consecutive weeks now, even though initial claims dropped by 14,000 to 460,000 in the latest week. Initial claims have clearly been trending around the 450,000 level for months now, when we would like to see them slip back to the 350,000-400,000 level that often characterizes a normal labor market during economic expansion. Thankfully, other employment indicators are not quite as scary. The monthly payroll data have indicated positive job growth for four consecutive months now. The household survey data are indicating an even stronger return of job creation, although one third of those new jobs are part-time. Indeed, we expect the May jobs report that is to be released next week will reveal even more job gains than in April, though much of the strength will likely be from temporary census hiring.

We also got confirmation that despite Herculean efforts to support the housing market through homebuyer tax credits, mortgage modifications and record low mortgage rates, the ability to stabilize home prices at current levels appears fragile. The Office of Federal Housing Enterprise Oversight (OFHEO) released its monthly purchase-only home price index report for March, showing an increase of 0.3 percent from February after a string of three consecutive monthly declines. However, this home price index is still down 1.9 percent from a year ago. By contrast, the seasonally-adjusted national Case-Shiller index revealed renewed weakness in home prices in the first quarter. The Case-Shiller index plunged at an annualized 5.05 percent rate in the first quarter, even though the year-over-year figure improved to a 2.13 percent home price gain. In the wake of the homebuyers’ tax credit expiration and the rise in the U.S. foreclosure rate, further declines in national home prices can be expected.

Where is the good news, you ask? Consumer confidence jumped in May to 63.3, better than expected. Fewer consumers reported jobs were hard to get and more planned to buy a car over the next six months. April durable goods orders rose another 2.9 percent, paced by a large increase in commercial aircraft orders and computers and electronics orders. Finally, manufacturers in the Richmond Fed region reported continued robust growth in new orders and wages in May.





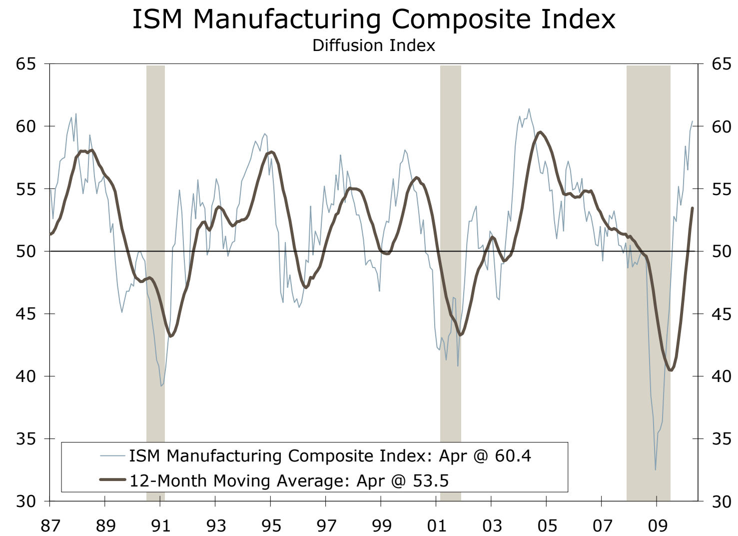


ISM Manufacturing • Tuesday

The Institute for Supply Management's (ISM) headline manufacturing index remained solidly in expansionary territory in April, reflecting continued strength in the manufacturing sector. The forward-looking new orders index has remained well above the threshold of 50 for 10 consecutive months and at 65.7, continues to suggest further gains in industrial production. The employment index continues to reflect stabilization in manufacturing employment. While some regional manufacturing surveys have posted declines in April, we expect continued strength in the manufacturing sector in the coming months. A moderation in the pace of manufacturing activity is imminent, however, as inventories are brought in line with sales. We expect the ISM Index to remain solidly in expansionary territory in May.

Previous: 60.4 **Wells Fargo: 59.4**

Consensus: 59.5

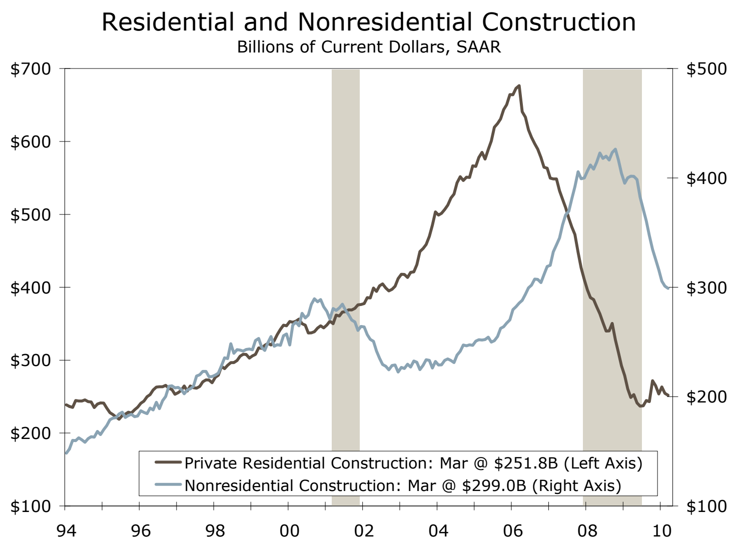


Construction Spending • Tuesday

Construction spending rose o.2 percent in March driven by gains in the public sector. Public spending was boosted by large increases in power and transportation. Single-family construction also rose as homebuilders rushed to beat the first-time homebuyers' credit deadline. Private residential and nonresidential outlays, however, continued to show weakness. Private nonresidential construction spending has declined nearly 30 percent since late 2008, but declines are expected to moderate over the course of 2010. Office, warehouse and retail construction have already declined more than it they during the 2001 recession, despite a relatively modest build during the preceding expansion. An abundance of empty space and a lack of financing will likely hold construction activity to a minimum over the next year.

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

Consensus: 0.1%

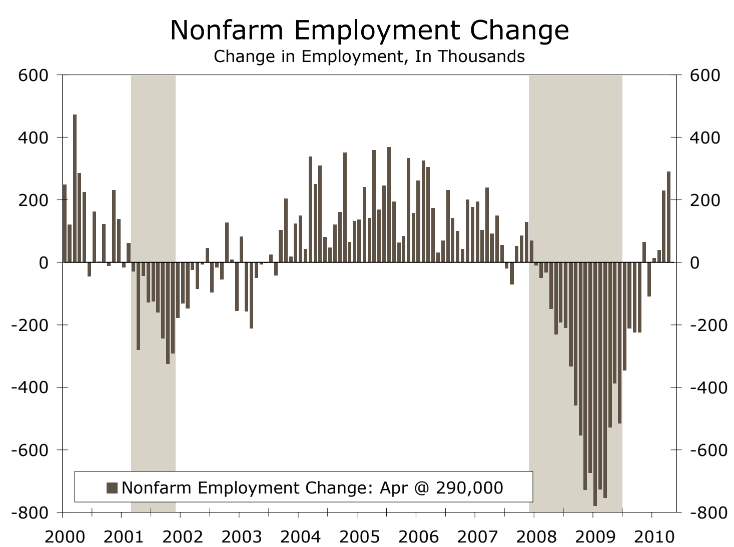


Nonfarm Employment • Friday

Nonfarm payrolls should rise significantly in May boosted by Census hiring and continued improvement in the private sector. Since January, Census hiring has likely added only 155,000 jobs, which is well below the U.S. Census Bureau's original projection of filling 700,000-800,000 temporary positions in the first half of the year. With May likely being the peak for Census hiring, we expect payrolls to increase by 511,000 jobs. While census hiring will likely boost employment in May, continued improvement in the pace of private sector jobs would help reinforce a self-sustaining recovery. The unemployment rate will likely drop modestly to 9.8 percent; however, discouraged workers will likely continue to enter the labor force in significant numbers as unemployment benefits expire and the perception of the job market changes as the economy continues to recover.

Previous: 290K **Wells Fargo: 511K**

Consensus: 475K



Global Review

Have We Seen This Movie Before?

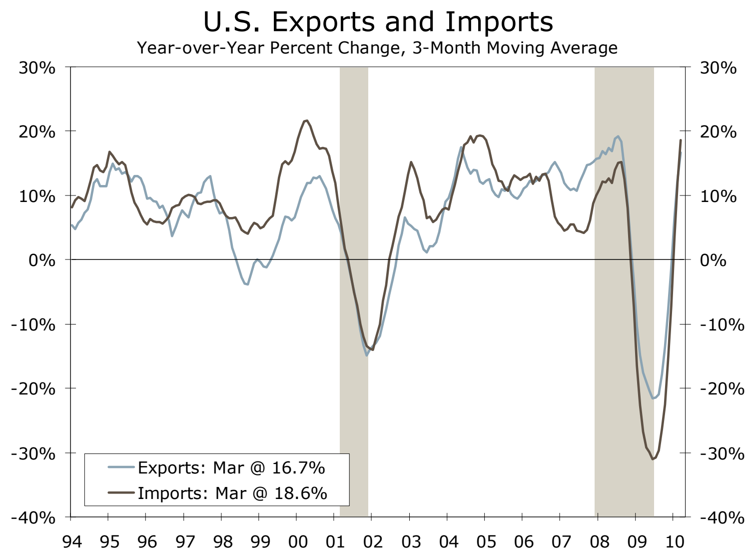
After some serious downdraft over the past few weeks, stock markets in most economies stabilized this week. However, financial markets remain on edge due to lingering concerns about the sovereign debt crisis in Europe. So if U.S. investors hold relatively little Greek, Portuguese and Spanish government debt, then why have U.S. financial markets reacted so poorly?

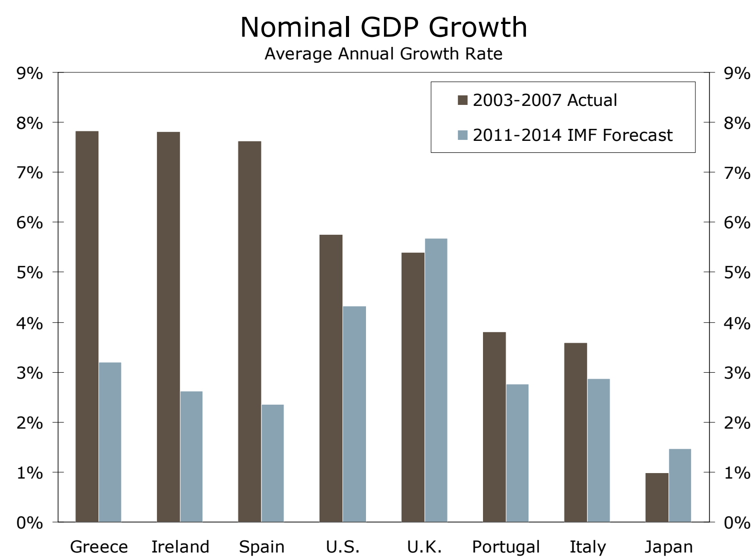
The sovereign debt crisis in the Euro-zone has two negative effects on the U.S. economy. First, fiscal tightening will likely weigh on GDP growth in Europe over the next few years, which would have a restraining effect on U.S. exports to the euro area that already are rather weak. In the first three months of the year the value of overall U.S. exports was up 17 percent on a year-over-year basis. Over that period, American exports to the euro area were essentially flat. Due to the sluggish recovery in the Euro-zone, which will likely become even weaker, U.S. export growth to that region will probably remain very weak. That said, exports to the Euro-zone are equivalent to slightly more than 1 percent of U.S. GDP, so the direct effect on the U.S. economy is rather small.

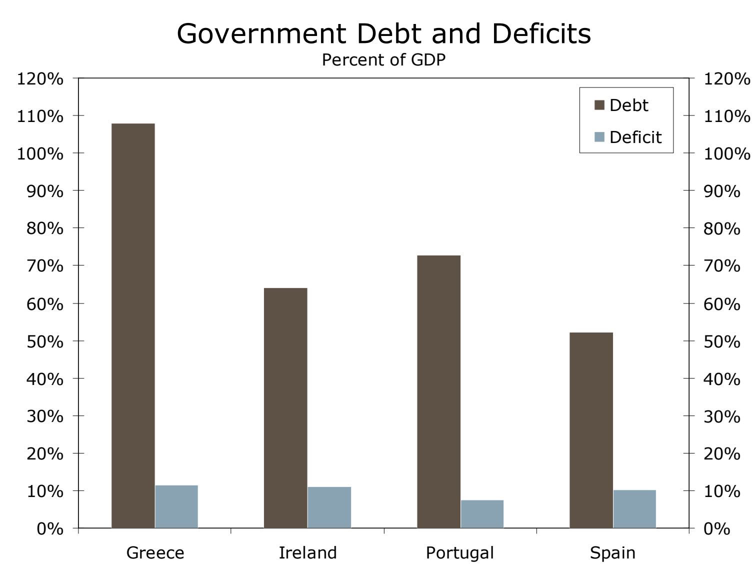
In our view, however, the much more important effect on the U.S. economy operates via the financial channel. Due to gaping budget deficits, the government debt-to-GDP ratios in many Euro-zone economies will rise even further over the next few years. If some of these governments need to restructure debt, then the holders of the debt, which include European banks, would be forced to write down their losses. Therefore, some banks may have become hesitant to lend to other banks recently for fear that their counterparties may be out of business when it comes time to pay off the loans. Moreover, a whole new wrench was thrown into the works recently by the news that some regional banks in Spain, which experienced its own housing bubble, were struggling. The news brought back bad memories of the subprime mortgage crisis and its effects on the financial system.

The strains in financial markets have shown up in LIBOR rates, which are the interest rates banks charge each other for funding. As shown on the front page, the 3-month dollar LIBOR rate has risen about 20 bps since early May as banks in Europe, which have some dollar-based assets, have scrambled to secure dollar funding. To put the rise in perspective, recall that the 3-month dollar LIBOR soared about 200 bps in the weeks after Lehman Brothers' failure in September 2008. In other words, the recent rise in LIBOR rates is mild compared with that earlier episode.

However, LIBOR rose about 20 bps in August 2007 at the onset of the subprime mortgage crisis. Credit markets subsequently tightened, eventually leading to the Lehman implosion, as lenders eyed each other warily. We do not want to sound alarmist, but the strains in bank funding markets at present bear close watching. A renewed downturn in the Euro-zone due solely to fiscal tightening is probably not enough to pull the United States back into recession. However, the outlook would darken considerably, not only for the United States but for the rest of the world as well, if another significant tightening of credit conditions were to set in.





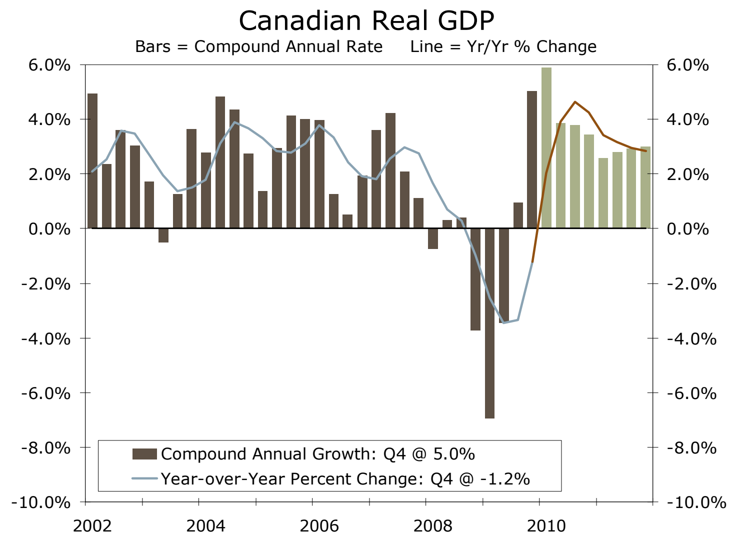


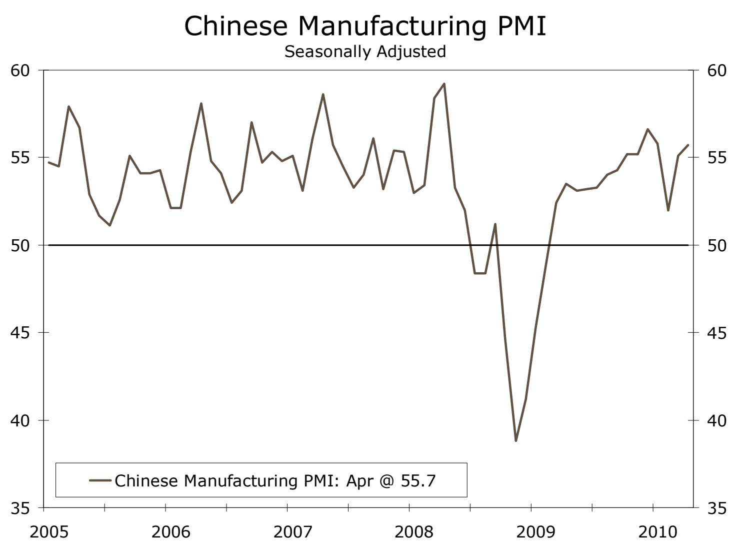
Canadian GDP • Monday

It should be a busy week for economic data in Canada next week. Real GDP data for the first quarter are due out on Monday. After expanding at a 5 percent annualized rate in the first quarter we expect that the economy grew at a nearly 6 percent annualized rate in the second quarter fueled by gains in consumer and business spending. The Bank of Canada (BoC) meets on Tuesday. While the BoC cannot turn a blind eye to the problems in Europe, we think the bank can no longer make a credible case that there is need for emergency funding to stave off recession in Canada. If first quarter GDP comes in anywhere north of 5.6 percent, it would mark the fastest pace of economic expansion in Canada since the 1990s. For that reason, we suspect the BoC to increase its target rate to 0.50 percent. Finally the May jobs report is due out on Friday, and analysts expect a fifth straight monthly gain.

Previous: 5.0% (CAGR) **Wells Fargo: 5.9%**

Consensus: 5.8%





Chinese PMI • Tuesday

The Chinese economy did not succumb to recession in the recent cycle, but even China was not spared from the adverse effects of the broader global slowdown. Real GDP slowed to a mid-single-digits pace before growth rebounded sharply in recent quarters. The government is directing banks to slow down the pace of credit creation before inflation becomes an issue. Most indicators point in the direction of continued strong growth in the second quarter. The manufacturing PMI picked back up again in April, but the consensus expects this measure of business sentiment will give up some ground in May. We should find out on Tuesday when PMI data for May become available, which will give us more insight on how the factory sector is shaping up in the second quarter.

Previous: 55.7

Consensus: 54.5

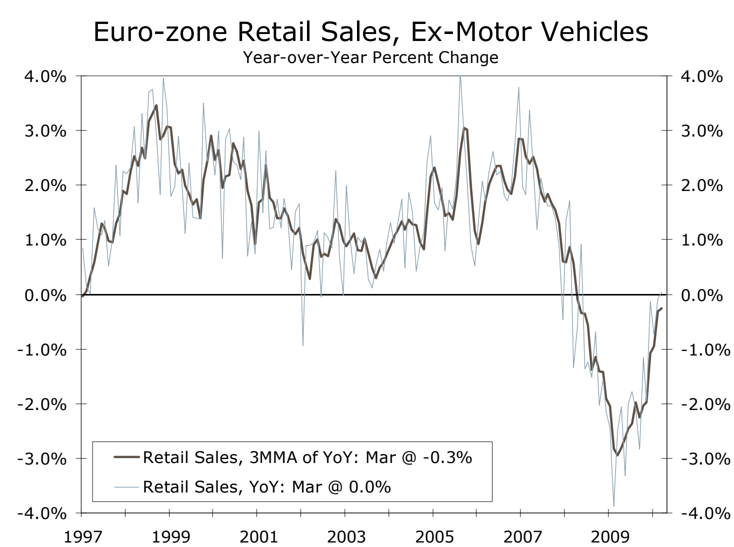
Euro-zone Retail Sales • Thursday

After contracting more than 5 percent on a peak-to-trough basis, the Euro-zone economy has been gradually recovering as real GDP has expanded modestly in each of the past three quarters. Similarly, retail sales fell more than 4 percent on a peak-to-trough basis, but a substantial recovery in consumer spending has yet to materialize. The year-over-year measure of retail sales is no longer in free fall, but the roughly flat readings are a result of depressed sales levels a year ago rather than a substantial increase in spending this year. On Thursday, markets will digest April retail sales data. Given the impending fiscal budget tightening widely expected across the Euro-zone, we do not expect a swift recovery in retail sales anytime soon.

A second look at first quarter GDP data on Friday will provide details on the underlying components of growth for the quarter.

Previous: 0.0% (Year-over-year)

Consensus: N/A



Interest Rate Watch

Credit Quality, Like Beauty, Is a Relative Thing—and Sometimes just as Fleeting.

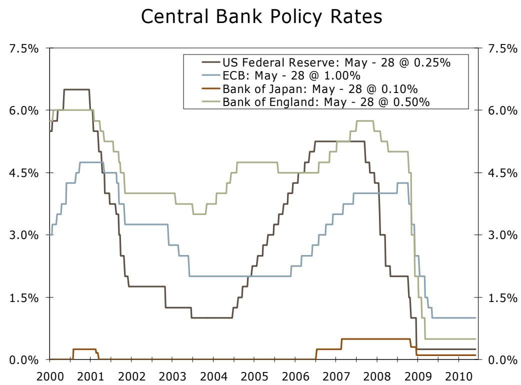
Absolute beauty is hard to define—so we judge on a relative scale. In recent weeks, the perception of credit quality has also become a relative benchmark. Despite perceptions of moderate growth and large fiscal deficits, the expected credit quality of both U.S. Treasury debt and the dollar has improved relative to the euro. Such is the way of the marketplace.

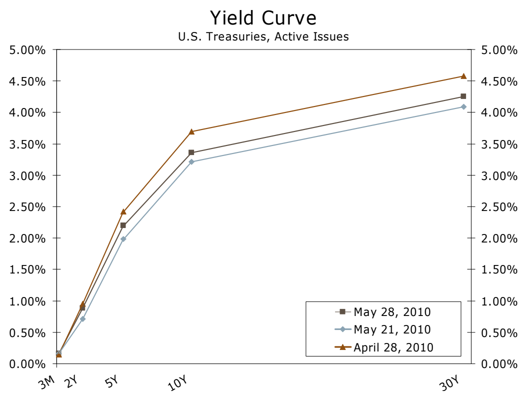
The Short and Long of It

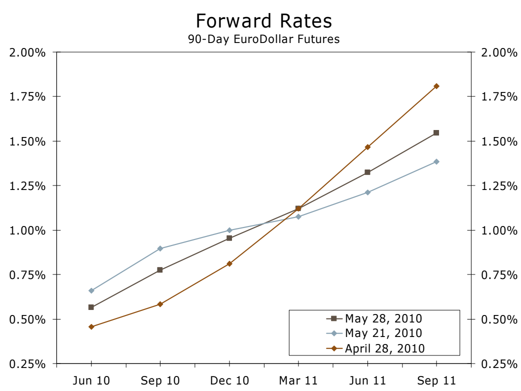
At the short end of the yield curve, the rise in LIBOR rates has reflected a change in the risk perceptions of European bank portfolios. The issue is increasingly perceived as a solvency issue and not simply liquidity. As such, counterparty exposures to European sovereign risk have pushed up LIBOR rates and, while dollar-swap lines may cap the rise in rates for now, the systemic nature of the credit issues suggests that spreads will remain wider for longer and, thereby, consumer credit costs are likely to rise despite a steady, accommodative fed funds rate. LIBOR has become an increasingly popular benchmark pricing tool for consumer variable rate loans. The vast majority of adjustable-rate mortgages and interest-only loans are priced off of LIBOR instead of the prime rate. At the long end of the curve, recent weeks have witnessed the halt to many high-grade and high-yield issues by all but the most highly-rated companies. Higher risk premiums and increased market volatility have led to fewer and more carefully timed bond issuance.

A Rise in Real Rates

Recent increases in interest rates tied to LIBOR have occurred while energy prices and the CPI have declined, thereby suggesting a rise in real rates. This further complicates the economic outlook. Therefore, we maintain our slower growth outlook for the second half of this year despite a lower interest rate outlook. In this case, lower benchmark Treasury rates do not suggest easier monetary policy but a reallocation of portfolios. Once again, the implications of lower rates are in the eye of the beholder—beauty is only skin deep.







Consumer Credit Insights

Consumer Credit Quality Improves

This week the Federal Reserve reported that the overall loan delinquency rate continued to rise in the first quarter, coming in at 7.5 percent, the highest since records began in 1985. The news was not all bad though. On a year-over-year basis, rates were higher for most categories, with residential real estate leading the way. On a quarter-over-quarter basis, residential real estate again saw the biggest increase, while commercial real estate (CRE) delinquencies also rose further. However, consumer loans saw welcome improvement on a year-over-year and quarter-over-quarter basis.

After hovering around 6.5 percent for the past year, the credit card delinquency rate fell noticeably in the first quarter to 5.8 percent, as consumers have continued to focus on paying down high-interest revolving debt. The delinquency rate for non-credit card consumer loans also fell to 3.4 percent from 3.7 percent in the previous quarter.

This is welcome news for consumers as well as the banks. Throughout the financial crisis, the nation's banks took steep losses on bad loans and bolstered their reserves against future losses. Both of these factors weighed heavily on profits, as well as lending. With credit quality improving, at least for consumer loans, bad loan losses and the need for reserves should diminish. This should help to open the credit spigots. However, continued deterioration in real estate credit quality will be a hindrance.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.78%	4.84%	5.06%	4.91%
15-Yr Fixed	4.21%	4.24%	4.39%	4.53%
5/1 ARM	3.97%	3.91%	4.00%	4.82%
1-Yr ARM	3.95%	4.00%	4.25%	4.69%
MBA Applications				
Composite	633.5	569.2	534.6	786.0
Purchase	185.7	192.1	257.9	256.6
Refinance	3,257.4	2,783.0	2,161.8	3,890.4

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

Topic of the Week

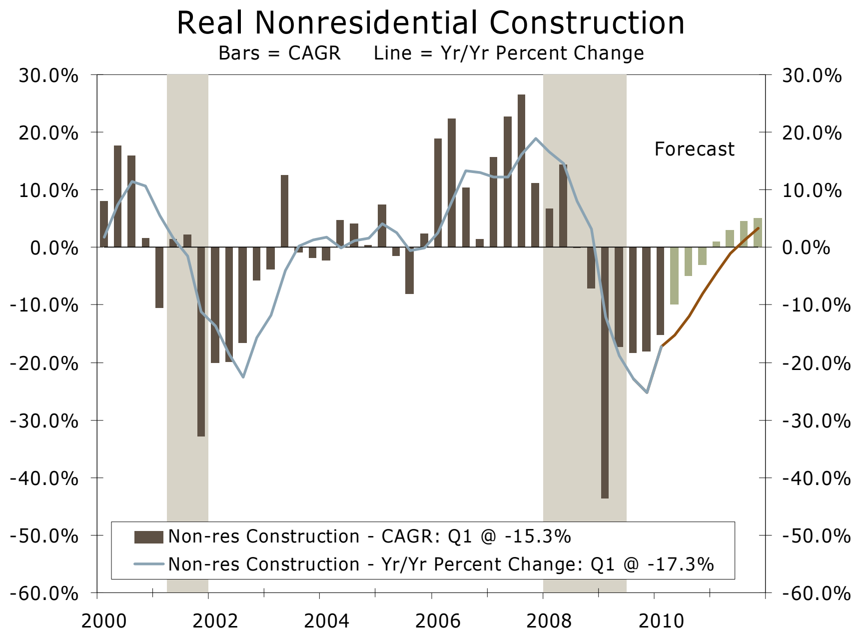
Hopefully, the Worst Is Behind Us for Commercial Real Estate

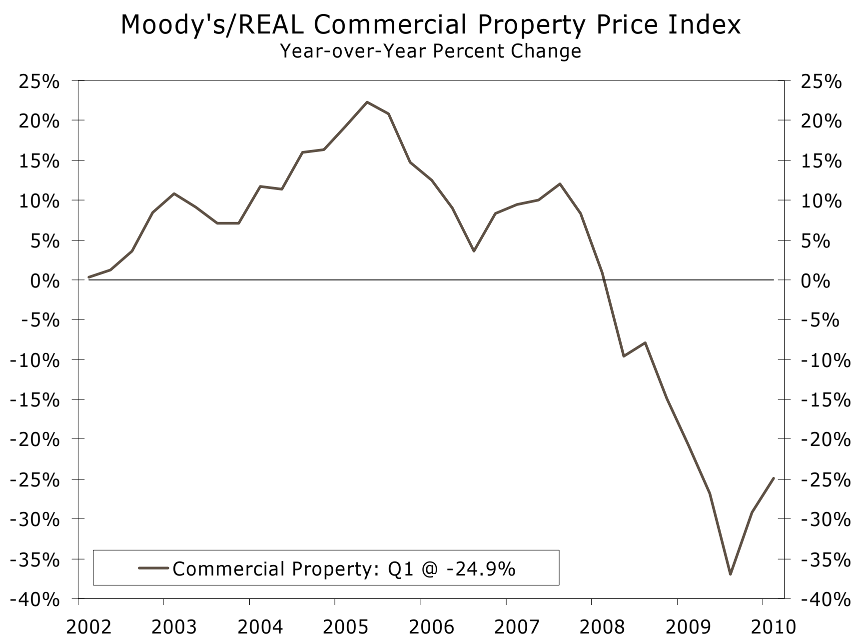
Most of the key metrics used to track and assess the health of the commercial real estate market continued to deteriorate during the first quarter. The pace of decline, however, has slowed markedly, reflecting the slightly stronger economic data reported for the period and the substantially reduced pace of declines in nonresidential construction. Demand for private office, industrial and retail space continued to contract during the quarter and rents declined. Sales prices have declined further, while transaction volume increased modestly. On the plus side, apartment leasing picked up during the first quarter and rents rose slightly. Improvement in the apartment market was evident across a wide assortment of markets, including several areas where single-family homes and condominiums are significantly overbuilt.

The commercial real estate market is currently in the belly of what looks to be an elongated U-shaped recovery. The bulk of declines in construction activity and prices is now likely behind us, but even modest growth in either is still a long way off. Declines in private nonresidential construction are expected to moderate significantly over the course of 2010. Building activity did not have as far to fall in this cycle, as commercial real estate was much more overbought than it was overbuilt. The recovery will likely take several years to gain significant momentum, as rents will likely remain depressed until employment and income recover enough to boost occupancy rates and rents.

Commercial property values continued to decline during the first quarter. The latest Moody's/REAL Commercial Property Price Index fell 0.5 percent in March, as prices for offices and retail space fell in most major markets. Commercial property prices are now down 24.9 percent over the past year and 42 percent from its October 2007 peak. Prices for apartments and industrial space both improved modestly during the quarter.

Please visit our website for the *Commercial Real Estate Chartbook: Quarter 1*.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 5/28/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.16	0.15	0.13
3-Month LIBOR	0.54	0.50	0.67
1-Year Treasury	0.19	0.14	0.20
2-Year Treasury	0.83	0.76	0.96
5-Year Treasury	2.14	2.02	2.44
10-Year Treasury	3.32	3.24	3.61
30-Year Treasury	4.23	4.10	4.49
Bond Buyer Index	4.28	4.27	4.61

Foreign Exchange Rates

	Friday 5/28/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.238	1.257	1.394
British Pound ($/£)	1.458	1.446	1.595
British Pound (£/€)	0.849	0.869	0.875
Japanese Yen (¥/$)	91.160	90.000	96.850
Canadian Dollar (C$/$)	1.046	1.060	1.113
Swiss Franc (CHF/$)	1.152	1.150	1.084
Australian Dollar (US$/A$)	0.849	0.832	0.784
Mexican Peso (MXN/$)	12.822	12.949	13.214
Chinese Yuan (CNY/$)	6.832	6.828	6.829
Indian Rupee (INR/$)	46.355	46.924	47.615
Brazilian Real (BRL/$)	1.821	1.853	2.003
U.S. Dollar Index	86.231	85.371	80.433

Foreign Interest Rates

	Friday 5/28/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.63	0.64	1.28
3-Month Sterling LIBOR	0.71	0.70	1.28
3-Month Canadian LIBOR	0.60	0.57	0.70
3-Month Yen LIBOR	0.25	0.25	0.52
2-Year German	0.53	0.51	1.40
2-Year U.K.	0.89	0.87	1.11
2-Year Canadian	1.81	1.63	1.27
2-Year Japanese	0.17	0.16	0.35
10-Year German	2.69	2.67	3.66
10-Year U.K.	3.58	3.55	3.80
10-Year Canadian	3.35	3.32	3.48
10-Year Japanese	1.26	1.25	1.49

Commodity Prices

	Friday 5/28/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	74.81	70.04	65.08
Gold ($/Ounce)	1212.93	1177.10	959.45
Hot-Rolled Steel ($/S.Ton)	645.00	645.00	375.00
Copper (¢/Pound)	315.05	305.15	213.55
Soybeans ($/Bushel)	9.42	9.34	11.93
Natural Gas ($/MMBTU)	4.27	4.04	3.96
Nickel ($/Metric Ton)	21,726	21,128	13,321
CRB Spot Inds.	481.15	481.64	382.46

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	31	**1**	**2**	**3**	**4**
U.S. Data		**ISM Manufacturing** April 60.4 May 59.4 (W) **Construction Spending** March 0.2% April -0.2% (W)	**Total Vehicle Sales** April 11.21M May 11.50M (W)	**ISM Non-Mfg** April 55.4 May 55.4 (W) **Factory Orders** March 1.1% April 1.9% (W) **Nonfarm Productivity** 1Q: 1st 3.6% 1Q: 2nd 3.2% (W)	**Nonfarm Payrolls** April 290K May 511K (W) **Unemployment Rate** April 9.9% May 9.8% (W)
Global Data	**Canada** **GDP** Previous (4Q) 5.0%	**China** **PMI Manufacturing** Previous (Apr) 55.7 **Canada** **Bank of Canada Rate** Previous 0.25%	**Euro-zone** **PPI (YoY)** Previous (Mar) 0.9%	**Euro-zone** **Retail Sales (MoM)** Previous (Mar) 0.0%	**Euro-zone** **GDP (QoQ)** Previous (1Q)A 0.2% **Canada** **Employment Change** Previous (Apr) 43.8

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

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