September 10, 2010

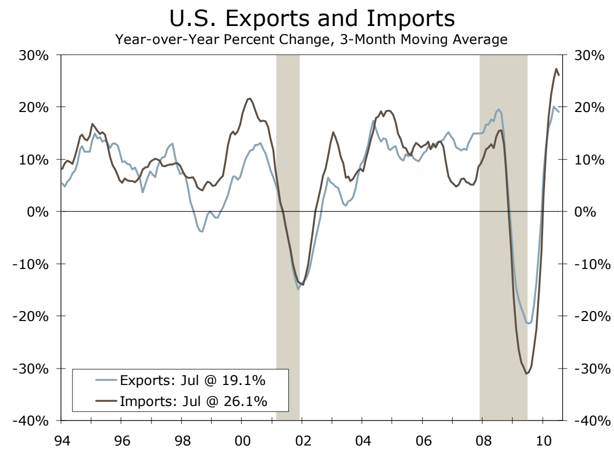
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

More Signs the Economic Recovery Is Still Intact

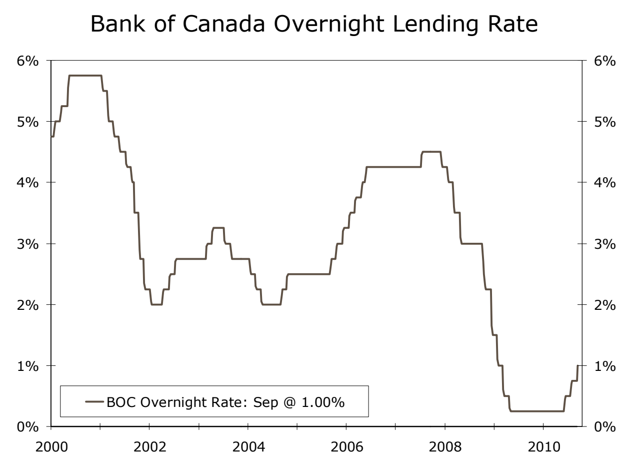
- This week's economic data went a long way toward easing fears about a double-dip recession. Worries that real GDP could fall into negative territory in the coming quarter now seem a little overblown.
- One clear sign the economy continues to grow is the recently released data on the trade balance. The U.S. trade deficit narrowed sharply by 14 percent to $42.8 billion in July.
- The Fed's Beige Book showed seven of the 12 districts reported modest growth or positive development from the previous reporting period.



Global Review

Canadian Recovery Continues, but Watch Out for Trade

- The Bank of Canada (BoC) raised its overnight lending rate to 1.00 percent this week. In its statement, the BoC noted it now expects a more gradual recovery in Canada, while expressing concern that the U.S. recovery "is being held back by high unemployment."
- The Canadian trade deficit widened to its largest gap on record in July as exports to the United States fell 2.2 percent.
- Unlike in the United States, employers in Canada have been adding to payrolls for the better part of the past year, including another 35,8oo jobs added in August.



Inside

Wells Fargo U.S. Economic Forecast

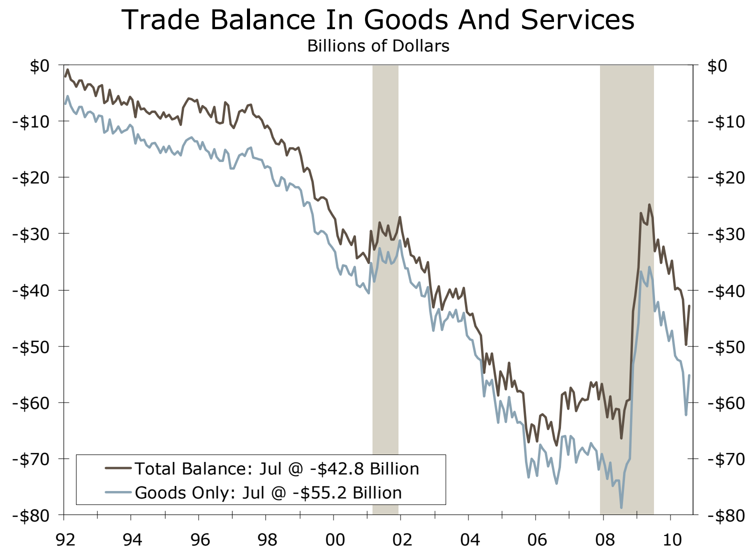
	Actual						Forecast		Actual				Forecast	
	2009				2010				2006	2007	2008	2009	2010	2011
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product [1]	-4.9	-0.7	1.6	5.0	3.7	1.6	1.6	2.3	2.7	1.9	0.0	-2.6	2.7	2.2
Personal Consumption	-0.5	-1.6	2.0	0.9	1.9	2.0	1.7	1.3	2.9	2.4	-0.3	-1.2	1.5	1.6
Inflation Indicators [2]														
"Core" PCE Deflator	1.6	1.5	1.3	1.7	1.8	1.5	1.3	1.0	2.3	2.4	2.3	1.5	1.4	1.1
Consumer Price Index	-0.2	-1.0	-1.6	1.5	2.4	1.8	1.1	0.6	3.2	2.9	3.8	-0.3	1.4	1.0
Industrial Production [1]	-17.6	-10.3	8.3	7.0	7.1	6.7	6.2	2.2	2.2	2.7	-3.3	-9.3	5.5	3.5
Corporate Profits Before Taxes[2]	-17.3	-11.4	-3.9	42.5	37.6	39.2	17.6	12.8	10.5	-6.1	-16.4	-0.4	25.8	6.8
Trade Weighted Dollar Index[3]	83.2	77.7	74.3	74.8	76.1	78.8	76.8	77.3	81.5	73.3	79.4	74.8	77.3	83.0
Unemployment Rate	8.2	9.3	9.6	10.0	9.7	9.7	9.6	9.9	4.6	4.6	5.8	9.3	9.7	9.6
Housing Starts[4]	0.53	0.54	0.59	0.56	0.62	0.60	0.55	0.60	1.81	1.34	0.90	0.55	0.59	0.81
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	0.31
Conventional Mortgage Rate	5.00	5.42	5.06	4.93	4.97	4.74	4.10	4.20	6.14	6.10	5.33	4.93	4.50	5.15
10 Year Note	2.71	3.53	3.31	3.85	3.84	2.97	2.50	2.60	4.71	4.04	2.25	3.85	2.98	2.98

Forecast as of: September 8, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

U.S. Review

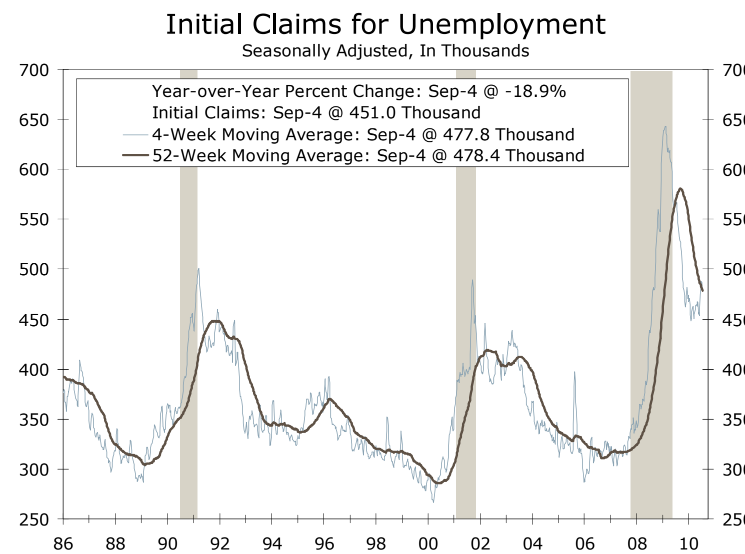
No Cause for Despair, but No Cause for Celebration

This week's economic data went a long way toward easing fears about a double-dip recession. A second downturn is not implausible, but worries that real GDP could fall into negative territory in the coming quarter now seem a little overblown. But, before we pop the champagne cork, our forecast still calls for sluggish economic growth through 2010 and gradually increasing over the course of 2011 (see our *Monthly Outlook*).



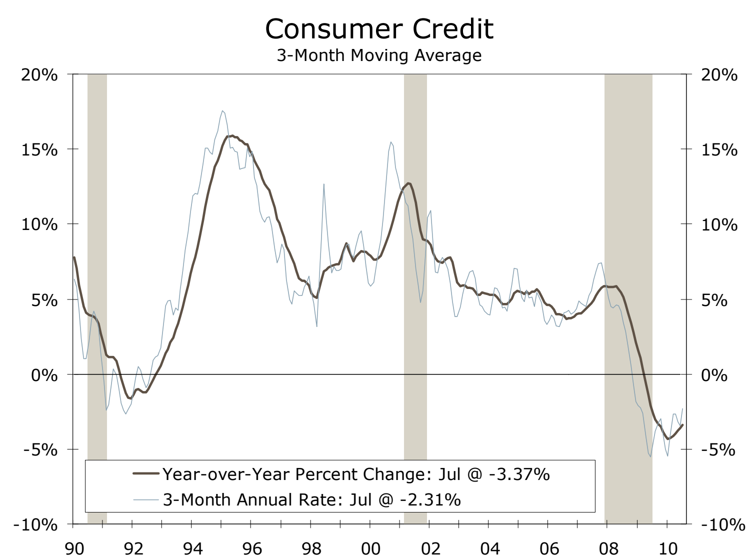
One clear sign the economy continues to grow is the recently released data on the trade balance. The U.S. trade deficit narrowed sharply by 14 percent to $42.8 billion in July, which was less than most analysts expected. The smaller trade gap was a welcome surprise, but was largely payback from a jump of $6.0 billion in non-oil imports in June. The increase was clearly unsustainable as imports well outpaced domestic demand. With imports growing at a faster pace than exports in the second quarter, net exports shaved off an astounding 3.4 percentage points from real GDP, the largest drag in more than six decades.

We don't think trade will continue to take such a large bite out of economic growth in the coming quarter, however. The real trade deficit in July is about equal to the average in the second quarter. If the trade deficit remains at this level over the next two months, trade should exert very little drag on overall real GDP growth in the third quarter.



The Fed's Beige Book also confirmed the economy is in recovery, but a slow recovery indeed. Seven of the 12 districts reported modest growth or positive development from the previous reporting period. Similar to the national economy, consumer spending appeared to increase and reports on manufacturing activity showed further expansion, but at a slower pace. Wage pressures remained limited with the exception of a few sectors that noted a mismatch in job requirements versus applicant skills.

Labor market indicators for the week were also promising. Initial jobless claims dropped 27,000, to 451,000, but they may be distorted due to the Labor Day holiday. On a trend basis, the four-week moving average is still very elevated at 477,750, but it is the second consecutive weekly decline and is moving in the right direction. We still need claims to drop to around 400,000 on a consistent basis to have a self-sustaining recovery.



Other data highlighting employment conditions were the Job Openings and Labor Turnover Survey. Hiring remains lackluster, but the brunt of layoffs is behind us. The hires and separation rate, which is the rate of hires and separations as a percentage of total nonfarm payrolls, remained unchanged at 3.3 and 3.4 percent in July, respectively.

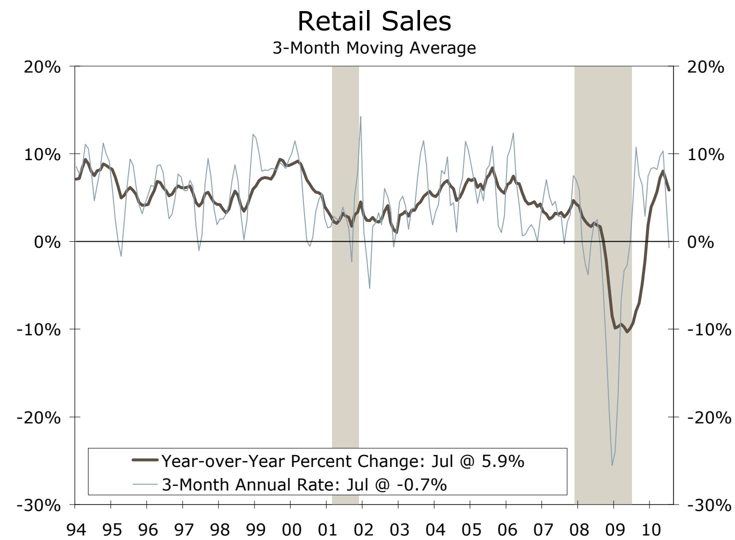
Consumer credit also printed this week and further illustrated the important adjustments that are needed to help consumers live within their means. Credit declined 1.8 percent in July with revolving credit (mostly credit cards) dropping 6.3 percent. Consumers are clearly using debit cards and cash more frequently in an effort to pay down debt to repair damaged balance sheets.

Retail Sales • Tuesday

Retail sales rose 0.4 percent in July with motor vehicle and gasoline station sales both largely responsible for the gain. Core retail sales, which exclude autos, gasoline and building materials, fell 0.5 percent on a three-month annualized basis. The weak showing in core retail sales is reflective of slower consumer demand, and the data suggest sluggish consumer spending in coming quarters. We expect retail sales to increase a modest 0.3 percent in August, due to a not-so-spectacular back-to-school shopping season. To attract customers, many clothing stores had to substantially mark down items. Discounting will likely slow overall sales in August. Gasoline station sales should also contribute slightly to the headline, but car sales should be flat. The underlying trend is still positive, but cautious consumers continue to think through buying decisions and look for the best deals.

Previous: 0.4% **Wells Fargo: 0.3%**

Consensus: 0.3%

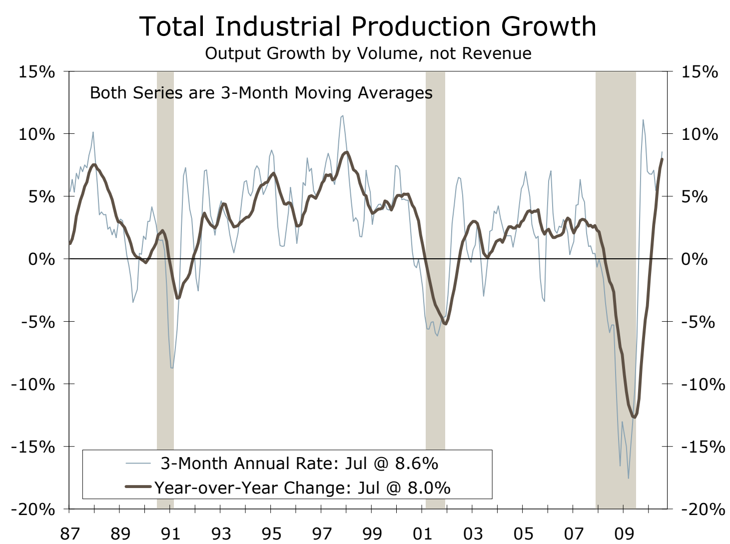


Industrial Production • Wednesday

Despite lackluster regional manufacturing surveys in July, industrial production rose 1.0 percent, which was stronger than the consensus forecast. Much of the increase was due to a 1.1 percent jump in manufacturing output. Auto production surged 9.9 percent as fewer auto plants shut down during the traditional retooling months. We do not expect this trend to stick and should begin to see some pullback in manufacturing production due to seasonal distortions. The ending of the inventory cycle will likely continue to keep gains modest in coming months. Due to the temporary nature of recent gains, we expect industrial production to increase 0.4 percent in August and capacity utilization to rise to 75 percent. While capacity utilization is much higher than recent lows, it remains well below its long-run average.

Previous: 1.0% **Wells Fargo: 0.4%**

Consensus: 0.2%

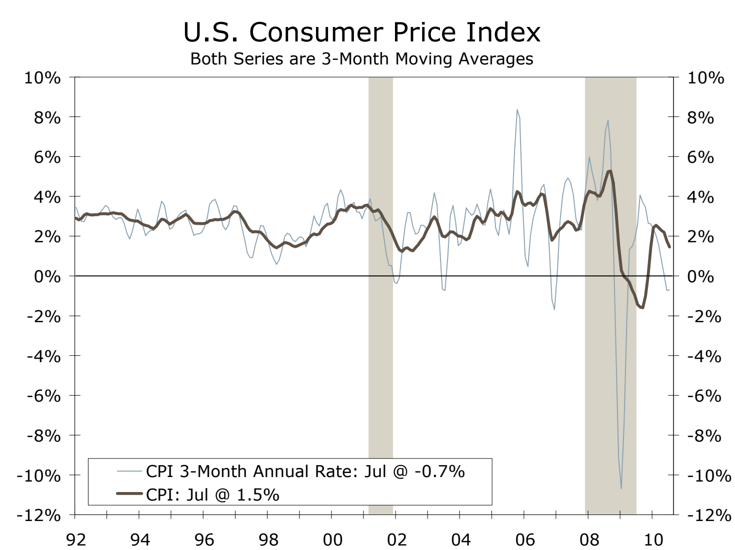


Consumer Price Index • Friday

With much of the talk around prices centered on deflation, the modest increase in consumer prices in July was a breath of fresh air and helped to quell some of the rhetoric. Led by a 4.3 percent gain in gasoline prices, headline CPI rose 0.3 percent. On a year-over-year basis, CPI is up 1.2 percent, which is well off its December 2009 peak of 2.7 percent, but still does not suggest the downside risk of deflation. Sustained declines in core CPI over the past two years were largely due to weakness in the shelter component. Both residential rent and owners' equivalent rent, which make a tremendous contribution to overall prices have stabilized recently. The Fed still expects inflation to remain "subdued for some time" given the substantial resource slack restraining cost pressures and stable inflation expectations.

Previous: 0.3% **Wells Fargo: 0.2%**

Consensus: 0.3%



Global Review

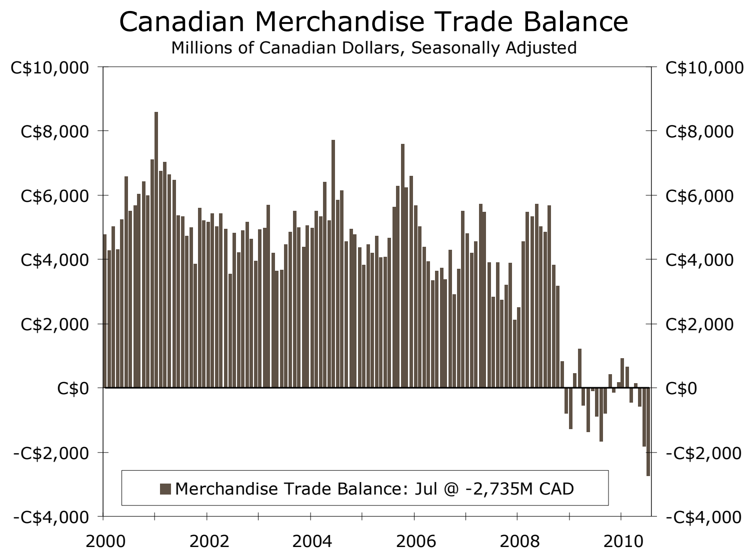
Canadian Economy Grows Despite Widening Trade Gap

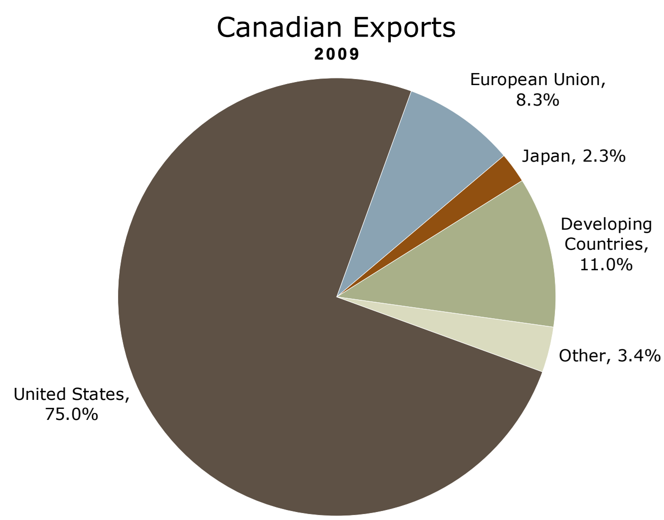
The Bank of Canada (BoC) raised its key lending rate again this week, taking the overnight rate to 1.00 percent. The BoC remains the only central bank from a G-7 economy to have raised rates—a solo role it has been playing since June. The language in the official statement omitted remarks about the European sovereign debt crisis, but it suggests the BoC is likely dialing back its own outlook somewhat. The bank now expects "the economic recovery in Canada to be slightly more gradual than it had projected in its July Monetary Policy Report (MPR), largely reflecting a weaker profile for U.S. activity." With a fragile economic recovery under way and the inflation rate at the bottom of its target range, we expect the BoC to leave its policy rate at the present level at least through the remainder of this year.

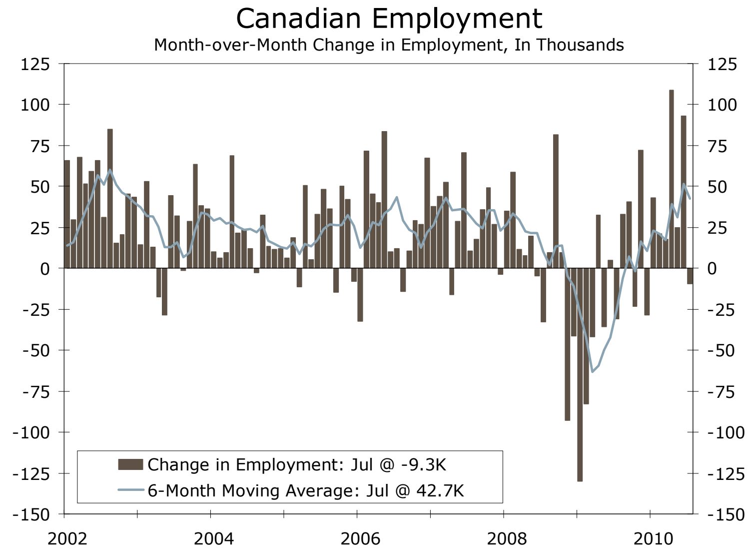
That concern has already begun to play out in the data as the July trade deficit widened to C$2.74 billion, which represents the biggest gap in the Canadian trade deficit since records began in 1971. A C$1.2 billion narrowing in the trade surplus with the United States was the primary explanation for the drop. The Canadian economy remains very susceptible to a slowdown in the United States, though Canada has diversified its export portfolio over the past decade. In 2001, 88 percent of Canadian exports were destined for America; by 2009 that share had dropped to 75 percent. That is not to say that Canadian exporters are not concerned about economic prospects in the United States, but countries beyond America will become increasingly important, at least at the margin, for Canada in the years ahead.

But for now, net exports are weighing on economic growth. Second-quarter GDP growth in Canada was weaker than both the BoC and the consensus had expected. Market watchers were not likely expecting net exports to exert a 4.5 percent negative contribution to GDP. Fortunately, final domestic demand grew at an annualized pace of 3.5 percent in the quarter, fueled by modest consumer spending and robust business fixed investment spending. So the question going forward is: Will domestic demand continue to be strong enough to offset the potential drag from net exports?

Manufacturing sales have increased in nine of the past 10 months, and the Ivey PMI in August climbed to its highest level since 2008, so it appears that business spending will continue to grow. On the consumer side, however, the data are somewhat less encouraging. Consumption grew at a 2.6 percent pace in the second quarter, slightly off from the 4.3 percent rate in the first. Retail sales have fallen in two out of the past three months, and consumer confidence has been slipping in recent months as well. For there to be sustainable growth in consumer spending, the labor market will need to continue to grow. The good news is employers in Canada have been adding to payrolls for the better part of the past year, including another 35,800 jobs added in August. Unlike the U.S. job market, which is still under water, the level of overall employment in Canada is now higher than it was before the recession began, which should be supportive of consumer spending in coming quarters.







Chinese Industrial Production • Monday

Chinese industrial production growth slowed for the fourth straight month in July to a year-over-year pace of 13.4 percent. It appears that efforts by the Chinese government to reign in runaway spending earlier this year has been largely successful in cooling economic activity somewhat. We think there is some support for the notion that loan growth will begin to pick up from here, which will be supportive of a solid pace of growth in China, though somewhat slower than the double-digit pace we saw earlier this year. August industrial production data are due out Monday, and the consensus is looking for further moderation in output. The Chinese retail sales report for August is due out the same day. Year–over–year sales growth has been humming along at about 18 percent since March and will likely continue to grow at that pace in August.

Previous: 13.4%

Consensus: 13.0%

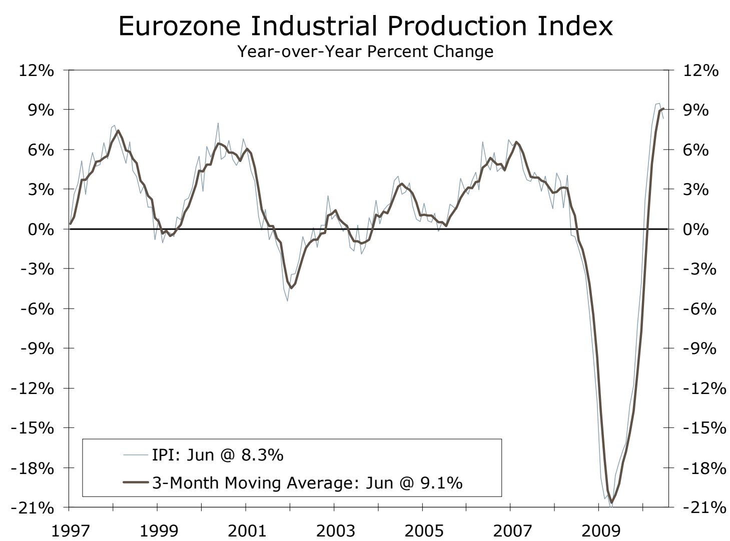
Eurozone Industrial Production • Monday

Despite the sovereign debt situation in some European countries, the economic data out of the Eurozone are consistent with our outlook for slow recovery to continue. Real GDP expanded at an annualized rate of 3.9 percent in the second quarter, faster than the 1.3 percent pace of growth in the first quarter. Industrial production (IP) data were also stronger in the second quarter, though output slipped by a tenth of a percent in June. We get our first look at Q3 output data when July IP data hits the wire on Monday. Manufacturing PMI readings remained in the mid-50s in July and August, so another pick-up in IP in July seems likely.

Also on the docket in the Eurozone are August CPI data. Prices were flat in June and slipped a bit in July, though they remain higher on a year-over-year basis. A modest gain in August is expected.

Previous: -0.3% (Month-over-Month)

Consensus: 0.1%

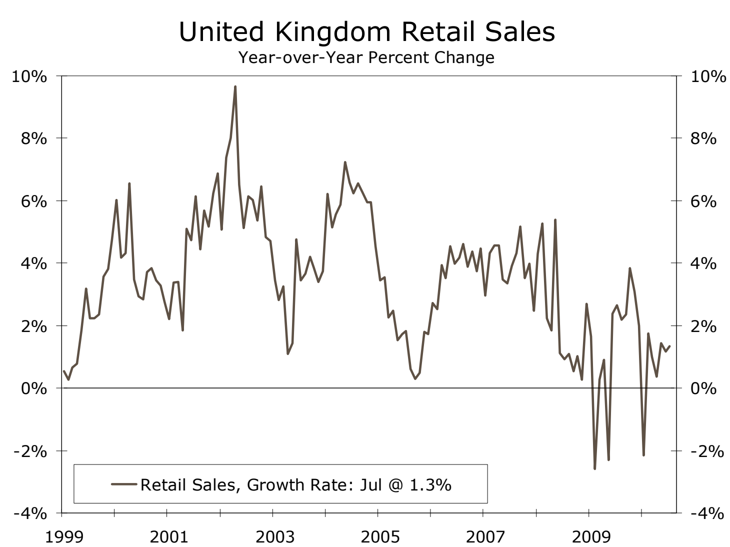


U.K Retail Sales • Thursday

The U.K. economy grew at an annualized pace of 4.9 percent in the second quarter, which was the fastest sequential growth rate in more than a decade. While the turnout was stronger than markets were expecting, it seems likely the second quarter will be the high-water mark for expansion in the United Kingdom for the foreseeable future. Several measures of activity provide signal that growth is continuing in the third quarter, but at a slower pace. Both the services and manufacturing PMIs have fallen for the first two months of the third quarter, though both remain in expansion territory. Despite the fact that consumer confidence also deteriorated in July, retail sales have held up, increasing 1.1 percent in July, the first month of the third quarter. The consensus expects a more modest increase of 0.3 percent when the August retail sales numbers come out on Thursday.

Previous: 1.1% (Month-over-Month)

Consensus: 0.3%



Interest Rate Watch

Rates Rise as Downside Risk Slide

Bond yields rose this week as investors began to feel more comfortable with the economy's near-term growth prospects. A double-dip recession now seems less likely and worries about deflation are also lessening somewhat. At the same time, the federal government continues to tap the markets for billions in additional financing and talk of new stimulus programs does little to relieve fears about the deficit.

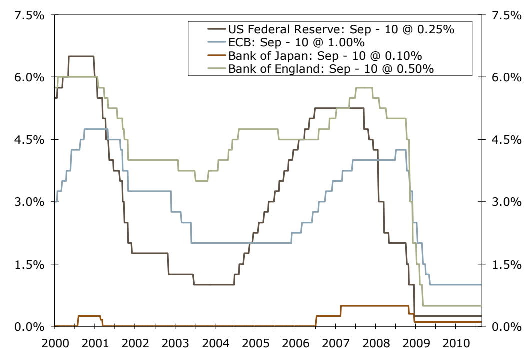
Uncertainty about the prospects for extending the Bush tax cuts also appears to be pulling money into the fixed-income market. Many equity investors understandably feel jilted by the collapse in equity values following the onset of the financial crisis, the corporate scandals earlier in the decade and the Flash Crash that occurred in early May. As a result, anything that restores confidence in the economy and stock market might present some upside risk to bond yields.

The Fed's Beige Book noted a widespread moderation in economic activity across the country but was no worse than expected. Home sales have slowed tremendously following the expiration of tax incentives, and low mortgage rates are only a relatively modest boost to refinancing activity. Consumer spending is showing modest gains across the country, and pricing power remains extremely limited, but there is little to no sign of actual deflation. Hiring was seen as picking up modestly, but many firms are opting to hire temporary workers instead of permanent employees.

The Fed is still weighing the prospects for additional monetary stimulus but is unlikely to do much in the near term. We still assign a relatively high probability of a second quantitative easing (QE2) following the November election, with such a move possibly announced as soon as the Nov. 2-3 FOMC meeting but more likely announced later that month.

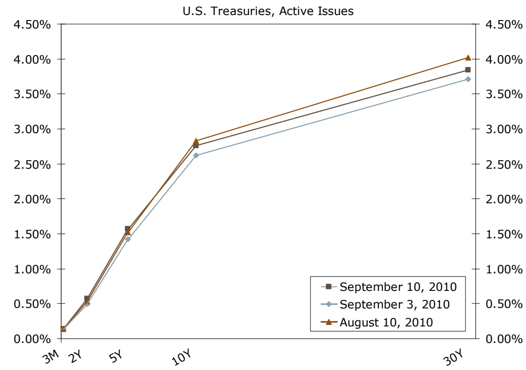
We continue to hold on to our view that the Fed will reverse course late next year and begin raising the Federal Funds rate. That forecast is based on our belief that economic growth will improve over the coming year, removing much of the downside risks.

Central Bank Policy Rates



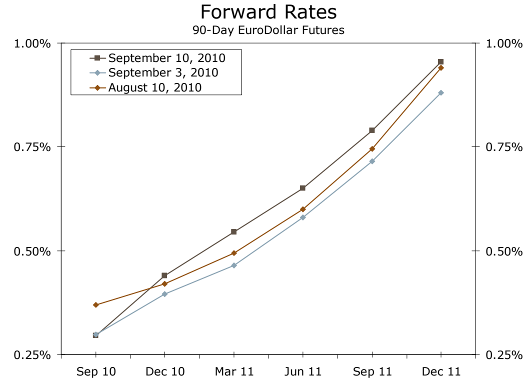
Yield Curve

U.S. Treasuries, Active Issues



Forward Rates

90-Day EuroDollar Futures



Consumer Credit Insights

Putting It on Plastic

Consumer spending rose 0.4 percent in July. However, since personal incomes only rose 0.2 percent, the savings rate declined to 5.9 percent from 6.2 percent. In addition, credit card balances at commercial banks declined by $6.8 billion during the month. These numbers suggest that after three months of bolstering their savings, consumers met pent-up demand by using cash, checks or "putting it on plastic." But this time around, it's a different plastic. Rather than adding to their debt by using credit cards, consumers are increasingly turning to debit cards when making purchases.

This has important ramifications for the economy and for the banking industry. By paying down their credit card balances and not using credit cards for purchases, consumers are certainly repairing their own balance sheets. However, banks are losing out on the interest on those accounts so vital to the bottom line. The result is likely to be higher bank fees and slower consumer spending growth for a time.

More and more, it's looking like this recession could be causing a permanent shift in consumer behavior. If this leads to a permanent, or at least long-lasting, leftward shift of the aggregate demand curve, the economy could be in for a fairly long period of low inflation and elevated unemployment. The "new plastic" is likely to be en vogue for some time to come.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.35%	4.32%	4.44%	5.07%
15-Yr Fixed	3.83%	3.83%	3.92%	4.50%
5/1 ARM	3.56%	3.54%	3.56%	4.51%
1-Yr ARM	3.46%	3.50%	3.53%	4.64%
MBA Applications				
Composite	880.0	893.8	734.3	648.3
Purchase	184.5	173.6	175.4	304.1
Refinance	4,926.5	5,085.3	3,993.0	2,651.2

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

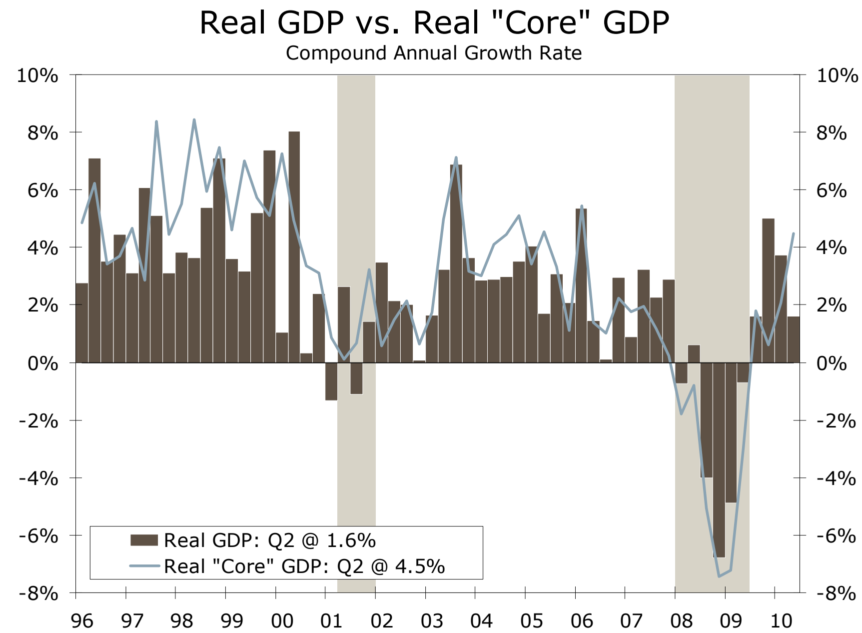
Topic of the Week

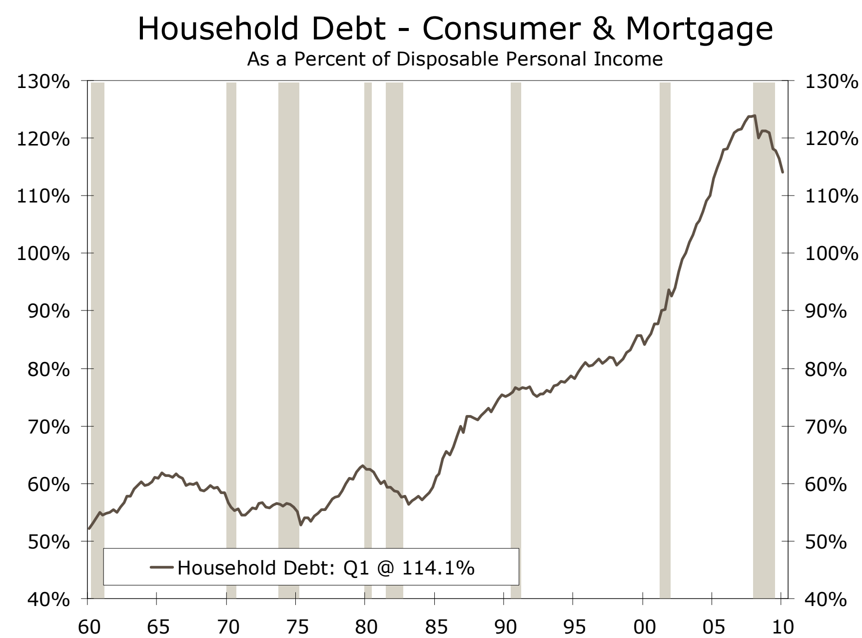
No Double Dip for Chips or the Economy

After the BEA made a massive downward revision to GDP, there was a great deal of hand-wringing and worrying that real GDP growth would slow even further and possibly slip into negative territory. Now that much of the July and early August data show modest economic gains, a double dip now seems much less likely. Moreover, private final demand actually looks a bit stronger that previously thought. Consumer spending was actually revised higher in the same report that showed real GDP revised down. Overall private final demand grew at a 4.3 percent annual rate during the second quarter and we believe growth in private demand should remain strong enough to offset the winding down of stimulus programs and inventory rebuilding.

All of the focus on the downside risks to the economy has diverted attention away from some of the more positive trends that have taken place over the past year. There has been significant healing in a number of key areas, including the balance sheets of large companies and major financial institutions. Both sectors have been able to raise substantial amounts of new capital and have seen profitability restored.

Households are also making progress at strengthening their financial standing. Private-sector wage and salary growth picked up over the past year, rising 1.1 percent. The increase allowed consumers to both modestly boost spending and increase saving. The saving rate has risen from a low of 2 percent two years ago to around 6 percent currently. Much of that increased saving has been used to pay down debt. The ratio of household debt to after-tax income has fallen from a peak of 123.9 percent to 114.1 percent. Clearly, consumers still have a long way to go to bring household balance sheets back to health, but more progress has been made than many realize and the process of deleveraging appears to be well under way. Moreover, income growth is likely to be stronger over the next couple of years than it was over the last, so deleveraging will likely occur in a quicker manner in the future.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 9/10/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.13	0.12	0.14
3-Month LIBOR	0.29	0.29	0.30
1-Year Treasury	0.28	0.23	0.30
2-Year Treasury	0.57	0.51	0.88
5-Year Treasury	1.58	1.48	2.28
10-Year Treasury	2.78	2.70	3.35
30-Year Treasury	3.85	3.78	4.20
Bond Buyer Index	3.92	3.86	4.33

Foreign Exchange Rates

	Friday 9/10/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.272	1.290	1.458
British Pound ($/£)	1.537	1.545	1.665
British Pound (£/€)	0.828	0.834	0.875
Japanese Yen (¥/$)	84.190	84.310	91.730
Canadian Dollar (C$/$)	1.037	1.039	1.077
Swiss Franc (CHF/$)	1.019	1.016	1.038
Australian Dollar (US$/A$)	0.925	0.917	0.864
Mexican Peso (MXN/$)	12.955	12.934	13.368
Chinese Yuan (CNY/$)	6.770	6.804	6.829
Indian Rupee (INR/$)	46.479	46.713	48.510
Brazilian Real (BRL/$)	1.718	1.733	1.811
U.S. Dollar Index	82.674	82.463	76.817

Foreign Interest Rates

	Friday 9/10/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.82	0.83	0.74
3-Month Sterling LIBOR	0.72	0.73	0.63
3-Month Canadian LIBOR	1.20	1.03	0.50
3-Month Yen LIBOR	0.23	0.23	0.37
2-Year German	0.74	0.64	1.22
2-Year U.K.	0.76	0.72	0.91
2-Year Canadian	1.46	1.28	1.21
2-Year Japanese	0.15	0.14	0.22
10-Year German	2.40	2.35	3.30
10-Year U.K.	3.13	3.01	3.68
10-Year Canadian	2.98	2.87	3.33
10-Year Japanese	1.16	1.15	1.33

Commodity Prices

	Friday 9/10/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	76.07	75.02	71.94
Gold ($/Ounce)	1243.75	1246.75	996.60
Hot-Rolled Steel ($/S.Ton)	545.00	545.00	555.00
Copper (¢/Pound)	339.55	348.80	285.95
Soybeans ($/Bushel)	10.21	9.81	9.58
Natural Gas ($/MMBTU)	3.90	3.75	3.26
Nickel ($/Metric Ton)	22,744	21,595	17,914
CRB Spot Inds.	511.90	506.79	454.91

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	13	14	15	16	17
U.S. Data		**Retail Sales**	**Industrial Production**	**PPI**	**CPI**
		July 0.4%	July 1.0%	July 0.2%	July 0.3%
		August 0.3% (W)	August 0.4% (W)	August 0.3% (W)	August 0.2% (W)
		Retail Sales Less Autos	**Capacity Utilization**	**Core PPI**	**Core CPI**
		July 0.2%	July 74.8%	July 0.2%	July 0.1%
		August 0.3% (W)	August 75.0% (W)	August 0.1% (W)	August 0.1% (W)
		Business Inventories	**Import Price Index**	**Current Acount**	
		June 0.3%	July 0.2%	Q1 -$109.0B	
		July 0.2% (W)	August 0.2% (W)	Q2 -$125B (W)	
Global Data	**China**	**Japan**	**Canada**	**UK**	
	Industrial Prod. (YoY)	**Industrial Prod. (MoM)**	**Mfg Sales (MoM)**	**Retail Ex Auto Fuel**	
	Previous (Jul) 13.4%	Previous (Jun) 0.3%	Previous (Jun) 0.1%	Previous (Jul) 0.9%	
	Euro-zone	**Germany**	**Euro-zone**		
	Industrial Prod. (MoM)	**Zew Survey (Econ.Sen.)**	**CPI (MoM)**		
	Previous (Jun) -0.1%	Previous (Aug) 14.0	Previous (Jul) -0.3%		

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

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