December 17, 2010

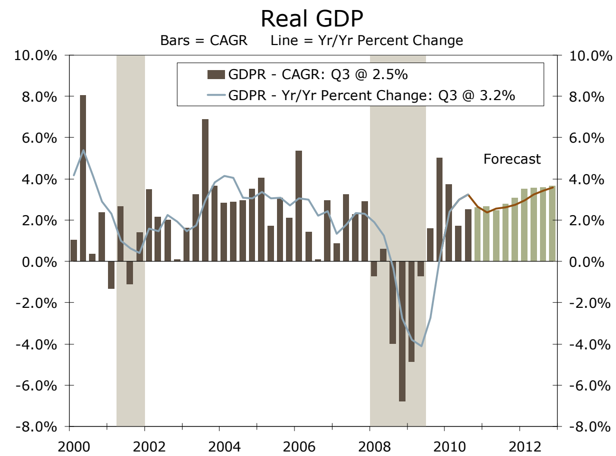
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Steady Beat of Good Economic News

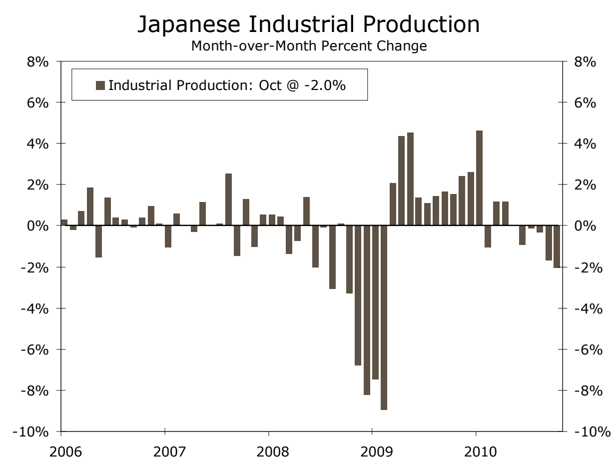
- In what was a very busy week for economic indicators, the theme was generally better-than-expected readings on the economy, which is consistent with our outlook for steadily improving growth in the next couple of years.
- The retail sales report pointed to better consumer spending numbers. Another dip in jobless claims suggests improvement in the job market might not be far away. Industrial production gains and improving business survey data tell us the manufacturing recovery has legs. Finally, consumer prices remain in check, but producer prices are another story.



Global Review

Softer Data, But It Could Be Worse

- Japan's industrial production for October was revised 0.2 percentage points lower, plunging 2.0 percent from the month before. Yet, Japan's Tankan report for December provided a ray of hope that Japan's economy is only slowing down at the moment and not entering another recession.
- Global manufacturing production appears to be holding up fairly well. Canadian new manufacturing orders jumped in October, while Reuter's December PMI for Germany increased to a robust 60.9 from 58.1 the month before.



Wells Fargo U.S. Economic Forecast

	Actual			Forecast					Actual		Forecast		
	2010				2011				2008	2009	2010	2011	2012
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	3.7	1.7	2.5	3.8	2.7	2.5	2.7	3.1	0.0	-2.6	2.9	2.8	3.3
Personal Consumption	1.9	2.2	2.8	3.4	2.0	1.8	2.2	3.1	-0.3	-1.2	1.8	2.4	2.2
Inflation Indicators [2]													
"Core" PCE Deflator	1.8	1.5	1.3	0.9	0.8	0.9	1.0	1.2	2.3	1.5	1.4	1.0	1.5
Consumer Price Index	2.4	1.8	1.2	1.1	1.1	1.7	1.8	1.8	3.8	-0.3	1.6	1.6	2.2
Industrial Production [1]	7.1	7.2	5.9	1.0	0.8	1.3	3.5	4.5	-3.3	-9.3	5.5	2.5	4.4
Corporate Profits Before Taxes [2]	37.6	37.0	27.8	12.5	8.2	6.2	6.2	6.7	-16.4	-0.4	27.9	6.8	6.7
Trade Weighted Dollar Index[3]	76.1	78.8	73.6	73.0	72.5	73.0	74.0	75.0	74.3	77.7	75.4	73.6	78.0
Unemployment Rate	9.7	9.7	9.6	9.8	10.0	9.9	9.8	9.6	5.8	9.3	9.7	9.8	9.2
Housing Starts[4]	0.62	0.60	0.59	0.55	0.59	0.65	0.70	0.75	0.90	0.55	0.59	0.68	0.84
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	1.88	0.25	0.25	0.25	0.50
Conventional Mortgage Rate	4.97	4.74	4.35	4.90	4.80	5.00	5.10	5.10	6.04	5.04	4.74	5.00	5.55
10 Year Note	3.84	2.97	2.53	3.30	3.20	3.40	3.50	3.60	3.66	3.26	3.16	3.43	4.03

Forecast as of: December 17, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units
[5] Annual Numbers Represent Averages

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U.S. Review

Economic Recovery is Gaining Momentum

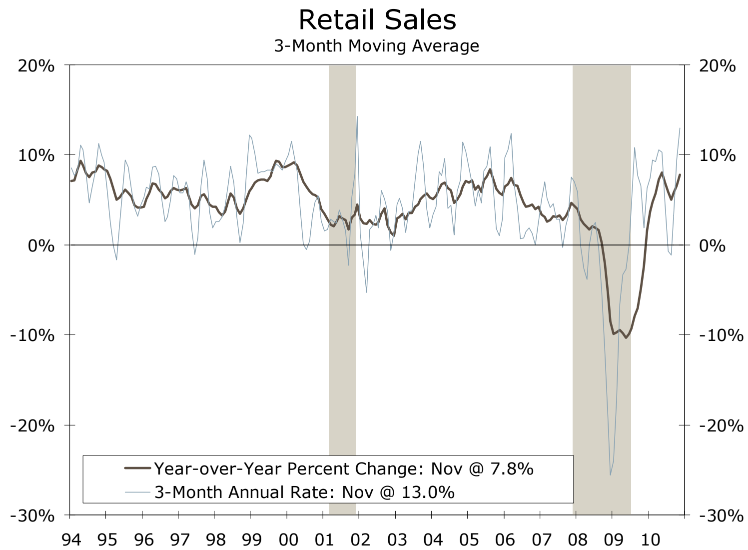
Developments in the economy this week were generally better than expected and served to underpin our long-held view of slow growth while simultaneously diminishing the credibility of the double-dip crowd.

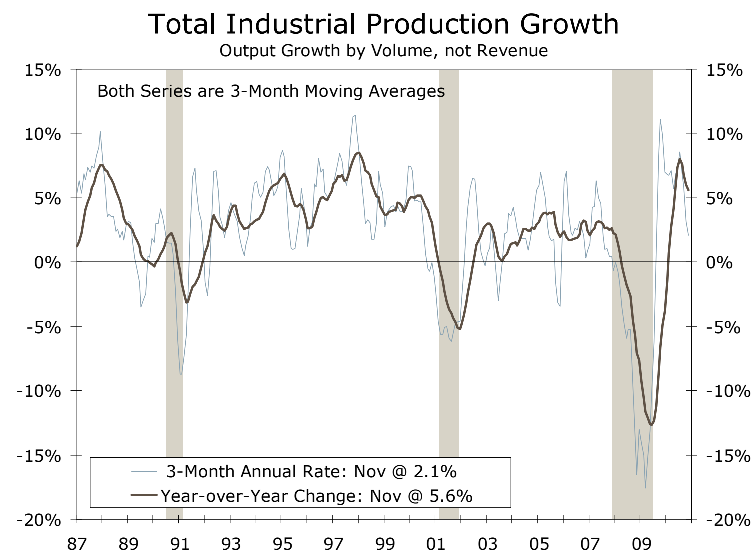
We raised eyebrows a few weeks ago with our upbeat holiday sales outlook. This week's stronger-than-expected retail sales report for the month of November suggests that our forecast for a 5.0 percent year-to-year increase in holiday sales should be on track. Some of the strongest monthly gains were seen in sectors associated with holiday shopping like department stores, general merchandise stores, and, of course, clothing stores.

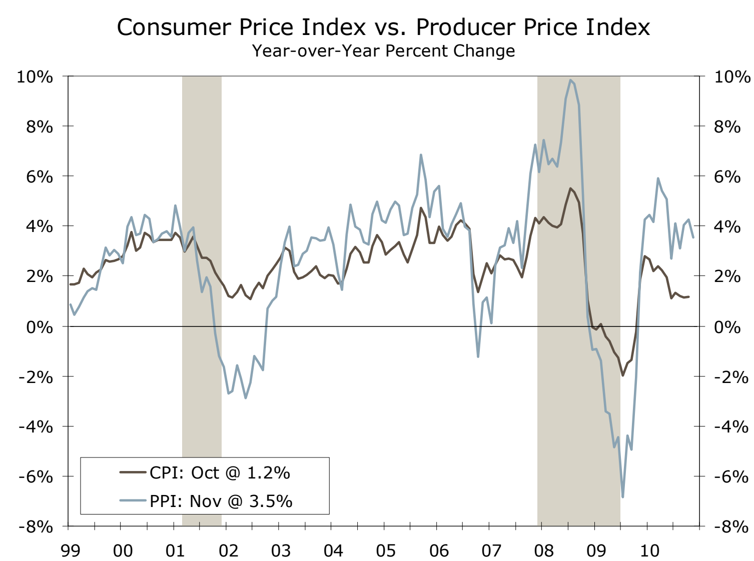
Strength was not limited to consumer spending. We also learned this week that industrial production rose 0.4 percent in November with gains spread across many sectors including consumer appliances, business equipment, construction supplies and materials. Outside of motor vehicles, output was even stronger, up 0.7 percent on the month. This strength is consistent with our expectation for continued growth in business investment as a support for continued growth, as we recently expressed in our Annual Outlook for 2011.

Speaking of the manufacturing sector, various regional surveys released this week provided a more encouraging view of industry, at least in some parts of the country. In the New York area, for example, the Empire Index from the NY Federal Reserve bested the consensus forecast with gains in new orders and shipments. One hundred miles to the south, the Philadelphia Federal Reserve also reported a gain of roughly two-points in the Philly Fed Index. While the gain was rather modest, the consensus had expected a decline to a level of 15. The details of the report also revealed a faster pace of growth in orders and unfilled orders. Also worth noting in these surveys was the continued pricing pressure for manufacturers. This pressure shows up in the surveys in the "prices paid" measure which jumped in both the Empire and the Philly Fed measures.

The concern about rising prices for manufacturers is that it can be difficult for businesses to pass on those price increases to consumers when unemployment is still high and consumers are discerning about their spending habits. When producers cannot pass on price increases, it comes out of the corporation's profits. In addition to what purchasing managers tell us in surveys, "hard" price data do indeed appear to be rising at a fairly steady clip. The producer price index jumped 0.8 percent in November. Prices further back in the pipeline also increased with intermediate goods up 1.1 percent and crude goods up 0.6 percent. However at this stage in the economic cycle, the increases in wholesale prices have yet to show up in consumer prices. Indeed, the consumer price index (CPI) for November increased a mere 0.1 percent and core prices were also up 0.1 percent. On a year-over-year basis, the CPI is up only 1.1 percent. We do not look for much of a pick up in consumer inflation anytime soon—a factor that may weigh on corporate profits.





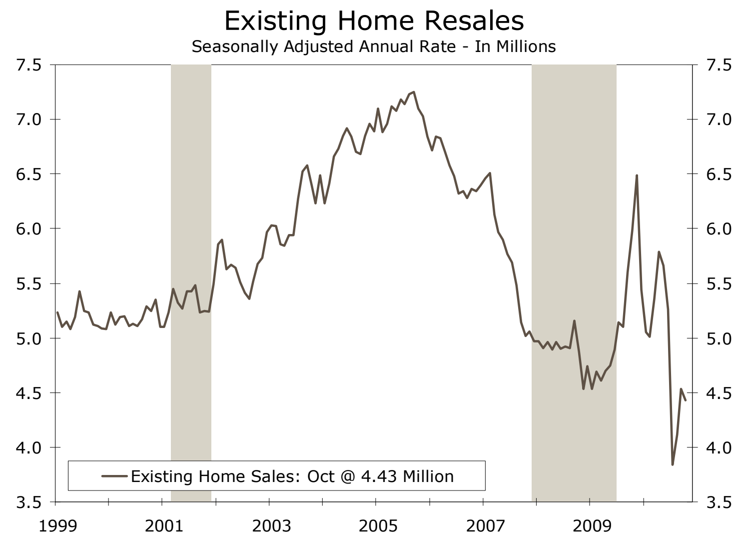


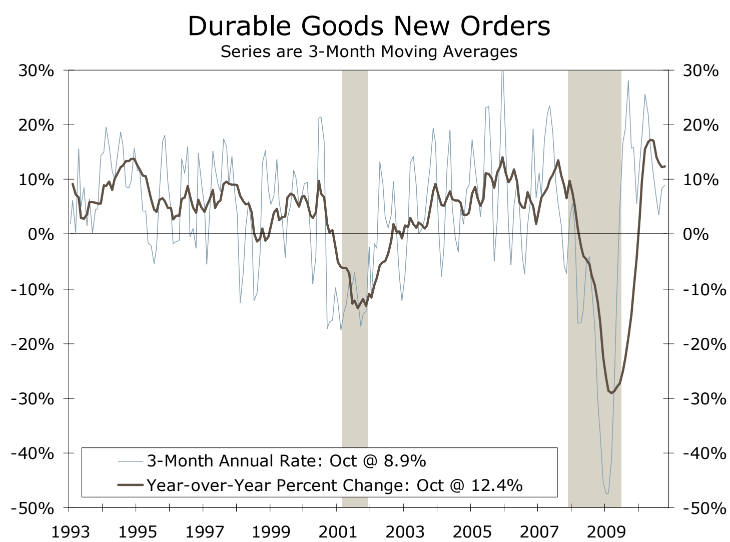
Existing Home Sales • Wednesday

Existing home sales fell 2.2 percent to a 4.43 million unit seasonally adjusted annual rate in October. Single-family homes dropped 2.0 percent, while multifamily homes slid 3.6 percent. Despite record-low mortgage rates, sales have been extremely weak amid high unemployment, tight credit, underwater mortgages and fear of further price declines. Adding salt to the wound lately has been the foreclosure signing issue. The supply of homes for sale fell to 3.86 million in October, but the weak sales pace kept the inventory/sales ratio at a still-high 10.5 months. Following the expiration of the tax credit, the median sales price has plunged again from $183,000 in June to $170,500 in October. We expect all of the above factors to continue weighing on sales in the months ahead. However, November sales may have gotten a boost from the resumption of some foreclosure sales. Recent increases in mortgage rates are yet another headwind, but could prompt some fence-sitters to act.

Previous: 4.43M **Wells Fargo: 4.65M**

Consensus: 4.75M





Durable Goods Orders • Thursday

Durable goods orders fell 3.3 percent in October following a strong September reading that was driven by a surge in non-defense aircraft orders. In October, all major categories saw declines, led by computers and electronics. Non-defense capital goods, excluding aircraft, a proxy for future business investment, slid 4.5 percent. In addition, the inventory/sales ratio climbed to 1.61, the highest in over a year and on par with levels seen during the 2001 recession. This suggests production could slow in the months ahead as inventory replenishment slows. However, recent economic data show that the economy has picked up a bit. This, along with the volatile nature of this indicator, suggests we should see a better reading in November. Emerging market strength, along with replacement of aging equipment and capacity expansion, could support orders despite the rising inventory/sales ratio.

Previous: -3.4% **Wells Fargo: 1.9%**

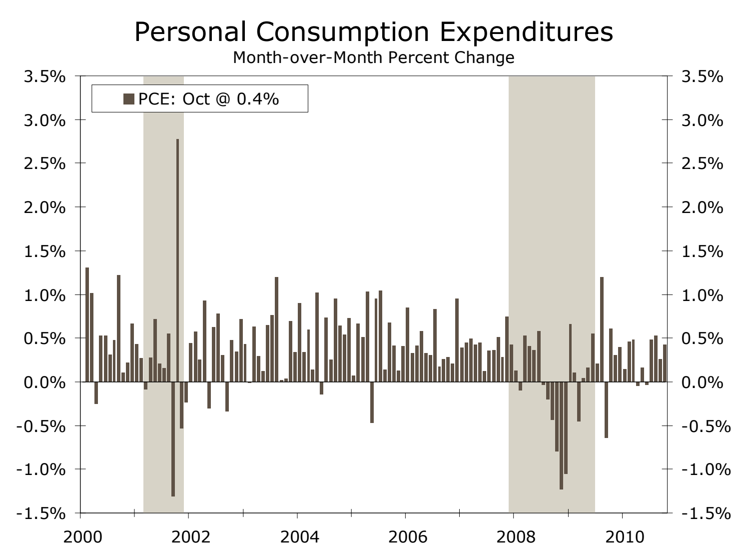
Consensus: -0.6%

Personal Spending and Income • Thursday

Personal spending rose 0.4 percent in October, slightly less than expected but slightly better than September's pace. Personal income rose 0.5 percent following no change in September. Wages and salaries rose 0.6 percent, the most since May, as employment jumped by 172,000. Still, core PCE inflation, the Fed's preferred measure, was a record-low 0.9 percent. With incomes rising faster than spending, the savings rate edged up to 5.7 percent. Pent-up demand, rising incomes, job gains, a stock market rally and built-up savings are all supporting spending during the holiday season. We expect to see another decent reading for spending in November. However, income growth may be tempered a bit by the weak job gains seen in November. The rebound in the unemployment rate could give some consumers reason to be cautious, but any slowdown in spending, if it occurs, will likely not happen until after the holidays.

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

Consensus: 0.5%



Global Review

A Silver Lining To Global Releases

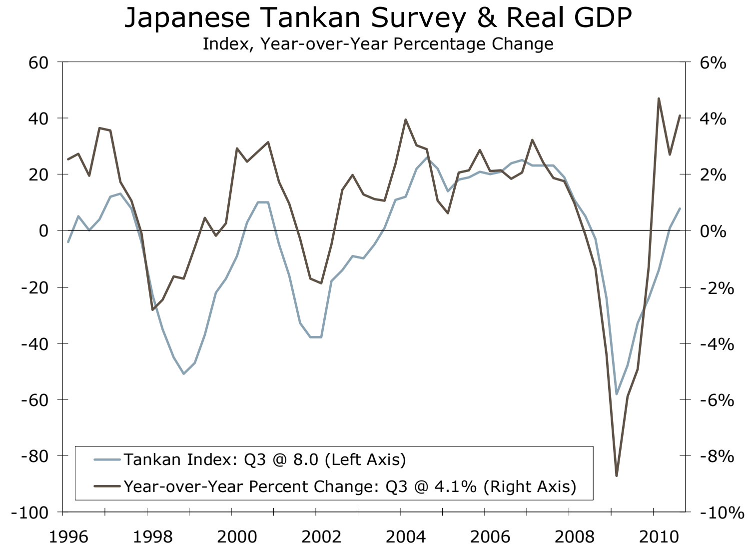
Just in time for the holidays, the global economic data had something for everyone's stocking. On balance, signs of global economic slowdown abounded, but the markets shrugged it off, already anticipating as much, and there were even some pleasant upside surprises to report.

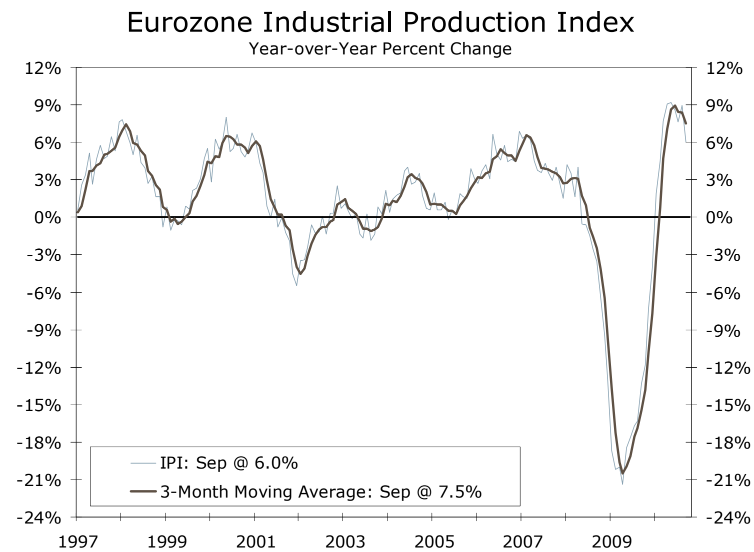
In Japan, the Ministry of Economy, Trade and Industry released the final reading on industrial production in October. The initially reported 1.8 percent decline was revised down to a 2.0 percent drop. Industrial production in Japan has been falling for six consecutive months as global inventory building subsides and a stronger yen and slowing China weigh on manufacturing. Yet before doom and gloom could really catch fire in Japan, the Tankan report for December came in much stronger than anticipated and far better than forecasted back in September. Back in September, the large manufacturing diffusion index was expected to fall into contraction in December, but the actual out-turn ended up being a positive five. There was notable outperformance and strength in chemicals, petroleum and coal, nonferrous metals, machinery, and motor vehicles.

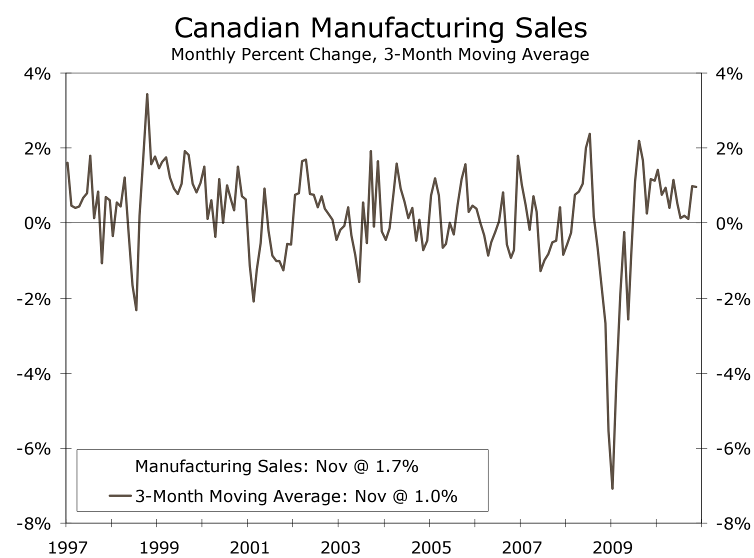
Even large non-manufacturing business confidence remained at a positive one. Among service businesses, Japanese real estate, wholesaling, and communications businesses were far stronger than anticipated back in September. Even so, the outlook for Japanese manufacturing and service businesses remains one of slowing activity. The forecast for March 2011 is a -2 for large manufacturers and a -1 for non-manufacturers. So, continued softer economic data are expected for Japan, but perhaps the landing won't be as hard as some analysts anticipate.

On the other side of the world, Europe was reporting its own manufacturing performance pointing to slower but continued manufacturing growth ahead. Industrial production in the Eurozone rose 0.7 percent in October following a 0.7 percent decline in September. This rebound in Eurozone manufacturing was somewhat weaker than expected, but the September data was revised higher by 0.2 percentage points. The consumer durable sector was the weak spot, contracting another 0.1 percent on the month, after falling 2.5 percent the month before. The phasing out of car purchase incentives in several European countries has knocked the auto industry for a loop temporarily. German manufacturing continues to look comparatively robust. Reuter's advance manufacturing PMI for Germany jumped to 60.9 for December from 58.1 the month before. France's manufacturing PMI softened a bit to 56.3 from 57.9.

Canada's manufacturing report was unabashedly robust this week. Canada's manufacturing shipments jumped a larger-than-expected 1.7 percent in October. Strong gains were reported in petroleum, primary metals, and motor vehicles. Future manufacturing growth in Canada appears likely as new manufacturing orders increased 3.0 percent, following a 5.3 percent decline the month before.







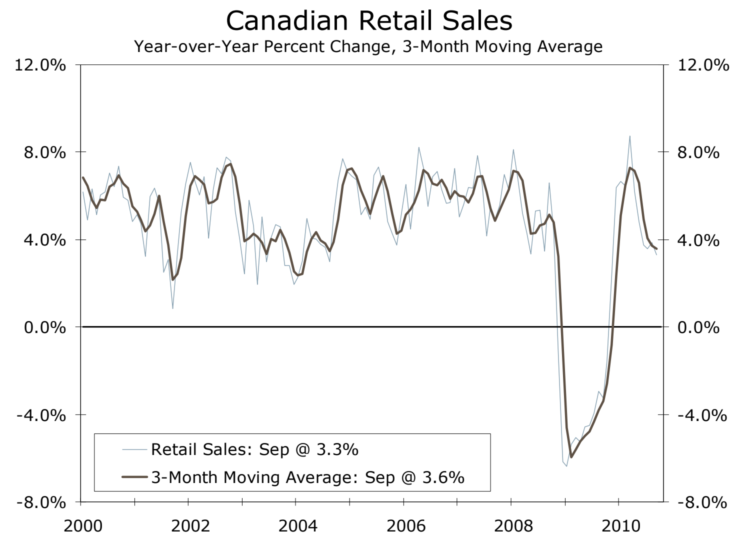
Canadian Retail Sales • Tuesday

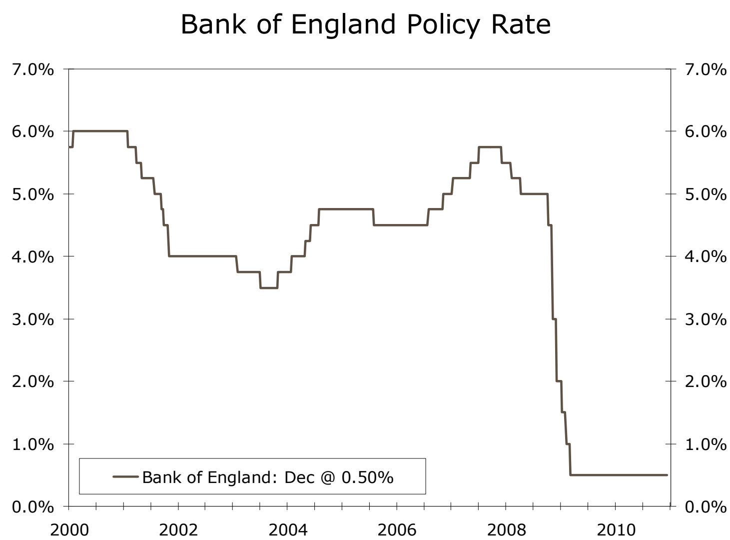
The recovery in Canada has been driven, at least in part, by strong growth in consumer spending. Although the year-over-year growth rate in retail spending has eased somewhat recently from earlier this year, the sequential rate of growth remains fairly buoyant. If, as the market consensus forecast anticipates, retail sales rose 0.5 percent in October relative to the previous month, then retail sales would be up more than 3 percent on a year-ago basis.

That said, the modest slowdown that appears to be under way in Canada has allowed the Bank of Canada to keep its main policy rate unchanged at 1.00 percent at its last two policy meetings. The benign rate of core CPI inflation—only 1.8 percent year-over-year in October—has afforded the Bank the luxury of patience. In that regard, CPI inflation data for November, which are also on the docket on Tuesday, should show that inflation remains in check.

Previous: 0.6%

Consensus: 0.5% (Month-over-Month)





Bank of England Minutes • Wednesday

At its meeting on December 9, the Monetary Policy Committee (MPC) kept its main policy rate unchanged at 0.50 percent, where it has been maintained since March 2009, and it refrained from changing the size of its quantitative easing program from £200 billion. The minutes of that policy meeting, which are slated for release on Wednesday, will give investors more insights into the MPC's current thinking and the outlook for monetary policy in the months ahead.

Final revisions to third quarter GDP growth data will be released on Wednesday, but a significant change from the 0.8 percent (not annualized) sequential growth rate that was originally reported is not likely. Data on consumer confidence and mortgage lending will also print next week.

French Business Confidence • Thursday

The rebound in French business confidence since early 2009 is consistent with the economic recovery that has taken hold over that period. The index for December, which will be released on Thursday, will offer some insights into the current state of the French economy. The consensus forecast anticipates an increase in confidence, which, if realized, would indicate that the French economy has ended the year on a rather strong note. Business confidence data for the overall Eurozone will also print on Thursday.

In general, growth in French consumption expenditures has trended higher over the course of the year. Data on French consumer spending that are on the docket on Thursday will indicate whether the trend remained intact in November.

Previous: 100

Consensus: 102 (Index)

Interest Rate Watch

Interest Rate Increase: Rebalancing

"Inflation will remain moderate and short-term interest rates low, but longer-term interest rates will rise in anticipation that the Federal Reserve will succeed in raising inflation." So concludes the first paragraph of our *Annual Outlook for 2011*.

Fundamentals for growth, inflation, the dollar and federal finance as well as investor behavior are consistent with the rebalancing of credit markets interest rates. As evidence of sustained economic growth has become apparent to many investors the flight to safety trade has diminished in attraction. So, investors, at the margin, have moved toward equities and corporate debt and away from Treasury notes.

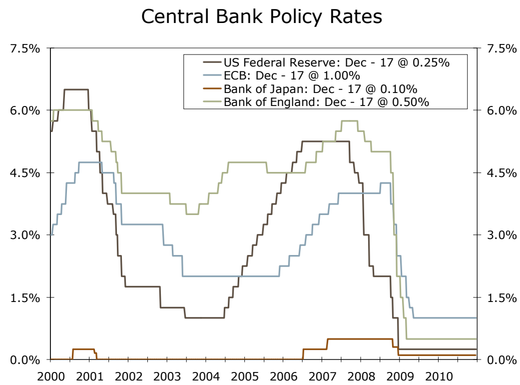
Inflation and the Dollar

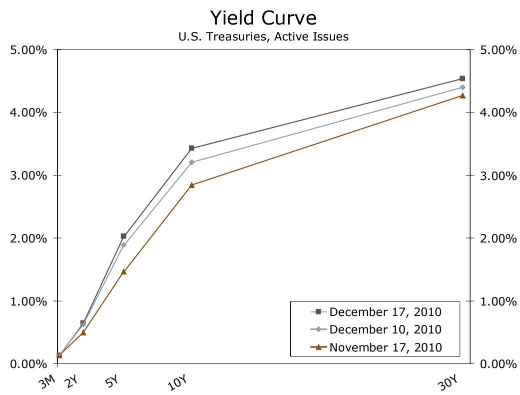
As stated in our *Annual* report, "[i]nflation remains well below the level consistent with the Federal Reserve's dual mandate, which has prompted a series of unconventional monetary policies such as quantitative easing. Concerns about rapid inflation in the near-term are overstated, but the long-term picture is more complicated given the massive amount of liquidity in the banking system. Our expectation is that "core" inflation will rise one percent in the year ahead." With the Fed apparently committed to moving inflation toward its two percent target it should be no surprise that Treasury notes yielding below two percent are of little interest since after inflation the real return is negative.

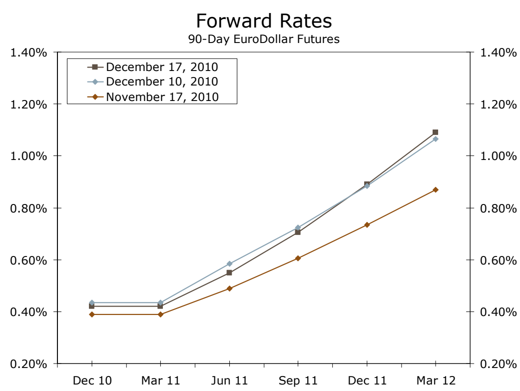
While dollar depreciation may not be the direct aim of the Federal Reserve the risk of exchange rate depreciation must be considered by foreign investors. Increased perception of higher U.S. inflation and the acceptance by Washington policy makers of dollar depreciation would reduce the real return to foreign investors and therefore they will demand higher interest rates to offset that risk.

Deficits & the Kindness of Strangers

U.S. Treasury finance remains dependent on the kindness of strangers (China, Japan, and Taiwan) and that kindness cannot be assumed to be unlimited.







Credit Market Insights

Cash on the Sidelines Curtails Commercial Paper Issuance

The commercial paper (CP) market, a vital source of short-term funding for businesses to finance payrolls, accounts receivables, and inventories continues to show a downward trend. CP outstanding on a seasonally adjusted basis fell by $26.2 billion in the week ending December 15, to $981.7 billion. CP is now down roughly 56 percent since peaking in late July 2007 with much of the drop due to declines in asset-backed commercial paper (ABCP).

What is driving the downward trend in the CP market? It appears that companies with large amounts of cash on their balance sheet don't have the same short-term funding needs. The best way to test this theory is to look at the cash equivalent to total assets ratio to determine how much cash is actually sitting on the sidelines. We find that as of the third quarter, the ratio of cash equivalent to total assets is at an all time high of 5.9 percent and well above its long-run trend of 3.8 percent and suggests companies are indeed awash in cash.

Second, with the economy growing at such a modest pace the traditional uses for short-term funding are not as great. The private sector is hesitant to add new workers to payrolls and businesses continue their efforts to align inventories with slower sales. We expect that once economic growth picks up on a sustainable basis, companies will likely once again put cash to work, which should lift CP issuance.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.83%	4.61%	4.39%	4.94%
15-Yr Fixed	4.17%	3.96%	3.76%	4.38%
5/1 ARM	3.77%	3.60%	3.40%	4.37%
1-Yr ARM	3.35%	3.27%	3.26%	4.34%
MBA Applications				
Composite	589.7	603.5	713.6	667.3
Purchase	200.3	210.9	179.2	241.2
Refinance	2,910.9	2,932.0	3,831.0	3,214.0

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

Topic of the Week

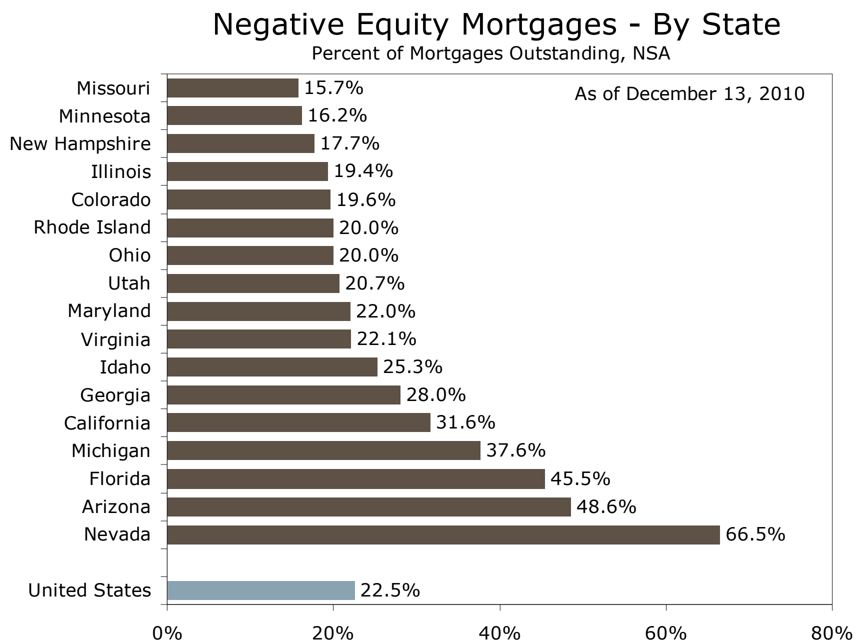
State and Local Budgets: Challenges Imminent

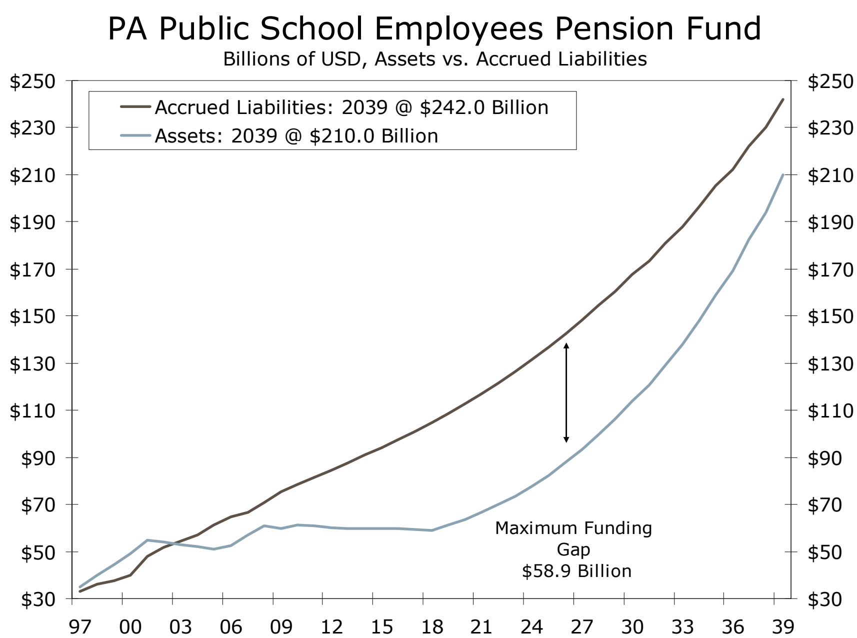
Over the next year, challenges to state and local budgets across the United States will take center stage. During the prior two years, state and local budget problems were largely avoided via federal government assistance. In the coming years, however, less assistance is likely, due to federal budget concerns, necessitating spending cuts and tax increases at the state and local level.

Exceptional challenges confront a number of states. For these states the challenges are both structural and cyclical. On the cyclical side of the equation, declining valuations for homes and commercial real estate will continue to impact local government property tax revenues and thereby limit local budget flexibility. States like Nevada, Arizona and Florida have seen their revenue bases erode significantly due to the housing collapse and associated negative wealth effects. With the percentage of households with negative equity on their home mortgages exceptionally high in states hit hardest by the housing collapse, key revenue generating industries that have provided crucial tax revenues flows to state and local governments in the past will likely remain weak in 2011, adding pressure to local budgets.

On the structural side of the equation, the road will be extremely difficult. In 2011, many states will be forced to deal directly with underfunded entitlement programs and unsustainable spending commitments. Public pension retirement programs are one of the largest culprits of state and local structural budget problems. In states like California and Pennsylvania, public pension retirement programs have resulted in enormous payment obligations that far out-strip money set aside at public agencies to meet these obligations.

We remain optimistic that the U.S. recovery will continue to improve in 2011, though the aforementioned state and local budgets issues do present some risks. Our expectation is that state and local budget issues will hinder growth somewhat in 2011, but our forecast still calls for growth of around 2.8 percent next year.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 12/17/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.11	0.12	0.04
3-Month LIBOR	0.30	0.30	0.25
1-Year Treasury	0.28	0.27	0.33
2-Year Treasury	0.63	0.64	0.75
5-Year Treasury	2.01	1.98	2.21
10-Year Treasury	3.40	3.32	3.48
30-Year Treasury	4.50	4.43	4.42
Bond Buyer Index	5.15	4.86	4.18

Foreign Exchange Rates

	Friday 12/17/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.314	1.323	1.434
British Pound ($/£)	1.548	1.580	1.615
British Pound (£/€)	0.849	0.837	0.888
Japanese Yen (¥/$)	84.160	83.950	89.960
Canadian Dollar (C$/$)	1.013	1.009	1.071
Swiss Franc (CHF/$)	0.972	0.981	1.048
Australian Dollar (US$/A$)	0.985	0.985	0.887
Mexican Peso (MXN/$)	12.444	12.452	12.866
Chinese Yuan (CNY/$)	6.664	6.655	6.829
Indian Rupee (INR/$)	45.355	45.225	46.666
Brazilian Real (BRL/$)	1.714	1.707	1.782
U.S. Dollar Index	80.568	80.070	77.694

Foreign Interest Rates

	Friday 12/17/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.95	0.96	0.67
3-Month Sterling LIBOR	0.75	0.75	0.60
3-Month Canadian LIBOR	1.23	1.23	0.47
3-Month Yen LIBOR	0.18	0.18	0.28
2-Year German	1.06	1.08	1.15
2-Year U.K.	1.20	1.11	1.18
2-Year Canadian	1.65	1.72	1.29
2-Year Japanese	0.21	0.23	0.17
10-Year German	3.03	2.95	3.14
10-Year U.K.	3.55	3.52	3.85
10-Year Canadian	3.20	3.30	3.37
10-Year Japanese	1.20	1.21	1.26

Commodity Prices

	Friday 12/17/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	88.03	87.79	72.65
Gold ($/Ounce)	1367.90	1386.00	1098.90
Hot-Rolled Steel ($/S.Ton)	600.00	580.00	510.00
Copper (¢/Pound)	414.95	410.50	311.05
Soybeans ($/Bushel)	12.74	12.67	10.35
Natural Gas ($/MMBTU)	4.05	4.42	5.77
Nickel ($/Metric Ton)	24,645	23,547	17,434
CRB Spot Inds.	573.94	571.07	477.30

Next Week's Economic Calendar

	Monday 20	Tuesday 21	Wednesday 22	Thursday 23	Friday 24
U.S. Data			**GDP** 3Q (2nd) 2.5% 3Q (3rd) 2.7% (W) **Existing Home Sales** October 4.43M November 4.65 (W)	**Personal Income** October 0.5% November 0.2% (W) **Durable Goods Orders** October -3.4% November 1.9% (W) **New Home Sales** October 283K November 300K (W)	
Global Data		**Canada** **CPI (YoY)** Previous (Oct) 2.4% **Canada** **Retail Sales (MoM)** Previous (Sep) 0.6%	**United Kingdom** **B of E Minutes**	**France** **Consumer Spending** Previous (Oct) -0.7% **Canada** **GDP (MoM)** Previous (Sep) -0.1%	

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

Wells Fargo Securities, LLC Economics Group

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