October 15, 2010

Economics Group

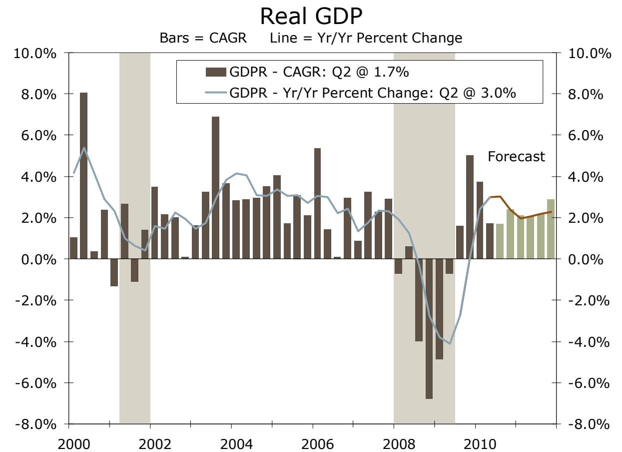
WELLS FARGO SECURITIES

Weekly Economic & Financial Commentary

U.S. Review

After a Dreary Week, Retail Sales Surprise on the Upside

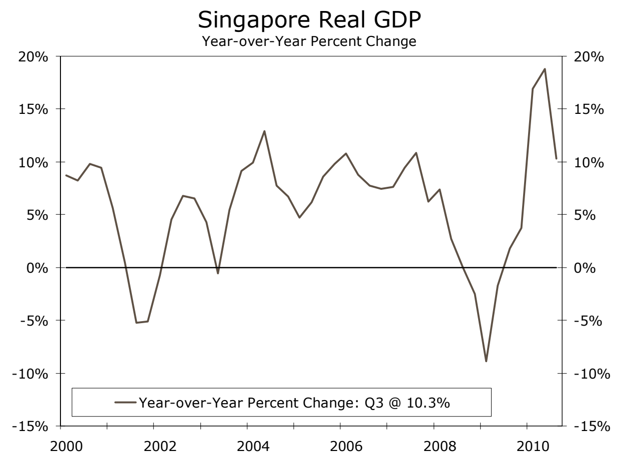
- Data this week fit the mold for how this recovery has been taking shape. Jobless claims picked up again suggesting further struggles for employment. Trade data indicated a modest drag from net exports on third quarter GDP. A bright spot was retail sales, which picked up nicely in September even as August sales numbers were revised higher.
- Price data released this week showed further evidence of an environment in which producer price inflation is outpacing increases in consumer prices—not a welcome scenario for corporate profitability.



Global Review

Despite Decline in GDP, Singapore Tightens Policy

- Singapore became the first country to release third-quarter GDP results, and the data showed that the economy contracted on a sequential basis in the third quarter. However, sequential GDP data in the Lion City are volatile, and we see little risk of a renewed downturn in Singapore.
- Singaporean authorities are more concerned about inflation at present than they are about insufficient economic growth. Indeed, the central bank sanctioned a faster appreciation of the currency, which will act as an effective tightening of monetary policy in the city-state.



Wells Fargo U.S. Economic Forecast

	Actual						Forecast					Forecast		
	2009				2010				2007	2008	2009	2010	2011	2012
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product [1]	-4.9	-0.7	1.6	5.0	3.7	1.7	1.7	2.4	1.9	0.0	-2.6	2.7	2.1	3.0
Personal Consumption	-0.5	-1.6	2.0	0.9	1.9	2.2	2.2	1.4	2.4	-0.3	-1.2	1.6	1.6	1.6
Inflation Indicators [2]														
"Core" PCE Deflator	1.6	1.5	1.3	1.7	1.8	1.5	1.4	1.1	2.4	2.3	1.5	1.4	1.1	1.4
Consumer Price Index	-0.2	-1.0	-1.6	1.5	2.4	1.8	1.2	0.8	2.9	3.8	-0.3	1.5	1.1	1.7
Industrial Production [1]	-17.6	-10.3	8.3	7.0	7.1	6.5	4.9	2.2	2.7	-3.3	-9.3	5.4	3.4	5.2
Corporate Profits Before Taxes [2]	-17.3	-11.4	-3.9	42.5	37.6	37.0	17.0	12.0	-6.1	-16.4	-0.4	24.9	6.5	6.9
Trade Weighted Dollar Index [3]	83.2	77.7	74.3	74.8	76.1	78.8	72.5	72.0	73.3	74.2	77.5	74.9	75.1	80.5
Unemployment Rate	8.2	9.3	9.6	10.0	9.7	9.7	9.6	9.9	4.6	5.8	9.3	9.7	9.7	9.0
Housing Starts [4]	0.53	0.54	0.59	0.56	0.62	0.60	0.56	0.58	1.34	0.90	0.55	0.59	0.78	1.05
Quarter-End Interest Rates														
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	4.25	1.63	0.25	0.25	0.25	0.50
Conventional Mortgage Rate	5.00	5.42	5.06	4.93	4.97	4.74	4.10	3.90	6.10	5.92	5.10	4.43	4.33	4.89
10 Year Note	2.71	3.53	3.31	3.85	3.84	2.97	2.40	2.40	4.04	3.39	3.35	2.90	2.93	3.30

Forecast as of: October 13, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

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Together we'll go far

U.S. Review

Slow Inflation, Soft Exports, but a Resilient Consumer

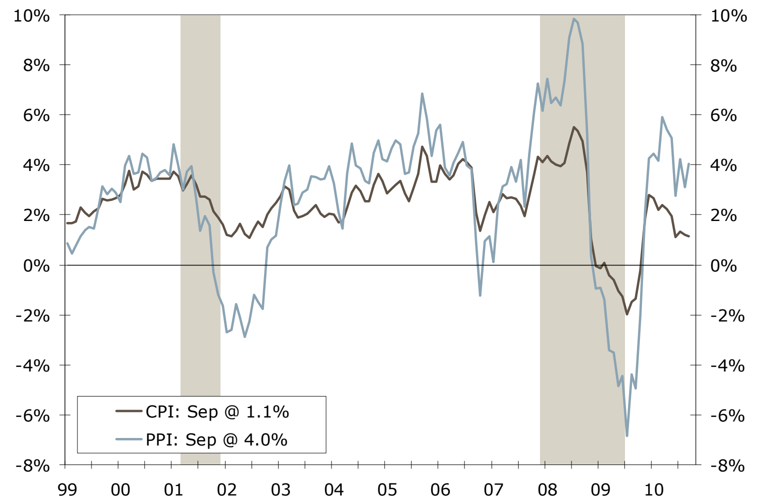
On Tuesday, markets had their first opportunity to digest the minutes from the Sept. 21 FOMC meeting. Most of the commentary about the minutes this week has focused on the fact that the Fed may engage in additional quantitative easing (QE) to stimulate the sluggish economy, but we note that the details from the minutes reveal that inflation was a significant topic for the committee as well. While the committee remains concerned that prices are stagnating somewhat, some participants noted that the risks of deflation and disinflation may be abating. (Unlike deflation, which is when prices fall, disinflation is when the prices continue to rise, but rise at a slower pace.) The minutes described in detail the fact that "if inflation continued to come in below levels consistent with the FOMC's dual mandate, it would be appropriate to provide additional monetary policy accommodation." Markets essentially took that to mean additional quantitative easing most likely in the form of increased government purchases of mortgage bonds and Treasury securities.

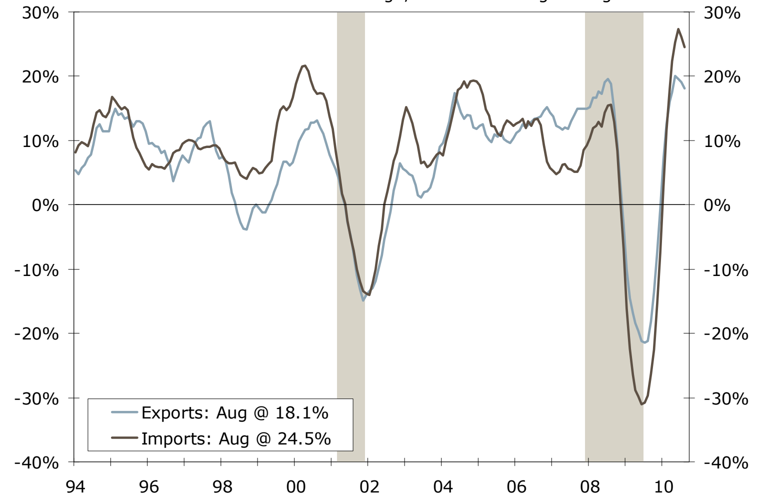
Speaking of prices, we received the latest readings for both consumer prices and producer prices this week. The theme in prices that seems to be taking hold in 2010 is one of gradual producer price increases, which are outpacing more modest consumer price inflation. In the first nine months of the year, producer prices for finished goods are up 1.8 percent. In contrast, consumer prices have risen only 0.5 percent for the same period. Essentially, input costs for businesses are going up, but with high unemployment and slow growth in the broader economy, companies are not able to pass on those price increases to consumers. This will clearly put pressure on corporate profits. We expect this dynamic to continue with consumer prices growing 1-2 percent for the next couple of years and wholesale prices clipping along at a 2-3 percent pace.

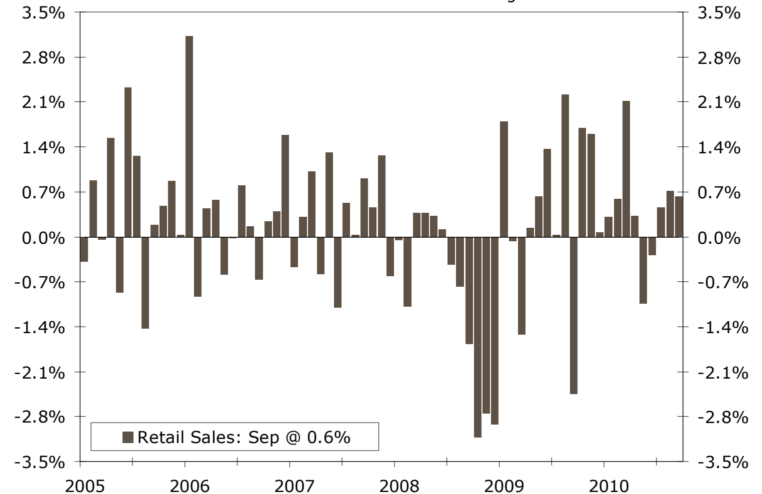
International trade data released this week showed that export growth was outpaced by gains in imports in August. The net result is likely to be a modest drag from net exports on third quarter GDP growth. For the rest of 2010 and into 2011, we do not expect net exports to significantly influence growth in either direction, as the trade deficit stays in a fairly tight band between $45 billion and $50 billion.

Retail sales data for September increased 0.6 percent—the third straight monthly gain and the latest sign that consumers have not gone into hiding as some had feared. The report also revealed upward revisions to previously reported data and suggest a brighter picture of the U.S. consumer spending. Still, with high unemployment and a weak economic recovery, consumer spending will grow at a less than 2 percent pace through 2011. That is a far cry from the 3 percent pace that consumer spending growth averaged between 2003 and 2007.

Much of the spending during the last expansion was fueled by a consumer that became highly leveraged. As consumers unwind that debt over the next couple of years, consumer spending should grow at roughly half the pace it did earlier this decade.

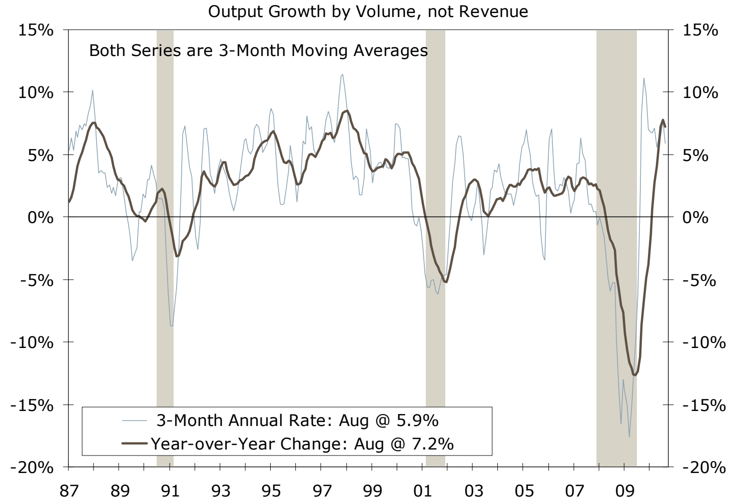






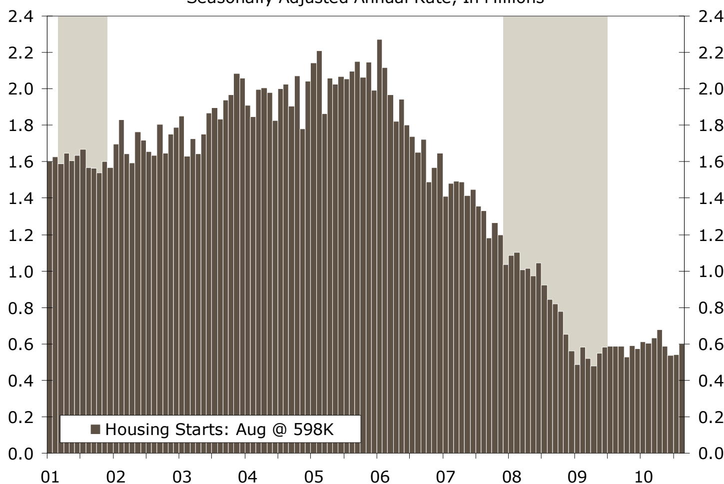
Industrial Production • Monday

The manufacturing sector, which helped fuel the early recovery, is beginning to lose steam. Industrial production has risen steadily over the past year, but the pace is slowing. The slower momentum in factory production at this stage of the business cycle is fairly typical as inventories are brought in line with demand. Moreover, warmer weather in September and early data from some regional manufacturing surveys suggest September may also see modest gains. We expect industrial production to increase to 0.2 percent in September and capacity utilization to rise slightly to 74.8 percent. While capacity utilization is much higher than recent lows, it remains well below its long-run average.



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

Consensus: 0.2%



Housing Starts • Tuesday

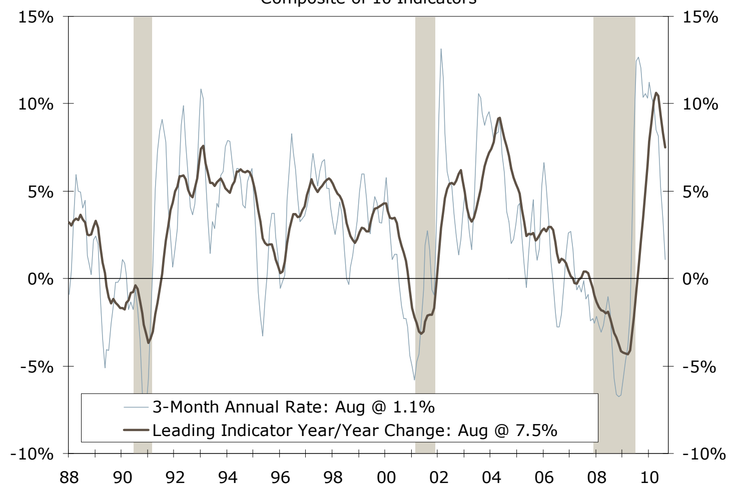
Homebuilders continue to struggle with tepid demand. While starts have increased in each of the past two months, much of the increase has been due to the volatile multi-family component. Single-family starts rose 4.3 percent in August after three consecutive monthly declines, with the drop likely due to payback from the homebuyers' tax credit. The recent increase in single-family starts suggests monthly declines induced by the tax credit could be over, but the housing market remains weak. Single-family permits have fallen five months in a row and are running below the current pace of construction, which suggests little to no near-term improvement. Starts could linger close to current levels for the next few months. A return to the 1.55 million-unit pace averaged from 1985 to 2005 will most likely not be seen for another five years at the earliest.

Previous: 598K **Wells Fargo: 550K**

Consensus: 583K

Leading Economic Indicator • Thursday

The leading economic indicator (LEI) rose just 0.3 percent in August, but is probably weaker than the headline number suggests. The wider interest rate spread boosted the index by 0.3 percent in August and has made a slightly larger contribution to the index for a little more than two years now. With the federal funds rate essentially at zero, however, the value of this component remains in question. Excluding the interest rate spread, the LEI would have fallen in four of the past five months, which is in line with our forecast of slow economic growth. We expect the LEI to continue its tepid momentum and increase 0.4 percent in September. A widening in the interest rate spread, decline in initial claims and increase in stock prices, permits and money supply should offset declines in consumer expectations and supplier deliveries. All other components should be flat on the month.



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

Consensus: 0.3%

Global Review

Despite Decline in GDP, Singapore Tightens Policy

Singapore became the first country to report third-quarter GDP data this week, and the results were a bit sobering. On a year-over-year basis, real GDP growth slowed from 18.8 percent in the second quarter to 10.3 percent in the third quarter (see chart on page 1). More dramatically, however, real GDP plunged at an annualized rate of 19.8 percent between the second and third quarters. Does this mean Singapore has tumbled back into a deep recession? And if economic activity in Singapore has turned down again, what does this portend for other Asian economies that will be releasing their own GDP data over the next few weeks?

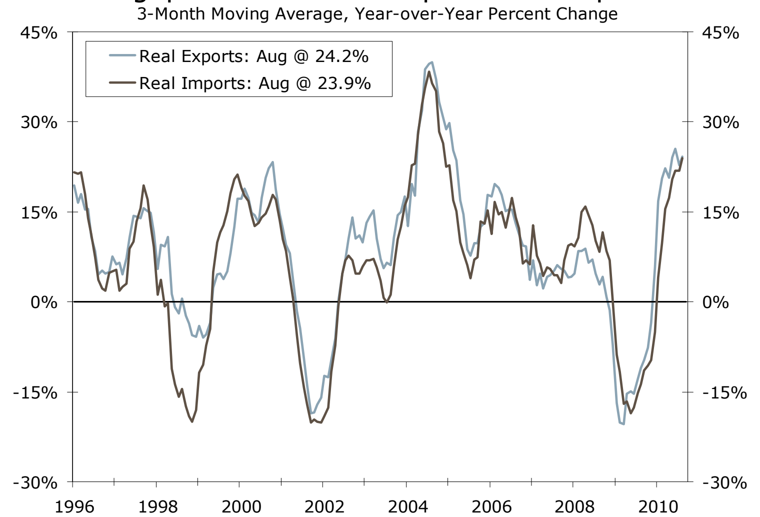
Before going into panic mode regarding the outlook for Asian economies, consider that Singapore is one of the most open economies in the world. Consequently, the sequential GDP growth rates can get whipped around as exports and imports, which are both equivalent to roughly 200 percent of the GDP rise and fall. For example, the sharp "downturn" in the third quarter follows the 24 percent annualized rise in real GDP in the second quarter and the 46 percent surge in the first quarter.

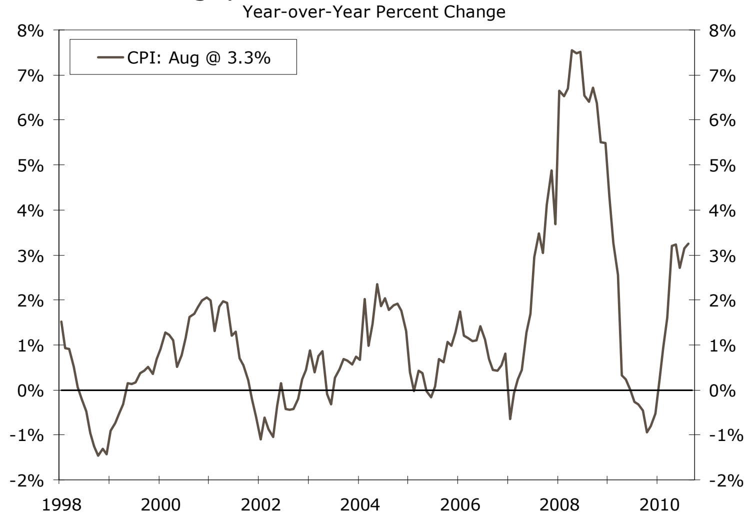
Export growth appears to have remained rather buoyant in the first two months of the third quarter (top chart). However, acceleration in imports may have helped to depress the overall level of real GDP in the third quarter. (A breakdown of real GDP into its underlying demand components will not be available for a few more weeks.)

Therefore, we are not overly alarmed by the recent decline in real GDP because indicators of domestic demand in Singapore generally remain strong. The growth rate of retail sales (excluding autos) is about six percent at present, and house prices are rising rapidly again. Although export growth undoubtedly will slow further in the months ahead as foreign economies decelerate, a collapse in exports, à la 2000-2001 when the tech bubble imploded or 2008-2009 in the wake of the global financial crisis, does not appear likely.

Indeed, authorities in Singapore appear to be more concerned about rising inflationary pressures—the overall rate of CPI inflation currently exceeds three percent (middle chart)—than they are about insufficient growth. On the same day that the GDP data were reported, the Monetary Authority of Singapore (MAS), the country's central bank, announced that it would allow the trade-weighted value of the Singapore dollar to strengthen at a faster rate than previously allowed. Since early June, the Sing dollar has risen about 10 percent versus the greenback (bottom chart), although it has weakened about five percent or so versus the euro and the yen over that period.

Because Singapore is such an open economy, the exchange rate can have a significant effect on the economy. Consequently, the trade-weighted value of the currency is the main policy instrument of the MAS, and the decision this week to allow faster appreciation of the Sing dollar is an effective tightening of monetary policy.





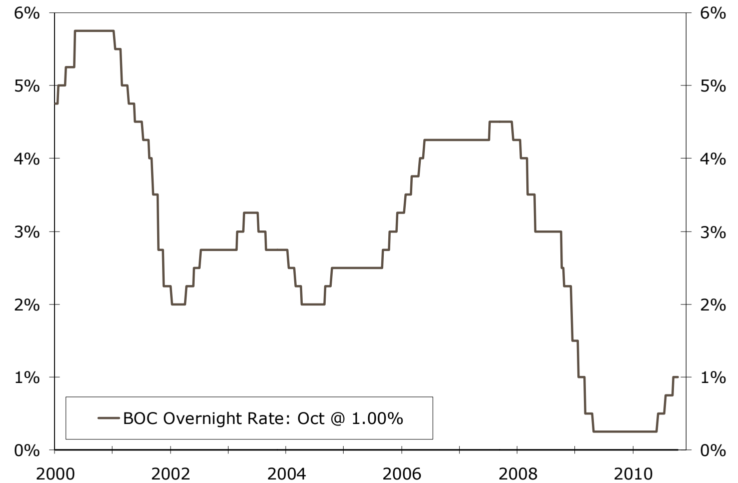
Bank of Canada Policy Meeting • Tuesday

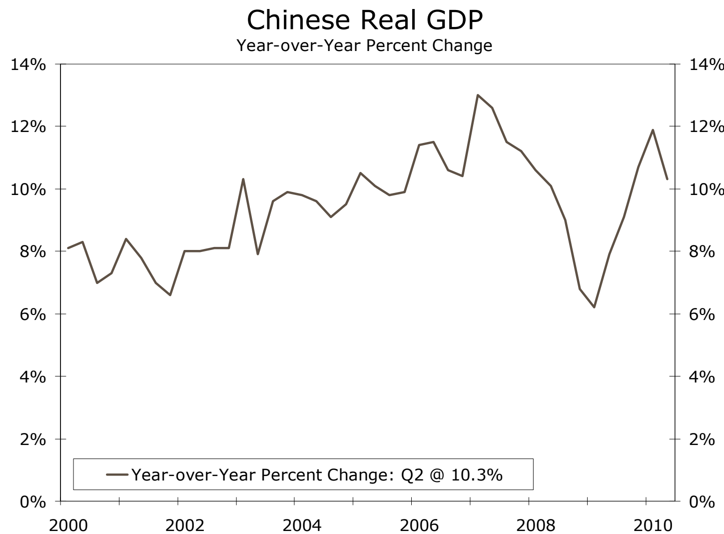
The Bank of Canada (BoC) has hiked its policy rate by 75 bps since June, but most analysts, including ourselves, expect that the BoC will remain on hold at its meeting on Tuesday. There have been signs that growth in Canada is starting to slow, including the 0.1 percent decline in real GDP in July. Although we do not expect the Canadian economy will slip back into recession, signs of slower growth in Canada, in conjunction with question marks about the durability of the U.S economic recovery, will probably be enough to bring about a pause in the BoC's tightening cycle.

Although official figures will not yet be available for the BoC policy meeting, August data on retail sales and September data on CPI inflation will print on Friday. Because inflation is benign—the core rate of CPI inflation is only 1.3 percent at present—the BoC is probably in no hurry to tighten aggressively.

Current Policy Rate: 1.00% **Wells Fargo: 1.00%**

Consensus: 1.00%





Chinese GDP • Thursday

The year-over-year rate of real GDP growth in China slowed from 11.9 percent at the start of the year to 10.3 percent in the second quarter, and further slowing is expected in the recently completed three-month period. Not only have the year-ago comparisons become more challenging, but tightening measures enacted by the government earlier this year are starting to exert some drag. That said, the Chinese economy maintains a significant amount of forward momentum, and the likelihood of a downturn is very small.

Although the GDP release should be the data highlight of the week, September data on consumer prices, retail sales and industrial production, which are also slated for release on Thursday, will give investors insights into how the Chinese economy ended the third quarter.

Previous: 10.3% **Wells Fargo: 9.1%**

Consensus: 9.5% (year-over-year)

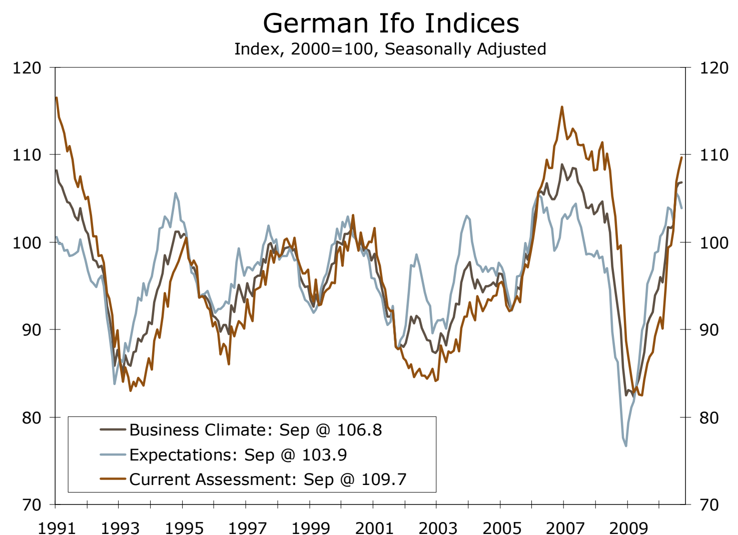
German Ifo Index • Friday

The Ifo index of German business sentiment, which has a high degree of correlation with growth in German industrial production, has been very buoyant in recent months. Although the expectations component of the index has edged lower the "current assessment" component continues to rise, which suggests that growth in German industrial production has remained solid, at least through September. Investors will scrutinize the Ifo index and all its many sub-components for insights into the current state of the German economy.

More broadly, the purchasing managers' indices for the manufacturing and service sectors in the overall euro area will print on Thursday. The consensus forecasts anticipate that both indices in October remained above the demarcation line that separates expansion from contraction.

Previous: 106.8

Consensus: 106.4



Interest Rate Watch

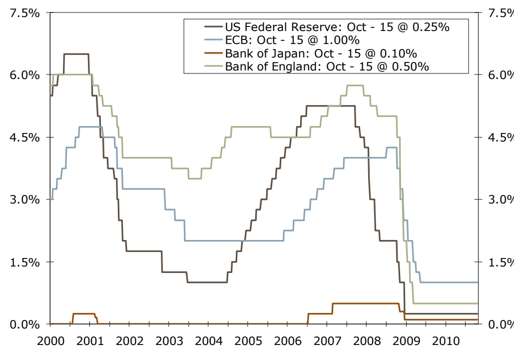
What about Tom?

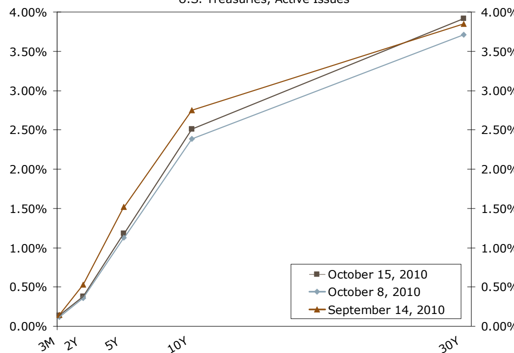
When a new person enters the Economics department at Wells Fargo Securities, LLC, we suggest several books to read—one of those books is Thomas Sowell's "A Conflict of Visions." Why? Sowell's book helps the reader understand the "other" side. Sowell helps explain why Democrats have a set of beliefs that is different from Republicans.

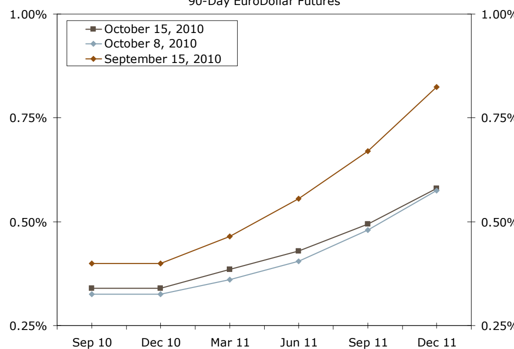
So it is for monetary policy. Why does President Tom Hoenig have a consistent, dissenting view on monetary policy going into next week's FOMC meeting?

From President's Hoenig's speech earlier this week at the National Association for Business Economics conference, we drew the following views: first, while the public may have a sense that the Fed must "do something," President Hoenig is asking why. Second, there is no shortage of liquidity in the financial system right now. Banks and non-financial firms have lots of extra cash right now so liquidity is not the issue. Third, how well can the Fed fine tune the market response to quantitative easing? The lags in monetary policy are long and variable and the impacts on inflation are not evenly spread over many product areas. For example, farmland, metals and corn prices are rising, while the estimated impact of $500 billion of Fed easing is estimated to have a modest 20 bps-30 bps impact on interest rates. So why all this effort for so little return? Why take all these risks if the benefit is so small?

Two final points. First, the lesson of the 1960s was that over time inflation pressures build up and continued increases in reserves (high powered money) today will generate rising inflation pressures down the road, and it is not clear that the Fed will be able to reign in such pressures so easily. Finally, what does this episode indicate for the risks of the Fed's independence? Is the Fed the new first lender of first resort to address the unemployment problem? How independent can the Fed be in an environment when it is also a major buyer of public (Treasury) and private debt? The Fed as a marginal buyer would set the price—a politically risky scenario for an independent Federal Reserve.







Credit Market Insights

Credit Contraction Accelerates

Over the past few months, consumer credit outstanding at commercial banks had held fairly steady. While credit card balances had been steadily declining, non-credit card balances had been on the upswing. However, consumer credit outstanding has contracted sharply over the past few weeks as credit card balances have continued their downward trend and non-credit card balances have nose-dived.

For the third quarter, average credit card balances plunged while non-credit card balances actually rose slightly as the higher balances earlier in the quarter led to a higher average, despite the recent drop-off. The result was a decline of $14.4 billion in total consumer credit outstanding during the third quarter. If third-quarter charge-off levels (due out in November) remain near levels seen in the second quarter, which we assume, the decline in credit would imply much weaker net lending activity in the third quarter versus the second quarter. If charge-off levels improve enough, it could actually signal negative net lending activity. Either way, it is very likely that net lending activity was weaker in the third quarter following the burst in the second quarter that was fueled, in part, by the optimism from the homebuyers' tax credit. This suggests that the economy has still not healed enough to start taking on new debt. With the unemployment rate still high, housing stuck in a rut and credit still tight, we expect consumers to remain frugal for months to come.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.19%	4.27%	4.37%	4.92%
15-Yr Fixed	3.62%	3.72%	3.82%	4.37%
5/1 ARM	3.47%	3.47%	3.55%	4.38%
1-Yr ARM	3.43%	3.40%	3.40%	4.60%
MBA Applications				
Composite	897.2	782.6	801.5	742.9
Purchase	181.8	198.7	183.7	290.9
Refinance	5,060.3	4,180.8	4,396.1	3,374.6

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

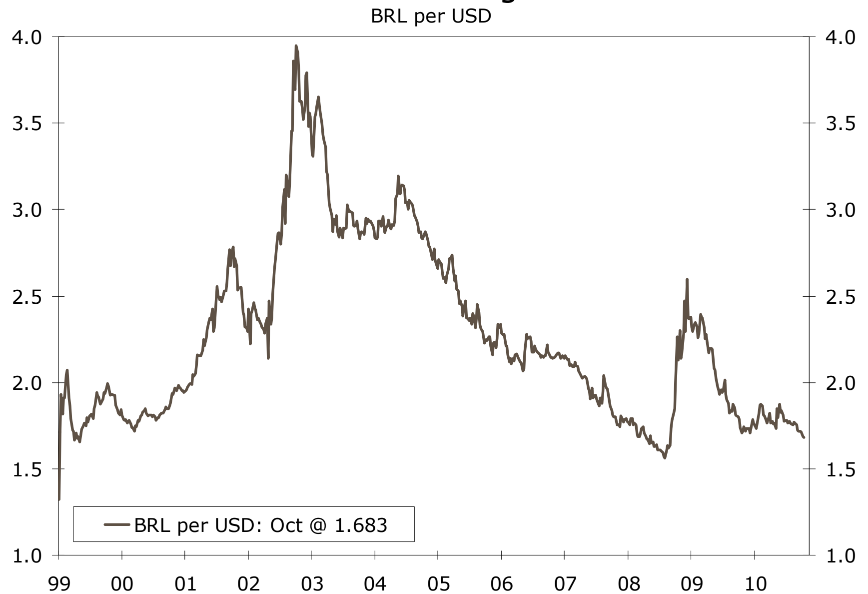
Topic of the Week

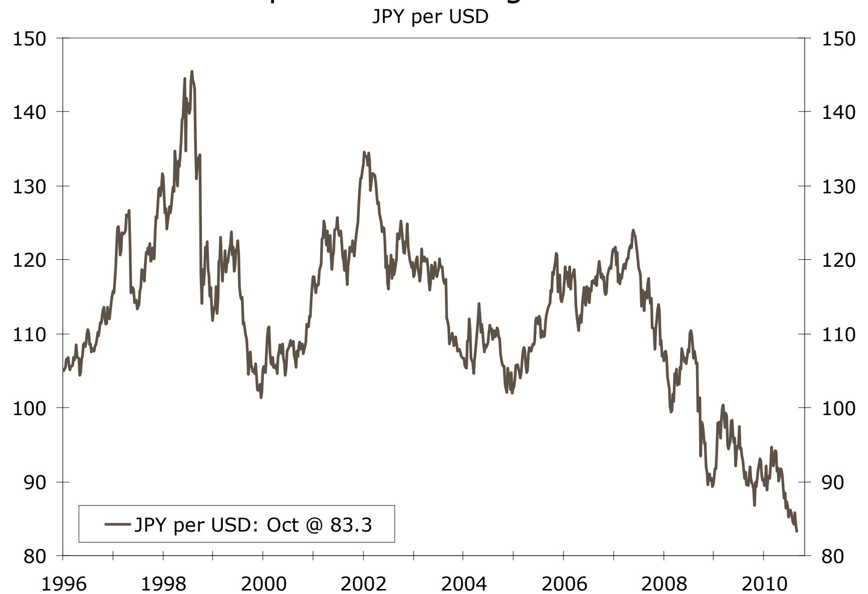
Would a "Currency War" Be Dangerous?

Guido Mantega, the finance minister of Brazil, recently made headlines when he said "we're in the midst of an international currency war." Mantega was referring to the recent depreciation of the U.S. dollar that has caused other countries to take steps to prevent their currencies from strengthening. For example, the Brazilian real has strengthened to its highest level versus the greenback since the heady days of summer 2008 (top chart) and the Japanese yen is within spitting distance of its all-time high of 80 yen/dollar.

Some commentators take a benign view of the effects of a "currency war." The dollar has depreciated recently as investors have discounted the likelihood of further quantitative easing by the Federal Reserve. In order to offset some of the upward pressure on the yen, the Bank of Japan recently expanded its own QE program. According to this view, a "currency war" could be beneficial if it leads central banks, in countries that are experiencing lackluster growth at present, to stimulate their economies further via QE.

We have an appreciation for this argument, but we are much more concerned about the downside risks from a "currency war." For example, Brazil recently doubled the tax that is designed to discourage speculative capital inflows that are contributing to the recent appreciation of the Brazil real. Such taxes could distort global capital flows if more countries implemented them. Moreover, protectionist measures could be enacted if some governments perceive that other countries are manipulating their exchange rates to gain commercial advantage. China's policy to manage the value of its currency is controversial, and the U.S. House of Representatives recently passed legislation that would make it easier for U.S. companies to win trade disputes against China. A trade war, which would not benefit anybody, could ensue if protectionist passions become too inflamed. As in most conflicts, a "currency war" would have more costs than benefits.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 10/15/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.13	0.11	0.05
3-Month LIBOR	0.29	0.29	0.28
1-Year Treasury	0.22	0.22	0.42
2-Year Treasury	0.35	0.34	0.94
5-Year Treasury	1.17	1.10	2.38
10-Year Treasury	2.53	2.39	3.46
30-Year Treasury	3.96	3.75	4.30
Bond Buyer Index	3.82	3.84	4.32

Foreign Exchange Rates

	Friday 10/15/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.402	1.394	1.495
British Pound ($/£)	1.604	1.596	1.627
British Pound (£/€)	0.874	0.873	0.919
Japanese Yen (¥/$)	81.370	81.930	90.550
Canadian Dollar (C$/$)	1.011	1.011	1.034
Swiss Franc (CHF/$)	0.957	0.963	1.015
Australian Dollar (US$/A$)	0.989	0.985	0.921
Mexican Peso (MXN/$)	12.438	12.414	13.081
Chinese Yuan (CNY/$)	6.641	6.671	6.828
Indian Rupee (INR/$)	44.105	44.435	46.240
Brazilian Real (BRL/$)	1.663	1.666	1.701
U.S. Dollar Index	76.748	77.387	75.481

Foreign Interest Rates

	Friday 10/15/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.93	0.91	0.69
3-Month Sterling LIBOR	0.74	0.74	0.57
3-Month Canadian LIBOR	1.24	1.23	0.50
3-Month Yen LIBOR	0.20	0.21	0.34
2-Year German	0.80	0.79	1.39
2-Year U.K.	0.67	0.62	0.86
2-Year Canadian	1.43	1.34	1.68
2-Year Japanese	0.13	0.13	0.25
10-Year German	2.36	2.25	3.30
10-Year U.K.	2.94	2.87	3.57
10-Year Canadian	2.78	2.75	3.55
10-Year Japanese	0.89	0.87	1.32

Commodity Prices

	Friday 10/15/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	82.22	82.66	77.58
Gold ($/Ounce)	1368.15	1346.74	1050.20
Hot-Rolled Steel ($/S.Ton)	535.00	535.00	555.00
Copper (¢/Pound)	380.00	376.65	285.10
Soybeans ($/Bushel)	11.34	10.18	9.89
Natural Gas ($/MMBTU)	3.61	3.65	4.48
Nickel ($/Metric Ton)	24,259	23,864	18,480
CRB Spot Inds.	542.89	531.77	433.26

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	18	19	20	21	22
U.S. Data	**Industrial Production** August 0.2% September 0.2% (W) **Capacity Utilization** August 74.7% September 74.8% (W)	**Housing Starts** August 598K September 550K (W)		**LEI** August 0.3% September 0.4% (W)	
Global Data		**Canada** **Bank of Canada Rate** Previous 1.00%		**China** **Real GDP (YoY)** Previous (2Q) 10.3% **Euro-zone** **PMI Manufacturing** Previous (Sep) 53.7	**Canada** **Retail Sales (MoM)** Previous (Jul) -0.1% **Germany** **IFO-Business Climate** Previous (Sep) 106.8

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

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