July 08, 2009

Economics Group

MONTHLY OUTLOOK

U.S. Overview	International Overview

Not Out of the Woods Yet

Optimism about the apparent ending of the recession has been tempered by the reality of substantial further deterioration in employment conditions and ongoing struggles with state and local government budgets. Real GDP is expected to rise slightly during the third quarter as inventory liquidations slow dramatically and consumer spending is revived. The ending of the recession, however, does not mark the end of the economy's troubles. Economic activity will likely remain subdued well into 2010 and the unemployment rate will likely rise through the middle of next year, topping out at around 10.5 percent.

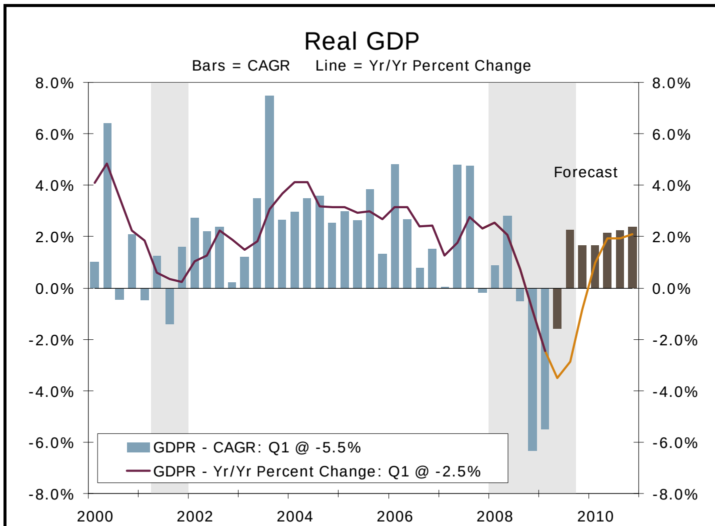
There are considerable risks to the forecast. On the upside, there is a great deal of stimulus in the pipeline, including the $787 billion economic recovery act, low interest rates, the completion of a colossal drawdown in inventories and the prospect of falling gasoline prices. On the downside, employment losses remain massive and the unemployment rate continues to increase. Moreover, hours worked and earnings are down even more than employment, which is leading to incredibly sluggish wage growth. Household wealth has also taken a huge hit and many state and local governments are grappling with huge budget shortfalls. The net result is likely a very sluggish recovery, with real GDP growth not returning to a strong enough pace to reduce the unemployment rate until the second half of 2010. With growth remaining subdued, inflation should continue to moderate well into next year, allowing the Fed to remain on hold through the middle of next year.

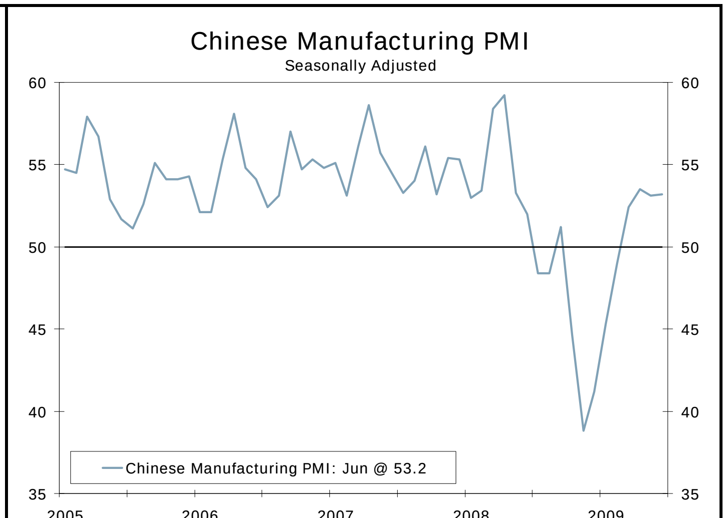
Some Signs of Stabilization

Global economic activity contracted sharply in the first quarter, but there have been some tentative signs of stabilization more recently. The region showing the most promise at present is Asia. The manufacturing PMI in China has been in expansion territory for four consecutive months, and industrial production in many other Asian economies has strengthened as well. Banking systems in the region were generally not leveraged, at least not to the same extent as their counterparts in the West were, and most Asian governments responded to the crisis with sizeable fiscal stimulus programs.

Unfortunately, signs of positive growth in Western Europe have been much scarcer. The best thing that can be said about Western Europe is that the rate of economic contraction in the second quarter appears not to have been as rapid as in the previous quarter. Growth in Western Europe should turn positive in the next quarter or two, but the initial pace of recovery probably will be sluggish. Many economies in Eastern Europe, which went on a borrowing binge earlier this decade, are in depression at present. Eastern Europe likely will be the last major region to emerge from its slump.

The global economy is on pace to register a year of negative growth for the first time in decades. Although global growth should turn positive again next year, most major economies likely will expand at sub-par paces, at least initially. With economic growth remaining weak, inflation should remain benign on a global basis over the next few years.





Source: IHS Global Insight, U.S. Department of Commerce and Wells Fargo Securities, LLC

Together we'll go far

This report is available on wellsfargo.com/research and on Bloomberg WFEC

The Recession Appears to be Ending

While the recession appears to be ending, the economy is not out of the woods just yet. Real GDP appears poised to grow at around a 2.2 percent annual rate during the third quarter and our current forecast has overall economic activity remaining in positive territory throughout the forecast horizon. Growth remains unusually sluggish over the next few quarters, however, with most of the near term improvement coming from a reduction in the rate of inventory draw down and a further decline in imports. Growth in real final sales to domestic purchasers are expected to remain near zero through the spring of next year, which means recessionary conditions will remain in place for some time to come.

We have repeatedly pointed to “core” GDP and real final sales to domestic purchasers as being the best guides to underlying economic conditions. These data began to signal the onset of a recession well before real GDP, which remained positive right up until the financial markets began to collapse late last summer. The weakness in domestic demand is one of the reasons layoffs remain so high and is a major contributing factor to the huge budget gaps at state and local governments.

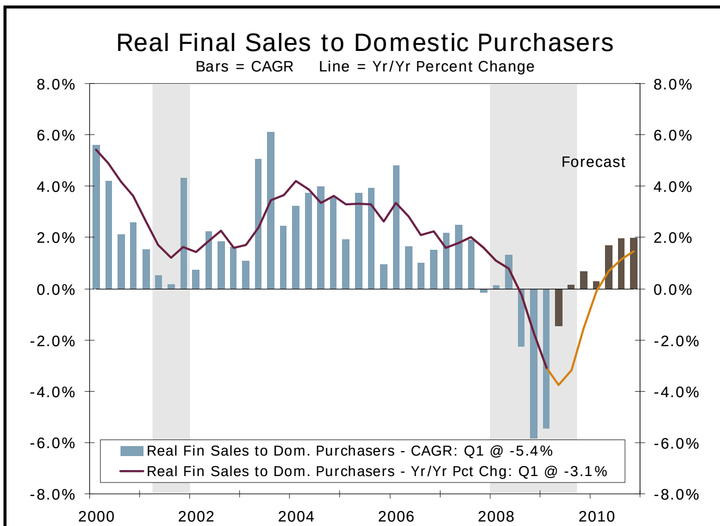
Domestic demand is restrained by continued job losses, sluggish wage and salary growth, and a massive loss of wealth. Nonfarm employment has fallen 4.7 percent since the recession began, producing a net loss of 6.4 million jobs. Job losses are only part of the problem. Companies are also reducing operating hours and pay. Hours worked plummeted at a 7.9 percent annual rate over the past three months and are down 6.8 percent over the past year. The net result is earnings are down much more than in past recessions. When you add in the loss of wealth from falling home prices and the decline in the stock market, you get a perfect storm that results in dramatically lower consumer spending and widespread problems for everyone that depends on such spending.

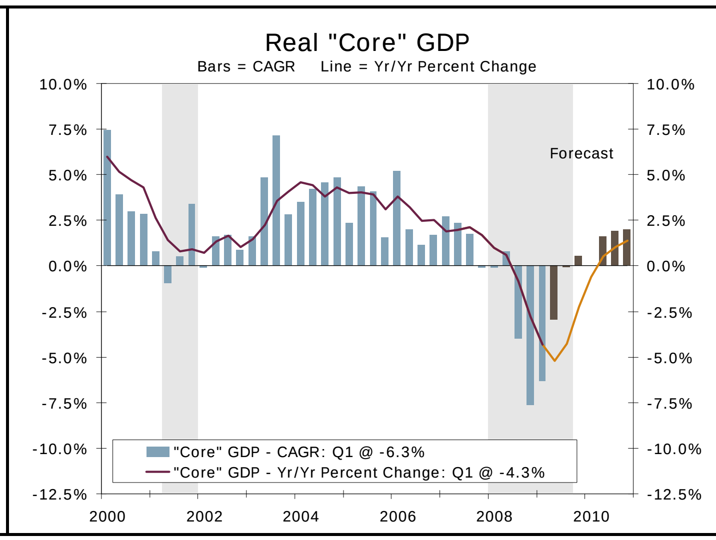
In the very near term we see consumer spending rising slightly. Reductions in tax withholding schedules and increases in cost of living allowances for government workers and social security recipients boosted outlays during the latter part of the second quarter. The increase came too late to lift second quarter personal consumption but spending likely ended the quarter on a strong note, virtually ensuring a modest gain in the third quarter. Consumer spending should also get a boost from falling gasoline prices, lower interest rates and the “cash for clunkers” trade-in program. Following this brief increase, consumer spending should essentially keep pace with real after-tax income growth, and possibly even trail it.

Another ingredient necessary for a sustainable recovery is a turnaround in business fixed investment. Nondefense capital goods shipments did not fall anywhere near as much as they did during the first quarter, which means business fixed investment fell at a less dramatic pace during the second quarter. It still dropped, however, and probably at a hefty double-digit pace. Business fixed investment should moderate further and will not likely turn positive until spring of next year. Outlays for equipment and software should turn up a little sooner, however, turning positive late this year.

Government outlays are not nearly as strong as expected given the size of the federal government stimulus program. Increased federal outlays are being offset by massive cutbacks by state and local governments. Many municipalities are also raising taxes, which will cut further into disposable income and further restrain consumer spending.

The sluggish pace of economic recovery should keep inflation contained. Inflation typically moderates through the second year of an economic recovery, which means worries that excessive money growth will set off an inflationary spiral are extremely premature. Sluggish growth, high unemployment, and low inflation will keep the Fed on hold well into 2010.





Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Wells Fargo U.S. Economic Forecast

	Actual									Forecast							Actual			Forecast	
	2007				2008				2009				2010				2006	2007	2008	2009	2010
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product (a)	0.1	4.8	4.8	-0.2	0.9	2.8	-0.5	-6.3	-5.5	-1.6	2.2	1.6	1.6	2.1	2.2	2.4	2.8	2.0	1.1	-2.4	1.7
Personal Consumption	3.9	2.0	2.0	1.0	0.9	1.2	-3.8	-4.3	1.4	-0.6	1.7	1.0	1.2	1.6	1.6	1.5	3.0	2.8	0.2	-0.7	1.3
Business Fixed Investment	3.4	10.3	8.7	3.4	2.4	2.5	-1.7	-21.7	-37.3	-13.4	-10.7	-2.8	-9.4	1.1	4.0	5.0	7.5	4.9	1.6	-18.6	-4.3
Equipment and Software	0.0	6.9	3.6	1.0	-0.5	-5.0	-7.5	-28.1	-33.7	-17.7	-9.2	2.8	5.3	4.0	6.3	6.4	7.2	1.7	-3.0	-20.1	1.3
Structures	11.2	18.3	20.6	8.6	8.7	18.4	9.6	-9.4	-42.9	-8.5	-15.0	-18.0	-15.0	-8.0	-3.5	0.0	8.2	12.7	11.2	-16.9	-11.7
Residential Construction	-16.2	-11.6	-20.6	-27.0	-25.0	-13.3	-16.1	-22.7	-38.8	-23.0	-7.2	1.5	3.0	4.0	5.0	5.5	-7.1	-17.9	-20.8	-22.9	0.1
Government Purchases	0.9	3.9	3.8	0.8	1.9	3.9	5.8	1.3	-3.1	0.9	1.1	1.3	1.6	1.8	2.0	1.8	1.7	2.1	2.9	0.8	1.5
Net Exports	-618.6	-571.2	-511.8	-484.5	-462.0	-381.3	-353.1	-364.5	-296.8	-281.9	-276.3	-268.3	-251.3	-252.9	-257.6	-255.6	-615.7	-546.5	-390.2	-280.8	-254.3
Pct. Point Contribution to GDP	-1.2	1.7	2.0	0.9	0.8	2.9	1.1	-0.2	2.4	0.5	0.2	0.3	0.6	-0.1	-0.2	0.1	0.0	0.6	1.4	0.9	0.2
Inventory Change	-15.0	-2.8	16.0	-8.1	-10.2	-50.6	-29.6	-25.8	-87.1	-99.0	-45.7	-27.0	-5.8	8.2	20.2	28.2	42.3	-2.5	-29.1	-64.7	12.7
Pct. Point Contribution to GDP	-1.1	0.5	0.7	-1.0	0.0	-1.5	0.8	-0.1	-2.2	-0.4	1.9	0.7	0.7	0.5	0.4	0.3	0.0	-0.4	-0.2	-0.3	0.7
Nominal GDP	4.3	6.9	6.4	2.3	3.5	4.1	3.4	-5.8	-2.9	-0.9	3.0	2.6	2.8	3.5	3.9	4.3	6.1	4.8	3.3	-0.8	2.9
Real Final Sales	1.1	4.3	4.0	0.8	0.9	4.4	-1.3	-6.2	-3.3	-1.4	0.3	1.0	0.9	1.6	1.8	2.1	2.8	2.4	1.4	-2.1	1.0
Retail Sales (b)	2.6	3.0	3.1	4.4	2.6	2.4	0.4	-8.0	-8.9	-9.7	-7.8	-0.4	2.0	3.5	3.7	3.7	5.3	3.3	-0.7	-6.8	3.2
Inflation Indicators (b)																					
"Core" PCE Deflator	2.3	2.1	2.0	2.2	2.2	2.3	2.3	1.9	1.8	1.8	1.3	1.2	1.0	0.8	1.0	1.1	2.3	2.2	2.2	1.5	1.0
Consumer Price Index	2.4	2.6	2.3	4.0	4.2	4.3	5.2	1.5	-0.2	-1.2	-2.6	-0.2	0.6	0.9	1.2	1.4	3.2	2.9	3.8	-1.0	1.0
"Core" Consumer Price Index	2.6	2.3	2.1	2.3	2.4	2.3	2.5	2.0	1.7	1.8	1.3	1.2	1.1	0.8	1.0	1.1	2.5	2.3	2.3	1.5	1.0
Producer Price Index	1.9	3.4	3.6	6.8	7.2	7.6	9.5	1.4	-2.2	-4.7	-6.6	-1.1	0.9	1.7	1.8	1.9	2.9	3.9	6.4	-3.7	1.6
Employment Cost Index	3.5	3.3	3.3	3.3	3.3	3.1	2.9	2.6	2.1	2.0	1.9	2.0	2.0	1.9	1.8	1.9	3.1	3.4	3.0	2.0	1.9
Real Disposable Income (a)	4.4	-0.6	3.1	0.6	-0.7	10.7	-8.5	2.9	6.0	3.3	-1.6	1.0	1.2	1.8	2.6	2.9	3.5	2.8	1.3	2.0	1.3
Nominal Personal Income (b)	6.4	6.1	6.1	5.8	4.2	5.0	3.8	2.1	0.7	1.1	4.7	3.1	4.1	2.9	0.3	3.5	7.1	6.1	3.8	2.4	2.7
Industrial Production (a)	1.8	2.4	2.1	0.8	0.2	-4.6	-9.0	-13.0	-19.0	-14.3	3.1	2.9	1.2	2.3	3.0	4.1	2.3	1.5	-2.2	-11.1	1.3
Capacity Utilization	80.6	80.6	80.7	80.4	80.1	78.9	76.9	74.2	70.4	68.0	68.8	68.9	68.4	68.1	68.3	69.3	80.9	80.6	77.6	69.0	68.5
Corporate Profits Before Taxes (b)	-1.0	-0.5	-2.7	-2.0	-1.5	-8.3	-9.2	-21.5	-17.6	-16.0	-12.0	-8.0	1.5	5.0	8.5	8.5	15.2	-1.6	-10.1	-13.7	5.8
Corporate Profits After Taxes	-0.9	-0.2	-0.8	-0.6	1.8	-6.4	-7.9	-15.0	-14.7	-12.0	-9.0	-7.0	3.0	8.0	10.5	11.0	16.0	-0.6	-6.9	-10.9	8.1
Federal Budget Balance (c)	-178.0	137.5	-40.6	-106.8	-205.9	26.9	-168.9	-332.5	-448.9	-370.6	-622.0	-611.5	-572.5	-240.0	-326.0	-333.0	-248.2	-161.5	-454.8	-1773.9	-1750.0
Current Account Balance (d)	-199.1	-190.5	-171.6	-165.3	-179.3	-187.7	-184.2	-154.9	-101.5	-100.0	-105.0	-110.0	-110.0	-110.0	-110.0	-105.0	-803.5	-726.6	-706.1	-416.5	-435.0
Trade Weighted Dollar Index (e)	80.5	78.7	74.4	73.3	70.3	71.0	76.1	79.4	83.2	77.2	82.6	85.0	86.9	87.9	87.0	85.0	81.5	73.3	79.4	85.0	85.0
Nonfarm Payroll Change (f)	133	82	2	167	-113	-153	-208	-553	-691	-436	-365	-230	-80	60	137	160	178	96	-257	-431	69
Unemployment Rate	4.5	4.5	4.7	4.8	4.9	5.4	6.1	6.9	8.1	9.3	9.8	10.2	10.3	10.4	10.2	10.2	4.6	4.6	5.8	9.3	10.3
Housing Starts (g)	1.46	1.45	1.29	1.17	1.06	1.02	0.87	0.66	0.53	0.49	0.52	0.55	0.59	0.65	0.73	0.82	1.81	1.34	0.90	0.52	0.70
Light Vehicle Sales (h)	16.3	16.1	15.9	16.0	15.2	14.1	12.9	10.3	9.5	9.6	10.6	10.2	10.6	11.1	11.4	11.5	16.5	16.1	13.1	10.0	11.2
Crude Oil - WTI - Front Contract (i)	58.16	65.03	75.38	90.68	97.90	123.98	117.98	58.74	43.08	59.62	65.00	65.00	65.00	67.00	70.00	70.00	66.22	72.31	99.65	58.18	68.00
Quarter-End Interest Rates																					
Federal Funds Target Rate	5.25	5.25	4.75	4.25	2.25	2.00	2.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	5.25	4.25	0.25	0.25	0.50
3 Month LIBOR	5.35	5.36	5.23	4.70	2.69	2.78	4.05	1.43	1.19	0.60	0.50	0.50	0.50	0.60	0.70	0.75	5.36	4.70	1.43	0.50	0.75
Prime Rate	8.25	8.25	7.75	7.25	5.25	5.00	5.00	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.50	8.25	7.25	3.25	3.25	3.50
Conventional Mortgage Rate	6.16	6.66	6.38	6.10	5.97	6.32	6.04	5.33	5.00	5.42	5.10	5.20	5.30	5.40	5.50	5.60	6.14	6.10	5.33	5.20	5.60
3 Month Bill	5.04	4.82	3.82	3.36	1.38	1.90	0.92	0.11	0.21	0.19	0.20	0.30	0.30	0.40	0.50	0.60	5.02	3.36	0.11	0.30	0.60
2 Year Note	4.58	4.87	3.97	3.05	1.62	2.63	2.00	0.76	0.81	1.11	1.00	1.10	1.20	1.30	1.40	1.50	4.82	3.05	0.76	1.10	1.50
5 Year Note	4.54	4.92	4.23	3.45	2.46	3.34	2.98	1.55	1.67	2.54	2.40	2.50	2.60	2.70	2.80	2.90	4.70	3.45	1.55	2.50	2.90
10 Year Note	4.65	5.03	4.59	4.04	3.45	3.99	3.85	2.25	2.71	3.53	3.50	3.60	3.70	3.80	3.90	4.00	4.71	4.04	2.25	3.60	4.00
30 Year Bond	4.84	5.12	4.83	4.45	4.30	4.53	4.31	2.69	3.56	4.32	4.30	4.40	4.50	4.60	4.70	4.80	4.81	4.45	2.69	4.40	4.80

Forecast as of: July 8, 2009

Notes:
(a) Compound Annual Growth Rate Quarter-over-Quarter
(b) Year-over-Year Percentage Change
(c) Quarterly Sum - Billions USD; Annual Data Represents Fiscal Yr.
(d) Quarterly Sum - Billions USD
(e) Federal Reserve Major Currency Index, 1973=100 - Quarter End
(f) Average Monthly Change
(g) Millions of Units
(h) Quarterly Data - Average Monthly SAAR; Annual Data - Actual Total Vehicles Sold
(i) Quarterly Average of Daily Close

Any Turnaround in Sight?

The second quarter of 2009 is now in the books, and it appears the quarter was mixed for the global economy. Although some major foreign economies likely experienced positive growth during the quarter, others continued to contract, albeit at a less rapid pace than they did in the first quarter.

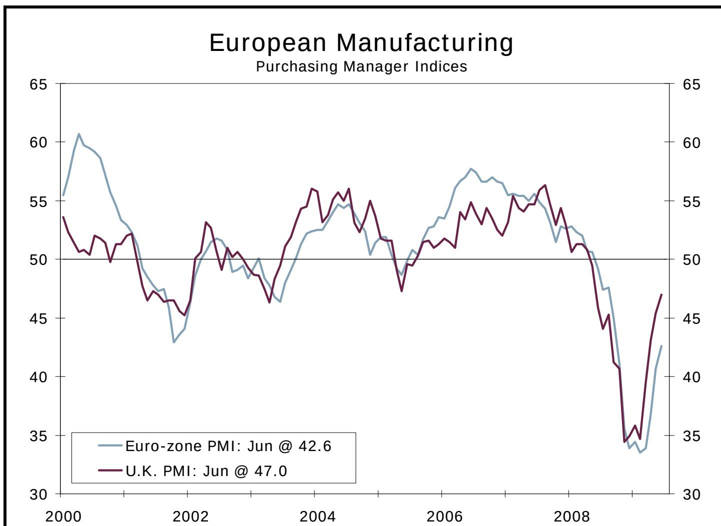
The good news was largely in Asia. For example, the purchasing managers' index in China stood at 53.2 in June, the fourth consecutive month it has been above the demarcation line that separates expansion from contraction (see chart on front page). In Korea, industrial production (IP) in May was down roughly eight percent on a year-over-year basis. However, Korean IP has surged nearly 20 percent from its low in December, and production in many other Asian countries also started to rebound during the quarter. Some important economies in Latin America are showing signs of stabilization as well. For example, IP in Brazil, the region's largest economy, is up more than seven percent from its low in December.

What makes Asia so special? There are a few factors that explain the stabilization in those economies. First, banking systems in the region were generally not leveraged, at least not to the same extent as their counterparts in the West were, so Asian financial systems never really became dysfunctional when the credit bubble burst. Secondly, Asia is tied together by extensive trade ties, and economic activity in the region weakened sharply last autumn when global trade finance dried up. Now that trade finance is starting to flow again, however, exports are rebounding. In addition, governments in many Asian countries were quick to enact fiscal stimulus packages that have helped to shore up economic activity.

In Western Europe the story is not as positive. The best that can be said at present is that most economies in the region are no longer contracting as sharply as they were in the first quarter. However, there aren't many signs yet of positive growth either. For example, real GDP in the both the Euro-zone and in the United Kingdom plunged at annualized rates exceeding nine percent in the first quarter. The recent rebound in the manufacturing PMIs suggests that industrial production is no longer in freefall (see chart below). However, both indices remain in territory that is consistent with continued contraction in industrial production.

Policy moves in Western Europe have helped to put a floor under the region's economies. The Bank of England has slashed its main policy rate to only 0.50 percent, and the comparable rate at the European Central Bank stands at 1.00 percent. In addition, European governments took unprecedented steps last autumn to shore up their financial systems. However, many banks in Western Europe were quite leveraged, and growth in bank lending remains rather weak at present. In addition, the fiscal policy response in many countries was generally tepid. Although growth in Western Europe likely will turn positive again in the next quarter or two, real GDP growth likely will remain sluggish for some time as banks slowly repair their battered balance sheets.

Speaking of leverage, many Eastern European countries went on borrowing binges earlier this decade, and these economies have been especially hard hit by the global financial crisis. For example, Russian industrial production was 17 percent lower in May than it was 12 months ago (see chart below). The Latvian economy is in depression with real GDP in the first quarter down 18 percent on a year-over-year basis. In our view, Eastern Europe will be the last major region to emerge from the downturn. The global economy is on pace to contract more than one percent in 2009, the first year of negative growth in decades. Although growth should turn positive again next year, most major economies likely will grow at sub-par paces. With economic growth remaining weak, inflation should remain benign on a global basis over the next few years.



Source: IHS Global Insight and Wells Fargo Securities, LLC

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2008	2009	2010	2008	2009	2010
Global (PPP weights)	3.2%	-1.4%	3.3%	6.0%	2.2%	2.5%
Global (Market Exchange Rates)	2.1%	-2.6%	2.1%	n/a	n/a	n/a
Advanced Economies[1]	0.9%	-3.8%	1.6%	3.4%	-0.7%	0.4%
United States	1.1%	-2.4%	1.7%	3.8%	-1.0%	1.0%
Eurozone	0.6%	-4.9%	1.0%	3.3%	0.3%	0.4%
United Kingdom	0.7%	-4.0%	1.6%	3.6%	1.3%	0.3%
Japan	-0.7%	-6.7%	0.9%	1.4%	-1.2%	-0.8%
Korea	-1.0%	-1.0%	3.6%	4.7%	2.7%	2.3%
Canada	0.4%	-2.0%	2.3%	2.4%	0.3%	1.0%
Developing Economies[1]	6.1%	1.6%	5.3%	9.3%	5.6%	5.0%
China	9.1%	8.0%	8.4%	5.9%	-1.0%	0.3%
India	6.7%	6.5%	7.3%	7.8%	7.8%	5.3%
Mexico	1.3%	-7.7%	2.1%	5.1%	5.3%	3.1%
Brazil	5.0%	-1.8%	3.5%	5.7%	4.8%	4.0%
Russia	5.6%	-8.2%	3.6%	14.1%	12.0%	7.3%

Forecast as of: July 8, 2009

[1]Aggregated Using PPP Weights

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2009		2010				2009		2010			
	Q3	Q4	Q1	Q2	Q3	Q4	Q3	Q4	Q1	Q2	Q3	Q4
U.S.	0.50%	0.50%	0.50%	0.60%	0.70%	0.75%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%
Japan	0.40%	0.25%	0.25%	0.25%	0.25%	0.25%	1.50%	1.60%	1.70%	1.80%	1.90%	1.95%
Euroland	1.20%	1.15%	1.15%	1.20%	1.75%	2.25%	3.80%	4.00%	4.20%	4.40%	4.55%	4.60%
U.K.	1.00%	0.75%	0.75%	0.75%	1.00%	1.50%	4.00%	4.20%	4.50%	4.80%	4.85%	4.90%
Canada	0.55%	0.50%	0.50%	0.50%	1.00%	2.00%	3.75%	4.00%	4.30%	4.60%	4.70%	4.75%

Forecast as of: July 8, 2009

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