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Special Commentary

Annual Economic Outlook 2011

Turning the Corner in 2011

Dear Valued Clients,

As we enter the second calendar year of recovery following the worst recession in a half century, we hope your business is positioned to turn the corner.

Indeed, the coming year may provide opportunities for economic growth and expansion. With growth already at or exceeding the long-run trend in many developing economies, we believe the U.S. economy will eventually improve. That said, growth in the coming year will remain modest, containing risks that could potentially hinder the performance of your business.

Please read on as we explore the challenges and opportunities that will face your business, and the U.S. and global economies in the year ahead.

-Wells Fargo Economics Group



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Executive Summary: Charting the New Course

Every economic recovery has a different story, with its own heroes and villains, twists and turns and a lengthy list of surprises—both in the overall pace of growth and its component parts. Meanwhile, the challenge to decision-makers, in both private and public sectors, is to adapt to this different story while retaining the same institutional goals. For the year ahead, we anticipate a change in the composition of growth with less inventory gains and federal spending and greater support for growth from final private demand. State and local government spending is the one sector we expect to remain a drag on economic expansion throughout 2011. 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.

There is no double-dip or V-shaped recovery. Every economic recovery is a new normal—the 1960s were very different than the 1970s, the 1970s were very different than the 1980s, and so on... The new normal is not anything new—it happens every economic cycle. In contrast, what we see is what we have to deal with: moderate economic growth, fiscal deficits, low inflation and a central bank that is going to explore new paths of monetary policy. Finally, we are faced with the legacy of decisions made, or often postponed, over the last forty years. We do not start with a clean slate. Our decisions today are path dependent; they reflect the legacy of prior decisions we made or avoided.

There is no double-dip or V-shaped recovery, every economic recovery is a new normal.

Figure 1

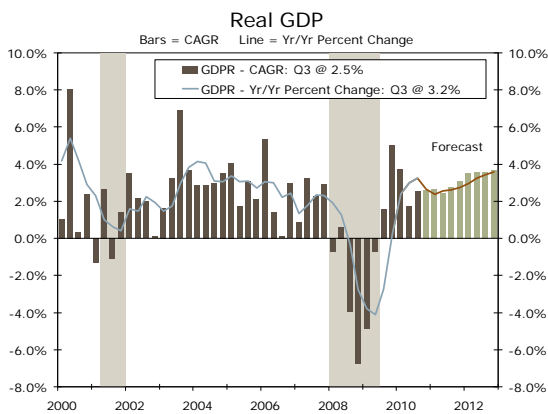
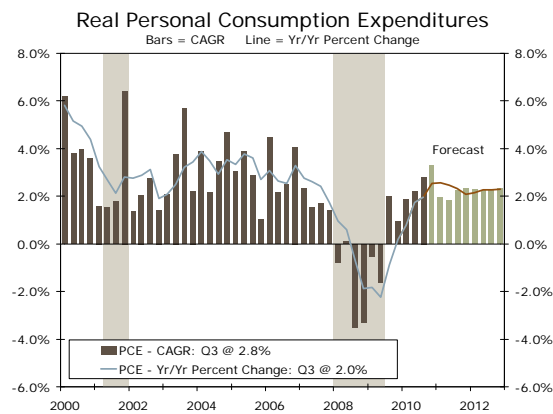


Figure 2



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

Economic Fundamentals: Sustained Growth

For the year ahead, sustained growth will reflect the influence of continued improvements in consumer and business investment as well as the turnaround in residential and commercial construction. Consumer spending, representing the majority of aggregate demand in the economy, will benefit from a streak of positive, yes positive, employment reports by mid-2011, lower unemployment rates and rising real personal income. Spending will not be as strong as in the past corresponding phases of earlier recoveries, but will be positive nonetheless. Personal income is up 4.1 percent year-over-year compared to a decline of 2.1 percent last year at this time. Personal income less transfers was down five percent last year, but is now up two percent this year. In part, this reflects a year-to-date gain of over one million jobs as well as gains in employment in many of the higher paid professional services fields. Positive momentum in consumer spending would be further boosted by the extension of the Bush-era tax cuts and the two percent reduction in the payroll tax.

Consumer spending will continue to improve gradually, in line with the employment picture.

Meanwhile, the saving rate is around six percent while consumers continue to deleverage their credit exposure. Slower consumer spending growth and deleveraging are reflected in the decline in home-equity loans, which draw down net home asset values to spend as income today. Households are right-sizing their debt load and this behavior will likely persist for several more

years for many households. The financial obligations ratio, as calculated by the Federal Reserve, measures the ratio of consumer interest expense relative to income. In the second quarter, the ratio stood at 15.52 percent compared to 16.52 percent a year ago. For 2011, we estimate consumer spending to pick up 2.4 percent compared to 1.8 percent in 2010 and down 1.2 percent in 2009.

Equipment and software spending and federal government spending continue to support positive growth momentum. Solid equipment and software spending has a second effect that is of interest: productivity gains from better or more equipment are usually associated with better real wages and corporate profits. Both these effects are positive for the recovery in the long-term.

Growth in non-defense capital goods orders ex-aircraft has slowed in recent months to a 15.35 percent pace compared to 21.03 percent year-over-year pace last April. This slowdown is consistent with the moderation we have witnessed in the Institute for Supply Management survey as well as industrial production. In part, this slowdown reflects the end of the inventory build-up during the first three quarters of 2010, which made up for the sharp cuts in production and inventories in 2009. Continued strength in capital goods orders reflects the competitiveness imperative for global competition. With Asian economic growth so strong, U.S. firms have the incentive to capture or at least retain their global market share. For the year ahead, we anticipate growth in equipment and software spending of 15.5 percent compared to 15.7 percent this year.

In 2011, we expect trends in commercial and residential real estate, two areas of the economy that have been significant drags on headline growth, to turn positive for the first time since the beginning of the recession. Despite being near record lows, housing starts will begin to gain momentum breaking 700,000 in 2011. The turnaround in housing is largely attributable to gains in employment, consumer income, as well as favorable demographic trends. Meanwhile, from the financing perspective, mortgage rates remain low and housing affordability remains high. Though broadly positive, these trends do not reflect a return to the boom years, which were characterized by excessive liquidity and perverse incentives.

Commercial real estate should begin to contribute to growth by the second half of 2011. Operating fundamentals for all major property types are either improving or showing signs of stabilizing. Leasing has picked up, rents are rising or stabilizing and sales have increased. Demand for high quality properties in choice locations remains exceptionally strong, which has helped pull prices higher for non-distressed deals. There are still plenty of troubled projects that need to be disposed of, however, and prices for distressed projects are likely to fall further once lenders become committed to cleansing their portfolios.

This past year saw consistent buildup in inventories, but we expect a more modest rise in line with final sales in 2011.

Figure 3

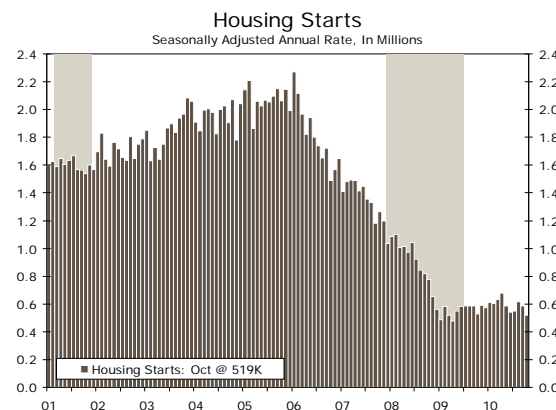
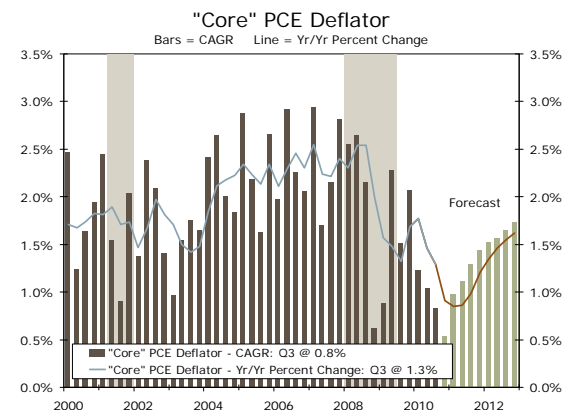


Figure 4



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

Businesses are not only moving forward with rebuilding their payrolls, but are also moving forward on stalled projects, such as building out their retail and distribution networks. Nonresidential construction is showing signs of bottoming and the early signs of a pick up are in

place, including an increase in inquiries to commercial realty firms and improvement in the Architectural Billings Index. The apartment sector now appears to be in full recovery. In the industrial space, net absorptions are outpacing completions for a second consecutive quarter.

Inflation 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. A by-product of the Fed's massive expansion of the money supply was a depreciation of the dollar and a surge in dollar-denominated commodity prices. Due to slack consumer demand, producers have been unable to pass these costs on to their customers, resulting in a moderation in corporate profit growth. We expect gains of 6.8 percent for pre-tax profits in 2011 compared to 27.9 percent this year.

Inflationary concerns are overstated, for now, despite massive monetary stimulus.

Policy and Politics

The results of November's midterm elections, and the administration's reaction to them, will dictate the framework of economic policy going forward. Both the Republican controlled House and the Democratic Senate saw broad gains by fiscally conservative candidates. Our expectation is that these results will translate into further tax cuts, restrained spending, and less support for state and local governments. Despite mounting criticism of the Federal Reserve's asset purchasing program, we believe the Fed will complete its latest round of Treasury purchases, especially given the slow recovery in employment and the continuing risk of deflation in the near-term.

The recently announced extension of the Bush-era tax cuts is a welcome sign that Washington still has the capacity to act quickly and compromise on key economic issues. The extension of the tax cuts for two years does a great deal to reduce uncertainty for the consumer, businesses, and the financial markets. Coupled with an extension of emergency unemployment benefits, the tax cuts will boost personal income and spending in the year ahead, spurring continued forward momentum for the consumer. During 2010, the majority of growth was contributed by inventory building and capital investment by firms, but we expect these trends to slow as businesses pass the torch to consumers in the year ahead. The extension of the Bush-era tax cuts will provide further positive momentum to the current recovery.

Not a Clean Slate

In our outlook this year, we have chosen to examine the path dependence issue that defines our expectations for the economy and the options for private and public decision-makers in their strategic planning for the year ahead. This economic recovery begins with four main challenges. First, unconventional monetary policy tools have been employed on a massive scale in an attempt to prevent a deflationary spiral, a process responsible for deep recessions in the U.S. in the 1930s and Japan in the 1990s. Second, we are limited by the policy decisions of the past forty years, which have levered our government, both federal and local, to unsustainable levels. Several of our most populous and politically important states, such as California and Florida, are among the worst examples of these troubling trends. Third, both the public and private sector fueled a bubble that blinded households and investors alike to the true value of assets in the housing market. Today, with continued government intervention and oversupply, the market still cannot indicate the true values of real estate. Finally, the pace of globalization continues to present challenges to economic actors due to path dependence.

Debt, public and private, continues to exert substantial headwinds on the pace of expansion.

Despite the challenges that face us, we have put the most arduous portion of our journey behind us. We have turned the corner and emerged from the deepest recession in half a century, but the road ahead looks to be a long, uphill climb. This recession's legacy of damaged consumer balance sheets, experimental monetary policy, and fiscal imbalances will add considerable mileage to our journey towards renewed economic vitality; however, we believe the American economy will continue growing mile by mile, quarter by quarter.

-Wells Fargo Economics Group

As the Economic Cycle Changes, So Must Our Focus

As the global economy leaves the recession behind, the challenge is no longer survival, but shaping our future. Yet in practice, we cannot return to the days of developing our strategy based on a forecast drawn from straight-line projections in a spreadsheet as is typically done with most year-ahead strategy pieces. Moreover, not only was the Great Recession atypical, but we have entered an atypical recovery. First, the contribution to growth of certain sectors has changed dramatically, with some industries failing to contribute at all. Second, several sectors of the economy, housing and state and local government most noticeably, are experiencing secular changes that demand a new approach to decision-making. Third, the relative importance of some economic inputs and the way they influence the economy has changed. This changes the strategy profile of decision-makers, forcing a reassessment of the character of this recovery. A telling example today is the stubbornly high unemployment rate despite sustained economic expansion.

Decision-makers feel more comfortable focusing on their business or their state and not on forecasting. Yet the model of the economy has continued to evolve over time, rendering old guidelines for behavior inaccurate. There is a tradeoff between simplicity and reality and there remains a tendency to emphasize the simplicity of sound-bites at the cost of failing to address the more complex realities.

Decision traps limit the leader's ability to deal with cyclical and especially longer-term changes. Decision-makers tend to anchor their expectations for the future in the past, choosing to analyze trends and developments from a historical perspective. In addition, the existing structure of a firm or institution profoundly shapes its strategic thinking for the future, reflecting a path dependent bias. Path dependence translates into slower assessment and adaption to the new economic realities that economic agents face. For instance, public policy makers are notoriously slow to recognize the changing dynamics of competitiveness in industries, states and localities; thereby, subsidizing inefficient activities for far too long. This has occurred in the automotive, textile and consumer electronics industries here in the United States.

One decision today may limit options tomorrow, while another decision could create opportunities down the road. One prime example in light of the past recession is the long-term impact of excessively lenient credit standards in the household sector. In the public sector, state and local governments are facing crippling limitations because of the overly generous promises they have made over the past forty years. These promises ignored a changing economic and demographic reality, placing them outside the range of what the government can realistically deliver.

In practice, the confluence of cyclical and structural change in our economic models has given rise to significant forecast errors that bring into question the very nature of those models. Delinquencies and foreclosures have been far more severe given the depth of the recession. Home prices have declined more than would have been forecasted using the traditional models. The scale of state and federal budget deficits, both in the U.S. and abroad, have surprised many analysts. All this suggests that when the complexity of the economy exceeds the ability of models to deliver accurate results, the failure is due to the restrictive assumptions and methods used to ensure the results are accessible and actionable. Therefore, when times are anything but normal, strategies and models created on assumptions of normality and subject to a path dependent bias will leave economic actors lost at sea when the storm hits.

Barriers to Effective Decision-Making

Over the last forty years, the American economy has consistently ignored the gradual deviation from trend of a number of important economic sectors. This normalization of deviance has been increasingly apparent in the housing, labor and government finance markets. In these situations, we adapt to the small quarterly and yearly changes without stepping back to digest what these changes mean when aggregated. On a daily basis, a dripping faucet causes little concern, but the picture can change dramatically when considered over the course of a year and across millions of households.

The new normal presents problems for path dependent economic agents.

In the economy, normalization of deviance was apparent in the credit standards involved in subprime lending, yet a sufficient number of borrowers continued to pay, ensuring profitability in the short-run. The rise in housing prices over the last twenty years provided the underlying rationale for the housing market bubble. Credit standards were continually eased, often for political purposes, and capital gains taxes were reduced on housing profits while interest rate deductions were eliminated on consumer and auto loans. Thus, to meet their desire for consumption, households increased their leverage by drawing on home equity to replace alternate forms of financing. This greatly reduced the capital cushion of ownership. Meanwhile, easier credit standards meant that purchasers of homes had less “skin in the game.” Essentially, the buyer of the home had less initial investment and less incentive to pay off their mortgage in the event of an economic crisis. While credit continued to expand, the real risk of lending imperceptibly skyrocketed. Effectively, the housing market became excessively levered leaving many households in precarious financial situations should the housing market falter. Surging demand boosted prices in the early stages of expansion, but, near the end of the cycle, supply caught up to demand. When the economy slowed and supply continued to expand, the carrying costs of mortgages could not be justified. Buyers and sellers walked away from the market causing a near total collapse.

The rapid expansion of credit fueled the housing bubble, leaving many households in unsustainable financial positions.

Normalization of deviance is evident in the deterioration of credit standards that came to be accepted and the resulting housing market crash of 2008-2009. Mortgage standards had eased so much by 2006 that 60 day plus delinquencies were rising earlier in the life of adjustable rate mortgages (ARM), suggesting that the risk profile of the borrowers had risen quicker than most investors had expected. The rapid rise in delinquencies in 2006 suggested that the housing problem was in fact greater than many had expected.

Figure 5

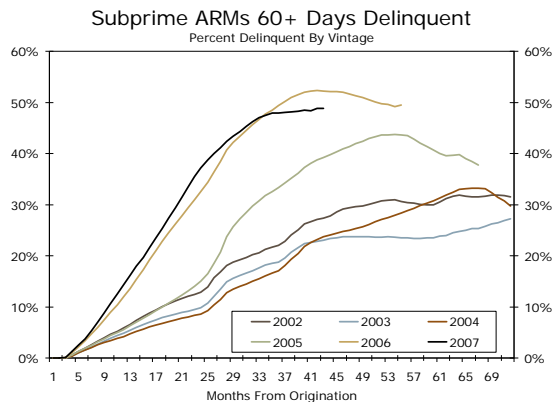
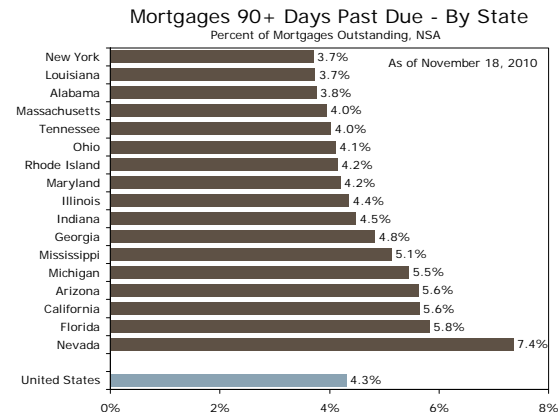


Figure 6



Source: Intex, Mortgage Bankers Association and Wells Fargo Securities, LLC

In short, the housing and mortgage markets changed without private and public lenders taking notice. Rising home prices seemed to justify the increasing deviance of lending standards, until prices peaked and began their dramatic tumble. In fact, in the history of market bubbles, it often takes a substantial change in prices to reveal the underlying deviance of traded prices from their fundamentals.

Political choices also played a prominent role. Frequently, political goals are introduced into many aspects of the economy—ethanol subsidies, first-time home buyer credits and education subsidies—often with the best of intentions or driven by some economic necessity. Politics, however, introduces a confusion of purpose to the activity, as it did for housing, leading to a misallocation of resources and the normalization of market activity away from market fundamentals. For the policy decision-makers in Washington, success under both Democratic and Republican presidents was defined in terms of rising home ownership. This perception of success was not tempered by increasing concerns over the underlying credit quality of borrowers and

Increased product differentiation and lower overhead are the keys to success in a globalized market.

housing market values. Policymakers decided to normalize the deviance in credit standards in exchange for increased home ownership.

Globalization has also brought a rapid rise in the global production of goods and a surplus of savings. In effect, these factors have also produced a trend of lower consumer goods inflation and lower interest rates. Lower inflation, on average, suggests a reduction in pricing power for businesses with products and services increasingly perceived by customers as commodities or perfect substitutes in a perfectly competitive market place. The challenge for businesses is to create the impression, if not the reality, of product differentiation or imperfect substitutes in a monopolistically competitive environment. For example, in financial services, are the services offered really different enough to justify a pricing differential or should the lion's share of value-added be found in cost cutting with more efficient back office record keeping processes?

For many American workers, globalization has meant the increasing reliance on less expensive foreign labor in many companies' production processes. This has had two effects. First, the growth of traditionally blue-collar, middle income jobs has slowed. This effect has been reinforced by the increased use of high-tech production processes in an effort to substitute capital for labor. Second, the job openings that do occur are increasingly higher-skilled, computer literate positions. The assembly line of the post-WWII period has given way to an assembly line of robots with laptop managers.

Recent years have also witnessed a general decline in interest rates even after the Great Recession of 2007-2009 was officially declared over. This is odd since perceptions of risk rose with the recession and the associated delinquencies and defaults in the housing sector. Perhaps the lower interest rates reflected risk aversion as investors sought a safe-haven in U.S. Treasury debt as well as a change in perceptions of the sustainable growth rate of the global economy, or at least that of the U.S. and Europe. In addition, lower interest rates may reflect the market's belief that inflation will remain at low levels in the short to medium-term. This trio of changes has produced lower interest rates in an era of high risk.

Anchoring refers to overemphasis on an initial reference point in determining the true value of a good or service.

Anchoring is a third decision-making bias that blinds decision-makers to cyclical and structural change. Anchoring refers to the overemphasis on an initial reference point that distorts estimates of the true value of a good or service. For example, an anchoring bias can be the listing price of a home, which a seller sees as a reasonable estimate of value. Yet, as recent years demonstrate, the real value of a home is what someone will pay for the home, not the price at which someone wishes to sell.

In economics and public finance, this anchoring bias is readily apparent and widely seen in the constitution of many strategic plans. In reality, picking a starting point in time and determining the range of values can give an observer a biased anchoring point to begin any analysis. We can see this most recently in the inability of the Deficit Commission to reach a consensus because the majority are overcommitted to current norms instead of creating a new model altogether.

Cheers and relief characterized the fall of the Berlin Wall in 1989 and yet few at the time foresaw its economic implications. A sense of political freedom spread throughout Eastern Europe, as well as a diminished fear of nuclear war. The product and labor markets of Eastern Europe opened up, encouraging the Soviet Union to restart trade with the West. This in turn helped Communist China recognize that its future lay in more open trade relations. The following years saw a surge in neoliberal economic thinking, with a host of emerging nations joining the push for free trade agreements and supporting the growing influence of the World Trade Organization (WTO).

Given all these changes, what were the feedback effects on the then accepted economic model? First, an increase in the available supply of production facilities meant an outward shift in the aggregate supply of many commodities, particularly those produced by low and medium-skilled labor. This lowered prices and the pace of inflation, on average, in the West. It also brought about lower interest rates, which led to a rise in real investment in equipment in developed and emerging markets.

In contrast, the housing price correction, as well as the equity market decline, led to a negative shock to the demand side. Households' perceived wealth in their homes, retirement plans, and savings fell sharply. The depressed housing market forced households to reassess the real economic returns for investing in a new or current home. Feedback effects also included a higher consumer saving rate and a slower pace of spending on consumer durables, especially autos. Slower consumer spending meant a slower pace of overall growth in the economy. Slower demand growth, coupled with significant global capacity to produce, caused inflation rates to stay lower than many expected given the economic recovery. A traditional economic framework predicts interest rates will rise with inflation during economic expansions, but the new economic reality has rendered low interest rates, low inflation, and slow, sustained growth.

The decline in housing and equity prices severely damaged household wealth and will limit spending going forward.

Finally, household wealth was battered by the housing market correction and the corresponding equity correction. The knock-on effect for state and local revenue has created massive headaches for governments that have enjoyed relatively stable financing markets. Slower economic growth, depressed consumer spending, and low inflation in the short to medium-term will put a vice grip on government budgets going forward, which have already suffered setbacks in revenue derived from the housing market. The hard choices for state and local governments are just beginning.

Not Just Another Economic Recovery

Deleveraging will be a slow, arduous process for both households and the government.

Since the beginning of the recession, our efforts have been aimed at identifying what distinguishes this cycle from past cycles; namely, the cyclical and structural changes to the existing economic framework for decision-makers. We were never in the “double-dip” camp or the “V-shaped” recovery camp, our outlook for 2010 called for slow growth in the context of consumer deleveraging and a shift in the use of credit to finance consumer activity. We expect that leverage at the federal, state, and local levels has probably peaked and that in the future, global investors will be less likely to lend to the U.S. at low interest rates and a high dollar value. The costs of long-term structural deficits are likely to rise with a weaker dollar, higher inflation, and higher interest rates.

There is a cyclical recovery in business investment and the troubled commercial real estate market has turned the corner, but for many businesses greater returns on investment can be found in emerging markets rather than in the developed world. Forty years of over spending and deficit finance has left the domestic U.S. economy with a legacy of challenging obstacles to overcome. As we revise our business models and career plans, we also see the need to revise our model of government fiscal conduct. Major economic turning points often force the economy to adjust and prepare for new realities and developments, just as the world adapted to the fall of the Berlin Wall and the emergence of a free market oriented Eastern Europe. The time is now for us to reevaluate our domestic model as well.

Experiments in Policy: The Federal Reserve Pursues Quantitative Easing

In 1788, France faced daunting fiscal deficits due to royal extravagance and military spending, which, combined with ineffective taxation, rendered the government essentially bankrupt. Less than a year later, the chaos of the French Revolution began in earnest. In an attempt to prime the pump of the economy, the government issued government debt secured by expropriated church property. Easy money became addictive and several more debt issues were arranged. The excessive reissuance of these notes caused the money supply to skyrocket and hyperinflation to ensue, exacerbating the violence of the Revolution. By the end of the 18th century, all the issued government debt was repudiated and became worthless. The years of fiscal turmoil were finally put to rest by Napoleon Bonaparte, who adopted the franc, and never returned to paper money. Voltaire predicted such an outcome, saying, “paper money eventually returns to its intrinsic value.”

Quantitative easing—a policy experiment—has its risks.

Economic policy experiments, much like wars, are easy to start and often difficult to end with clean results. Wage-price controls in the 1970s and the Civil War are outstanding examples. Quantitative easing is the process by which any central bank buys long term assets, often domestic sovereign debt, with the objective of increasing liquidity in the economy to boost growth or avoid deflation, a process of continuously declining prices. This policy experiment contrasts with the traditional monetary policy measures to increase liquidity, such as altering bank reserves to target a given level of the Federal Funds rate. So why is there a shift in policy approach?

Our model of the economy has changed considerably since the recession, which dictates a change in policy approach—for now. Our traditional interest rate channel loses effectiveness when market interest rates tread near the lows we have experienced in recent years. First, due to the experience of the Great Recession, there is still a high degree of risk aversion on the part of lenders and borrowers such that the risk premium in the credit markets is very high, preventing a large increase in credit in the economy. Second, the rate of unemployment has remained very high and home prices depressed or declining, calling into question the value of the collateral in any transaction. In recent months, about 20 percent of all home mortgage applications have been declined because the appraisal has fallen too far below the market price agreed upon by the buyer and seller. Third, regulatory requirements have been significantly increased such that the cost of the regulatory wedge between lender and borrower has diminished credit market liquidity. Even for households with historically good credit, the regulatory cost to process a loan for the lender has risen, reducing liquidity across credit markets. Fourth, aggregate demand has slowed as

consumers defer spending due to expectations of deflation and use their savings to repair damaged balance sheets.

All this suggests a liquidity trap-type phenomenon in the economy, where interest rate changes lose the ability to incentivize further consumer spending via traditional monetary transmission mechanisms. In a liquidity trap, the elasticity of the response from economic actors to marginal interest rate reductions has been eroded by the deterioration in the expected rate of return on investment activity, limiting the effectiveness of traditional open market operations. For example, with home price deflation common in many areas of the real estate market, expected further price declines reduce the incentive for anyone to borrow today. For any buyer, it is better to wait and buy at a lower price.

The current rationale for quantitative easing reflects the central bank's belief that it faces an economic environment characterized by a technically zero interest rate target policy. Essentially, monetary policy becomes constrained by what has been called the "zero interest bound."¹ The Federal Reserve, in order to avoid a potentially serious deflationary environment, has pushed interest rates to almost zero, but the economy has not responded sufficiently to the policy. Thus, the Federal Reserve needs to create another instrument of monetary policy that will "deliver the goods." The Fed needs to convince markets that it is prepared to do whatever it takes to prevent a deflationary environment, while at the same time keeping conventional monetary policy instruments in place that will allow the central bank to combat inflation if inflation threatens to return.

The "zero bound" forced the Fed to pursue less conventional monetary policies.

In an economy with very low interest rate elasticity what is the central bank to do? Under a quantitative easing program, the goal of the program is to raise inflation expectations—which has been the explicit goal of the Federal Reserve as it attempts to increase the rate of inflation. This has two effects. First, as most evident in the consumer durables and housing sectors, raising inflation expectations will shift buyer expectations away from deflation towards inflation and thereby provide an incentive to enter the marketplace. In addition, raising inflation expectations will reduce the expected real interest rate, the cost of borrowing, on any transaction, providing another incentive to engage in the marketplace.

Figure 7

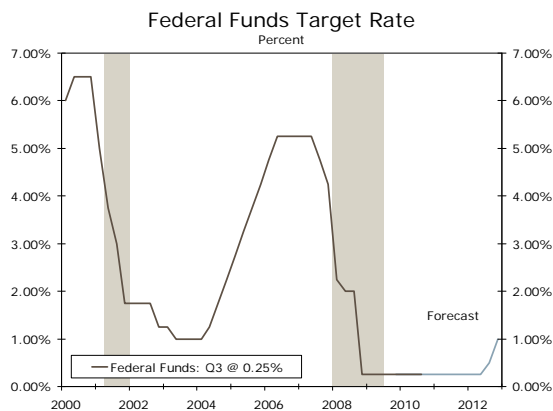
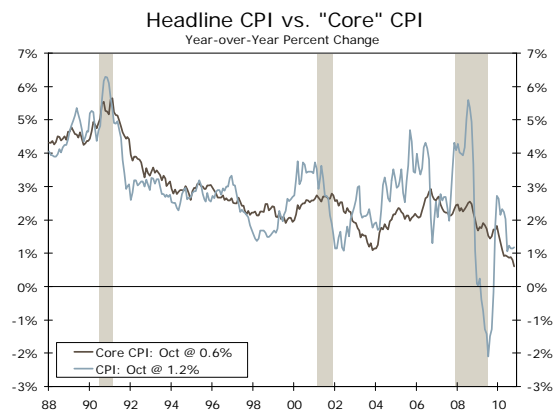


Figure 8



Source: Federal Reserve Board, U.S. Department of Labor and Wells Fargo Securities, LLC

Second, any monetary expansion will lead to the depreciation of the currency in an economy with free capital flows and a flexible exchange rate, such as the United States. Recent comments by U.S. Treasury and Federal Reserve policy makers have asserted that a depreciating dollar was not the direct intention of quantitative easing. Whatever the intentions of the Federal Reserve

¹ See Marvin Goodfriend, "Managing Monetary Policy at the Zero Interest Bound." Shadow Open Market Committee, October 12, 2010.

happened to be, the depreciation of the dollar could not have come as a surprise to anyone who has taken an introductory course in economics.

Implications of Quantitative Easing in an Uncertain World

As much as we might like to believe that the implementation and effectiveness of quantitative easing is simply a matter of turning up and down the Federal Reserve credit through the reserve creation process, we need to recognize four major areas of uncertainty.

Quantitative easing raises concerns about unintended consequences.

First, quantitative easing today represents an experiment in policy by trial and error by a central bank in an environment of global capital markets and flexible exchange rates. Thus, nobody knows the potential unintended effects of using this new monetary policy instrument. The U.S. is not a closed economy and its Treasury market is the most liquid capital market in the world that also serves as a benchmark for central bank reserves around the world. Most of the intellectual debate behind this new round of quantitative easing, called QE2, has to do with the uncharted territory the Federal Reserve is entering and the unknown future consequences for the U.S. economy and global capital markets.

Second, there is the issue of the dual mandate for the Federal Reserve. What is the balance of unemployment and inflation that the Fed is seeking to achieve in the current environment? How does the impact of structural unemployment impact estimates of full employment and the Federal Reserve's effectiveness in achieving any given unemployment goal? What is the ability of the Fed to raise inflation expectations and inflation itself just enough to move the economy forward, but not so much as to generate a unhinging of inflation expectations?

Estimates performed by the Federal Reserve indicate that buying approximately \$500 billion in U.S. Treasuries will be equivalent to decreasing the Federal Funds rate by 50 basis points or 0.5 percentage points.² While this estimate is preliminary and theoretical, the fact of the matter is that quantitative easing is no easy feat and its beneficial effects are highly in question today. But what most concerns many analysts is not the potential benefits of QE2, but rather the potential negative effects for the economy. Chief among these concerns is that the Fed may be successful in creating inflation, but unsuccessful in containing the inflationary process once it has begun.

Inflation Expectations and the Brazilian Experience

Expectations of inflation play an important role in creating real inflation.

Third, the historical experience of a nation impacts the effectiveness of policies in altering expectations. Inflation expectations reflect the impact of two driving forces. First, the supply of money injected into the economy relative to the demand for that money will alter its price (inflation) within an economy. For the U.S. today, the demand for money is fairly high as inflation is low and economic uncertainty leads both households and businesses to maintain a high level of precautionary balances. If there is an increased amount of money injected into the economy and households and business alter their expected inflation outlook, then more of this money will leave savings and enter the marketplace. The second component of inflation expectations reflects the fear or greed psychology of business or consumer sectors. What is the belief about future inflation that individuals and economic agents have? If expectations about future inflation increase then inflation accelerates today as businesses and households quickly drive down their cash holdings and spend today to avoid higher prices in the future.

Brazil, before Luiz Inácio "Lula" da Silva won the Brazilian presidential elections in 2002, serves as a great example of how inflation expectations can prompt economic agents to substitute consumption today for consumption tomorrow. By mid-2002, Brazilian inflation was hovering between seven and eight percent. The presidential elections were scheduled for October 6 with a second round of voting on October 27 if no candidate managed to garner more than 50 percent of the vote. By this time, Lula da Silva was the clear front runner and all the polls were predicting that he would become the next president of Brazil.

² See President of the Federal Reserve Bank of New York, William C. Dudley's remarks on October 1, 2010 entitled "The Outlook, Policy Choices, and Our Mandate." Available on the Federal Reserve Bank of New York's website.

During several highly publicized interviews, Lula da Silva said that he would be in favor of accepting higher inflation if the economy grew at a faster pace. After those interviews, Brazilian inflationary expectations rose considerably and inflation started to accelerate without any change in monetary policy by the Brazilian central bank. In fact, inflation accelerated from 14.5 percent in January 2003 when Lula da Silva took office to 17.3 percent by May 2003. Thus, the Lula administration had to spend almost its entire first year in office undoing the effects of Mr. da Silva's commentaries regarding inflation. How did inflation increase so fast? It was all about a change in expectations regarding future inflation by individuals and economic agents that doubled the rate of inflation in less than six months, nothing else. Believing that inflation was about to rise, Brazilians spent money today to avoid higher prices in the future.

Figure 9

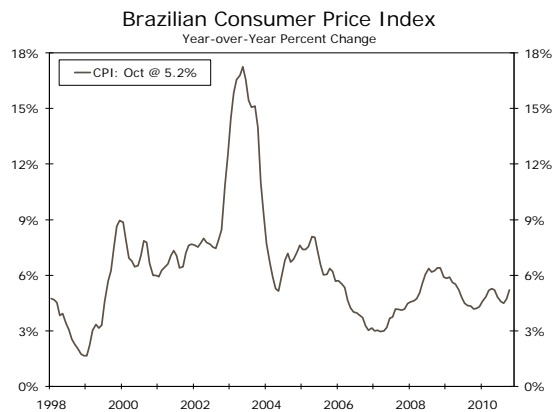


Figure 10



Source: IHS Global Insight and Wells Fargo Securities, LLC

How could this happen if the central bank does not change the amount of money in the economy? One possible explanation is a change in the velocity of money in circulation. That is, individuals and economic agents ran to the exits to get rid of the Brazilian currency before inflation ate the currency's purchasing power; however, the velocity of money in circulation did not change significantly during this period of time. A second explanation is, as we said before, a change or resetting in expectations of future inflation. Thus, money supply kept on increasing even as the central bank increased interest rates and tightened monetary policy. Banks kept on lending even as the central bank kept increasing the interest rate to slow down lending. By the time of the presidential elections in October, money supply, as measured by M1, was growing at almost 32 percent year-over-year rate while the broader measure of money supply, M3, started to accelerate considerably from a low of 6.6 percent in July 2002 to 24.5 percent in May 2004.

Of course, the Brazilian context is very different than the U.S. today, so we should not make any direct extrapolation from the Brazilian case to the United States. For example, Brazil had beaten a hyperinflationary process early in the 1990s and individuals and agents were very aware of the potentially damaging effects of runaway inflation and thus reacted to the candidate's commentaries forcefully, just in case.

For the U.S., the Federal Reserve has flooded the U.S. economy with bank reserves in an attempt to raise inflation expectations, but we must recognize the implicit assumption of policy makers that the velocity of money would not be significantly altered by rising inflation expectations. This is a delicate balance. Individuals and other economic agents must believe that inflation will rise and thereby put the reserves into circulation, but not expect inflation to rise so much as to unhinge inflation expectations. This is a difficult line to toe when much of the Treasury yield curve is yielding returns below the perceived Federal Reserve's two percent target inflation rate. Will attempting to beat the inflation monster by consuming today replace hoarding as the new game in town?

Flight to safety has kept the dollar afloat since the recession.

In a Global Capital Market There is the U.S. Dollar

While inflation has risen very little in recent years, the U.S. dollar has resumed its downward bias whenever flight to safety dissipates. We have observed this phenomenon after such crises as the Greek and European sovereign debt as well as the recent flare up in tension on the Korean peninsula. Monetary expansion above and beyond what it is needed to conduct economic transactions tends to lead to the depreciation of a currency and to inflation in the medium and long-term.

Monetary expansion impacts the value of any currency, including the U.S. dollar, by altering the relative supply of the currency compared to other currencies. Even before quantitative easing became a hot button issue, U.S. economic policy had a clear bias towards a weaker U.S. dollar. From a macroeconomic perspective, the U.S. economy appears to benefit from a weaker currency, mostly because of concerns about the bulging current account deficit, which in the last couple of years has approached seven percent of GDP; a level that, if sustained or surpassed, would pose a serious threat to the economy in the long run.

Though comparing the crises of different countries is a difficult exercise, analysts may recall the current account crises that have hammered several countries because of unsustainable levels of external financing. Some notable recent examples are the Mexican Tequila Crisis in 1994-1995, the case of the East Asian countries in 1997, Russia default crisis in 1998, the Brazil devaluation in 1999, and the Argentinean devaluation in 2001. Some authors have called these episodes "sudden stops," that is, a process where capital flows from other countries suddenly stop flowing and countries that have accumulated large current account deficits have to face a severe depreciation of their currencies to be able to reduce their deficit.³ A very large and sudden depreciation of a currency is some times called a "hard landing." The hard landing of a currency is normally followed by a very large rise in inflation.⁴

The U.S. dollar has not seen a "hard landing."

Today, a number of analysts have been speculating that the U.S. economy was bound to suffer a sudden stop and that the U.S. dollar would depreciate at a very fast pace, that is, suffer a hard landing. However, this rapid depreciation has not yet materialized. Thus, while we have seen a very large depreciation of the U.S. dollar in recent years, there has been no sudden stop or hard landing in the U.S. economy. The U.S. dollar has depreciated almost 40 percent versus the currencies of its largest trading partners, but the process has happened slowly over the years; however, the slow pace of the depreciation does not mitigate concerns about the overall trend. Will the Fed's securities purchasing program result in unstable inflation that creates sharp swings in the value of the U.S. dollar and market interest rates?

While this lax monetary policy has produced a large depreciation of the U.S. dollar during the last ten years, it has also created a very challenging environment for those countries whose currencies have appreciated against the U.S. dollar. We are just starting to hear complaints from across the world that excessive printing of money by developed countries is affecting other countries' ability to export at competitive prices. In short, developed countries' central banks have been printing money at a very fast pace in what is becoming a competitive devaluation of the "beggar thy neighbor" type. This is the same pattern seen in global currency markets before the establishment of the Bretton Woods currency accords after the Second World War.

Preventing Deflation Could Mean Generating Inflation

From a policy perspective, it is also clear that the Federal Reserve is trying to do whatever it takes to avoid a deflationary environment, with quantitative easing being its current tool of choice. In an ironic turn of events, the Fed, an institution that has been fighting inflation since its inception, is actually embarking in all out effort to do just the opposite and convince markets that it wants higher inflation. The only way to do that is to change agents' expectations regarding the future of prices in the economy. Quantitative easing is the Fed's latest effort to change these expectations.

Is inflation the lesser of two evils? The Fed seems to believe so.

³ See Guillermo A. Calvo, Alejandro Izquierdo, and Luis Fernando Mejía, "Systematic Sudden Stops: The Relevance of Balance-Sheet Effects and Financial Integration," Working Paper 14026, National Bureau of Economic Research, May 2008.

⁴ See Guillermo A. Calvo and Ernesto Talvo, "The Resolution of Global Imbalances: Soft Landing in the North, Sudden Stop in Emerging Markets?" The Journal of Policy Modeling, Issue 28, 605-613, 2006.

One problem with this monetary policy is that the Fed is trying to avoid one monster, deflation, by calling on another monster, inflation. Yet, we recognize this could generate serious issues in the future. The policy of creating inflation to fight deflation runs the risk of overshooting a comfortable inflation target and unintentionally setting in motion an inflationary spiral; especially, if the Federal Reserve is unable to withdraw the injected liquidity in an rapid, but orderly fashion. However, for the Federal Reserve the trade off is very clear: central banks around the world have had more experience controlling inflation and enjoy a wider range of tools that stem inflationary processes, while monetary authorities have found themselves more constrained when faced with deflation. Thus, the policy direction is a “no-brainer,” once inflation returns, then the Federal Reserve can increase interest rates a-la-Volker and bring inflation back down. At least, that is the hope.

Of course, the strategy being played by the Federal Reserve is very risky, especially if expectations about future inflation are reset at a higher level. The Federal Reserve will have to bring those expectations down again and the only way to do that is to increase interest rates and threaten an economic slowdown, just as ex-Fed Chairman Volcker did in the 1980s. A possibility that Chairman Bernanke has decided worthwhile when compared to a severe deflationary scenario.

State & Local Government: Short on Revenue, Long on Promises

Even as the national economic recovery picks up pace, state and local government finances will remain a drag on the overall recovery. Over 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, which will necessitate painful 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, which means any resolution is likely to be especially difficult given the modest economic recovery expected in 2011. 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. For example, in the case of Nevada, the state's gaming industry, a historical driver of public revenues, will not provide as much of a boost to state and local finances because of continued weakness in the industry as consumers prefer to pay down debt and save more.

Over the last two years, state and local budget problems were largely avoided via federal assistance.

Figure 13

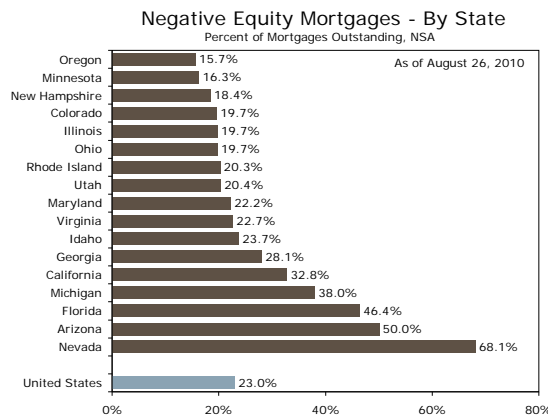
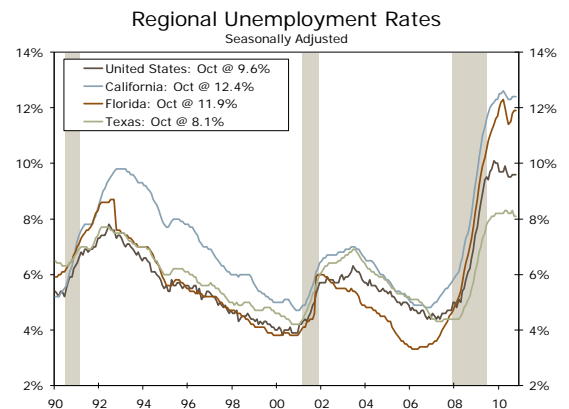


Figure 14



Source: Core Logic, U.S. Department of Labor and Wells Fargo Securities, LLC

Alternatively, states in the West North Central and Mountain West regions should fare comparatively well, benefitting from high commodity prices and abundant harvests. These states also tend to be less exposed to the housing decline and the credit & banking problems that resulted from the recent recession and many have also been supported by better than average income growth from healthy agricultural income and strong metals and energy prices.

On the structural side of the equation, the road will be extremely difficult for state and local governments. 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. For example, in Pennsylvania the contribution rate for employers of public school employees is expected to spike in 2011, which will reach unmanageable funding levels by 2013. In California, a very high dependency ratio and a weakening tax base has created a huge budget gap, currently estimated to be around \$25.4 billion. Any solution to structural state and local budget issues will likely involve painful spending cuts and tax increases in the near-term. With the likelihood of further assistance from the federal government slim, state and local governments will be forced to

Public pension retirement programs are one of the largest culprits of state and local structural budget problems.

enact structural reforms to deal with underfunded entitlement programs, including changing the process by which future benefits are paid out and cutting obligations to new recipients.

While state and local budget issues will take center stage in 2011, housing remains a continuing problem area for many states. Twenty-three percent of mortgages are currently underwater and foreclosures remain a serious problem in many states. The drag from the housing slump is greatest in Arizona, Nevada, Florida, California, Michigan and Georgia. But nearly every state faces some residual hangover from the housing slump, which has made it more difficult for homeowners to sell their current home and relocate.

Regions that are less bogged down by ailing state and local budgets and a hangover of overbuilt residential and commercial properties will continue to post the strongest gains in 2011. This means the Great Plains, Mountain West, and West North Central will continue to lead. Energy producing states, such as Texas, Oklahoma and West Virginia should also see growth improve, as stronger domestic economic growth drives demand for oil, natural gas and coal. Other bright spots include areas where federal government accounts for a larger share of the economy, such as Virginia, Maryland and Washington D.C. States that have been more dependent upon population gains and new construction for growth will lag, but many will see at least modest improvement this year. Economic growth is clearly picking up in Georgia and the Carolinas and activity has even improved somewhat in parts of California, including San Jose and the Greater San Francisco area.

Twenty three percent of mortgages are currently underwater.

Among the largest states, Texas faces the brightest near-term prospects. The Lone Star State has been less weighed down by the housing bust, with less overall overbuilding and seeing only modest price declines in most major markets. Inventories of unsold homes have increased in recent months, reflecting reduced in-migration from other states where the housing market is in far worse shape. Manufacturing has been bolstered by the state's growing high tech sector. The collapse in natural gas prices has slowed exploration activity, but exports of energy exploration equipment, software and know-how remain strong. Economic activity is expected to moderate somewhat in 2011, as a stronger dollar and weaker economic conditions in Europe reduce exports. Cutbacks in the Space program and defense outlays will hurt the state, however, leading to layoffs in these high-paying sectors.

Figure 15

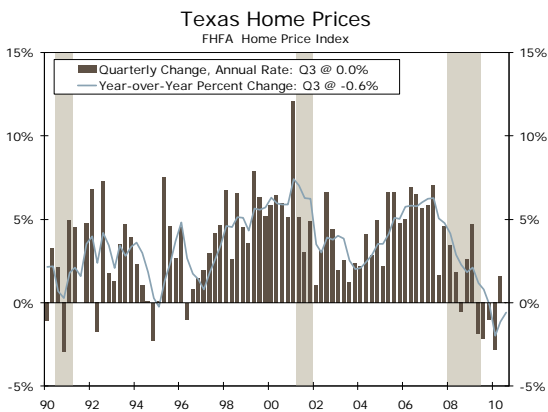
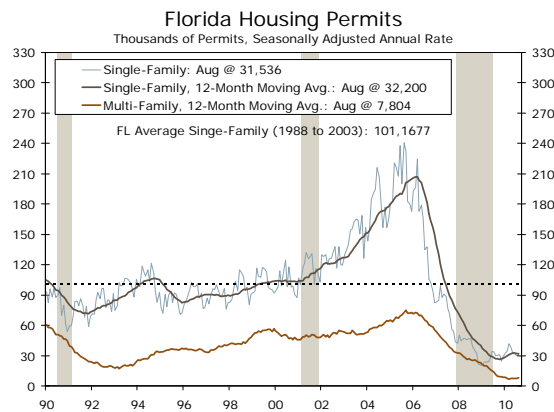


Figure 16



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

Florida's recovery will continue to lag behind the rest of the country. Housing is more overbuilt in the Sunshine State and the imbalances are far more difficult to correct than in any other state. Housing prices are likely to further decline substantially during the coming year, as foreclosures and distress sales account for the bulk of home sales. New home construction remains in the doldrums and will rise inconsequentially if at all in 2011. As bleak as conditions appear, there are some bright spots. International trade and tourism continue to post solid gains, lifting activity in Miami, Fort Lauderdale and Orlando. Jacksonville also appears to be recovering ahead of the rest

of the state. We expect modest gains in employment and income during the coming year, but gains will only offset a small fraction of the 890,000 jobs lost during the recession.

The California economic outlook is one of improvement in 2011 as private sector employment growth accelerates a bit and the drag from construction job cuts dissipates. However, the legacy of the housing bubble remains. The state's unemployment rate is expected to hold above 12.0 percent next year, well above the U.S. average. Foreclosed and distressed sales of homes remain high and home values and state and local tax revenues continue to be at risk. The new Governor of California, Jerry Brown, is still facing a projected state budget deficit of around \$25 billion dollars over the next 18 months. It is expected that spending cuts rather than tax increases will be the main path used in closing the budget gap. The pace of state and local job losses in California will likely intensify yet again in 2011. On the bright side, income growth is improving as private sector workers that have jobs work more hours and stronger productivity gains drive real wage growth. Overall, California's recovery should continue to broaden and strengthen next year, but the pace of job gains are likely to remain painfully slow compared to past recoveries and the state's economy will likely continue to perform somewhat below the national average.

Housing: An Agonizingly Slow Recovery

We continue to maintain a very conservative outlook for home sales and new home construction. The partial suspension of foreclosure sales, increased scrutiny of the mortgage market by state attorneys general and the poor start to quantitative easing all contribute to a much more uncertain outlook. Increased downside risks for home sales, new home construction and home prices persist for many metro areas. We have reduced our expectations for new and existing home sales over the next two years and further trimmed back our forecast for housing starts over this period. Home prices are now expected to decline toward the lower end of the six to eight percent range we had been expecting from mid-2010 levels, and we have pushed the timing of reaching the bottom in home prices further out until mid-2011. The risk of more substantial price declines has also increased, particularly in highly overbuilt markets like Phoenix, Las Vegas, South Florida and Southern California.

A true recovery in home sales will not begin until government involvement in the housing market subsides and private sector employment growth increases. There is more reason to be optimistic about the latter rather than the former. Government involvement in the mortgage and foreclosure process looks like it will continue at a very high level for the foreseeable future, with various efforts to stem the tide of foreclosures and increased scrutiny of the foreclosure process by state attorneys general likely to hang over the housing market at least through the first half of 2011. Regardless of the intentions, the net effect of these initiatives will be to push out the recovery in housing at least a few more months into the second half of 2011 or later.

Any broader recovery in home sales will be contingent on a rebound private sector employment growth. There is more reason to be optimistic on this front, as we expect private sector hiring to pick up from a net gain of 110,000 jobs a month in 2010 to 150,000 jobs per month in 2011. The increase in hiring should lift household formations and also encourage household mobility, which should lead to stronger demand for both rental and for-sale housing. Sales of existing homes are expected to rise 4.4 percent in 2011 to a 5.075 million unit pace. New home sales should rise 21 percent and average a 400,000-unit pace.

Housing starts are not expected to return above the psychologically important one million unit level until 2013. New home construction is being held back by competition from the existing home market and foreclosures. There was a 10.2-month supply of existing homes on the market toward the end of 2010. In addition, another 2.2 million homes were in foreclosure and mortgages on 2.2 million homes were 90 days or more past due. While all of these homes will not necessarily need to be sold off before home construction can recover, the oversupply will keep housing starts below where demographics would dictate where they would be for the next three years. Home construction will rise over this period, however, just not as fast it would have in a typical recovery.

The pace of state and local job losses in California will likely intensify yet again in 2011.

A true recovery in home sales will not begin until government involvement in the housing market subsides.

The large role that the overhang of supply is playing on the housing market means housing market conditions will vary considerably throughout the country. The bulk of the excess supply of housing is located in states where construction soared the most during the boom years, including Florida, Arizona, California and Georgia, or states facing serious demographic challenges, like Michigan and Illinois. These states also tend to have the highest percentage of home mortgages with negative equity and most face additional downside pressure on prices. Unfortunately there are relatively few markets in these states poised to lead a rebound, even though affordability remains near historic highs. The best markets are concentrated in the Great Plains states, which are home to few large metropolitan areas. Among major metro areas, markets that have seen supply and demand move back into balance and also seen general economic conditions improve include Boston, Central New Jersey, Denver, and Dallas/Fort Worth.

The bulk of excess supply of housing is located in states where construction soared the most during the boom years.

Figure 17

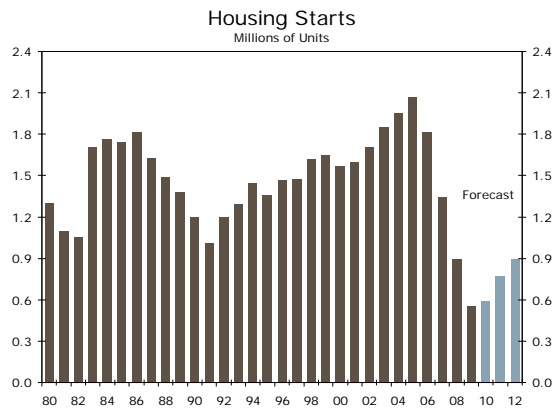
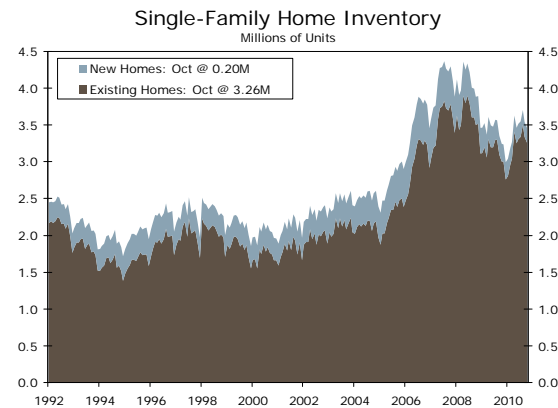


Figure 18



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

Commercial Real Estate: Cyclical Recovery—At a Moderate Pace

Commercial real estate markets showed surprising resiliency throughout the year despite frustratingly slow economic growth and a stubbornly high unemployment rate. Operating fundamentals for all major property types are either improving or showing signs of stabilizing. Leasing has picked up, rents are rising or stabilizing and sales have increased, albeit from very depressed levels. Demand for high quality properties in choice locations remains exceptionally strong, which has helped pull prices higher for non-distressed deals. The improvement in some operating fundamentals has occurred more quickly than would have been expected given the modest rebound in employment seen so far in this recovery.

While the improvement in operating fundamentals is encouraging, it is still too soon to pop the champagne. We remain cautious in our outlook for commercial real estate and nonresidential construction, as macro drivers for commercial real estate fundamentals remain modestly positive at best. High unemployment will constrain the improvement in property fundamentals for the next 12-18 months. In particular, office and retail properties are extremely oversupplied. Much of the recent leasing activity reflects upgrades of space, but is leaving large blocks of leased but vacant space on the market. The improvement in the apartment and industrial sectors seems more genuine and both should continue to improve during the coming year.

High unemployment will constrain the improvement in property fundamentals for the next 12-18 months.

The largest immediate issues with commercial real estate continue to be the overhang of commercial real estate loans coming due over the next few years and the large number of development projects that have been partially completed and continue to weigh on community bank portfolios. Commercial real estate prices should remain under pressure. Higher prices for non-distressed deals will continue to garner attention as buyers scramble for a small number of higher-quality properties. Prices will likely drift lower, however, as the proportion of distressed

transactions grows. According to the Moody's Real Commercial Property Price Index, prices are now down roughly 45 percent since peaking in early 2008, but declines should moderate throughout 2011. Excluding distressed transactions, prices should remain roughly stable for much of next year.

Figure 19

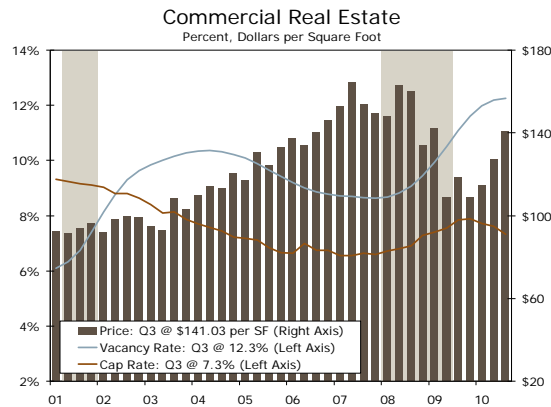
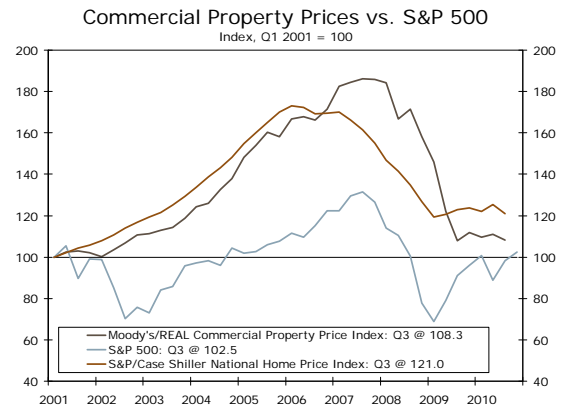


Figure 20



Source: Moody's, S&P Corp. and Wells Fargo Securities, LLC

The improvement in operating fundamentals achieved this year provides a better idea of where rents will settle.

While the pace of economic growth will likely remain relatively sluggish compared to previous recoveries, final demand for goods and services should consistently strengthen over the next two years, which should lead to increased demand for commercial real estate. The improvement in operating fundamentals achieved this year provides a better idea of where rents will settle, which should better enable investors and lenders to properly value properties so they can be sold, refinanced or redeveloped. We expect nonresidential construction to fall a modest 1.5 percent in 2011, weighing on real GDP growth in the first half of the year, but modestly adding to growth thereafter. Construction has fallen so much in the private sector that even a handful of well located projects breaking ground will provide a boost to construction outlays. The totals will be relatively small, however, and a more substantial and sustained recovery is still at least two years away.

Bifurcated Global Expansion: Global Imbalances and Currency Wars

Miraculously, it appears that global GDP will have grown almost five percent in this year. Some of the strength in global economic activity in 2010 reflects the bounce-back from the deep downturn in 2009, the first time that global GDP growth was negative in at least forty years. However, economic policy, which consisted of sizeable stimulus programs in many countries in 2009, also had a role to play in the global recovery. Not only did most major central banks slash policy interest rates to unprecedented lows in the wake of the global financial crisis two years ago, but fiscal policy turned expansionary as well in many countries. In addition, a rebuilding of inventories, which were slashed in late 2008 and early 2009, helped to lift GDP growth rates this year.

In our view, global GDP will expand at a slower pace in 2011 than it did in 2010. As shown on page 27, we project that global GDP will grow 4.0 percent in 2011 after the 4.9 percent growth rate that we estimate was achieved in 2010. Moreover, we look for a bifurcated global economy in 2011. That is, we forecast that many developing countries will continue to post strong growth rates in 2011. However, most advanced economies should experience another year of subpar economic growth as their public and private sectors continue to deleverage.⁵

We project global GDP will grow at 4.0 percent in 2011.

Figure 21

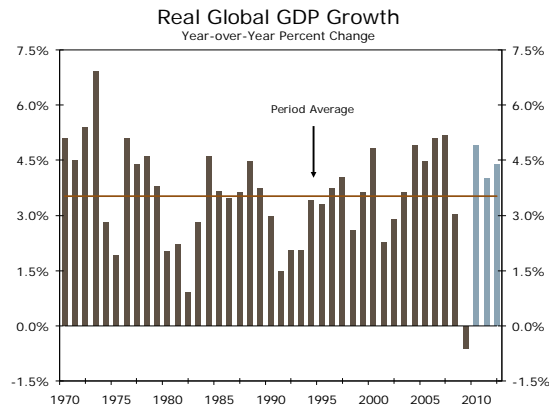
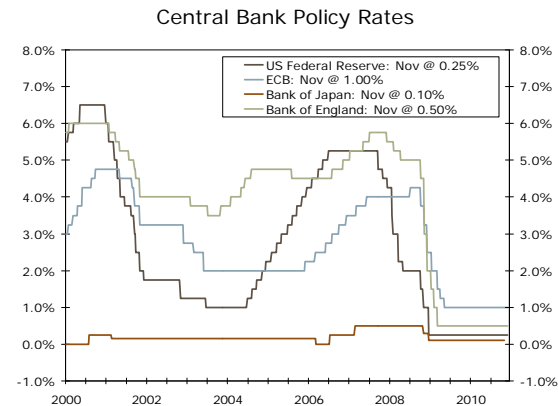


Figure 22



Source: Bloomberg LP and Wells Fargo Securities, LLC

Advanced Economies: Continued Sluggish Growth

As noted earlier in this report, we forecast that the United States, which accounts for more than 20 percent of global GDP, will continue to grow at a sub-trend pace—only 2.6 percent in 2011, which is significantly below the annual average growth rate of 3.2 percent that was achieved between 1992 and 2007—as consumers continue to deleverage. Unfortunately, the United States is not the only major country in the world with a consumer leverage problem at present. Some countries in the euro area, which represents roughly 20 percent of global GDP, also experienced sizeable increases in consumer debt in the last decade. For example, Spain and Ireland registered sharp rises in house prices, and these countries are now suffering the hangover effects of their burst housing bubbles. Although Eastern Europe is rather small in terms of worldwide economic output, many economies in the region are cleaning up the mess of their own financial crises and likely will experience slow economic growth next year.

The ratio of household debt-to-disposable income in the United Kingdom exceeds the comparable ratio in the United States and growth in British consumer spending will likely remain lackluster

⁵ As shown on page 27, we project that real GDP in advanced economies will expand 2.2 percent in 2011 following the year-over-year percent growth rate that we estimate was achieved in that group of countries this year. Our forecast calls for 6.0 percent growth in the developing world next year after 7.5 percent in 2010. We follow IMF conventions in our distinction between advanced and developing nations as well as in our aggregation methodology.

Fiscal consolidation measures will exert headwinds on real GDP growth in many Eurozone economies.

for the foreseeable future. In addition, the increase in the value-added tax (VAT) that is scheduled to go into effect in January 2011 as part of the U.K. government's budget cutting program will also exert some headwinds early next year on British consumer spending growth.⁶

Speaking of fiscal consolidation, some countries in the Eurozone have their own budgetary corrections underway. The Greek government plans a massive fiscal correction, reducing its fiscal deficit from more than 13 percent of GDP in 2009 to less than three percent in 2014, and significant budget cutting measures are in place in Ireland, Portugal and Spain as well. Although bona fide fiscal consolidation should lay the groundwork for stronger economic growth in these countries in the long run, the spending restraint and tax hikes that will bring about consolidation will exert headwinds on real GDP growth in many Eurozone economies in the next year or two.

Japan is another G-7 economy that is experiencing a lackluster recovery at present. After plunging nearly nine percent on a peak-to-trough basis, real GDP in Japan remains more than four percent below its Q1-2008 peak. The Japanese recovery to date has been driven in large part by net exports as growth in domestic demand has been rather weak. In our view, the combination of slower global growth and the recent appreciation of the yen will cause the overall rate of Japanese GDP growth to downshift from 3.6 percent in 2010 to roughly one percent next year.

Slow economic growth should keep CPI inflation rates in most advanced economies quite benign in 2011. Among G-7 economies, we project that only the United Kingdom and Canada will have a CPI inflation rate in excess of two percent in 2011. (See global forecast table on page 27). Significant increases in commodity prices, should they occur, probably won't raise core rates of CPI inflation much because most businesses will have limited ability to raise output prices in the face of weak consumer demand. Lackluster economic growth and benign inflation is a recipe for continued monetary accommodation. Indeed, we believe that the Federal Reserve, the European Central Bank and the Bank of Japan will keep policy interest rates unchanged through most of next year, if not longer.

Developing World: Strong Fundamentals Support Solid Growth Outlook

In contrast to the lackluster expansions we forecast for most advanced economies in 2011, we project that economic growth in the developing world, especially in non-Japan Asia and Latin America, will remain strong. Real GDP growth in China will likely grow in excess of ten percent in 2010 and about nine percent next year. Likewise, the Indian economy should grow nearly eight percent in 2011. Most Latin economies will probably not be able to realize the very robust growth rates that China and India achieve. That said, the real GDP growth rate of five percent that we project for Brazil in 2011 is a very solid achievement for that economy.⁷

If GDP growth rates in most advanced countries are sluggish in 2011, then how can the developing world possibly continue to grow at a brisk pace? After all, won't sluggish real GDP growth in the advanced economies retard the rate of export growth in the developing world and thereby depress the rate of economic expansion in those countries?

Although slow export growth will exert some restraint on the overall rate of real GDP growth in the developing world, underlying economic fundamentals remain strong in most emerging markets. For starters, most economies in non-Japan Asia and Latin America did not become overly leveraged in the last cycle unlike their advanced counterparts. Consequently, banks in these countries have been able to maintain strong rates of lending growth. For example, year-over-year rates of loan growth in both Brazil and China are currently in excess of 15 percent. In contrast, bank credit in the United States is flat at present.

Underlying fundamentals remain strong in most emerging markets.

⁶ The household debt-to-disposable income ratio in the United States is 110 percent at present. The comparable ratio in the United Kingdom currently stands at 160 percent. For further reading on British budget cutting see our special report entitled "U.K. Announces Major Deficit Reduction Plan" (June 24, 2010) and "Outlook for U.K. Growth Amid Budget Cutting" (October 26, 2010), which are available upon request.

⁷ Between 1993 and 2008 real GDP in Brazil grew at an annual average growth rate of 3.4 percent.

Moreover, high national savings rates in many developing economies, especially in Asia, lay the groundwork for strong economic growth over the long-run.⁸ Indeed, the national saving rate in non-Japan Asia exceeds 40 percent at present. The work of Nobel Prize winning economist Robert Solow showed that savings is the key to long-run economic growth.⁹ High national saving rates finance strong growth in investment spending, lead to the building of better roads and railways, and give workers more capital equipment to help to power economic growth. National saving rates in Latin America, which are roughly half of those in Asia at present, have trended up a bit over the past decade or so due, at least in part, to smaller fiscal deficits. Although lower national saving rates, and consequently growth rates in investment spending, mean that potential GDP growth rates in Latin America are generally not as strong as in non-Japan Asia, we look for solid economic growth in both regions for the foreseeable future.

Figure 23

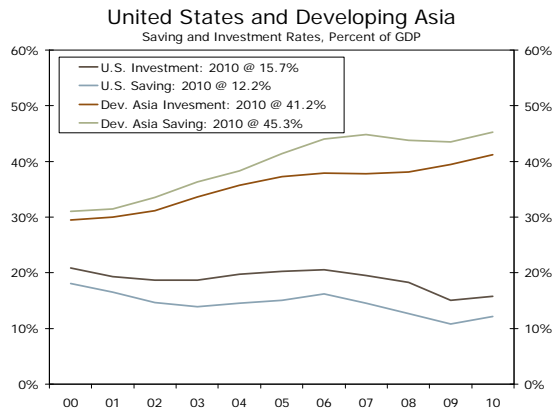
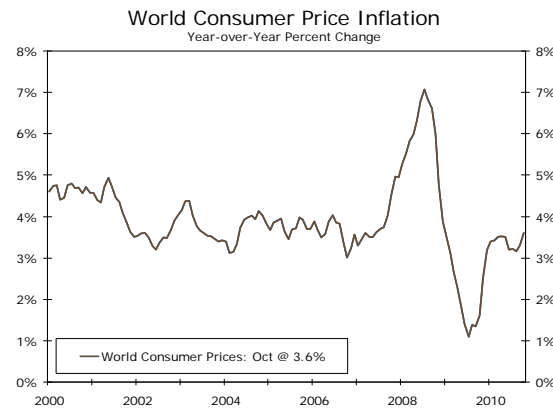


Figure 24



Source: IHS Global Insight, International Monetary Fund and Wells Fargo Securities, LLC

Challenges to the Developing World Outlook? Try Inflation.

What could change the relatively sanguine outlook for economic growth in the developing world? Obviously, another global financial meltdown would throw many emerging economies into recession again, but the probability of another major financial crisis in the near term seems rather low. In our view, the most credible downside risk to the economic outlook in the developing world at present stems from inflation.

Inflation rates in most economies are higher today than they were last year. Although rates of consumer price inflation have generally stabilized recently, another leg higher could ensue if food and energy prices, which have been creeping up lately, accelerate. In a worst-case scenario a significant increase in inflation could induce central banks in developing economies, many of which have already tightened modestly, to slam on the brakes. Excessive monetary tightening would cause economic growth in the developing world to slow more than we currently forecast. With real GDP growth in the advanced economies likely to be sluggish next year, significant deceleration in economic activity in the developing world would lead to markedly slower global GDP growth.

Inflation represents the most credible downside risk to developing economies.

We project that CPI inflation rates in most countries will ease back somewhat in 2011 due to slower global GDP growth. However, sharp increases in commodity prices, which could be caused by significant dollar depreciation, could lead to higher CPI inflation and excessive monetary tightening. Although we are fairly confident that inflation will recede somewhat in 2011 in most

⁸ A country's national saving rate expresses the saving of its households, businesses and public sectors as a percent of GDP.

⁹ See Jay Bryson and Tim Quinlan, "What Really Drives Growth in the Industrial Sector?" Wells Fargo Economics, 7 July 2010.

QE2 has sparked fears of capital flow imbalances in developing nations.

developing economies, we are mindful of the downside risks to the global economic outlook that significantly higher inflation rates would pose.

Currency War: Black Ops in the Global Economy

Speaking of dollar depreciation, another downside risk to the global economic outlook would be a full-blown “currency war.” Rightly or wrongly, many developing countries have heavily criticized the Federal Reserve for its recent decision to increase the size of its quantitative easing program. Some developing countries have imposed taxes on capital inflows to offset upward pressure on their currencies. In this environment, some countries may resort to raising tariff and/or non-tariff barriers to counter what they perceive to be attempts by trading partners to gain a competitive advantage and tit-for-tat retaliation could ensue. A global trade war would be in nobody’s interest.

Assuming that the costs posed by higher inflation and a “currency war” do not materialize, we believe the expansions that are underway in most developing economies will be sustained for the next few years. As noted above, financial systems in these countries are not overly leveraged at present. In addition, many developing countries are incurring modest current account deficits if not outright surpluses at present. Therefore, a wave of balance-of-payments crises in the developing world does not appear to be imminent.

Outlook for Dollar Exchange Rates: Mixed

Wells Fargo’s Currency Strategy Group has a mixed outlook for the value of the U.S. dollar vis-à-vis other currencies in 2011. Trends in U.S. monetary policy and interest rates, which were an important driver of U.S. dollar weakness in the second half of this year, will continue to be influential in 2011. After the Fed’s quantitative easing, the outlook for other major currencies will hinge on whether other major central banks also adopt accommodative monetary policies. With the Bank of Japan having already eased and the Bank of England likely to follow suit eventually, the yen and British pound should soften against the U.S. dollar. Over the medium-term, European debt difficulties should also weigh on the euro.

For the commodity-based and emerging market currencies, the medium-term outlook is more favorable. With short-term U.S. interest rates remaining at rock-bottom lows through 2011, the outlook for commodity and emerging currencies will depend in part on whether interest rates continue to rise in those countries. The increase in interest rates will help to attract further capital inflows into those markets. Broadly speaking, we expect central banks in Australia, Canada and New Zealand will keep raising policy rates in 2011, along with many emerging market economies. The continuing contrast between the interest rate outlook in commodity and emerging market economies relative to the United States should keep the greenback on the defensive against that group of currencies.

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Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2010	2011	2012	2010	2011	2012
Global (PPP weights)	4.9%	4.0%	4.4%	4.2%	4.3%	4.2%
Global (Market Exchange Rates)	3.7%	2.8%	3.2%	n/a	n/a	n/a
Advanced Economies ¹	2.7%	2.2%	2.8%	1.4%	1.6%	1.9%
United States	2.8%	2.6%	3.3%	1.6%	1.7%	2.4%
Eurozone	1.7%	1.5%	2.2%	1.6%	1.8%	1.9%
United Kingdom	1.8%	1.9%	2.1%	3.2%	2.6%	1.7%
Japan	3.6%	1.2%	1.7%	-0.7%	-0.5%	-0.2%
Korea	6.4%	4.0%	4.2%	2.9%	3.2%	3.0%
Canada	2.9%	2.1%	2.4%	1.7%	2.1%	1.9%
Developing Economies ¹	7.5%	6.0%	6.4%	7.6%	7.5%	7.0%
China	10.3%	9.0%	9.3%	3.2%	3.7%	2.7%
India	9.4%	7.6%	7.9%	12.4%	7.9%	7.1%
Mexico	5.3%	3.6%	3.5%	4.1%	4.8%	5.2%
Brazil	7.6%	5.0%	5.6%	5.0%	6.0%	6.0%
Russia	4.3%	4.1%	4.5%	6.9%	9.3%	9.3%

Forecast as of: December 8, 2010

¹Aggregated Using PPP Weights

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR														
	2010			2011			2012			10-Year Bond					
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	
U.S.	0.30%	0.30%	0.30%	0.35%	0.40%	0.40%	0.40%	0.40%	2.80%	2.80%	2.80%	2.90%	3.00%	3.20%	3.40%
Japan	0.20%	0.20%	0.20%	0.20%	0.20%	0.20%	0.20%	0.20%	1.09%	1.09%	1.10%	1.10%	1.15%	1.20%	1.25%
Euroland	1.00%	1.10%	1.15%	1.15%	1.40%	2.25%	2.25%	2.25%	2.80%	2.80%	2.85%	3.00%	3.50%	3.80%	3.90%
U.K.	0.75%	0.75%	0.75%	0.80%	1.00%	1.75%	1.75%	1.75%	3.30%	3.30%	3.40%	3.50%	3.90%	4.20%	4.30%
Canada	1.20%	1.20%	1.25%	2.00%	2.75%	3.25%	3.25%	3.25%	3.10%	3.10%	3.20%	3.60%	3.80%	3.90%	4.00%

Forecast as of: December 8, 2010

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