

# Economics Group

## Weekly Economic & Financial Commentary

### U.S. Review

#### Public Policy Shapes the Recovery

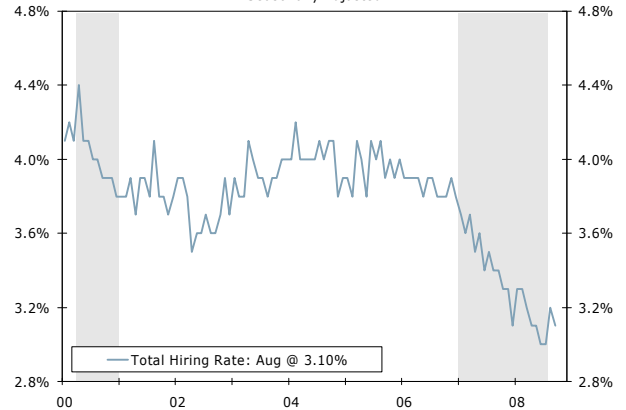
- September's 1.0 percent rise in the Leading Economic Index offers insight into next week's first look at Q3 GDP. The LEI is up at an 11.8 percent annual rate over the past six months, the strongest gain since 1983.
- Hopes that the recovery will rival the rebound from the 1981-2 recession will likely be disappointing—the growth mix is heavily weighted toward one-hit wonders like cash for clunkers and the first-time homebuyer tax credit.
- Hiring plans and hours worked remain depressed as businesses weigh risks of healthcare reform, cap and trade legislation and less friendly business conditions.

### Global Review

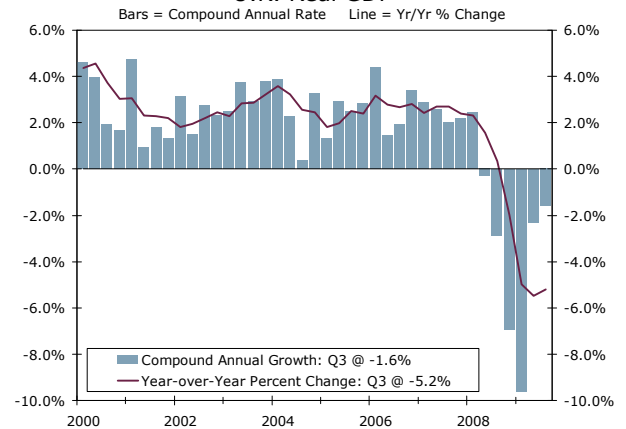
#### U.K. Economy Slumps for Sixth Consecutive Quarter

- U.K. GDP data that were released this week, which indicated that the British economy had contracted for the sixth consecutive quarter, were disappointing. Not only did the manufacturing and construction sectors weaken further, the service sector also posted a modest decline.
- The weaker-than-expected outturn raises the probability that the Bank of England will increase the size of its asset purchase program at next month's policy meeting. If so, sterling could encounter some selling pressure as the money supply rises further.

U.S. Hiring Rate  
Seasonally Adjusted



U.K. Real GDP



Wells Fargo U.S. Economic Forecast														
	Actual				Forecast				Actual			Forecast		
	2008		2009		2009		2010		2006	2007	2008	2009	2010	2011
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product <sup>1</sup>	-0.7	1.5	-2.7	-5.4	-6.4	-0.7	3.7	2.8	2.7	2.1	0.4	-2.4	2.4	2.2
Personal Consumption	-0.6	0.1	-3.5	-3.1	0.6	-0.9	2.3	0.0	2.9	2.6	-0.2	-0.8	1.0	1.4
Inflation Indicators <sup>2</sup>														
"Core" PCE Deflator	2.4	2.5	2.6	2.0	1.7	1.6	1.3	1.4	2.3	2.4	2.4	1.5	1.2	1.6
Consumer Price Index	4.2	4.3	5.2	1.5	-0.2	-0.9	-1.5	0.9	3.2	2.9	3.8	-0.4	1.6	2.0
Industrial Production <sup>1</sup>	0.2	-4.6	-9.0	-13.0	-19.0	-10.5	3.2	1.7	2.3	1.5	-2.2	-10.4	1.6	3.9
Corporate Profits Before Taxes <sup>2</sup>	-4.9	-12.0	-5.4	-25.1	-19.0	-12.6	-11.0	3.5	10.5	-4.1	-11.8	-10.6	7.8	9.8
Trade Weighted Dollar Index <sup>3</sup>	70.3	71.0	76.1	79.4	83.2	77.7	74.7	76.0	81.5	73.3	79.4	76.0	81.8	85.3
Unemployment Rate	4.9	5.4	6.1	6.9	8.1	9.3	9.6	10.0	4.6	4.6	5.8	9.2	10.4	9.9
Housing Starts <sup>4</sup>	1.06	1.02	0.87	0.66	0.53	0.54	0.60	0.60	1.81	1.34	0.90	0.57	0.66	0.80
Quarter-End Interest Rates														
Federal Funds Target Rate	2.25	2.00	2.00	0.25	0.25	0.25	0.25	0.25	5.25	4.25	0.25	0.25	1.25	3.25
Conventional Mortgage Rate	5.97	6.32	6.04	5.33	5.00	5.42	5.19	5.00	6.14	6.10	5.33	5.00	5.50	6.00
10 Year Note	3.45	3.99	3.85	2.25	2.71	3.53	3.31	3.40	4.71	4.04	2.25	3.40	3.80	4.40

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Forecast as of: October 7, 2009

<sup>1</sup> Compound Annual Growth Rate Quarter-over-Quarter

<sup>3</sup> Federal Reserve Major Currency Index, 1973=100 - Quarter End

<sup>2</sup> Year-over-Year Percentage Change

<sup>4</sup> Millions of Units

Together we'll go far



## U.S. Review

### After a Strong Start, Momentum will Fade

The Leading Economic Index rose a full percentage point in September, as eight of the ten indicators increased. The largest contributors were a wider interest rate spread, increased consumer expectations, and a decline in weekly unemployment claims. By contrast, the average workweek and building permits both declined. With September's increase, the LEI has risen for six consecutive months and is up at an 11.8 percent annual rate over that time period. This marks the strongest six-month pace for the LEI since August 1983, when the U.S. economy was in the midst of one of its strongest recoveries ever.

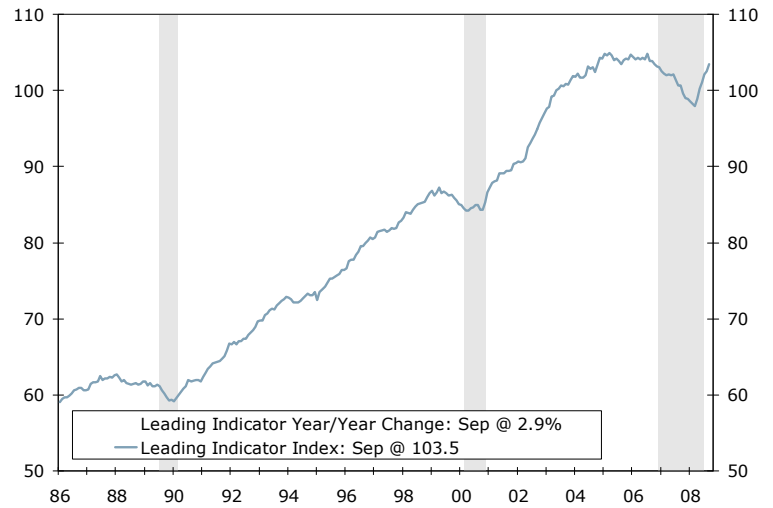
Hopes for another strong recovery appear to us to be considerably overblown. Much of the improvement in the LEI has come from the financial indicators and expectations for future economic conditions. The historic drawdown in inventories is also apparent in the LEI, showing up as a slower pace of deliveries. The closer you get to actual economic conditions, however, the less buoyant the figures look. Orders for consumer goods and nondefense capital goods show relatively little improvement and the average factory workweek's only real increase was in July, when motor vehicle output was restarted.

The coincident economic index, which measures current economic performance, was unchanged in September, following 0.1 percent gains in July and August. Continued declines in nonfarm payrolls and little to no growth in personal income and business sales are being offset by rising motor vehicle output. Increased motor vehicle output has lifted industrial production solidly over the past three months, benefitting a whole host of other industries ranging from steel to semiconductors. Without the lift from motor vehicle output, the improvement in industrial production would be imperceptible and the coincident economic index would still be negative.

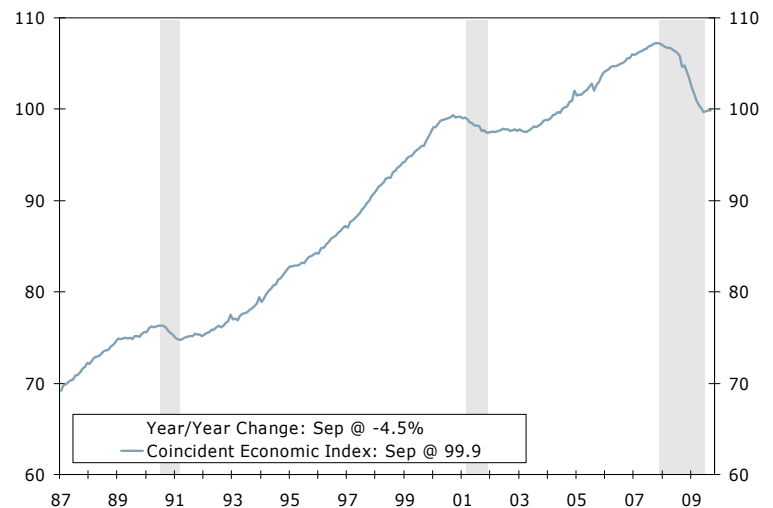
One area where there has been real improvement has been jobless claims. Weekly first-time unemployment claims peaked back in March and are currently down 21 percent from their high. Unfortunately, unemployment claims remain extremely high. Claims rose 11,000 during the latest week to 531,000. First-time unemployment claims averaged 532,250 over the past four weeks, which means that roughly 2,129,000 jobs were lost last month. Hiring remains well below that level, which means nonfarm employment likely posted another hefty decline during October.

Another area of improvement has been housing. Housing starts rose 0.5 percent in September and have now risen for five of the past six months. All of the improvement has been in single-family homes, which have risen in six of the past seven months. Much of that increase is being attributed to the \$8,000 tax credit for first-time homebuyers, which expires on November 30. Since home purchases must be closed by November 30, the impact of the tax credit on new home construction has likely passed. We expect home construction to stall out near current levels or even give back some of its recent gains. A sustainable rise in home construction will require tangible improvement in the labor market, which we have yet to see.

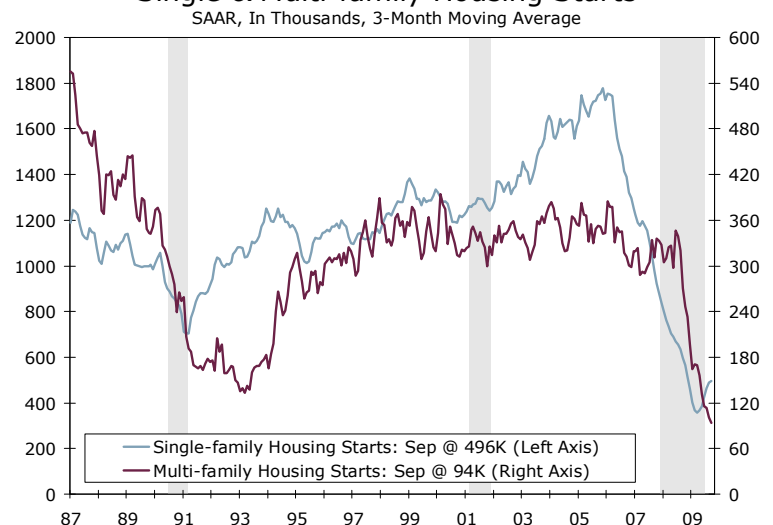
### Leading Indicator Index



### Coincident Economic Index



### Single & Multi-family Housing Starts



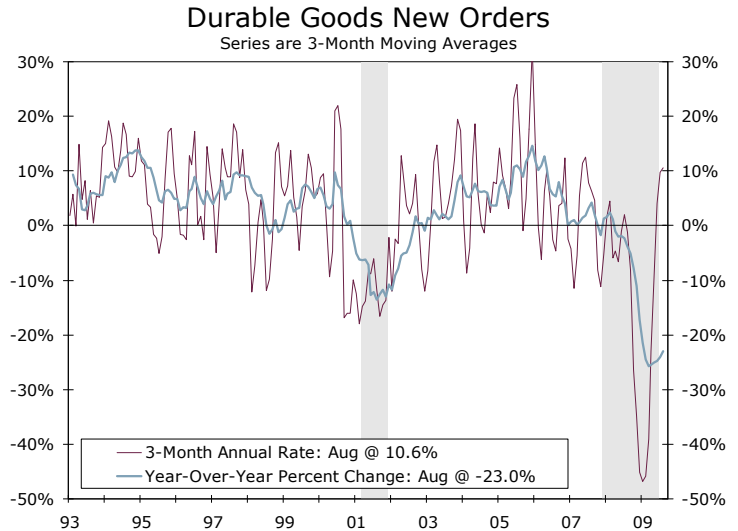
**Durable Goods • Wednesday**

New orders for durable goods fell 2.4 percent in August driven by a significant decline in nondefense aircraft orders. While orders appear to have fallen significantly, the “headline” tends to be extremely volatile on a month-to-month basis. The three month annual rate of nondefense capital goods orders excluding aircraft is a better gauge of manufacturing activity and it jumped to its highest level in over three years. Moreover, recent consecutive gains in industrial production suggest a similar rise in new durable goods orders in September. Hence, we expect “headline” durable goods orders to spike 4.8 percent in September. While motor vehicles and parts have played a key role in boosting the “headline,” orders excluding transportation were flat in August. Further, the continued depletion of inventories and increase in shipments suggest manufacturing activity is poised to pick up in coming months.

**Previous: -2.4%**

**Wells Fargo: 4.8%**

**Consensus: 0.9%**



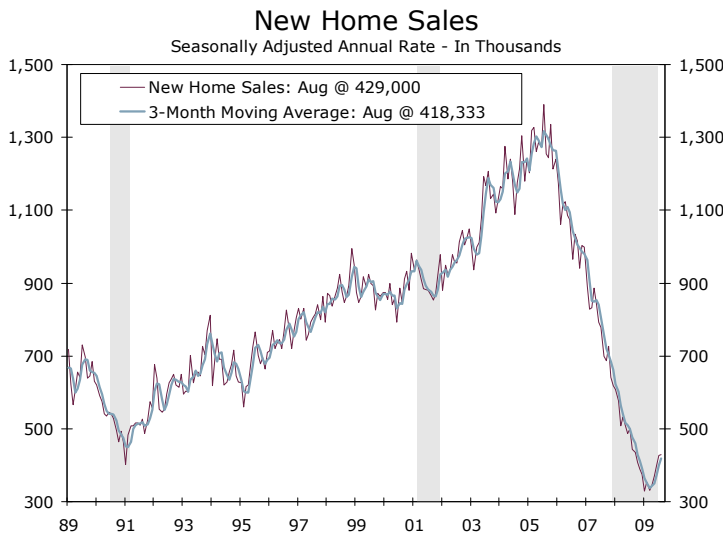
**New Home Sales • Wednesday**

New home sales rose for the fifth consecutive month in August and are well off of their lows reached earlier this year. With some of the improvement in sales being attributed to the first-time homebuyer tax credit, which is set to expire on November 30th, some retracement is likely. We are already beginning to see a slow down of the benefits from the program with sales rising only 0.7 percent in August, following a downwardly-revised 6.5 percent gain in July. We expect new home sales will likely rise only 0.2 percent in September to an annual pace of 430,000. While the pace of growth in new home sales is slowing, we do not expect a re-test of this year’s lows. Inventory levels continue to decline and are now at their lowest level since the early 1990s.

**Previous: 429K**

**Wells Fargo: 430K**

**Consensus: 440K**



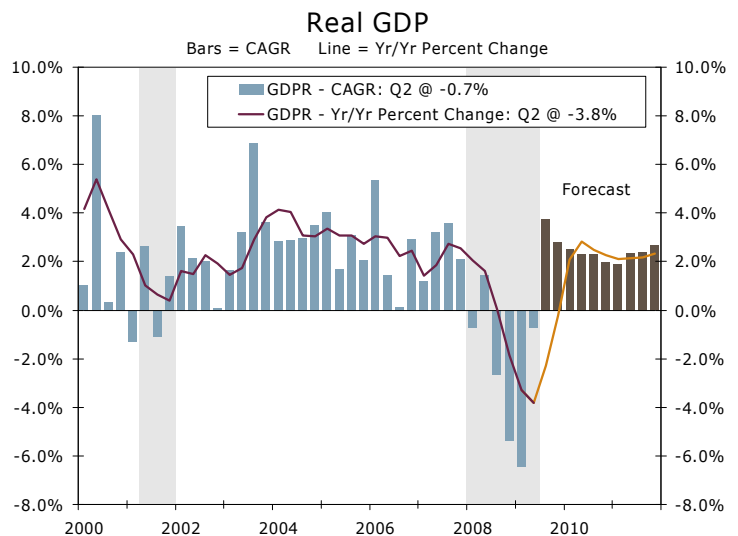
**GDP • Thursday**

Real GDP is expected to rise at a 3.7 percent annual pace in the third quarter and average a 3.1 percent pace for the second half of this year. The rise in GDP will likely mark the end of the most severe recession in the postwar era, but growth at this robust pace will likely be unsustainable. Much of the improvement will merely reflect stronger economic growth overseas which is boosting demand for exports, federal government spending and a reduction in the rate of inventory liquidations. Residential construction will also likely make a modest positive contribution after contracting from economic growth for 14 consecutive quarters. A sustainable economic recovery, however, will require an improvement in final demand in the private sector which remains exceptionally weak. Real GDP is expected to grow at an annual rate of 2.4 percent in 2010 which will make for a very sluggish recovery.

**Previous: -0.7%**

**Wells Fargo: 3.7%**

**Consensus: 3.0%**



## Global Review

### U.K. Economy Slumps for Sixth Consecutive Quarter

News released this week that real GDP in the United Kingdom slumped 0.4 percent (not annualized) in the third quarter relative to the previous quarter was very disappointing. Not only was the outturn much worse than expected—the consensus forecast had looked for a modest increase—but the data show that the economy is now about 6 percent smaller than it was when it peaked in the first quarter of 2008. The news came as a surprise because the purchasing managers' indices had suggested that the economy was expanding modestly (top graph). In addition, previously released data on consumer confidence, which rose to its highest level since April 2008, and the volume of retail sales had suggested that real personal consumption expenditures had grown somewhat in the third quarter.

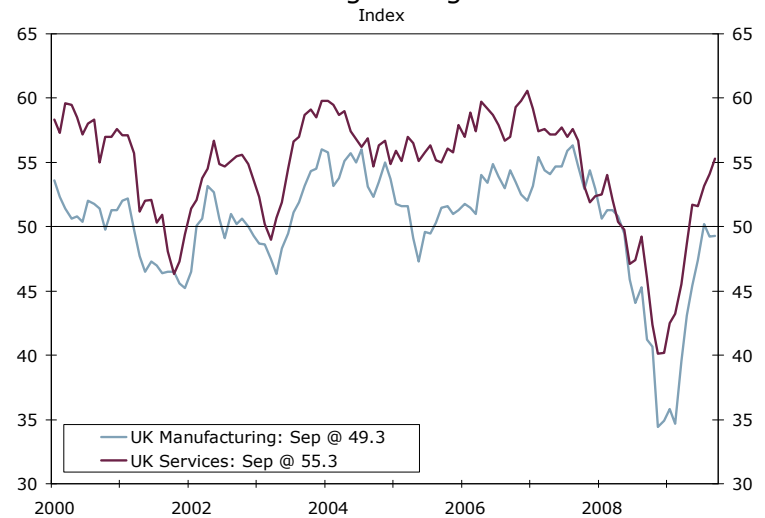
A detailed breakdown of real GDP into its underlying demand components will not be available for a few more weeks. However, preliminary data suggest that construction spending and industrial production were notably weak in the third quarter. British statistical authorities said that the former fell 1.1 percent and the latter was off 0.7 percent. Relative to last year, industrial production is down more than 10 percent (middle chart). Output in the service sector also appears to have contracted modestly.

One way to square the apparent growth in retail spending with the decline in overall GDP is via inventories. That is, British producers may still be slashing production to bring stocks back in line with final sales. If the soon-to-be-released demand-side components indicate that de-stocking did indeed weigh heavily on real GDP in the third quarter, then there may be a silver lining in the data. Namely, inventories may boost GDP over the next few quarters as the pace of de-stocking eases. Moreover, recoveries that appear to be underway in other parts of the world should eventually translate into stronger exports. The recent weakness of sterling, especially against the euro, should also help to bolster British exports (bottom chart).

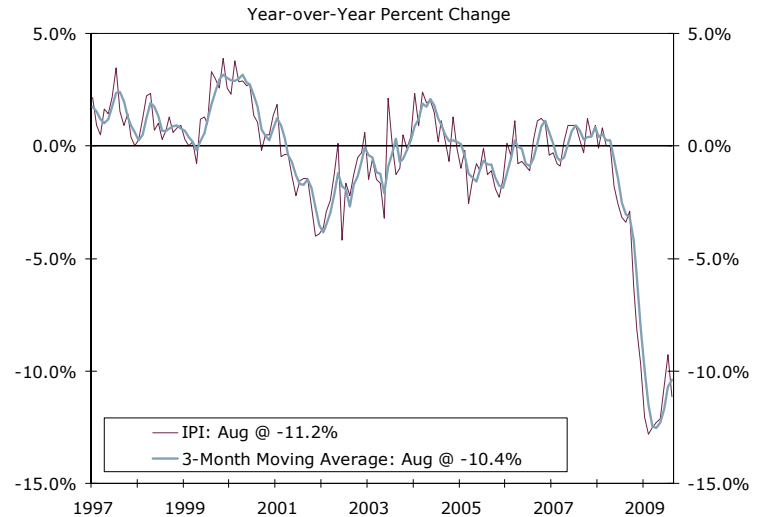
What are the implications of the weaker-than-expected GDP data for Bank of England monetary policy going forward? The minutes of the Bank's policy meeting in early October showed that all nine members of the Monetary Policy Committee (MPC) voted to keep the Bank's main policy rate at 0.50 percent, where it has been maintained since early March. In addition, the MPC decided to keep the size of its unconventional asset purchase program unchanged at £175 billion. However, the minutes also indicate that the MPC would revisit the size of the asset purchase program next month when the quarterly *Inflation Report* is prepared.

In our view, the disappointing GDP data raises the probability that the MPC will increase the size of its asset purchase program. Until a self-sustaining recovery is underway, the MPC may err on the side of additional monetary stimulus. If the MPC does indeed announce plans next month to step up its purchases of government and corporate bonds, which would have the effect of further increasing the U.K. money supply, the British pound could come under some selling pressure.

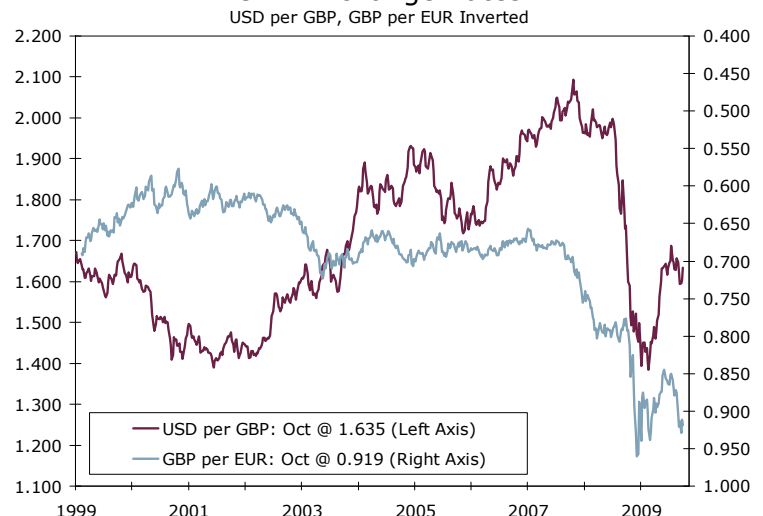
### UK Purchasing Manager Indices



### U.K. Industrial Production Index



### U.K. Exchange Rates



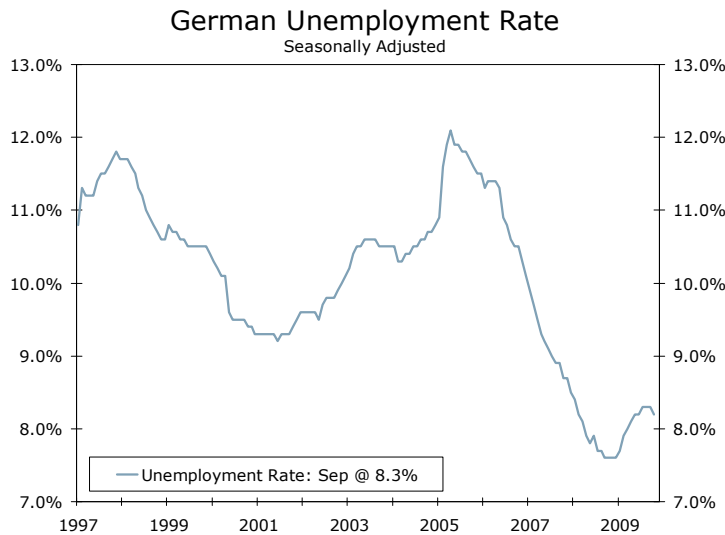
## Japanese Industrial Production • Thursday

The usual end-of-the-month barrage of Japanese economic data will hit the wires next week. Industrial production (IP) data for September will be one of the most closely watched releases. Since the bottom in February, IP is up 20 percent, but still remains down 18 percent year-over-year. It seems likely that production rose again in September, but probably at a slower rate. September data on retail sales and housing starts will also print next week.

Over the past year, the unemployment rate has risen from less than 4 percent to nearly 6 percent. The rate ticked down from 5.7 percent in July to 5.5 percent in August, and data that are slated for release on Friday will show whether this new trend continued in September. Due to economic weakness and the negative rate of CPI inflation, the Bank of Japan clearly will refrain from hiking rates at its policy meeting on Friday.

**Previous: 1.6% (month-on-month change)**

**Consensus: 1.0%**

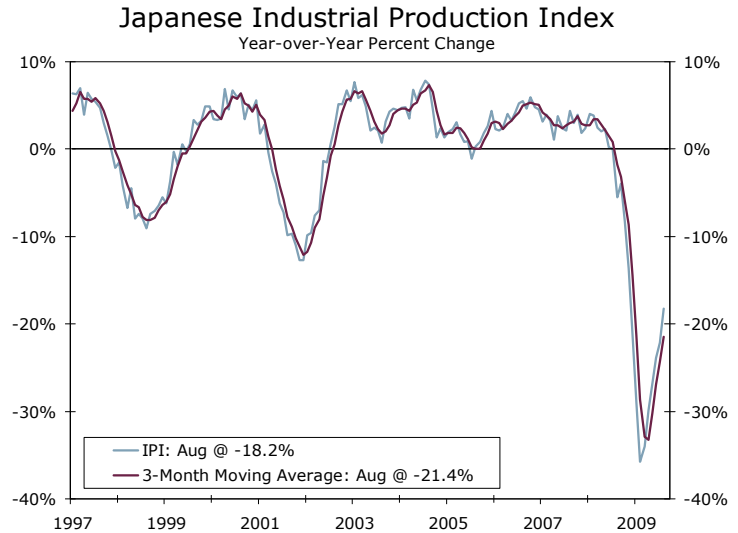


## Canadian GDP • Friday

Signs of stabilization in the Canadian economy are beginning to emerge. Real GDP increased slightly in June, the first monthly increase since the summer of 2008, and was flat in July. Economic activity will likely strengthen in coming months. The market expects August GDP data to show economic growth remained neutral. The Canadian labor market has exhibited signs of strength in recent months. Payrolls have added more than 50,000 new workers in the past two months—a number commensurate with a gain in the United States of over half a million jobs. As the labor market improves, consumer spending and economic recovery are not far behind. On Thursday September's price data for industrial products and raw materials will be published. Raw material prices may reflect the recent jump in commodities, while industrial product prices will likely remain benign.

**Previous: 0.0% (Month over Month)**

**Consensus: 0.0%**



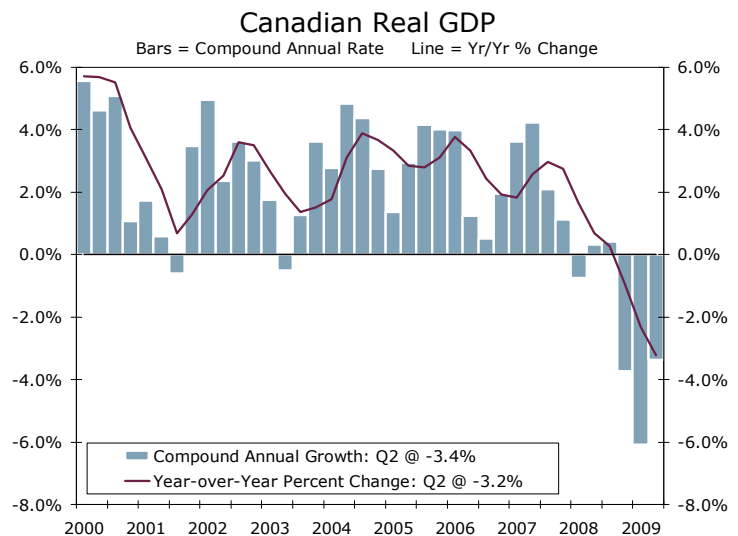
## German Unemployment Rate • Thursday

Real GDP in Germany plunged nearly 7 percent between the first quarter of 2008 and the first quarter of this year. However, the unemployment rate has risen only ½ percentage point over that time. Not only has the government implemented a program that allows employees to work shorter shifts, but some German businesses may be hoarding labor. If a sustainable recovery in Germany fails to take hold, the unemployment rate could rise significantly once the government program expires and businesses realize they can no longer afford to hoard labor.

Speaking of sustainable recoveries, retail sales in Germany have been weak over the past year or so. Indeed, the value of retail sales was off 2.6 percent in August relative to the same month last year. Data on retail spending in September print on Friday.

**Previous: 8.2%**

**Consensus: 8.3%**



**Interest Rate Watch**

**A “Return to More Normal Levels”**

In his editorial last week, Mervyn King, Governor of the Bank of England, offered investors and private/public sector decision-makers some guidance on the direction of long interest rates—they are going up. We agree.

Four forces provide the upward bias for interest rates. First, economic expectations will bias credit demands upward while the supply of credit will increasingly shift towards riskier assets and thereby the demand for Treasury debt will likely diminish on a relative basis.

Second, while interest from both the Fed and the investor class will wane for Treasury debt the supply of debt will continue to increase as Federal deficits expand, reflecting outsized spending relative to revenue gains.

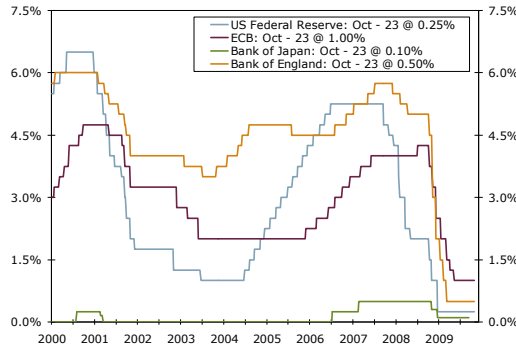
Third, the weaker dollar will increase currency risk in buying U.S. dollar denominated assets. Moreover, the current outlook is for public policy in the U.S. to exercise its “benign neglect” as in an earlier generation. The Treasury Department is responsible for the currency and at this point there appears to be little interest in altering public policy to shore up the dollar.

Finally, the intriguing challenge for financial markets will be the interplay between monetary and fiscal policy as the Federal Reserve attempts to exit the bond market. By the end of October the Fed will discontinue its purchases of Treasury debt and by March, 2010, the Fed will discontinue purchases of MBS and ABS securities. Such an exit strategy will be associated with a rise in interest rates if all else remains the same.

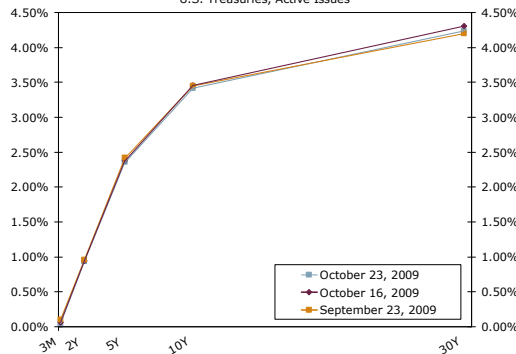
There are three steps in this process that will raise issues. First, how much will rates rise without the Fed’s direct support? Second, how much will any rate increase affect mortgage and consumer lending rates? Third, how much will any change in rates impact the economy and what will be the political response?

Any exit strategy becomes part of a political tug-of-war that will balance the Fed’s independence and the political concerns for reviving housing and the jobs market.

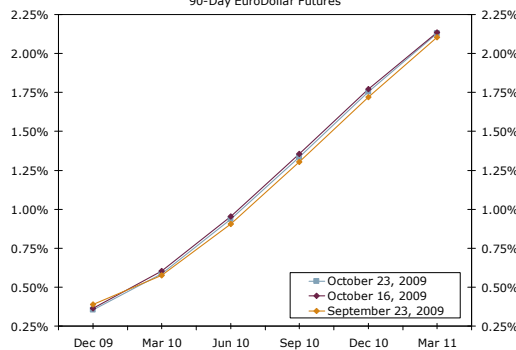
Central Bank Policy Rates



Yield Curve  
U.S. Treasuries, Active Issues



Forward Rates  
90-Day EuroDollar Futures



**Consumer Credit Insights**

**A Peak in Delinquencies?**

Historically, consumer credit delinquencies lag the business cycle. Our expectation is that the economy began to turn early summer. Recently we have noticed that selected delinquency series (prime adjustable mortgages and subprime adjustable-rate mortgages) appear to have peaked.

On the one side, household income and employment fundamentals remain weak. Consumer confidence, measured by the University of Michigan survey, has improved modestly but remains far below the levels associated with the last expansion.

So what has changed? Two aspects of the housing market may have supported this change in trends. First, the first-time buyer program coupled with the vast improvement in housing affordability has altered the demand side of the housing market. Buyers have a stronger hand and therefore are better able to purchase homes for which the seller may in some cases be delinquent. Second, foreclosure and delinquency intervention programs have probably led to the restructuring of financing for some delinquent owners and therefore now these efforts are starting to appear as peaks in the delinquency data.

Consumer credit delinquencies are a cyclical phenomenon and while the current rates are high these rates appear to have peaked in some instances and so consumer credit quality is likely to improve ahead.

**Mortgage Data**

	Current	Week Ago	4 Weeks Ago	Year Ago
<b>Mortgage Rates</b>				
30-Yr Fixed	5.00%	4.92%	5.04%	6.04%
15-Yr Fixed	4.43%	4.37%	4.46%	5.72%
5/1 ARM	4.40%	4.38%	4.51%	6.06%
1-Yr ARM	4.54%	4.60%	4.52%	5.23%
<b>MBA Applications</b>				
Composite	641.0	742.9	668.5	408.1
Purchase	268.8	290.9	288.3	279.3
Refinance	2,808.0	3,374.6	2,881.5	1,158.8

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

## Topic of the Week

### What Is Gold Telling Us?

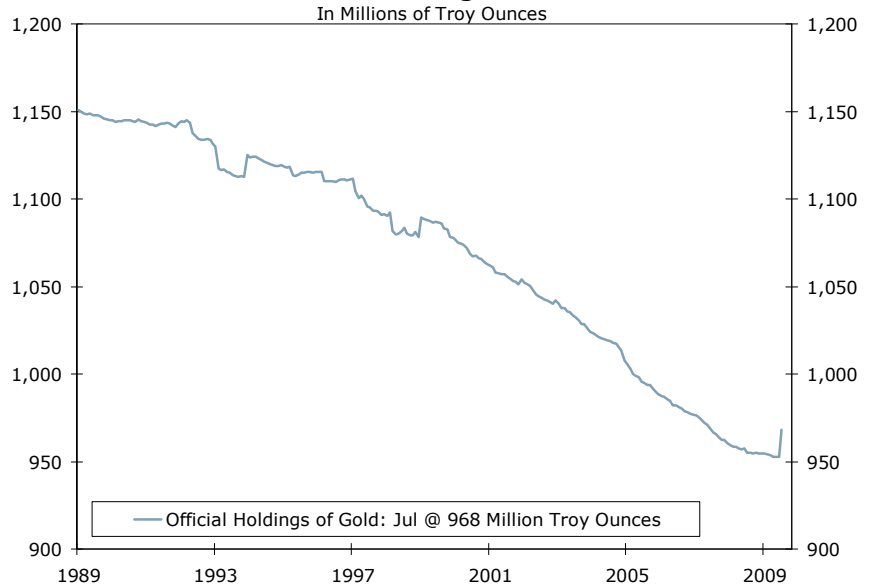
Some observers have interpreted the record rise in the price of gold recently as a warning that the United States is on the cusp of another inflationary period à la the late 1970s and early 1980s. However, other early warning indicators of inflation, such as yields on U.S. Treasury securities and measures of consumer inflation expectations, do not support the hypothesis that investors are universally concerned about a period of runaway inflation.

Rather, the recent rise in the price of gold appears to be related, at least in part, to attempts by foreign central banks to diversify their reserve holdings on a flow basis. After years of reducing their holdings of gold, foreign central banks bought a record amount of the precious metal in July and anecdotal evidence suggests that their net purchases have continued over the past few months. Speculators appear to be jumping on the pile as well. Since early September open interest has increased by 165,000 contracts, the largest six-week rise in about 10 years. Although it is impossible to determine how much central banks wish to increase their holdings of gold, the big decline in their gold portfolios that has occurred over the past two decades suggests that they have scope to continue buying gold for some time.

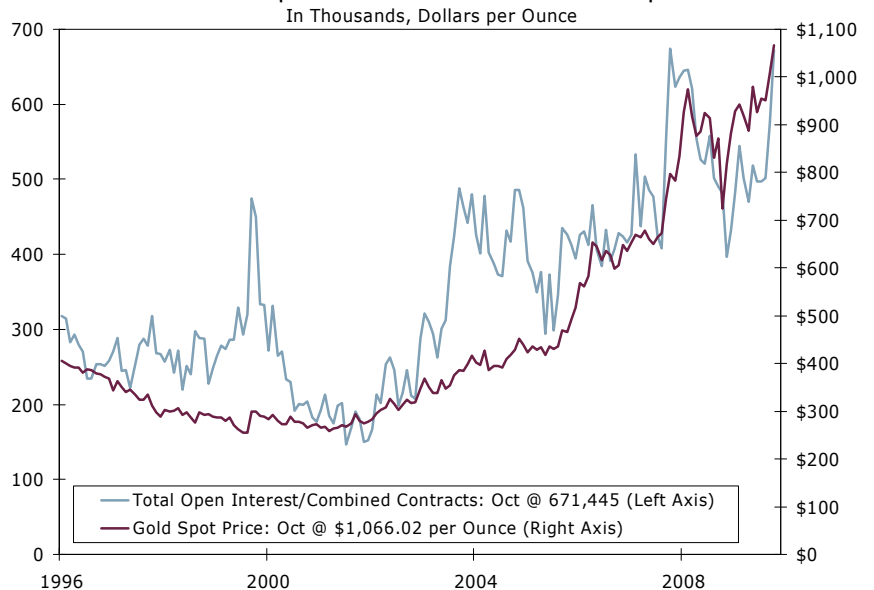
Interest by foreign central banks to increase their gold holdings begs a more fundamental question. Have they lost confidence in the dollar? Probably not, at least not yet. Foreign central banks have purchased \$53 billion worth of Treasury securities over the past 12 months. Although the pace of purchases has slowed from its rate of a year or so ago, we think foreign central banks would have become outright net sellers of Treasury securities if they had “lost confidence” in the greenback. Foreign central banks are not dumping dollars, but they appear to be diversifying away from the greenback on a flow basis.

For the full report, please see “What Is Gold Telling Us?” (October 20, 2009), which is posted on our website.

### Official Holdings of Gold



### Gold: Total Open Interest Contracts vs. Spot Price



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## Market Data ♦ Mid-Day Friday

## U.S. Interest Rates

	Friday 10/23/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.05	0.06	0.97
3-Month LIBOR	0.28	0.28	3.54
1-Year Treasury	0.45	0.45	1.17
2-Year Treasury	1.00	0.95	1.60
5-Year Treasury	2.42	2.35	2.63
10-Year Treasury	3.47	3.41	3.67
30-Year Treasury	4.28	4.24	4.05
Bond Buyer Index	4.31	4.32	5.32

## Foreign Exchange Rates

	Friday 10/23/2009	1 Week Ago	1 Year Ago
Euro (\$/€)	1.502	1.491	1.293
British Pound (\$/£)	1.639	1.636	1.623
British Pound (£/€)	0.917	0.911	0.797
Japanese Yen (¥/\$)	91.850	90.891	97.305
Canadian Dollar (C\$/\\$)	1.052	1.037	1.247
Swiss Franc (CHF/\\$)	1.007	1.018	1.159
Australian Dollar (US\\$/A\\$)	0.926	0.916	0.670
Mexican Peso (MXN/\\$)	12.903	13.111	13.417
Chinese Yuan (CNY/\\$)	6.829	6.827	6.836
Indian Rupee (INR/\\$)	46.520	46.308	49.820
Brazilian Real (BRL/\\$)	1.712	1.710	2.261
U.S. Dollar Index	75.268	75.597	85.360

## Foreign Interest Rates

	Friday 10/23/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.69	0.69	4.92
3-Month Sterling LIBOR	0.60	0.57	6.01
3-Month Canadian LIBOR	0.50	0.50	3.14
3-Month Yen LIBOR	0.33	0.33	1.01
2-Year German	1.39	1.42	2.78
2-Year U.K.	0.91	0.88	3.25
2-Year Canadian	1.52	1.60	2.12
2-Year Japanese	0.28	0.25	0.72
10-Year German	3.34	3.29	3.78
10-Year U.K.	3.67	3.60	4.47
10-Year Canadian	3.49	3.48	3.62
10-Year Japanese	1.37	1.34	1.51

## Commodity Prices

	Friday 10/23/2009	1 Week Ago	1 Year Ago
WTI Crude (\\$/Barrel)	81.59	78.53	67.84
Gold (\\$/Ounce)	1065.15	1053.60	721.45
Hot-Rolled Steel (\\$/S.Ton)	515.00	555.00	860.00
Copper (\\$/Pound)	303.00	283.75	179.55
Soybeans (\\$/Bushel)	10.01	9.78	8.24
Natural Gas (\\$/MMBTU)	5.03	4.78	6.42
Nickel (\\$/Metric Ton)	19,078	18,735	9,813
CRB Spot Inds.	434.30	430.42	376.40

## Next Week's Economic Calendar

	Monday 26	Tuesday 27	Wednesday 28	Thursday 29	Friday 30
U.S. Data		<b>Consumer Confidence</b> September 53.1 October 53.2 (W)	<b>Durable Goods Orders</b> August -2.4% September 4.8% (W) <b>Durables Ex. Transp.</b> August 0.0% September 1.2% (W) <b>New Home Sales</b> August 429K September 430K (W)	<b>GDP</b> 2Q -0.7% 3Q 3.7% (W)	<b>Personal Income</b> August 0.2% September 0.1% (W) <b>Personal Spending</b> August 1.3% September -0.5% (W) <b>Core PCE Deflator (YoY)</b> August 1.3% September 1.3% (W)
Global Data				<b>Japan</b> <b>Industrial Prod. (MoM)</b> Previous (Aug) 1.6% <b>Germany</b> <b>Unemployment Rate</b> Previous (Sep) 8.2%	<b>Canada</b> <b>GDP (MoM)</b> Previous (Jul) 0.0% <b>Japan</b> <b>Jobless Rate</b> Previous (Aug) 5.5%

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

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