September 04, 2009

Economics Group

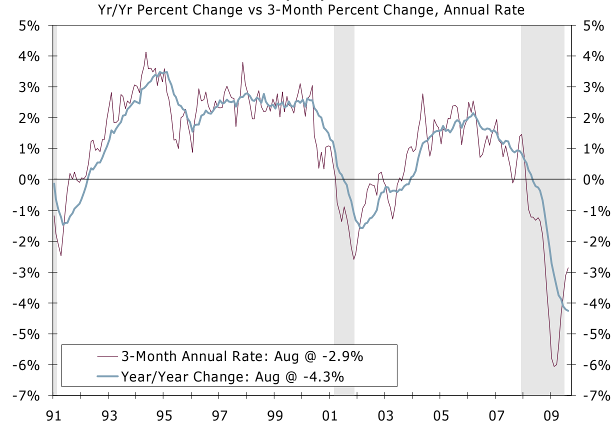
Weekly Economic & Financial Commentary

U.S. Review

Employment Not so Bad; Manufacturing Getting Better

- Employment fell just 216,000 with job losses concentrated in construction and manufacturing. Wage growth remains limited such that personal income and thereby consumption gains will also limit the pace of economic recovery.
- Manufacturing gains were signaled by the ISM manufacturing index with improvement in orders, production and vendor performance. Economic recovery with low inflation remains the outlook. However, the pace and sustainability of growth remains dependent on the exit strategies for both fiscal and monetary policies.

Nonfarm Employment Growth
Yr/Yr Percent Change vs 3-Month Percent Change, Annual Rate

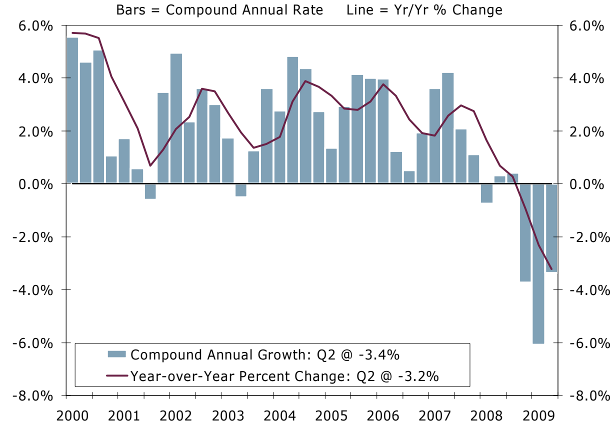


Global Review

Canadian Economy Seems Poised for Recovery

- Canadian GDP contracted at a 3.4 percent annualized pace in the second quarter as net exports of goods and services exerted the largest drag on growth. But GDP for the month of June grew 0.1 percent. While this increase was more modest than expected by the consensus, it may mark the end of the recession for the Canadian economy. It was the first increase in total monthly GDP since July 2008.
- The job market in Canada has shown early signs of recovery as well. In fact, the economy added 27.1K jobs in August, and the unemployment rate came down a bit.

Canadian Real GDP
Bars = Compound Annual Rate Line = Yr/Yr % Change

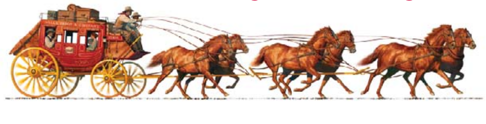


Wells Fargo U.S. Economic Forecast

	Actual						Forecast		Actual				Forecast	
	2008				2009				2005	2006	2007	2008	2009	2010
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product [1]	-0.7	1.5	-2.7	-5.4	-6.4	-1.0	3.4	2.6	3.1	2.7	2.1	0.4	-2.5	2.1
Personal Consumption	-0.6	0.1	-3.5	-3.1	0.6	-1.2	2.0	1.6	3.4	2.9	2.7	-0.2	-0.8	1.1
Inflation Indicators [2]														
"Core" PCE Deflator	2.4	2.5	2.6	2.0	1.7	1.6	1.3	1.2	2.3	2.3	2.4	2.4	1.5	1.2
Consumer Price Index	4.2	4.3	5.2	1.5	-0.2	-0.9	-1.8	0.5	3.4	3.2	2.9	3.8	-0.6	1.4
Industrial Production [1]	0.2	-4.6	-9.0	-13.0	-19.1	-11.6	5.3	2.9	3.3	2.3	1.5	-2.2	-10.3	1.8
Corporate Profits Before Taxes[2]	-4.9	-12.0	-5.4	-25.1	-19.0	-14.0	-11.0	2.0	16.8	10.5	-4.1	-11.8	-11.2	7.0
Trade Weighted Dollar Index[3]	70.3	71.0	76.1	79.4	83.2	77.7	78.5	80.9	86.0	81.5	73.3	79.4	80.9	81.4
Unemployment Rate	4.9	5.4	6.1	6.9	8.1	9.3	9.6	10.0	5.1	4.6	4.6	5.8	9.2	10.1
Housing Starts[4]	1.06	1.02	0.87	0.66	0.53	0.54	0.59	0.64	2.07	1.81	1.34	0.90	0.58	0.79
Quarter-End Interest Rates														
Federal Funds Target Rate	2.25	2.00	2.00	0.25	0.25	0.25	0.25	0.25	4.25	5.25	4.25	0.25	0.25	0.75
Conventional Mortgage Rate	5.97	6.32	6.04	5.33	5.00	5.42	5.50	5.40	6.27	6.14	6.10	5.33	5.40	5.80
10 Year Note	3.45	3.99	3.85	2.25	2.71	3.53	3.80	3.80	4.39	4.71	4.04	2.25	3.80	4.20

Forecast as of: August 12, 2009
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units

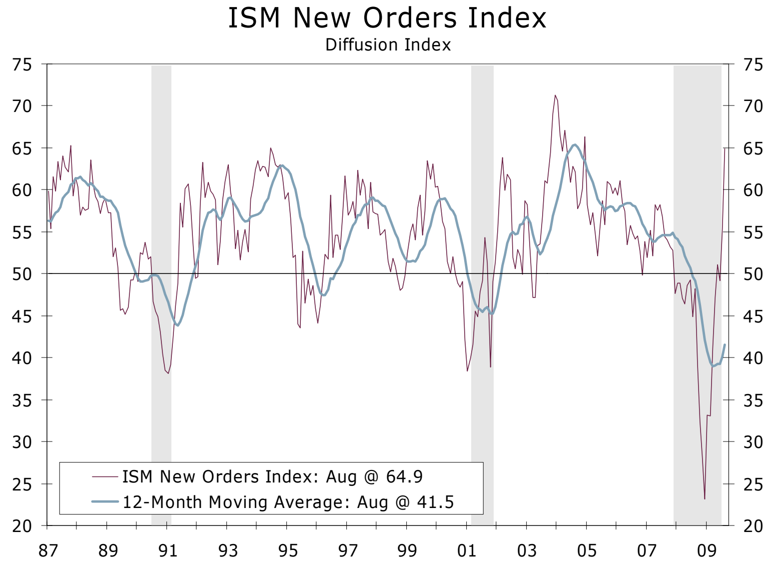
Inside



U.S. Review

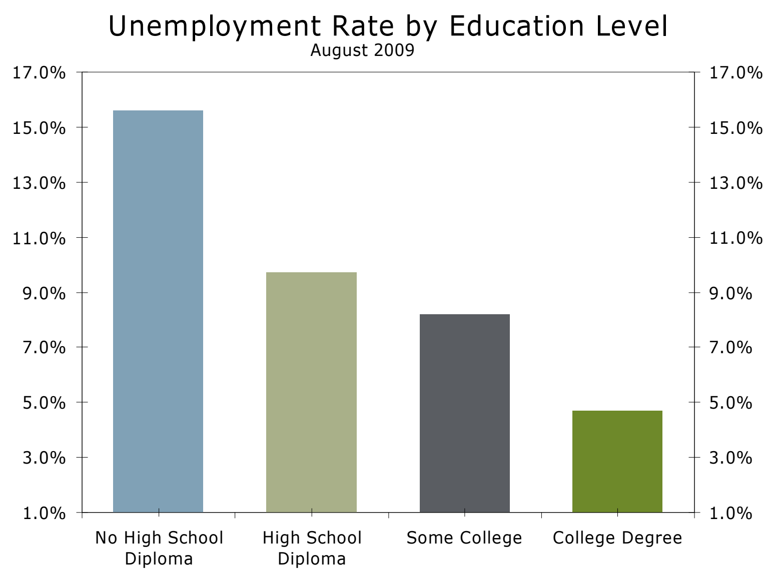
The Many Faces of Recovery

The economy presents many different faces depending on how we peel through the data to reveal the inner core. While on the surface economic signals for recovery are there, there is a creeping uneasiness that the character of this recovery already is different than prior recoveries. In August, the ISM manufacturing index broke above the 50 breakeven with gains in new orders, production and supplier deliveries. New orders, which preface production and employment advances, have been a very reliable leading indicator of recovery. Yet, beneath the surface lurks twin evils of weak employment and rising prices. The employment index remains below breakeven and manufacturing jobs have declined 76,000 over the last three months. Meanwhile, prices paid have risen steadily and are far above breakeven, suggesting upward pressure on input prices for production and thereby further depressing corporate profits.



Employment, both an economic and a political benchmark, serves as a lightening rod for the progress and character of the economic recovery. Employment fell 216,000 in August compared to 276,000 in July, with service-producing jobs declining much less than goods-producing. In fact, job losses in manufacturing actually rose to 63,000 from 43,000. Education and health was the big gainer but this may be overstated due to seasonal adjustment factors. Average hourly earnings declined by 2.6 percent year-over-year, and combined with job losses, suggest that earned personal income remains weak. Consumer spending will also likely remain subdued.

The unemployment rate for college-educated workers remained at 4.7 percent while the unemployment rate for workers with less than a high school diploma rose to 15.6 percent. In a labor market driven by demand for skilled workers, especially in the service sector, this month's employment report should not be a surprise. Cyclical recovery in the labor market faces several structural challenges. Progress of employment in this recovery compared to prior recoveries dramatically lags the path of the average gain in employment. First, unemployment is very centralized. Metropolitan area employment data released this week highlighted that of the 19 metro areas with unemployment rates above 15 percent, eight are in California (reflecting housing-related weakness) and five in Michigan (reflecting manufacturing declines).



Second, the first year of an economic recovery has been jobless since the 1970s. This is not a recent phenomenon. One possible culprit is the rising average duration of employment since the 1970s. Secular forces are most likely the culprit here with one likely suspect the increasing percentage of permanent compared to temporary workers over time.

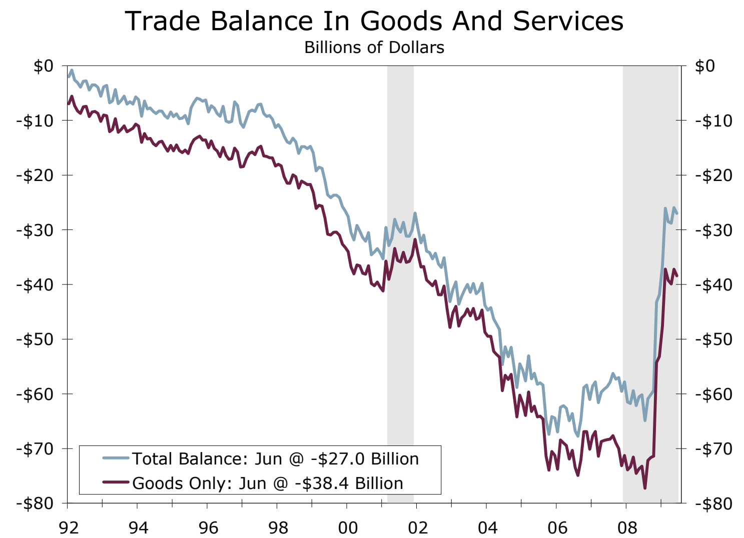
Third, manufacturing job growth peaked in 1994. Manufacturing jobs as a percent of the labor force has been declining since 1979 primarily due primarily to productivity gains and capital/labor substitution in the production process. All of this suggests that the nature of the labor market is changing over time and that cyclical gains are limited by secular change.

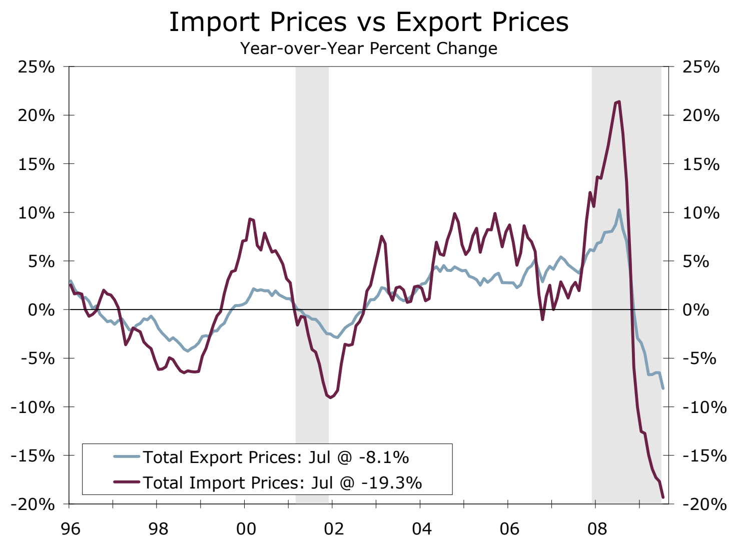
Trade Balance • Thursday

The trade deficit widened in June to $27 billion, which was less than the Bureau of Economic Analysis forecasted and suggests June's trade data will likely lead to a 0.2 percentage point upward revision to second quarter GDP growth, all else equal. For the second consecutive month, we expect the trade deficit to widen. The trade balance will likely widen to $29.2 billion in July. Both exports and imports rose in June around two percent on the month and were driven by a spike in industrial supplies led by crude oil. Strengthening economic growth in some of our major trading partners may account for the recent rise in exports and imports. In the coming months, we should see the trade deficit begin to narrow as oil prices have stabilized and import volume begins to edge higher.

Previous: -$27.0B **Wells Fargo: -$29.2B**

Consensus: -$27.0B





Import Prices • Friday

Import prices fell 0.7 percent in July, the first decline in six months. Headline import prices peaked in July 2008 when imported petroleum prices were the highest on record. As such, year ago levels are now down nearly 20 percent, the biggest decline on record. Excluding petroleum, import prices are now down 7.3 percent year over year. Capital and consumer goods also continued to edge lower in July. Import prices should continue to trend downward as oil prices and sluggish economic growth in the rest of the world continue to exert downward pressure. Moreover, the dollar will likely trend modestly higher against most major currencies through the end of 2009 which will also help to hold import prices down.

Previous: -0.7% **Wells Fargo: -0.5%**

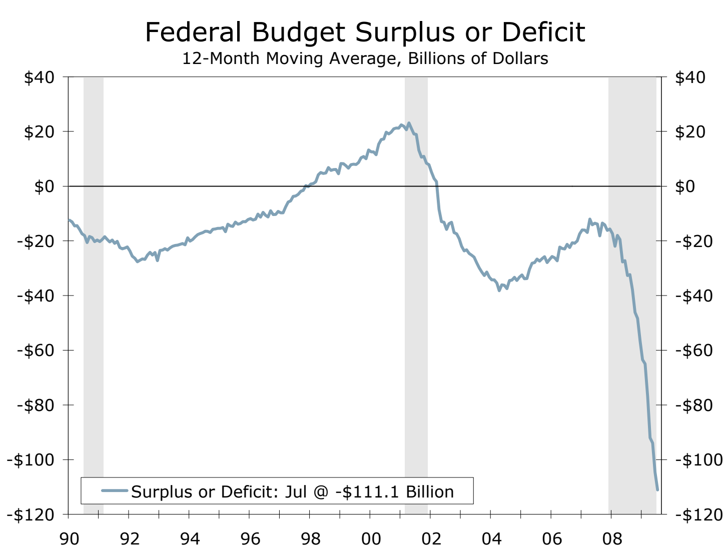
Consensus: 1.0%

Monthly Budget Statement • Friday

The U.S. federal budget deficit reached the $1 trillion dollar mark in June 2009 and now stands at $1.27 trillion, fiscal year-to-date. The Congressional Budget office (CBO) estimates that the 2009 federal budget deficit will likely reach $1.6 trillion, which at 11.2 percent of GDP, will be the highest in the post-War era. The CBO also projects the widely watched debt-to-GDP ratio will rise to 53.8 percent in 2009. The federal budget deficit continues to expand due to weak revenue and increased spending. Federal outlay growth is now 26 percent higher than year ago levels with Social Security and Medicare making up 34 percent of total federal expenditures in July. Receipts, which typically lag the recovery, are now down six percent from a year ago. These deficits will influence the allocation of global savings and the path of interest rates for the future.

Previous: -$111.9B

Consensus: -$174.0B



Global Review

A Recovery in Global Trade Would be Good for Canada

The slowdown in global trade in general and the recession in the United States in particular continued to be an impediment to Canadian economic growth in the second quarter. Net exports weighed on growth in the second quarter as both imports and exports continued to fall, though the pace of decline was slower than it was in the first quarter of this year. Net exports exerted a 3.5 percentage point drag to the annualized rate of growth for the quarter. Although net exports were the largest negative for growth, various indicators of global trade suggest that international commerce is beginning to pick back up, which means the second quarter may have marked the low point for Canadian trade and the economy may actually receive a boost from net exports in coming months. In fact, while trade was the biggest negative for GDP in Q2, monthly GDP data show that wholesale trade was actually the biggest positive for GDP for the last month of the quarter. The turnaround may already be under way.

Business spending was also negative in the second quarter as companies scrambled to cut costs. Investment in almost all categories of equipment and machinery showed declines during the quarter. Manufacturers have slowed production and have used existing stockpiles to meet current orders, which resulted in another quarter of contraction in inventories. This is the third straight quarter of negative contribution from inventories, and while this negatively impacted second quarter growth it may set the stage for a turnaround in the third quarter.

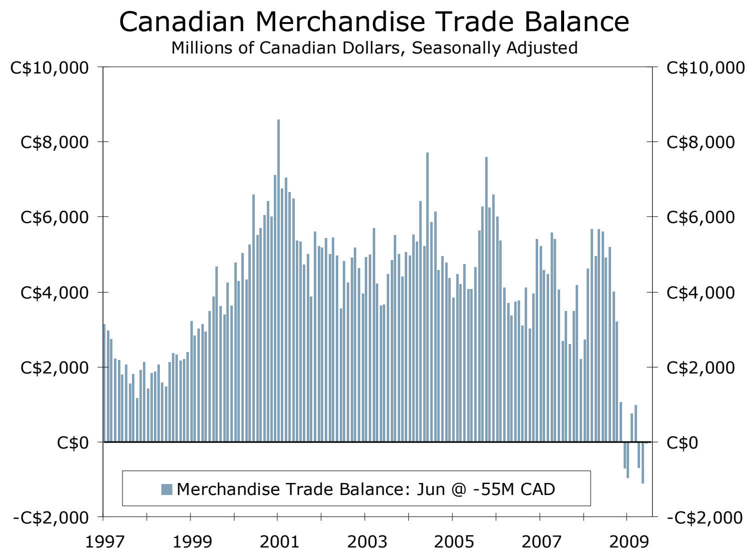
Domestic Demand Remains Steady

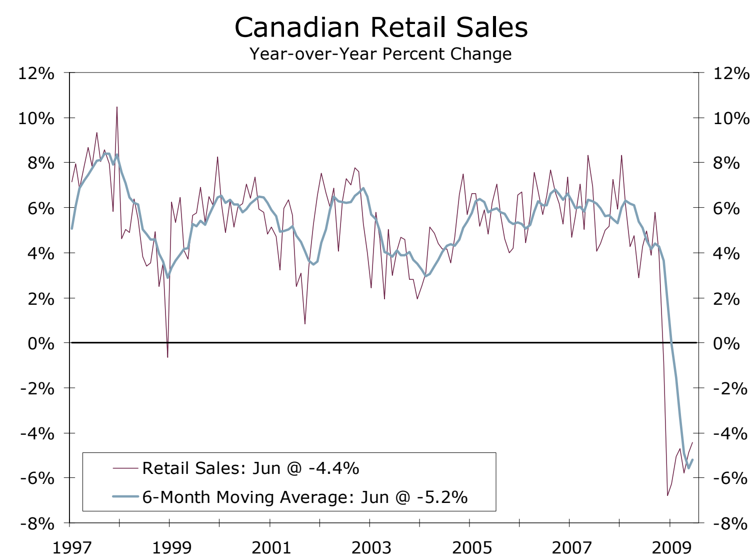
Recent housing data out of Canada have been generally stronger than expected. Investment in residential structures picked up in the second quarter reversing five straight quarters of declines in housing.

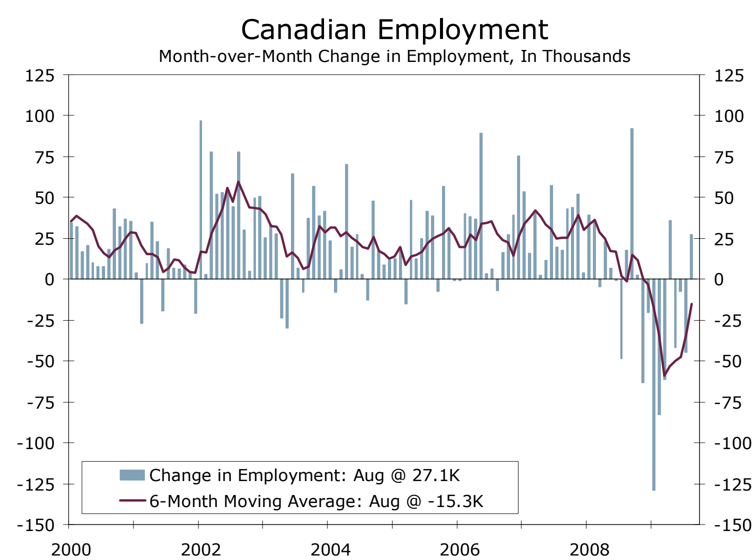
But the largest positive contribution to second quarter economic growth came from consumer spending which contributed 1.1 percentage points. As the nearby chart shows, Canadian retail sales fell off a cliff as the financial crisis intensified last fall, but on a sequential basis, they have turned the corner in recent months. If this trend continues and rising consumer spending combines with a turnaround in trade and a rebuilding of inventories, we would not be surprised to see GDP jump in the third quarter.

Job Market Recovering

Whether or not the Canadian consumer will continue to spend in the months ahead is partly dependent on employment. Monthly changes in Canadian nonfarm payrolls have a tendency to be highly volatile. A six-month moving average (reflected by the line in the bottom chart) can filter out some of the "noise" and reveal the broader trend, which has also picked up in recent months. The bulk of the layoffs appear to be behind us. In fact, Canada added 27.1K jobs in August, and the unemployment rate came down to 8.7 percent. One month does not a trend make, but if this sort of job growth proves sustainable, it could be supportive of consumer spending during the recovery.







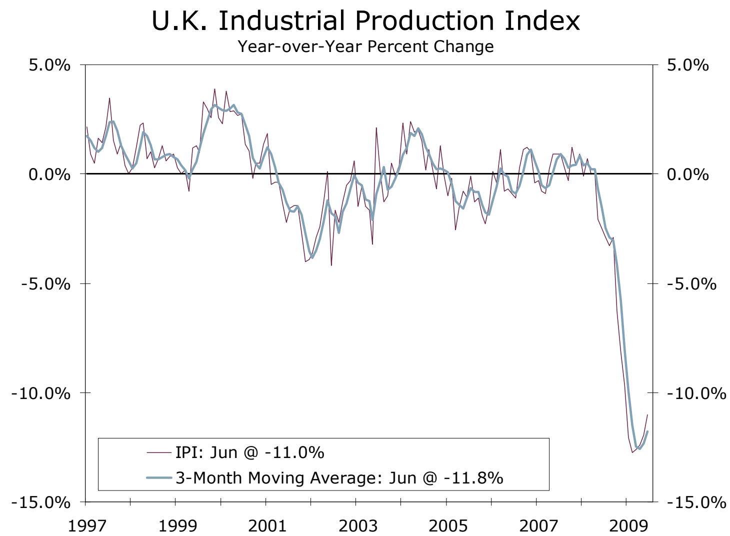
U.K. Industrial Production • Tuesday

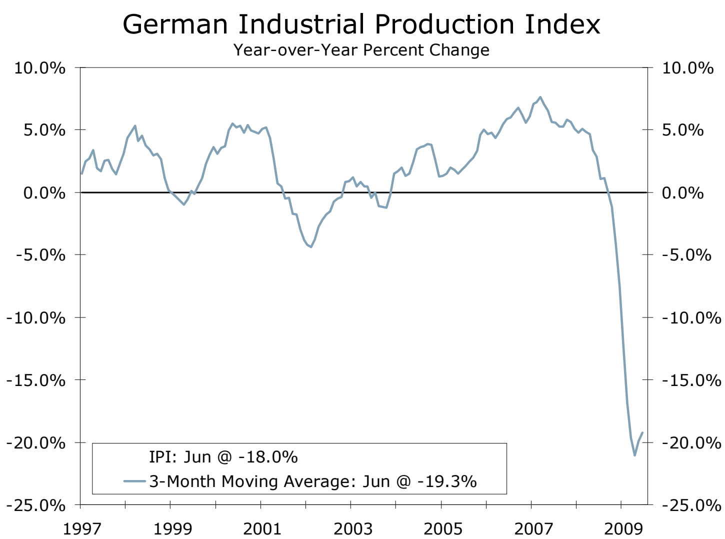
Following a collapse in UK industrial production (IP) in late 2008/early 2009, recovery appears to be in the works. There has been steady improvement in the level of the U.K. manufacturing PMI in recent months. The July and August readings of 50.2 and 49.7, respectively, suggest to us that manufacturing activity is straddling the line between growth and contraction. Still, a near-50 reading would be consistent with further slowing in the pace of decline in IP, but little in the way of actual growth...not yet anyway. The June number for IP will be released on Tuesday.

The Bank of England (BoE) meets this week and is not expected to change its key lending rate, but the more pressing question is if the BoE will announce another surprise expansion of their asset purchase program as it did in August. We do not expect the BoE to expand its programs beyond what has already been announced.

Previous: 0.5% (Month-over-month)

Consensus: 0.2% (Month-over-month)





German Industrial Production • Tuesday

German industrial production (IP) also fell off a cliff between last fall and this spring, but then jumped in May before giving up a tenth of a percent in June. The Ifo index of German business sentiment has risen to its highest level since the financial crisis intensified last fall. Combined with the bounce in German IP, we may have already hit bottom. We will get a better read on that when data for German industrial production in June prints on Tuesday.

Factory orders lead industrial production, and orders in Germany stabilized this spring before jumping 4.4 percent in May and another 4.5 percent in June. Data on factory orders for July will be released on Monday and further gains could signal that the worst is over for the German manufacturing sector.

Previous: -0.1% (Month-over-month)

Consensus: 1.6% (Month-over-month)

Chinese Industrial Production • Friday

Economic growth in China has clearly rebounded this year, and data scheduled for release next week will give investors some sense of the strength of the economy during the third quarter. The consensus forecast anticipates that growth in industrial production strengthened again last month.

Strong growth in credit, which has been encouraged by the government, is probably the most important reason for the current upturn. In that regard, money supply data will show how strong credit growth remained last month. Data on CPI inflation, which will be released on Thursday, should show that there are no inflationary pressures in the economy at present.

Previous: 10.8% (Year-over-year)

Consensus: 11.8% (Year-over-year)

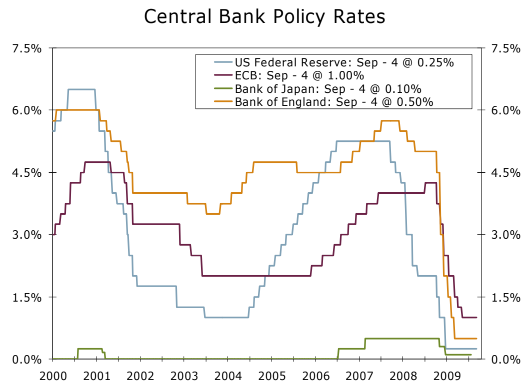
Interest Rate Watch

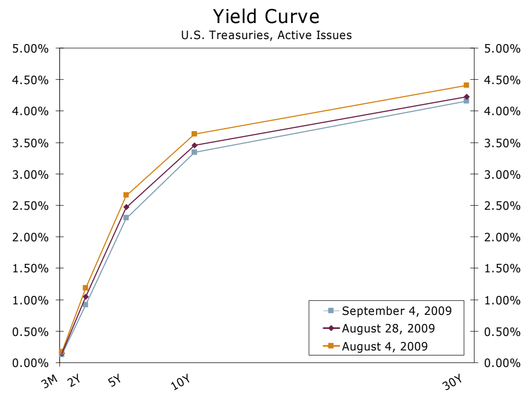
Exit Strategy: The Fed Reprises the Poseidon Adventure

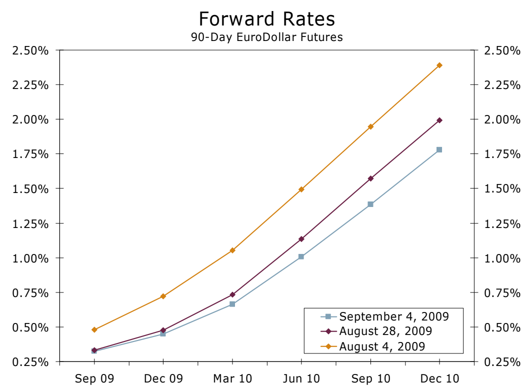
Exit strategies are easy to design, as is the mandatory evacuation drill aboard every cruise boat, but when the tidal wave hits the credit market ship, then the exit strategy becomes a high risk scramble to survive and the exit plans are out the window. Moreover, not everyone survives.

On paper, the Fed's exit strategy proposes to diminish the support to the capital markets that the Fed has supplied such that the private marketplace will stand on its own. Is that economically feasible? Is that even politically acceptable in 21st century America? The Fed's attempts to reduce liquidity and exit the current accommodative monetary stance would introduce increased volatility and thereby greater risk in a marketplace where households and businesses already have a difficult time estimating future returns from investing in homes and businesses. Any Fed exit strategy will alter the relative returns for all financial instruments, particularly for longer maturity assets such as Treasuries, mortgages and ABS. As these interest rates rise, the likely feedback is that the housing sector will witness weaker starts and recovery in house prices. Our escape from the sinking economy will become longer and more difficult than the paper-based exit strategy suggested.

There may also be a second tidal wave—think of this as another installment of the India Jones's series but on a ship—actually within a ship under the Ocean. This exit strategy will be conducted during subpar economic recovery with the additional risk that fiscal policy will follow political biases to spend and that global investors will turn increasingly skittish about both Treasury issuance and the dollar. In this scenario, the upward pressure on Treasury yields will likely be amplified and thereby further restrain economic growth. Since the capital markets have followed anything but a Hollywood script recently, we remain quite cautious on an exit strategy which allows everyone to safely escape. Higher interest rates, a depreciating dollar and higher inflation will take its toll—not everyone gets out alive.







Consumer Credit Insights

Beneath the Headlines—What Can We Say About…

The Fed's Survey of Consumer Finances (February 2009) highlights three major themes of interest in breaking down the American consumer by household characteristics and their relationship to household finances. First, education is a driving factor that delineates median income and net worth. Median income for college graduates was $78,200 compared to $36,700 for high school graduates. The disparity for family net worth is even greater.

Second, friends and relatives serve as the primary source of information. Sellers of financial services, bankers and brokers came in second for investing decisions. The Internet tied with these sellers when it came to borrowing. The use of the Internet decreased with age as over 70 percent of those below the age of 44 used the Internet for financial information while only 40 percent of those above 65 years did so.

Third, the percentage of families with credit card debt and debt secured by the primary residence rises with income, except that the percentage of families in the top 20 percent that have credit card balances declined. Most disturbing, however, is that 27 percent of families in the bottom 20th percentile of income have a debt ratio in excess of 40 percent. For creditors, the distribution of the debt burden is skewed and therefore aggregate debt numbers mask the problems at the individual family level.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	5.08%	5.14%	5.22%	6.35%
15-Yr Fixed	4.54%	4.58%	4.63%	5.90%
5/1 ARM	4.59%	4.67%	4.73%	5.97%
1-Yr ARM	4.62%	4.69%	4.78%	5.15%
MBA Applications				
Composite	554.1	566.4	517.3	453.1
Purchase	277.6	280.4	264.4	349.0
Refinance	2,164.1	2,233.5	1,996.7	1,059.7

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

Topic of the Week

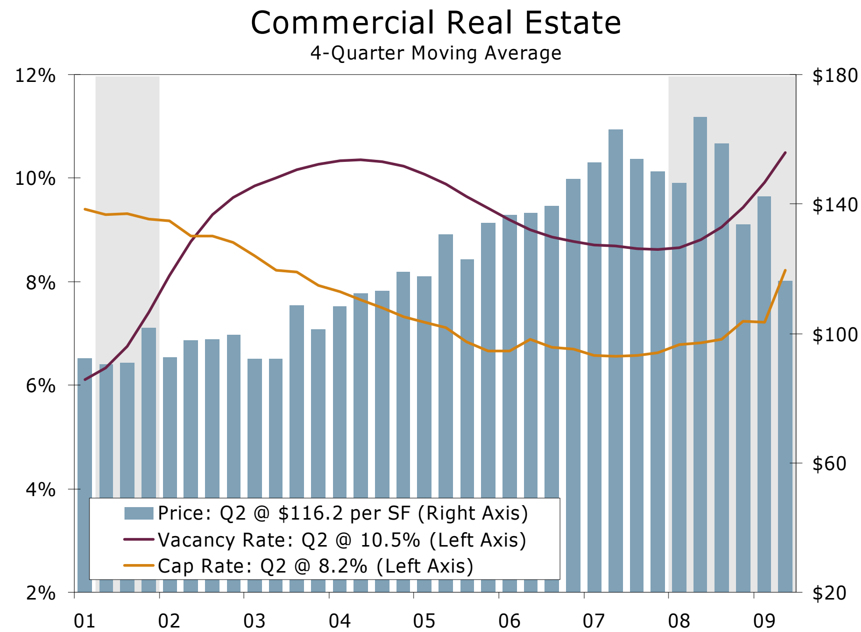
Commercial Real Estate the Next Shoe to Drop?

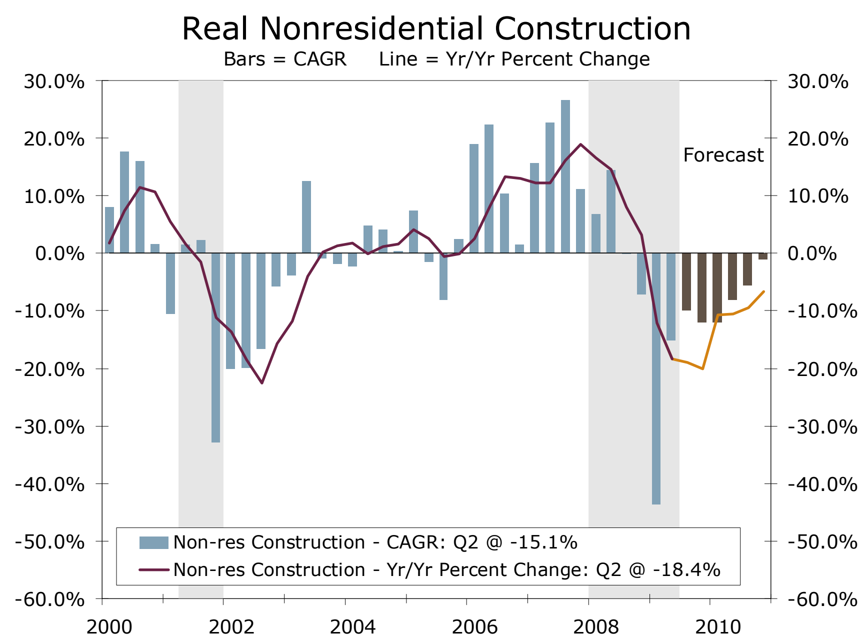
September marks the one-year anniversary of the intensification of the financial crisis. The first round of problems mostly resulted from the bursting of the housing bubble, which sent foreclosures soaring and home prices tumbling. One recurring fear is that another round of losses will result from the collapse of commercial real estate. Vacancy rates have increased, rents have declined and delinquency rates have risen. Moreover, changes in accounting rules have also helped allow banks to avoid write-downs on many commercial real estate loans. While low interest rates and relaxed accounting rules bought the industry some time, there is no way of getting around the deteriorating fundamentals.

One of the toughest job markets since the Great Depression has slashed demand for commercial properties. Rising vacancy rates are cutting into rental income and making it much more difficult to sell properties. On the positive side, the improvement in the financial markets has allowed REITS to raise a few billion dollars, which will likely be used to purchase properties.

Nonresidential construction has already pulled back significantly, as many commercial projects have been delayed or canceled outright. Overall construction has held up better than expected, however, as scores of energy-related projects have offset declines in commercial, lodging and communication building activity. Structure outlays have traditionally been a lagging indicator and tend to continue declining well after a recession has ended. We expect construction activity to continue to pull back over the next 18 months but expect declines to gradually taper off. Building activity was not as elevated as in past building cycles and will likely correct somewhat less. Unfortunately, property values still face significant further declines.

For our complete commentary, see the latest edition of the Commercial Real Estate Chartbook on our website.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 9/4/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.13	0.14	1.67
3-Month LIBOR	0.31	0.36	2.82
1-Year Treasury	0.29	0.37	1.89
2-Year Treasury	0.90	1.02	2.17
5-Year Treasury	2.30	2.45	2.85
10-Year Treasury	3.36	3.45	3.62
30-Year Treasury	4.19	4.20	4.26
Bond Buyer Index	4.37	4.53	4.62

Foreign Exchange Rates

	Friday 9/4/2009	1 Week Ago	1 Year Ago
Euro ($/€)	1.422	1.430	1.433
British Pound ($/£)	1.632	1.627	1.768
British Pound (£/€)	0.871	0.879	0.810
Japanese Yen (¥/$)	92.870	93.602	107.080
Canadian Dollar (C$/$)	1.093	1.092	1.070
Swiss Franc (CHF/$)	1.067	1.060	1.109
Australian Dollar (US$/A$)	0.844	0.841	0.823
Mexican Peso (MXN/$)	13.521	13.248	10.523
Chinese Yuan (CNY/$)	6.830	6.830	6.836
Indian Rupee (INR/$)	48.892	48.663	44.372
Brazilian Real (BRL/$)	1.855	1.881	1.718
U.S. Dollar Index	78.612	78.366	78.610

Foreign Interest Rates

	Friday 9/4/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.76	0.80	4.96
3-Month Sterling LIBOR	0.67	0.69	5.74
3-Month Canadian LIBOR	0.50	0.56	3.40
3-Month Yen LIBOR	0.38	0.39	0.89
2-Year German	1.11	1.26	4.06
2-Year U.K.	0.91	0.89	4.40
2-Year Canadian	1.27	1.29	2.70
2-Year Japanese	0.24	0.25	0.76
10-Year German	3.22	3.25	4.07
10-Year U.K.	3.63	3.56	4.46
10-Year Canadian	3.37	3.40	3.46
10-Year Japanese	1.33	1.32	1.52

Commodity Prices

	Friday 9/4/2009	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	67.47	72.74	107.89
Gold ($/Ounce)	989.62	955.00	796.45
Hot-Rolled Steel ($/S.Ton)	520.00	465.00	1125.00
Copper (¢/Pound)	282.75	292.30	329.70
Soybeans ($/Bushel)	9.87	10.59	12.51
Natural Gas ($/MMBTU)	2.56	3.03	7.32
Nickel ($/Metric Ton)	18,192	19,105	19,510
CRB Spot Inds.	447.98	444.38	465.96

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	7	8	9	10	11
U.S. Data	**Labor Day Holiday** U.S. Markets Closed	**Consumer Credit** June -$10.3B July -$4.0B (C)		**Trade Balance** June -$27.0B July -$29.2B (W)	**Import Price Index** July -0.7% August -0.5% (W) **Wholesale Inventories** June -1.7% July -1.0% (C)
Global Data	**Germany** **Factory Orders (MoM)** Previous (Jun) 4.5%	**Germany** **Indus. Production (MoM)** Previous (Jun) -0.1% **UK** **Indus. Production (MoM)** Previous (Jun) 0.5%	**Canada** **Housing Starts** Previous (Jul) 134.2K	**UK** **BOE Announces Rates** Previous 0.50% **Canada** **Bank of Canada Rate** Previous 0.25%	**China** **Exports (YoY)** Previous (Jul) -23.0% **Japan** **Consumer Confidence** Previous (Jul) 39.7

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

Wells Fargo Securities, LLC Economics Group

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