September 30, 2011

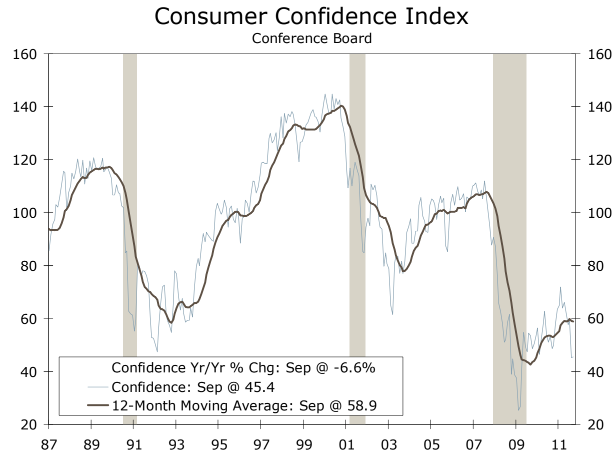
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Still a Mixed Picture

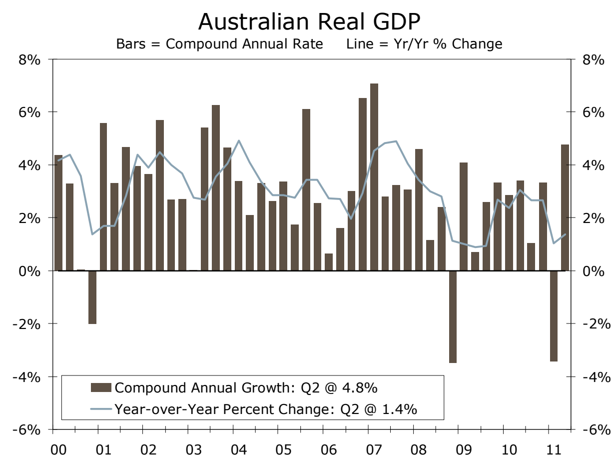
- Most of this week's economic reports that dealt with the consumer continued to flash warning signals. Consumer confidence remains weak, income growth is lagging and home sales remain dead in the water.
- Reports from the factory sector were decidedly more upbeat with orders for nondefense capital goods rising solidly, Boeing shipping its first 787 Dreamliner to Japan and the Chicago Purchasing Managers Index rising 3.9 points to a solid 60.4 in September.
- Weekly jobless claims also posted a surprisingly large drop in late September.



Global Review

What Does Slower Global Growth Mean for Australia?

- In recent weeks, two of the most respected bodies in international finance have dialed back growth expectations for the global economy. If forecasters at the Organisation for Economic Cooperation & Development and the International Monetary Fund are right, it could have serious implications for Australia, an economy that has supplied the raw materials needed to satisfy the growing needs of an expanding global economy.
- Economic data out of Australia the past several weeks present a mixed outlook for the island nation's growth prospects.



Wells Fargo U.S. Economic Forecast

	Actual				Forecast				Actual		Forecast		
	2011				2012				2009	2010	2011	2012	2013
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	0.4	1.3	1.6	1.5	1.0	1.3	1.9	1.7	-3.6	3.0	1.6	1.4	1.8
Personal Consumption	2.1	0.7	1.4	1.5	1.3	1.3	1.4	1.4	-2.0	2.0	2.1	1.3	1.3
Inflation Indicators [2]													
"Core" PCE Deflator	1.1	1.3	1.7	1.9	2.0	1.8	1.7	1.7	1.5	1.4	1.5	1.8	1.7
Consumer Price Index	2.2	3.3	3.7	3.7	2.8	2.3	2.0	1.8	-0.3	1.6	3.2	2.2	2.0
Industrial Production [1]	4.8	0.5	4.9	1.4	2.2	3.1	4.0	4.1	-11.1	5.3	3.8	2.8	3.9
Corporate Profits Before Taxes [2]	8.8	8.5	6.5	6.4	6.2	6.0	6.4	6.6	7.9	32.2	7.5	6.3	7.0
Trade Weighted Dollar Index [3]	70.6	69.4	68.5	69.5	70.5	71.5	72.5	73.0	77.7	75.6	69.5	71.9	74.9
Unemployment Rate	8.9	9.1	9.1	9.4	9.5	9.5	9.5	9.4	9.3	9.6	9.1	9.5	9.2
Housing Starts [4]	0.58	0.57	0.58	0.55	0.57	0.62	0.67	0.70	0.55	0.58	0.57	0.64	0.86
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Conventional Mortgage Rate	4.84	4.51	4.00	3.70	3.80	3.80	4.00	4.10	5.04	4.69	4.26	3.93	4.28
10 Year Note	3.47	3.18	1.90	1.75	1.80	2.00	2.20	2.30	3.26	3.22	2.58	2.08	2.55

Forecast as of: September 30, 2011
[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
[5] Annual Numbers Represent Averages

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U.S. Review

Consumers Remain Cautious Going into the 4th Quarter

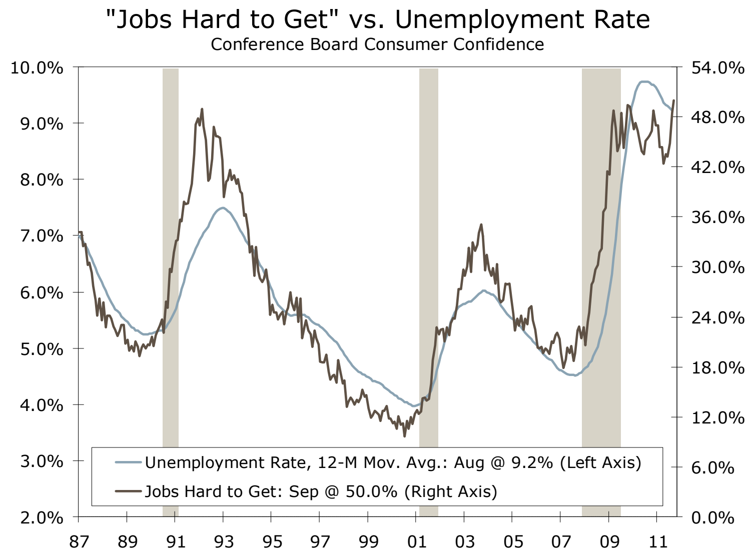
Consumers clearly remain frustrated with the economic recovery. For the fifth month in a row, consumers' view of current economic conditions worsened with the present situation index falling 1.8 points to 32.5 in September. Expectations for economic conditions six months ahead improved modestly, climbing 1.6 points to 54.0 last month.

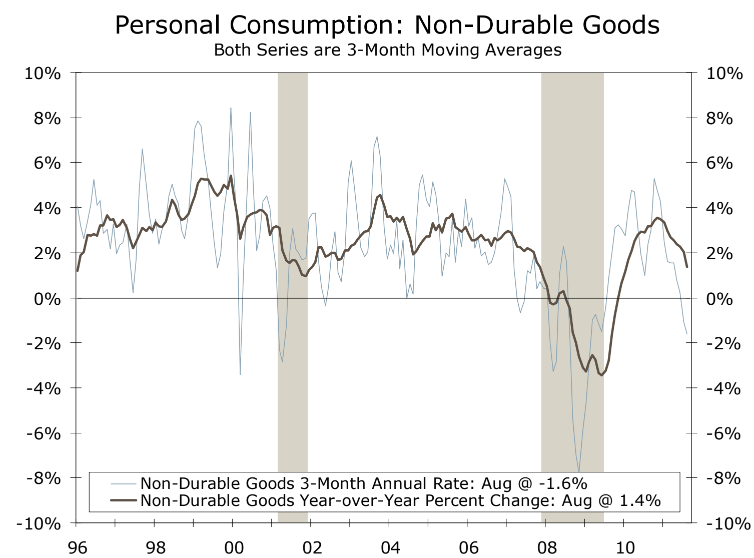
The biggest worry for consumers has been the diminished prospects for job and income growth. The proportion of households reporting that jobs were hard to get rose 1.5 points in September to 50.0 (top chart), which is the highest reading since May 1983. Moreover, despite an improvement in overall expectations, the proportion of households expecting their income to increase over the next six months fell a full percentage to just 13.3 percent, marking the fourth drop in the past four months.

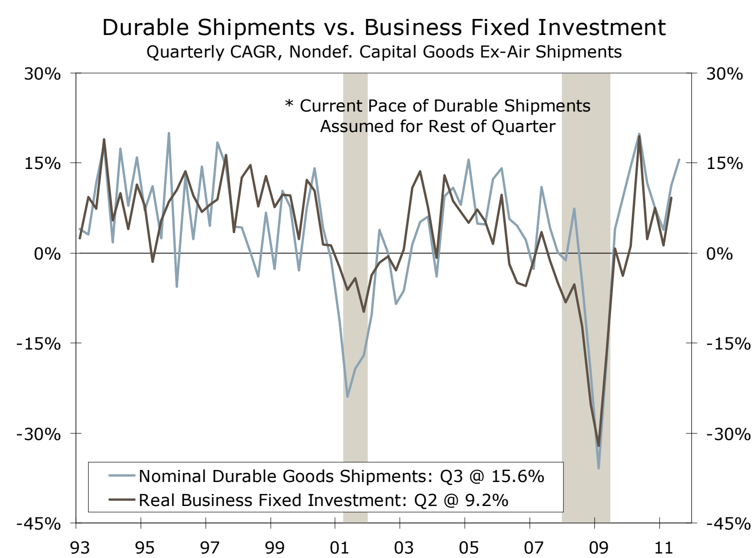
Consumers concerns about job and income growth are bourn out by the latest personal income and spending data, which show total personal income falling 0.1 percent in August, the first decline for total personal income since October 2009. Much of the gains in personal income since the recession ended have been in transfer payments. Now, however, with federal, state and local budgets under intense pressure, we are seeing those gains fade away. Tightening eligibility requirements for unemployment insurance and cutbacks in Medicaid reimbursements have led to substantial back-to-back declines in transfer payments, causing consumers to pull back even further. Spending for nondurable goods, which includes such things as groceries, clothing, toiletries and medicines, fell 0.4 percent in August, following a 0.5 percent drop in July (middle chart). The recent weakness in this normally stable category is unprecedented outside of recession periods.

This week's durable goods shipments data revealed an encouraging trend. Nondefense capital goods shipments, excluding aircraft, increased at a 16.2 percent three-month-annualized pace in August, up from a 14.2 percent pace in the prior month. Over time, this series tends to track real business fixed investment closely (bottom chart). The pace of durable goods shipments through August suggests that growth in business fixed investment during the third quarter should be stronger than that of the second quarter, which should provide a much needed boost to Q3 real GDP.

Initial unemployment insurance claims fell below the 400,000 mark to their lowest level since early April, which is an encouraging sign for the labor market. Much of that drop, however, reflects seasonal factors—unemployment insurance claims typically drop at the end of every quarter, but last week's drop was a little bit more pronounced than usual. On a not seasonally adjusted basis, initial unemployment insurance claims fell to their lowest level since May 2008. Our expectation is that the improvement in jobless claims will likely be short-lived. Next week's employment situation report will probably show a weak labor market, still struggling to gain traction.





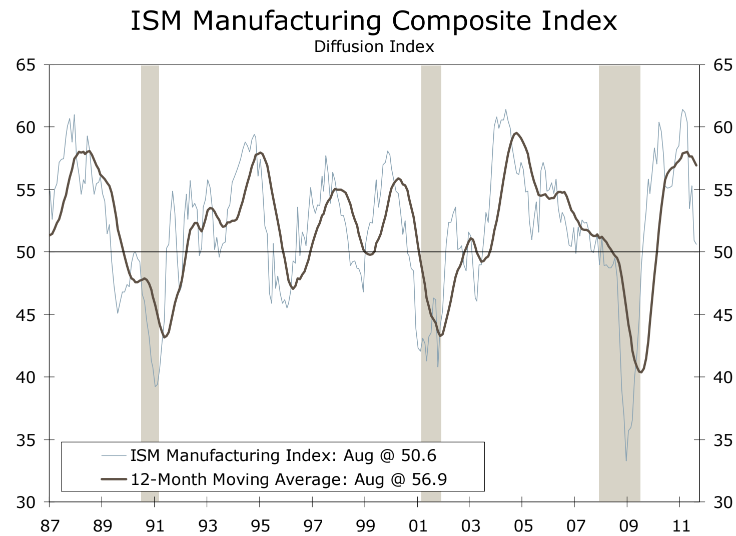


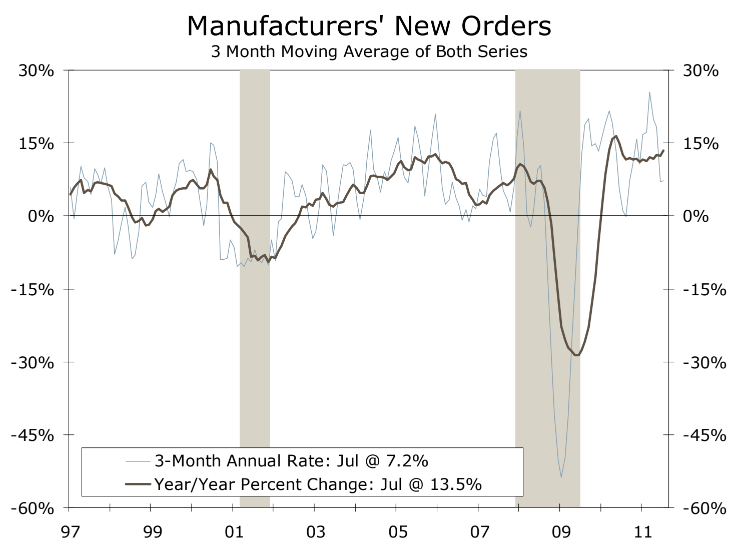
ISM-Manufacturing • Monday

The ISM-Manufacturing Index slowed to 50.6 in August, just barely in expansionary territory. The most troubling component of the report was the fall in both the production and new orders components into contractionary territory suggesting a further slowdown in manufacturing activity may be likely. Over the past month several of the regional manufacturing indices, while still negative, have started to reverse trend. August durable goods orders also signaled at a slower pace of production in September. We suspect that the index will remain little changed in September with a 51.0 reading. Our outlook indicates that manufacturing activity will post a modest gain in the third quarter of the year due to some bounce back in automobile production. However, manufacturing activity will likely pull back in the fourth quarter as weak consumer demand and business spending continues to gradually slow down.

Previous: 50.6 **Wells Fargo: 51.0**

Consensus: 50.4





Factory Orders • Tuesday

Factory orders remained strong in July posting a 2.4 percent increase. The boost in orders came from both durable and nondurable goods. Nondefense capital goods shipments, a key indicator of business fixed investment spending, fell 0.2 percent signaling a slowdown in the pace of business investment. Given the drop in both consumer and business confidence in August, we are skeptical that orders will remain strong. We suspect that new factory orders for August will continue to increase but at a much slower pace of around 0.3 percent. A slowdown in factory orders would be consistent with our view of a sluggish pace of manufacturing output over the next few months. Inventory building, particularly among technology companies, has helped to support manufacturing activity over the past couple of months. With demand falling for many of these products, orders will likely remain sluggish and thus hold back manufacturing output.

Previous: 2.4% **Wells Fargo: 0.3%**

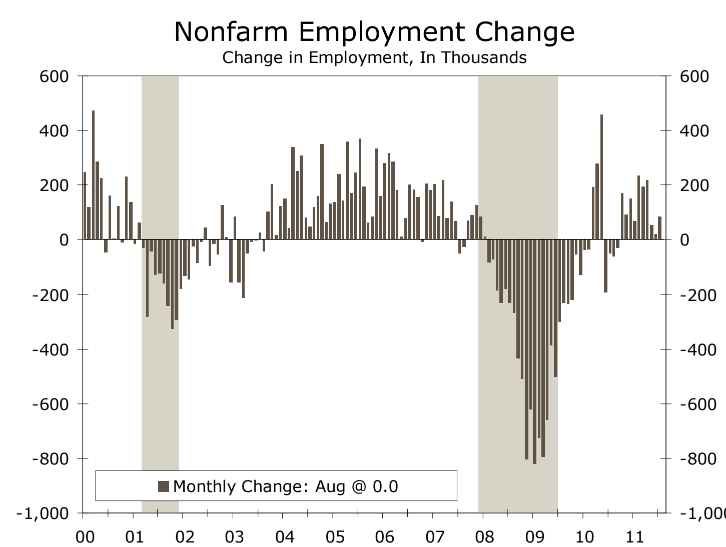
Consensus: 0.0% (Month-over-Month)

Employment • Friday

In August, the U.S. economy created zero net new jobs. The employment gains in professional and business services, along with education and healthcare, were offset by a pullback in employment in the local government and information sectors. The August employment numbers were likely skewed downward due to a strike in the telecom sector which should provide a bounce back in employment in September. We expect that job gains returned again in September with 35,000 jobs created with an unemployment rate of 9.1 percent. We continue to expect most of the job gains to be concentrated in the higher-skilled service sectors. Given the horizontal movement in initial jobless claims over the past few weeks, job growth is not likely to pick up anytime soon. We continue to forecast sluggish employment gains with the unemployment rate remaining around 9.4 percent by the end of the year.

Previous: 0K **Wells Fargo: 35K**

Consensus: 50K



Global Review

What Does Slower Global Growth Mean for Australia?

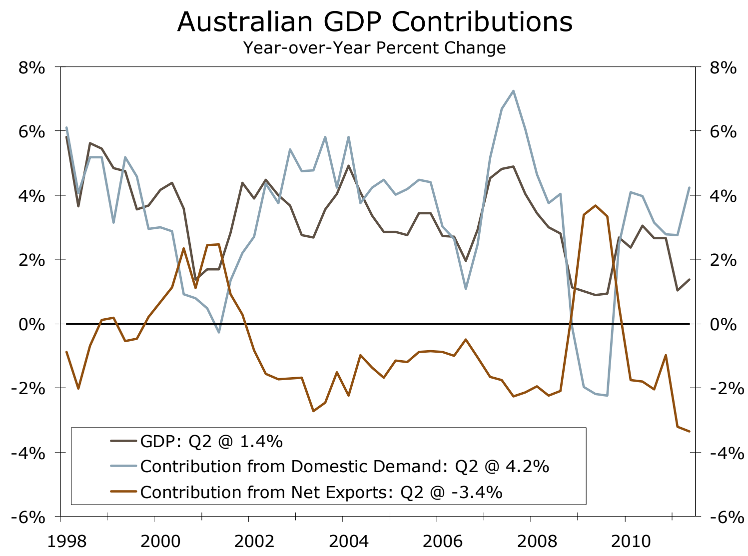
In recent weeks, global financial markets have experienced volatility not seen since the height of the financial crisis back in the autumn of 2008. As the world has watched the latest developments in Europe with worried anticipation, inconsistent economic data out of the United States have done little to calm nerves. Against this backdrop of uncertainty, it comes as little surprise that some of the heaviest hitters in global economics are rethinking their forecasts. Earlier in September, the Organisation for Economic Cooperation and Development (OECD) dialed back growth expectations for the global economy. Last week, the International Monetary Fund (IMF) followed suit in its publication of the most current World Economic Outlook, which revised growth for both the United States and the Eurozone sharply lower, while downgrading the global outlook more broadly.

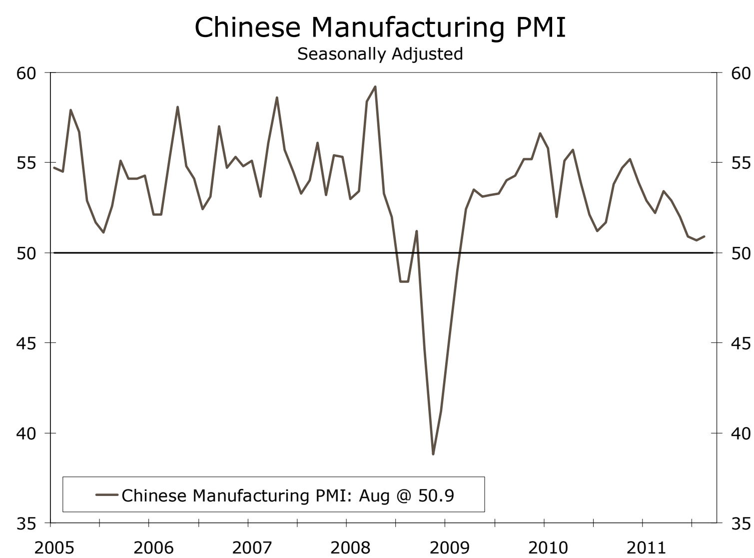
While much of the attention has been on Europe, this week we consider what a slower global growth environment would mean for Australia. During the global recession in 2009, Australia managed to sidestep recession thanks to strong growth in China, Australia's largest export partner. But this year an unlikely combination of factors including natural disasters and floods at home combined with the tsunami and the situation in Japan (Australia's No. 2 export partner) conspired to push GDP into negative territory in the first quarter. Although growth came back in the second quarter, the contribution to growth from net exports remained negative.

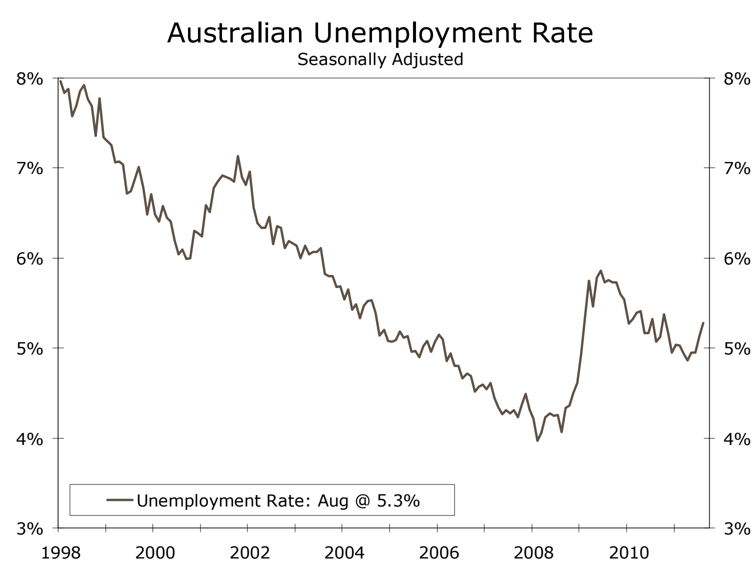
Chinese business sentiment has fallen well below 50. There is some concern that slower output in China could mean weaker Australian exports, which could make Australia more vulnerable to a global slowdown this time around. We do not lose much sleep over this concern. Generally speaking, a number below 50 in a PMI is associated with a slowing and a number above 50 is associated with expansion. But in the case of China, that thinking does not work. In the global recession for example, Chinese PMI fell below 40, but GDP there never dipped below 6 percent on a year-over-year basis. China also has plenty of room to boost growth by lowering rates or loosening lending if growth there seems to be poised to slow.

As the top chart shows, domestic demand has been the primary driver of economic growth in Australia recently. While we do not think that the Australian consumer is going into hiding, there are some indications that consumer spending growth is poised to slow somewhat. The unemployment rate has been trending higher since April. While still among the lowest unemployment rates in the developed world, the impact of a weaker job market is already having an effect on spending. Retail sales have come down in two out of the past three months.

The Australian housing market continues to limp along without showing signs of a major move in either direction. Data this week showed that new home sales picked up 1.1 percent in August, while a separate report showed prices slipping 0.4 percent.







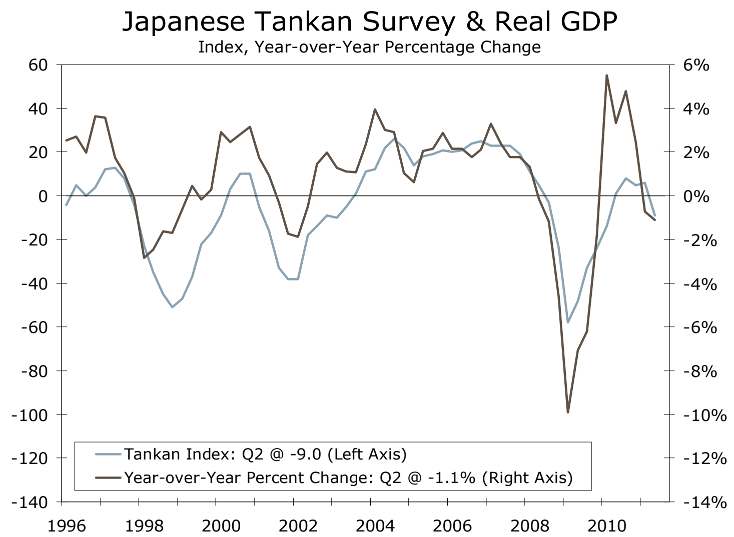
Japanese Tankan Index • Monday

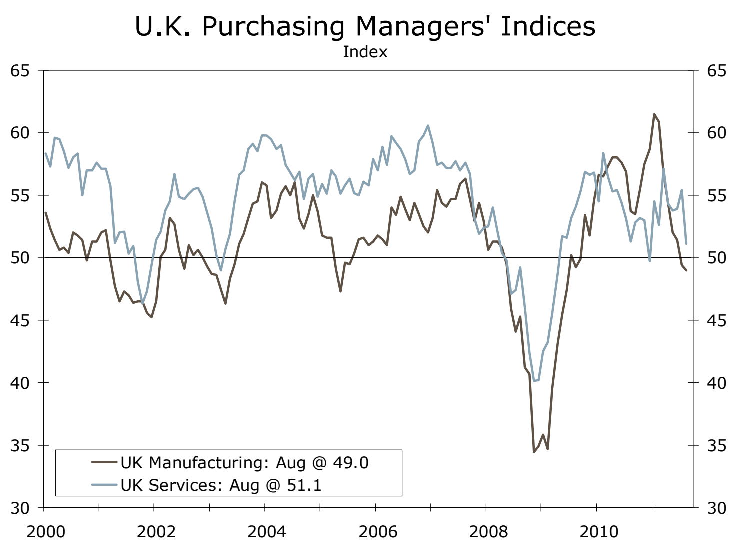
The quarterly Tankan survey of Japanese business sentiment is widely followed because it has a fair degree of correlation with Japanese GDP growth. The index slumped in June in the aftermath of the natural disasters that shook Japan in March. The consensus forecast anticipates that the "headline" index, which measures sentiment among large manufacturers, bounced back in September. We suspect that the sequential rate of real GDP growth returned to positive territory in the third quarter following three consecutive negative numbers. Part of the bounce reflects rebuilding and production coming back on stream after the disasters.

The Bank of Japan holds a policy meeting on Friday, and the outcome of the meeting is in little doubt. The BoJ has maintained its main policy rate at only 0.10 percent since December 2008 and, in our view, it will keep rates at extraordinarily low levels for the foreseeable future.

Previous: -9

Consensus: 2





U.K. Manufacturing PMI • Monday

The manufacturing PMI in the United Kingdom slipped below "50" in July, and most analysts expect that it remained in contraction territory in September. Through August, the service sector PMI remained above the demarcation line separating expansion from contraction. Although the consensus forecast anticipates some further deterioration in September, the economists suspect that the service sector PMI remained above "50." The construction PMI is also expected to have remained in positive territory. British economic growth may have remained positive in the third quarter, but the economy appears to be growing at a very sluggish pace.

As discussed in the "Interest Rate Watch" section on page 6, we suspect that the Bank of England will keep its main policy rate at 0.50 percent on Thursday. On Friday, data on input prices in September will give investors some insights into current price dynamics in the British economy.

Previous: 49.0

Consensus: 48.6

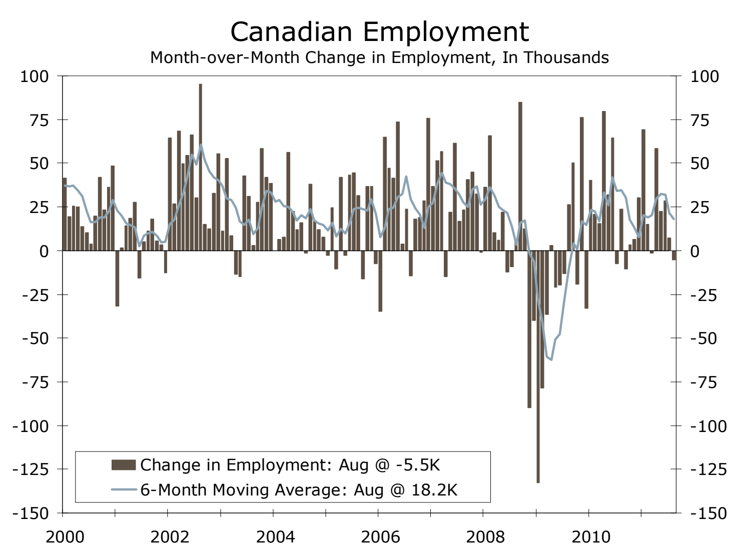
Canadian Employment • Friday

The Canadian labor market has performed much better than its American counterpart over the past two years. Whereas nonfarm payrolls in the United States remain 5.0 percent below their predownturn peak, employment in Canada is 1.1 percent above its previous high. That said, Canadian employment fell in August as 5,500 jobs were lost. The consensus forecasts looks for payrolls to have risen in September. In addition, the unemployment rate is expected to have held steady at 7.3 percent.

Other data that are slated for release next week will give investors further insights into the present state of the Canadian economy. After slumping throughout 2009, residential construction has rebounded. Data on building permits in August will print on Thursday. The Ivey purchasing managers' index for September will also be released on Thursday.

Previous: -5.5K

Consensus: 19.5K



Interest Rate Watch

More QE from the BoE?

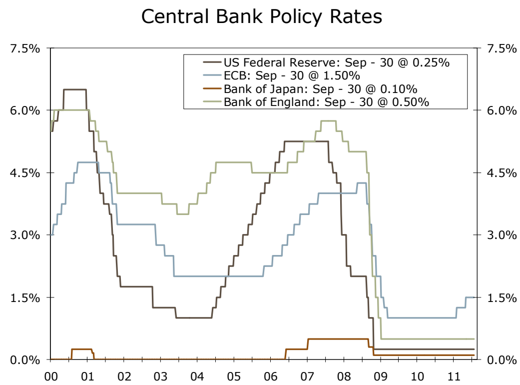
The Bank of England (BoE) holds its normal monthly policy meeting on Thursday and it is universally expected that the BoE will keep its policy rate unchanged at 0.50 percent, where it has been maintained since March 2009. However, weak economic activity—real GDP has been more or less flat since Q3 2010—makes it likely that the BoE will ease further at some point.

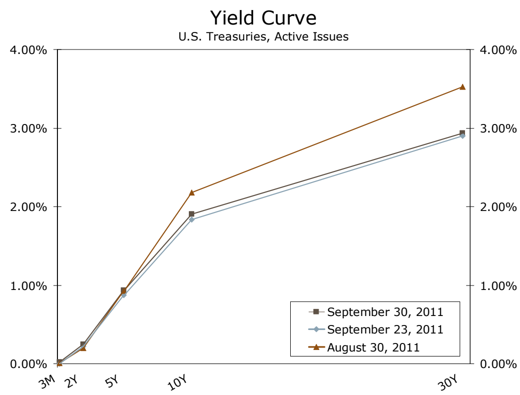
In that regard, we look for the BoE to eventually increase the size of its quantitative easing program from £200 billion to £250 billion or more. It may be premature to expect the move to happen on October 6, but weak economic activity and downside risks to growth make further easing likely, in our view. We also believe that the BoE will maintain its main policy rate at only 0.50 percent through at least the end of 2012.

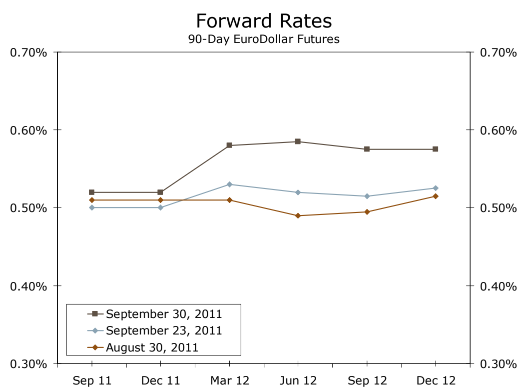
Will the ECB Cut Rates?

After implementing two 25-bps rate hikes earlier this year, the ECB appeared to have moved to an "easing bias" at its September policy meeting. We had been expecting the ECB to cut rates by 25 bps on Thursday until the "flash" estimate of CPI inflation printed much higher than expected. (Preliminary data showed that the overall rate of CPI inflation rose from 2.5 percent in August to 3.0 percent in September.) It may be difficult for the inflation-phobic ECB to sanction a rate cut if the current rate of inflation is 3.0 percent.

However, the pace of economic activity in the overall euro area is very weak, and the ongoing sovereign debt crisis poses significant downside risks to the Eurozone. Moreover, some European banks are having difficulty securing financing due to concerns about their balance sheets. Therefore, we look for the ECB to announce that it will allow banks to tap its liquidity financing operations for longer periods. We also think that the ECB will eventually cut rates. Although we do not rule out a rate cut at the October 6 policy meeting, we believe that the ECB will want to see inflation receding again before it takes that step.







Credit Market Insights

Net Interest Margin and Yield Curve

The Federal Reserve's latest attempt to jump-start the economy, dubbed "Operation Twist," will, in theory, push down long-term interest rates and push up short-term interest rates. In other words, it will flatten the yield curve. We say "in theory" because nobody truly knows how investors, or the economy, will react to the Fed's latest plan over time. But if the Fed gets its wish, long-term interest rates will fall and short-term interest rates will rise. Generally speaking, when the yield curve flattens, this will reduce the spread between what banks pay for deposits and what they will earn on lending. This reduced spread is termed a lower net interest margin. As a result, financial institutions in general will be less willing to lend as it is less profitable because net interest margins are squeezed. Therefore, the move to ease policy by Operation Twist, will be partly offset as the return on lending will be diminished by the lower net interest margin.

With a flatter yield curve, a second issue is that current rates of inflation, measured by the CPI or PCE deflator, will exceed the yield on long-term rates. This sets up another set of incentives to investors to avoid lending out the curve given the lack of a real, after-inflation, rate of return.

Finally, investors will also recognize that longer-term Treasury rates are no longer real, market-setting rates and thereby would not be reliable signals of inflation or market risk.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.01%	4.09%	4.22%	4.32%
15-Yr Fixed	3.28%	3.29%	3.39%	3.75%
5/1 ARM	3.02%	3.02%	2.96%	3.52%
1-Yr ARM	2.83%	2.82%	2.89%	3.48%
MBA Applications				
Composite	767.9	702.7	631.7	784.0
Purchase	176.6	172.2	159.3	181.8
Refinance	4,239.6	3,813.2	3,381.7	4,288.3

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

Topic of the Week

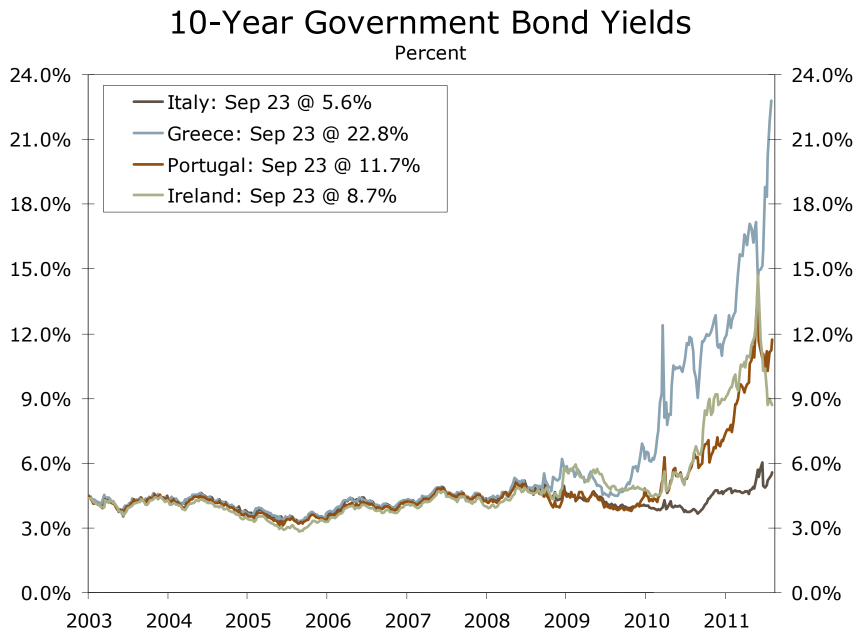
Is Ireland Turning the Corner?

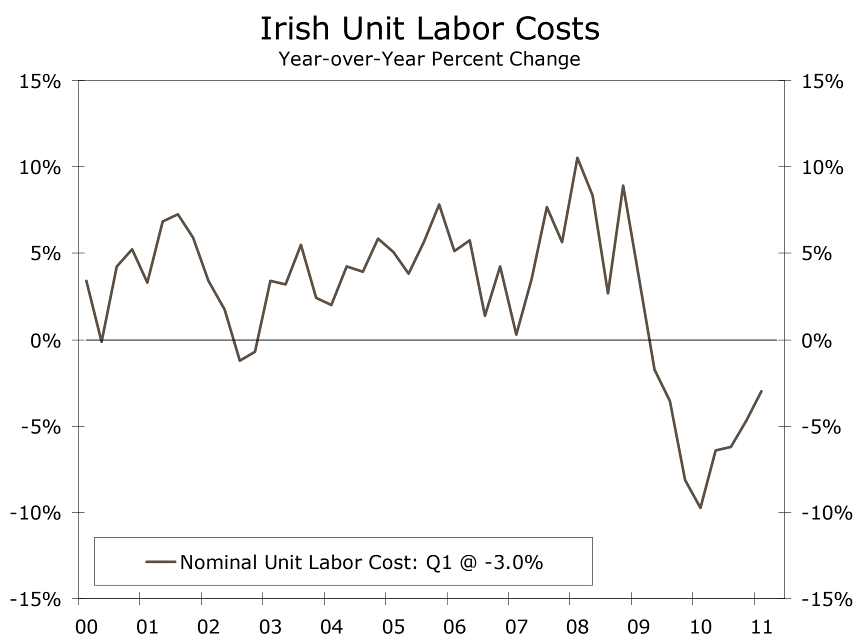
The European sovereign debt crisis remained in the headlines this week as the Greek parliament approved more austerity measures and the German Bundestag okayed reforms to the European Financial Stability Facility. Attention remains riveted on Greece. Underneath the radar, however, Ireland may be slowly "de-coupling" from the rest of the European periphery. Whereas the 10-year government bond yield in Greece is up about 800 bps since mid-July, the comparable yield in Ireland has dropped more than 600 bps over that period.

In some respects, the Irish economy remains depressed with the level of real GDP still 10 percent below its predownturn peak and an unemployment rate north of 14 percent. However, Ireland appears to be moving in the right direction with real GDP in the Emerald Isle up 3.5 percent over the past two quarters. As a point of reference, output in the United States has grown only 0.4 percent since Q4 2010.

The price of Irish goods vis-à-vis the goods of its trading partners has dropped about 12 percent over the past three years. Some of this improvement in Ireland's price competitiveness reflects the depreciation of the euro against the dollar and many Asian currencies over that period. However, unit labor costs in Ireland have dropped about 10 percent, which has also helped to improved Ireland price competitiveness. Although weakness in the labor market has helped to keep wages in check, strong productivity growth has also contributed to the decline in unit labor costs.

If the Eurozone, not to mention the global economy, were to slide back into recession due to uncertainties engendered by the sovereign debt crisis, the Irish economy would certainly not escape unscathed. For now, however, it appears that Ireland is moving in the right direction. For further reading, see "Ireland: Good News from the European Periphery?", which is posted on our website.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 9/30/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.02	-0.01	0.15
3-Month LIBOR	0.37	0.36	0.29
1-Year Treasury	0.18	0.11	0.23
2-Year Treasury	0.25	0.22	0.42
5-Year Treasury	0.94	0.87	1.26
10-Year Treasury	1.90	1.83	2.51
30-Year Treasury	2.93	2.90	3.68
Bond Buyer Index	3.93	3.85	3.84

Foreign Exchange Rates

	Friday 9/30/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.343	1.350	1.363
British Pound ($/£)	1.555	1.545	1.572
British Pound (£/€)	0.864	0.873	0.868
Japanese Yen (¥/$)	76.890	76.610	83.530
Canadian Dollar (C$/$)	1.046	1.028	1.029
Swiss Franc (CHF/$)	0.904	0.906	0.983
Australian Dollar (US$/A$)	0.969	0.978	0.967
Mexican Peso (MXN/$)	13.838	13.560	12.594
Chinese Yuan (CNY/$)	6.381	6.388	6.692
Indian Rupee (INR/$)	48.974	49.575	44.945
Brazilian Real (BRL/$)	1.865	1.834	1.687
U.S. Dollar Index	78.603	78.501	78.720

Foreign Interest Rates

	Friday 9/30/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.50	1.49	0.85
3-Month Sterling LIBOR	0.95	0.93	0.73
3-Month Canadian LIBOR	1.20	1.18	1.25
3-Month Yen LIBOR	0.19	0.19	0.22
2-Year German	0.55	0.39	0.83
2-Year U.K.	0.57	0.53	0.65
2-Year Canadian	0.86	0.87	1.38
2-Year Japanese	0.15	0.13	0.14
10-Year German	1.88	1.75	2.28
10-Year U.K.	2.41	2.37	2.95
10-Year Canadian	2.15	2.08	2.76
10-Year Japanese	1.03	0.99	0.94

Commodity Prices

	Friday 9/30/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	80.12	79.85	79.97
Gold ($/Ounce)	1613.45	1656.80	1308.35
Hot-Rolled Steel ($/S.Ton)	675.00	698.00	590.00
Copper (¢/Pound)	319.00	327.20	364.60
Soybeans ($/Bushel)	11.88	12.41	10.67
Natural Gas ($/MMBTU)	3.74	3.70	3.87
Nickel ($/Metric Ton)	18,640	18,855	23,364
CRB Spot Inds.	538.47	547.90	528.05

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	3	4	5	6	7
U.S. Data	**ISM Manufacturing** August 50.6 September 51.0 (W) **Construction Spending** July -1.3% August 0.0% (W) **Total Vehicle Sales** August 12.10M September 12.50M (W)	**Factory Orders** July 2.4% August 0.3% (W)	**ISM Non-Mfg.** August 53.3 September 52.5 (W)		**Nonfarm Payrolls** August 0K September 35K (W) **Consumer Credit** July $11.965B August $8.000B (c)
Global Data	**Japan** **Tankan Mfg. Index** Previous (Q2) -9 **U.K.** **Manufacturing PMI** Previous (Aug) 49.0	**Eurozone** **PPI (MoM)** Previous (Jul) 0.5%	**U.K.** **GDP (YoY)** Previous (Q2 P) 0.7% **U,K.** **Service Sector PMI** Previous (Aug) 51.1	**Canda** **Ivey PMI** Previous (Aug) 56.4	**Canada** **Unemployment Rate** Previous (Aug) 7.3% **Germany** **IP (MoM)** Previous (Jul) 4.0%

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

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