October 07, 2011

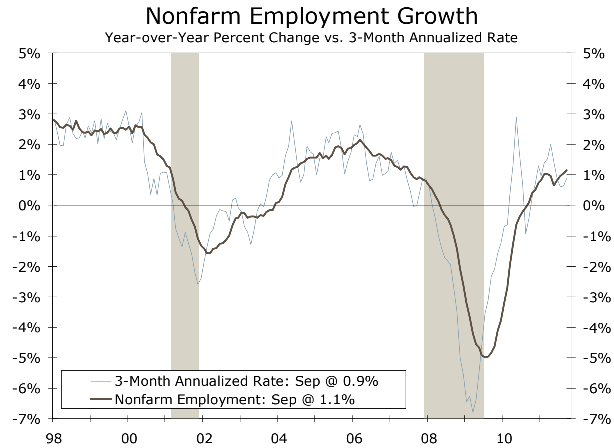
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Still Growing, but the Expansion Is Still at Risk

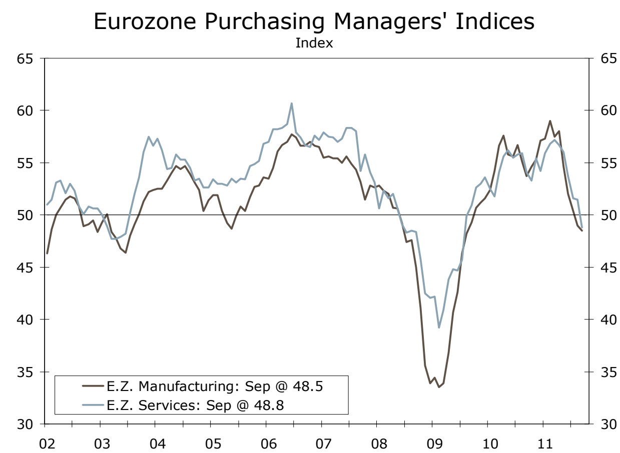
- The U.S. economy created 103,000 net new jobs in September with the private sector creating 137,000 net jobs, a pretty decent indication that modest economic growth continued in the United States in September. While still in the plus column and somewhat better than August's job reading, the labor market has clearly downshifted from the first quarter, putting the sustainability of the economic expansion at risk.
- The ISM manufacturing and non-manufacturing indexes both signaled modest expansion in September as well, although August factory orders declined.



Global Review

Global Growth Appears to Have Slowed Further

- Economic data out of the euro area have turned soft recently with the PMIs slipping below "50." We think that the Eurozone is slipping into a mild recession that will prompt rate cuts from the European Central Bank (ECB).
- Recent economic data from other countries point in the direction of slower growth as well. That said, most other economies do not appear to be contracting at this point. Unless Europe completely "blows up," we think a global recession will be averted.



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	1.2	1.8	1.9	-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	1.9	1.8	1.6	1.6	1.5	1.4	1.5	1.7	1.6
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	1.8	2.6	2.8	2.8	-11.1	5.3	3.8	2.4	3.1
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	72.8	69.5	70.5	71.5	72.5	73.0	77.7	75.6	70.6	71.9	74.9
Unemployment Rate	8.9	9.1	9.1	9.2	9.3	9.4	9.4	9.4	9.3	9.6	9.1	9.4	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	0.79
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	4.11	3.70	3.80	3.80	4.00	4.10	5.04	4.69	4.29	3.93	4.28
10 Year Note	3.47	3.18	1.92	1.75	1.80	2.00	2.20	2.30	3.26	3.22	2.58	2.08	2.55

Forecast as of: October 7, 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

Inside

U.S. Review

Slow and Steady Growth Continues

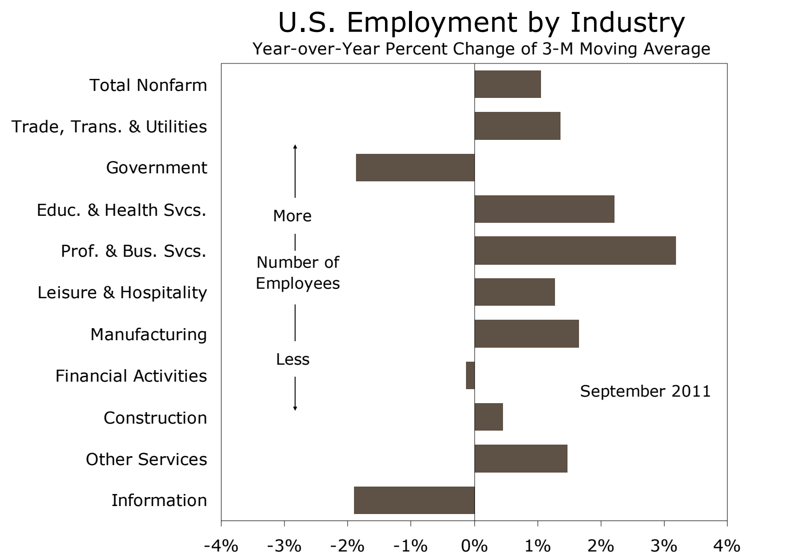
Expectations are now so low for the U.S. economy's performance that the creation of 100,000 plus jobs in September, which includes a one-off increase of 45,000 returning Verizon workers, is hailed as a solid employment report. True, there were some pleasant positive surprises in the release. For example, there was the net upward revision of job creation over the prior two months of 99,000 jobs. The unemployment rate held steady at 9.1 percent as household employment and the U.S. labor force both grew briskly. This is usually a sign of an improving labor market. Average hourly earnings and working hours both increased. There was net positive job growth in several important categories, including construction, retailing, information services, business services and education and healthcare. The bottom line, however, is that monthly job growth of this magnitude will not reinvigorate the economic recovery and still leaves the economy vulnerable to future financial shocks.

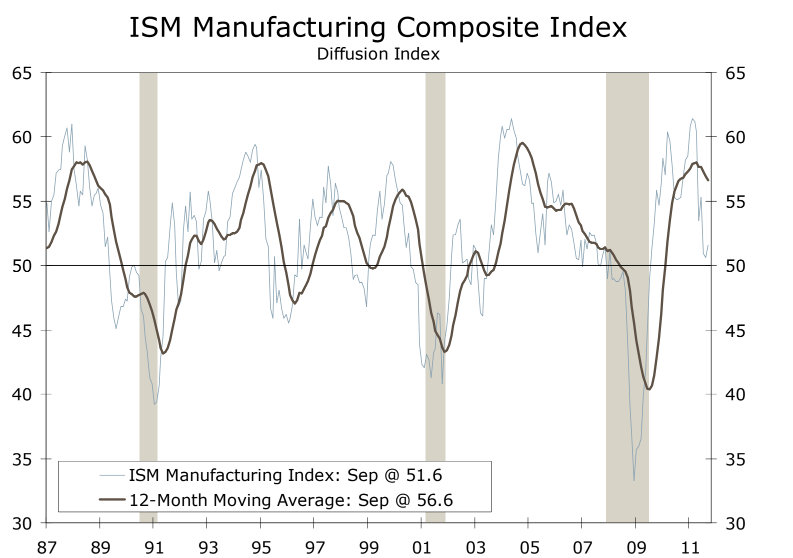
The other economic data released this week revealed steady activity continued in September, and there were even a few positive surprises to report for a change, helping to break the brooding mood that has taken a hold of the markets in recent weeks. The ISM manufacturing index improved to 51.6 in September from 50.6 in August, beating consensus expectations for a modest deterioration in this measure. A hopeful sign was the improvement in the employment sub-index that increased to 53.8 in September. Shipments and prices paid also improved, showing some strengthening in current manufacturing activity from August's anemic performance. This is consistent with the bounce that we saw in the Philly Fed and Chicago-PMI manufacturing surveys in September.

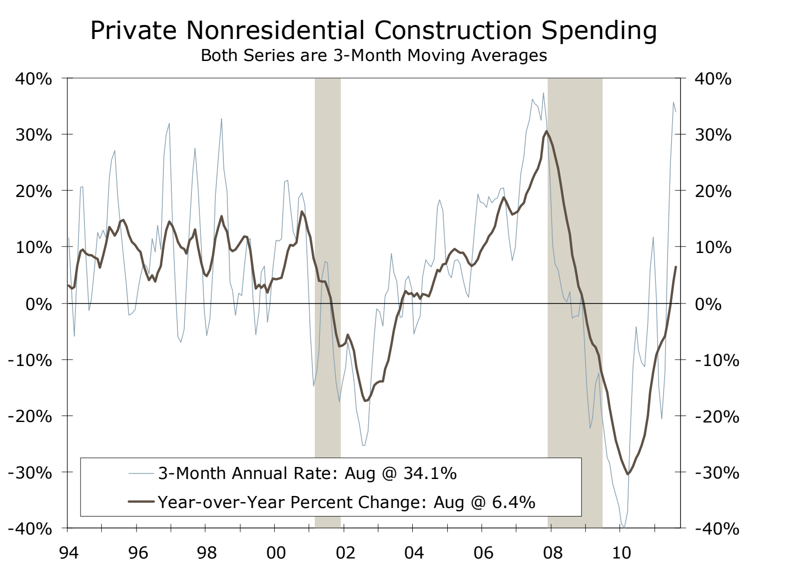
A particularly encouraging development this week was the solid domestic auto sales figures for September. Domestic auto sales improved to 4.2 million units from 4.1 million at a seasonally adjusted annual rate, despite declining consumer confidence and financial market volatility. Domestic light truck sales jumped to 5.9 million from 5.4 million. Strong farm incomes and pent-up demand for trucks were likely a big driver on the month. The solid auto and truck sales data will keep auto production humming along in the fourth quarter despite caution weighing on other manufacturers.

Construction was another bright spot this week. Construction spending jumped 1.4 percent. The jump reflected activity in August and was much bigger than expected, leading many analysts to push up their estimates for third quarter GDP growth. Construction spending is up 4.8 percent over the past five months.

The reading from the service sector was not quite as reassuring. The ISM non-manufacturing index softened to 53.0 in September from 53.3 in August. The factory orders report was also a bit of a downer. August factory orders slipped 0.2 percent on weakness in durable and nondurable orders. The decline in petroleum prices on the month helped push nondurable goods orders lower.







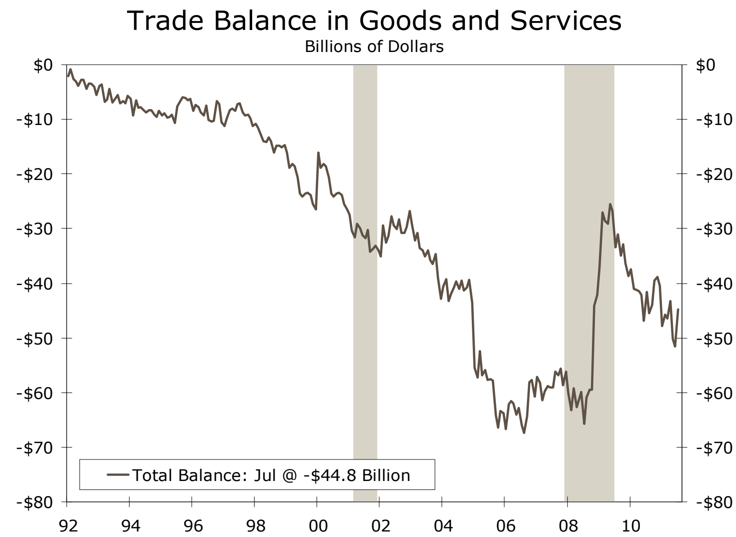
International Trade • Thursday

In the second quarter international trade was a 3.4 percentage point drag on GDP growth. In July, the first month of the third quarter, the trade deficit was more or less in line with the average for the second quarter. So if the deficit hold were to hold around these levels for August and September, trade could be a neutral variable for third quarter growth.

On Thursday, we will get a look at trade data for August, and we expect to see a widening in the month, but not enough to present the sort of drag on growth that we saw in the prior quarter. Still, this is a trend that we expect to continue, with the trade deficit gradually widening in the months ahead as the economy returns to health and imports gradually pick up steam. Growth in domestic demand will need to outpace the drag from trade to maintain growth in the economy.

Previous: -$44.8B **Wells Fargo: -$48.3B**

Consensus: -$46.0B



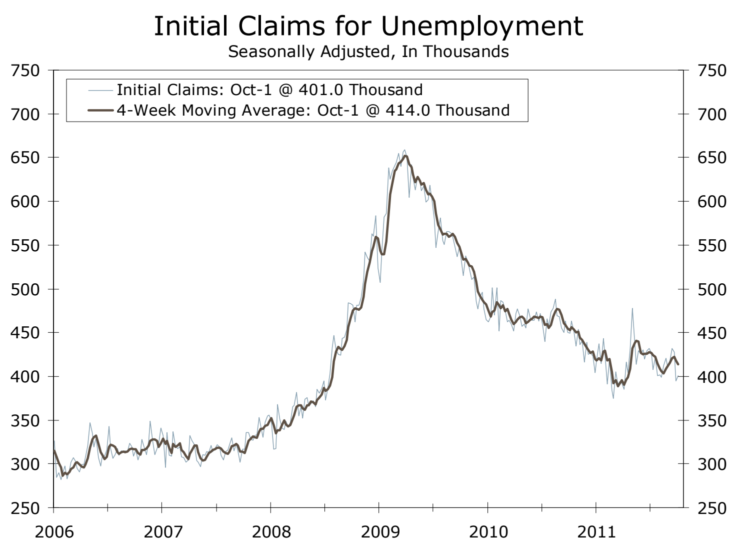
Initial Jobless Claims • Thursday

During the darkest days of the recession more than 650,000 people a week were filing their first-time claims for unemployment insurance. That number trended down for the next two years, but since the beginning of 2011, only rarely have initial claims dipped below 400,000. As the nearby chart illustrates, during the last expansion, claims were generally range-bound between 300,000 and 350,ooo. A return to this level is considered a pre-requisite for the sort of job growth needed to bring down the unemployment rate.

Through September, the three-month average change in nonfarm payrolls was 96,000. While the turnout in September was better than expected, a monthly change on the order of at least 150,000 or so is needed to outpace the growth in the labor force and bring down the unemployment rate.

Previous: 401K

Consensus: 405K



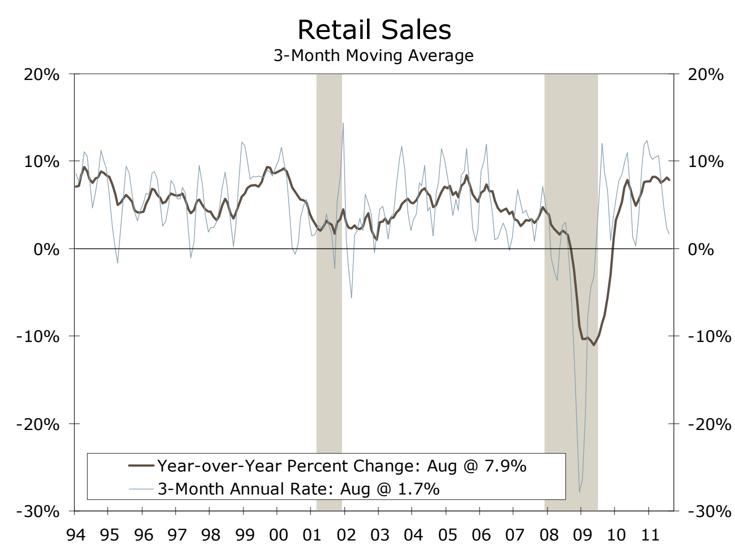
Retail Sales • Friday

The pace of retail sales growth has been slowing on trend throughout 2011. A number of one-off factors have influenced the numbers in recent months, most notably the Japan-related supply chain disruptions and the impact on auto sales this spring. But those factors cannot be blamed for all of the deterioration. Stores reported no change in sales for the month of August, essentially meaning that spending growth had slowed to a standstill.

Consumer sentiment is at levels that are fairly close to the lowest levels seen during the recession. But as we have pointed out before, what consumers *say* and what they *do* are often very different things. We expect to see sales pick up in September. The recent improvement in chain-store sales and better-than-expected auto sales are the primary factors driving the optimism in our forecast.

Previous: 0.0% **Wells Fargo: 0.7%**

Consensus: 0.6% (Month-over-Month)



Global Review

Global Growth Appears to Have Slowed Further

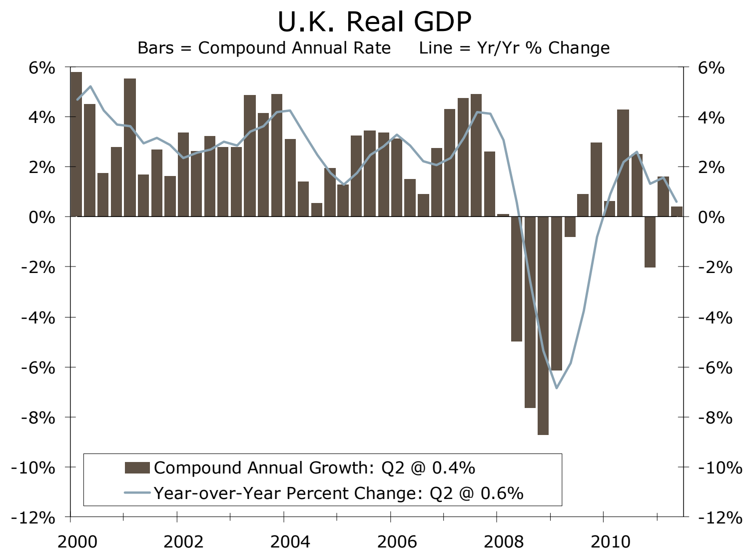
Recent economic data in foreign economies have been mixed, but they generally are consistent with a much slower pace of growth than what was the case a few months ago. Let's start with the Eurozone. The "final" readings on the manufacturing and service sector purchasing managers' indices (PMIs) confirmed what the "flash" estimates had suggested two weeks ago. Namely, both indices fell below the demarcation line that separates expansion from contraction in September. "Hard" data have also been a bit soft. Industrial production in Germany fell 1.0 percent in August, partially reversing the 4.0 percent rise during the previous month. Moreover, the 1.4 percent drop in German factory orders in August, which follows the 2.6 percent decline during the previous month, does not bode well for industrial production over the next few months.

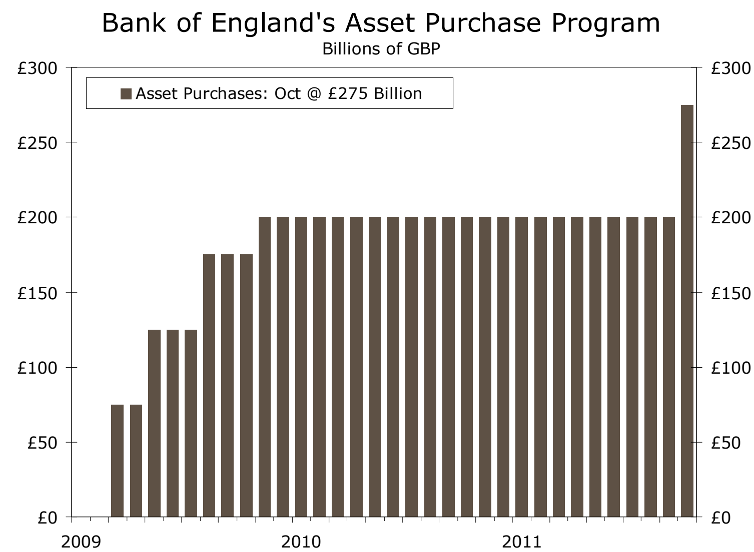
As we discuss in more detail in our forthcoming Monthly Economic Outlook, we believe the Eurozone is slipping back into recession. Over the next two quarters, we forecast that real GDP in the Eurozone will decline about one percent, prompting the European Central Bank to cut its main policy rate by 75 bps. (For more reading on the ECB and the European sovereign debt crisis, see "Some Thoughts on Recent European Developments," which is posted on our website.)

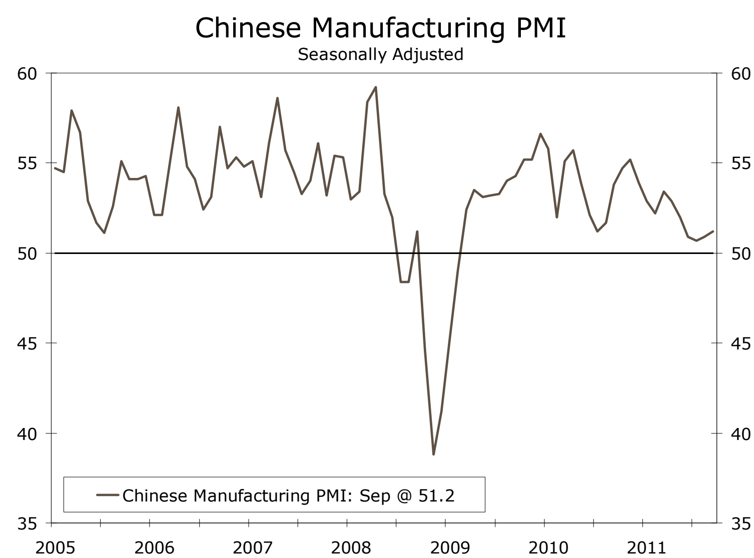
In contrast to the decline in the Eurozone PMIs, the comparable indices in the United Kingdom rebounded into expansion territory in September. Nevertheless, the U.K. economy is very weak at present. Revised GDP data showed that the downturn was deeper than originally estimated (top chart). Previously released data indicated that the peak-to-trough decline in real GDP in 2008-2009 was 6.4 percent. Revised data now show a 7.1 percent drop in output. In addition, the 0.2 percent increase in real GDP in the second quarter was revised down to only 0.1 percent. The revised data likely played a role in this week's decision by the Bank of England, which came as a surprise to many analysts, to increase the size of its quantitative easing program from £200 billion to £275 billion (middle chart).

Recent economic data out of Asia generally point in the direction of slower growth as well. The manufacturing PMI in China edged higher in September (bottom chart). However, manufacturing PMIs in Singapore and Taiwan fell significantly below "50" in September. These countries are small open economies that are very sensitive to trends in global trade. Therefore, the weakness in the Singaporean and Taiwanese manufacturing PMIs likely reflects slowdowns in other countries. Exports are very important to China as well, but the size of the Chinese economy means that domestic demand is relatively more important than exports per se. Therefore, the uptick in the Chinese PMI may indicate that the domestic Chinese economy is holding up relatively well.

In sum, recent monthly indicators point in the direction of slower global growth. Although the Eurozone appears headed for a mild downturn, the global economy is not in recession right now. Unless Europe completely "blows up," we think a global recession will be averted.







Japan Machine Orders • Tuesday

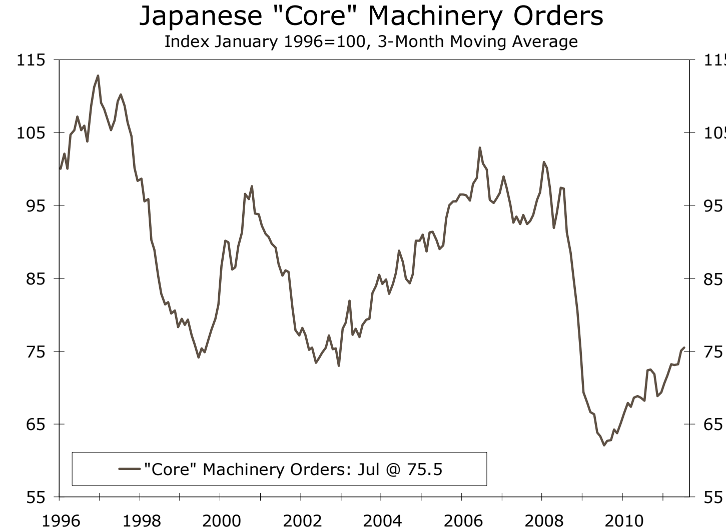
On Tuesday, Japan will release its machine orders number for August and markets are expecting confirmation that the Japanese economy continues the process of recovery from March's natural disaster and ensuing nuclear crisis.

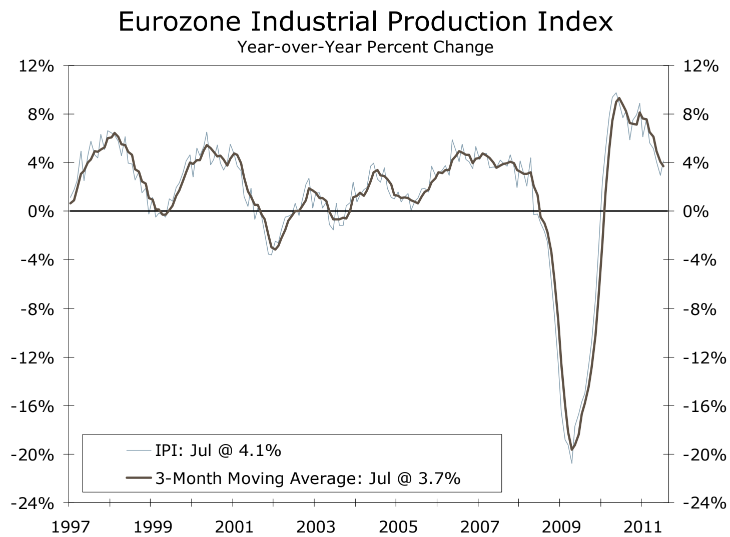
The machine orders series is a relatively important indicator because it gives an idea of the potential for faster growth ahead, as it is a measure of firms' investment in capital equipment in order to ramp up production in the future. Markets are expecting machine orders to rise 3.9 percent on a month-over-month basis in August after falling by 8.2 percent during the previous month.

Thus, a lower-than-expected number will be very disappointing, as it could indicate that the bounce that the Japanese economy enjoyed in the aftermath of the March disasters is already starting to fade.

Previous: -8.2%

Consensus: 3.9% (Month-over-Month)





Eurozone Ind. Prod. • Wednesday

U.S. markets will wake up on Wednesday to the latest news on the Eurozone industrial production number for August, and they will get another hint to the extent of the slowdown in economic activity across the Eurozone region. It is clear that the European Central Bank did not feel compelled to cut rates during its latest policy meeting due to the higher-than-expected "flash" inflation rate.

Industrial production in July was actually relatively strong, coming in at 1.0 percent on a month-over-month, seasonally adjusted basis and a higher-than-expected rate for August could indicate that things are not as bad as markets have been expecting. However, we do not expect industrial production to surprise on the upside during the August release as other indicators are pointing to a very disappointing economic performance in the Eurozone region.

Previous: 0.9%

Consensus: -0.8% (Month-over-Month)

China Trade Balance • Wednesday

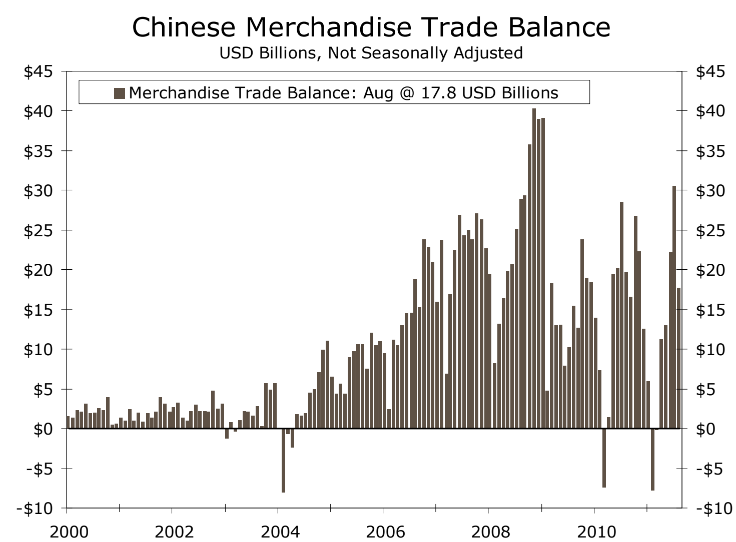
On Wednesday, we also have the release of China's trade balance numbers for September. The market expectation is for the country to post a $16.9 billion surplus during the month compared to a $17.8 billion surplus during August. The expectation is for exports to have grown by 20.8 percent and imports to have grown by 24.6 percent, both on a year-earlier basis.

A higher year-over-year growth rate in exports will be a welcome sign for the world economy and for commodity prices as it will probably indicate that the talked-about slowdown in Chinese economic activity is less worrisome than many have suggested.

If this is the case, then Thursday's release of the consumer price index numbers could move the markets as a higher-than-expected inflation rate could increase nervousness regarding further government actions to slow down economic activity.

Previous: $17.76B

Consensus: $16.90B



Interest Rate Watch

Jobs Suggest Steady Policy

Today's jobs report suggests a steady monetary policy for the months ahead and thereby a continuation of "Operation Twist" and a relatively flatter yield curve going forward.

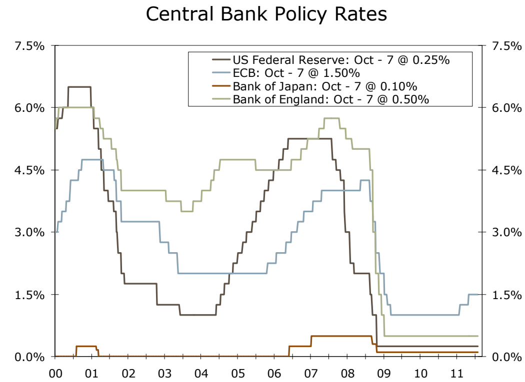
In September, the economy added 103,000 jobs and had average job gains of 96,000 over the past three months. These are numbers that lower the probability of any double-dip recession but also remain weak enough to suggest no acceleration in economic growth. This week, we also received the ISM-manufacturing and factory orders reports. The ISM index rose to 51.6, remaining in expansion mode. Nondefense capital orders rose a solid 5.2 percent in August. Our outlook for growth remains for modest growth of 1.5 percent to 2.0 percent for the rest of this year.

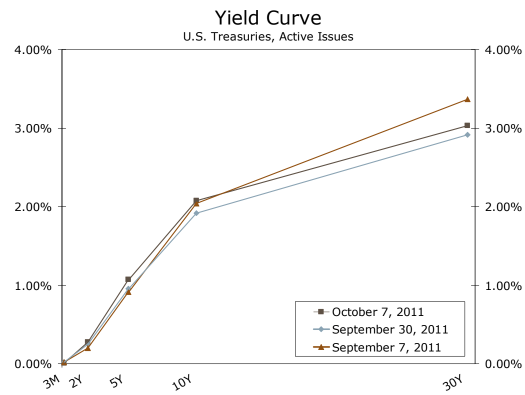
Meanwhile, inflation continues to creep upward. The core CPI is up 2 percent over the past year, while the overall CPI is up 3.8 percent. The Fed's inflation benchmark, the core PCE deflator, is at 1.3 percent, which gives the Fed enough room below its 2 percent perceived target to continue the "Operation Twist" program.

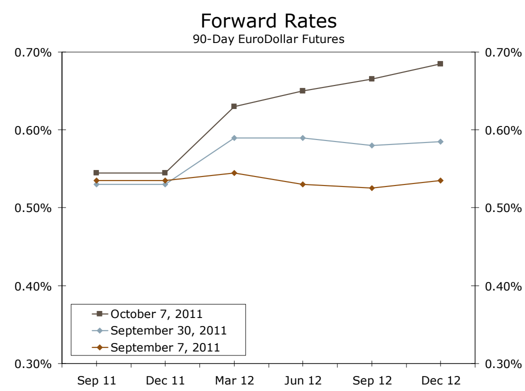
Growth and inflation fundamentals support the flatter, not flat, yield curve outlook. As for corporate rates, our expectation is that the shift in sentiment away from a possible double-dip recession will lead issuers and bond investors to view current spreads as a bit wide relative to perceived risks suggesting that spreads will come in and bond issuance will pick up.

Fundamentally, however, we believe that it is not interest rates that are holding back economic growth. The problem is the lack of visibility on final sales for business and jobs/income for consumers. For example, in the Conference Board's Consumer Confidence Survey, only 13.3 percent of households expect their income to increase over the next six months.

In fact, a stronger economy would be associated with higher interest rates as the demand for credit would rise. This would actually be a welcome signal that the current economic doldrums are fading away. Here is hoping for higher rates.







Credit Market Insights

Are We Twisting Yet?

Since the FOMC announced "Operation Twist" on September 22, there has been some indications that the Fed's twisting of the yield curve has occurred. The residential mortgage and the corporate bond markets have begun to reflect the policy change, with longer-term rates falling and shorter-term rates stabilizing, or in some cases rising. In the home mortgage market, the average 30-year fixed rate declined 7 bps for the week, with the average of the one-year adjustable rate mortgage increasing 12 bps in the past week. Lower mortgage rates appear to have stimulated some refinancing activity within the past month, as the number of refinance loans have increased three weeks in a row, before falling back down this past week.

One of the other expectations of "Operation Twist" is that it would accommodate corporate bond issuance. The yields for 2-year AA bonds have climbed, while the yields for AA 20-year bonds have gradually edged downward. The absence of a pickup in new issuance is likely tied to the uncertain economic climate.

The effect on interest rates from "Operation Twist" began several weeks earlier, following the August FOMC meeting, which strongly hinted that the Fed would initiate such a program. Thus, much of the movement in rates has likely been realized. The relatively modest effect on rates has been somewhat positive; however, the larger stimulative effects of the policy have not yet materialized.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	3.94%	4.01%	4.12%	4.27%
15-Yr Fixed	3.26%	3.28%	3.33%	3.72%
5/1 ARM	2.96%	3.02%	2.96%	3.47%
1-Yr ARM	2.95%	2.83%	2.84%	3.40%
MBA Applications				
Composite	734.9	767.9	601.0	782.6
Purchase	175.2	176.6	159.6	198.7
Refinance	4,019.0	4,239.6	3,169.4	4,180.8

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

Topic of the Week

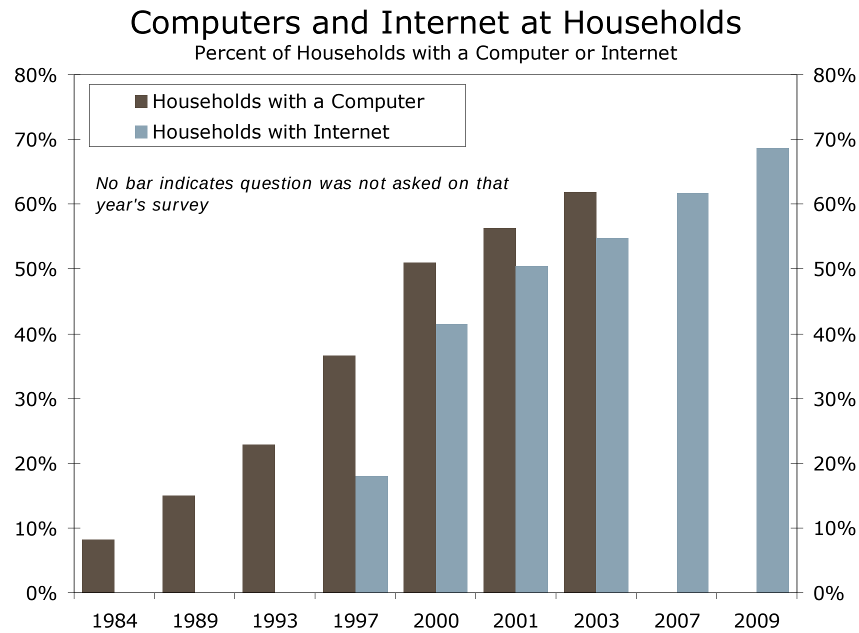
Steve Jobs's Lasting Effect

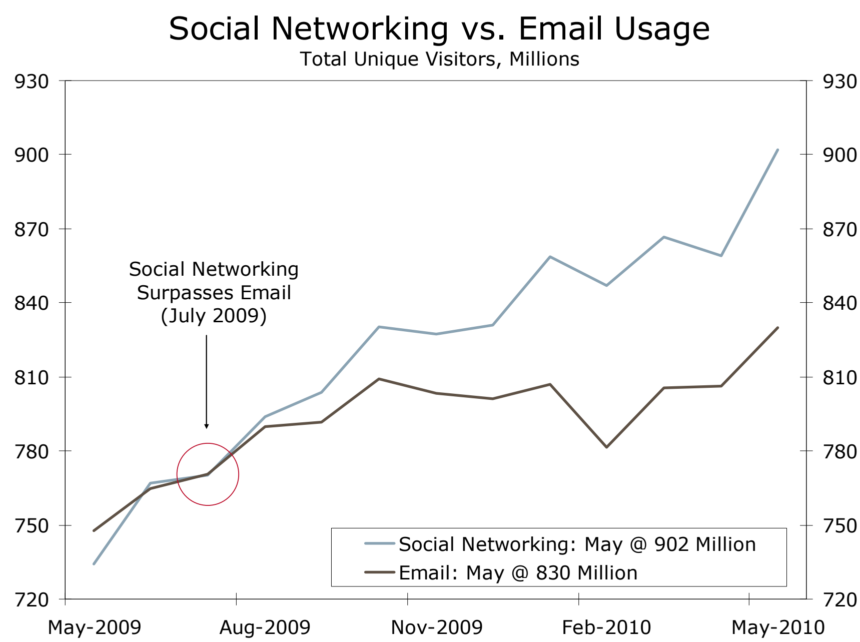
The death of Steve Jobs sparked considerable reflection about his contributions to the development of computers, the advancement of the information age and his influence on American-style capitalism. Steve Jobs has been compared to Thomas Edison, Henry Ford, Walt Disney and Leonardo DaVinci. Are such comparisons over the top? Probably not. Steve Jobs changed the world in many meaningful and lasting ways.

Steve Jobs's contributions are best understood by looking back to where computing used to be. In the early days of the PC, users had to deal with limited software choices that often required quite a bit of detective work, such as searching for cumbersome setup strings to properly print a spreadsheet. Apple broadened the appeal of personal computers beyond engineers and techies to ordinary people. A little later, following the introduction of the Macintosh, Jobs dramatically changed the way we use computers to this very day as well as inspired the Windows revolution in the PC world.

While on an involuntary sabbatical from Apple, Jobs developed a powerful new computer and operating system, which evolved into today's Mac. He also purchased LucasFilm's computer-graphics division and fundamentally changed the way animated movies are made, while producing popular hits such as "Toy Story", "Cars" and "Finding Nemo".

By the time Jobs returned to Apple in the late 1990s, PCs had become a commodity. Jobs took a different route and pursued more innovative designs and ways to integrate Apple's products with the Internet. New products, such as the iPod, revolutionized the way we listen to and purchase music, also laying the groundwork for the iPhone, which kicked off the smart phone revolution. More recently, the iPad has led to the development of an entire new class of computers and will likely prove to be the catalyst for explosive growth in cloud computing.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 10/7/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.01	0.02	0.11
3-Month LIBOR	0.39	0.37	0.29
1-Year Treasury	0.14	0.18	0.22
2-Year Treasury	0.28	0.24	0.35
5-Year Treasury	1.07	0.95	1.13
10-Year Treasury	2.08	1.92	2.38
30-Year Treasury	3.03	2.91	3.71
Bond Buyer Index	4.14	3.93	3.84

Foreign Exchange Rates

	Friday 10/7/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.350	1.339	1.393
British Pound ($/£)	1.562	1.558	1.588
British Pound (£/€)	0.865	0.859	0.877
Japanese Yen (¥/$)	76.750	77.060	82.410
Canadian Dollar (C$/$)	1.029	1.050	1.017
Swiss Franc (CHF/$)	0.916	0.908	0.966
Australian Dollar (US$/A$)	0.986	0.966	0.983
Mexican Peso (MXN/$)	13.263	13.897	12.551
Chinese Yuan (CNY/$)	6.360	6.381	6.679
Indian Rupee (INR/$)	49.155	48.974	44.195
Brazilian Real (BRL/$)	1.760	1.879	1.681
U.S. Dollar Index	78.252	78.553	77.387

Foreign Interest Rates

	Friday 10/7/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.50	1.50	0.90
3-Month Sterling LIBOR	0.96	0.95	0.74
3-Month Canadian LIBOR	1.21	1.20	1.23
3-Month Yen LIBOR	0.19	0.19	0.20
2-Year German	0.63	0.55	0.80
2-Year U.K.	0.63	0.58	0.65
2-Year Canadian	1.00	0.89	1.34
2-Year Japanese	0.14	0.15	0.13
10-Year German	2.02	1.89	2.26
10-Year U.K.	2.48	2.43	2.93
10-Year Canadian	2.27	2.16	2.75
10-Year Japanese	0.99	1.03	0.87

Commodity Prices

	Friday 10/7/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	83.29	79.20	81.67
Gold ($/Ounce)	1654.77	1623.97	1333.55
Hot-Rolled Steel ($/S.Ton)	665.00	675.00	570.00
Copper (¢/Pound)	328.00	314.50	367.35
Soybeans ($/Bushel)	11.23	11.88	10.18
Natural Gas ($/MMBTU)	3.51	3.67	3.62
Nickel ($/Metric Ton)	18,917	18,640	24,778
CRB Spot Inds.	537.53	538.47	531.77

Next Week's Economic Calendar

	Monday 10	Tuesday 11	Wednesday 12	Thursday 13	Friday 14
U.S. Data		**U.S. Budget** August -$134.2B September -$65.0B (c) **FOMC Meeting** Previous 0.25%		**Trade Balance** July -$44.8B August -$48.3B (W)	**Import Price Index** August -0.4% September -0.5% (W) **Retail Sales** August 0.0% September 0.7% (W) **Business Inventories** July 0.4% August 0.4% (W)
Global Data		**Japan** **Machine Orders** Previous (Jul) -8.2% **U.K.** **IP (MoM)** Previous (Jul) -0.2%	**Eurozone** **IP (MoM)** Previous (Jul) 0.9% **China** **Trade Balance** Previous (Aug) $17.76B	**Germany** **CPI (MoM)** Previous (Aug) 0.0% **China** **CPI (YoY)** Previous (Aug) 6.2%	**Eurozone** **CPI (MoM)** Previous (Aug) 0.2% **Eurozone** **Trade Balance** Previous (Jul) 4.3B

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

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