November 04, 2011

Economics Group

Weekly Economic & Financial Commentary

U.S. Review

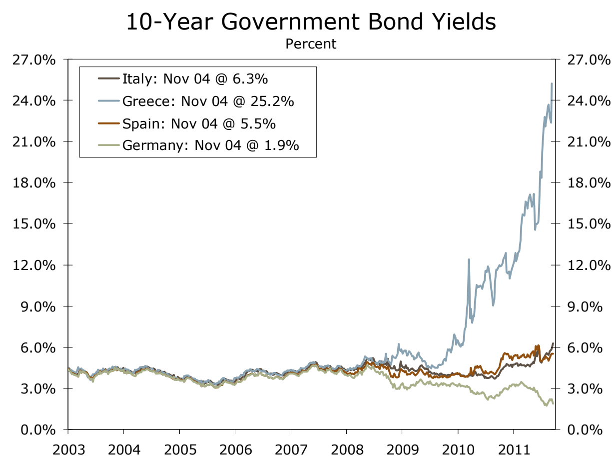
Slow But Steady Progress

- Nonfarm employment rose by 80,000 jobs in October and data for the previous two months were revised up. The unemployment rate fell to 9.0 percent.
- October's ISM surveys remained consistent with modest economic growth. Both the manufacturing and non-manufacturing surveys ticked down marginally in October, but remain slightly above the key 50.0 break-even level.
- Motor vehicle sales turned in another solid performance in October, running at a 13.2 million unit annual rate. Sales of luxury vehicles were particularly strong.

Global Review

Is this a Greek Circus or a Greek Tragedy?

- Last week, the markets were celebrating what seemed to be a potential agreement to start solving the Greek and Eurozone debt crisis. However, this week's events showed that politicians are upping their bets to get more than what they had originally bargained for.
- Mario Draghi, the new president of the ECB, delivered a surprise on Thursday when the ECB decided to cut interest rates by 25 bps to 1.25 percent. While we were expecting the ECB to move during the last month of the year as the Eurozone economy was clearly showing signs of slowing down, the decision took markets by surprise.



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	2.5	2.6	1.9	1.8	2.0	2.1	-3.6	3.0	1.8	2.1	1.8
Personal Consumption	2.1	0.7	2.4	2.6	1.3	1.4	1.5	1.4	-2.0	2.0	2.3	1.7	1.3
Inflation Indicators [2]													
"Core" PCE Deflator	1.1	1.3	1.6	1.8	1.8	1.6	1.5	1.6	1.5	1.4	1.5	1.6	1.6
Consumer Price Index	2.2	3.3	3.8	3.7	2.9	2.3	2.0	1.9	-0.3	1.6	3.3	2.3	2.0
Industrial Production [1]	4.8	0.5	5.1	2.0	1.9	2.6	2.8	2.8	-11.1	5.3	3.9	2.5	2.0
Corporate Profits Before Taxes [2]	8.8	8.5	6.5	6.4	6.1	5.9	6.3	6.5	7.9	32.2	7.5	6.2	6.9
Trade Weighted Dollar Index [3]	70.6	69.4	72.8	74.0	75.0	76.0	76.5	77.0	77.7	75.6	71.7	76.1	78.6
Unemployment Rate	8.9	9.1	9.1	9.1	9.2	9.3	9.3	9.2	9.3	9.6	9.0	9.3	9.0
Housing Starts [4]	0.58	0.57	0.62	0.57	0.57	0.60	0.63	0.65	0.55	0.58	0.58	0.61	0.74
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	4.10	4.10	4.10	4.10	4.10	5.04	4.69	4.39	4.10	4.50
10 Year Note	3.47	3.18	1.92	2.20	2.30	2.40	2.50	2.60	3.26	3.22	2.69	2.45	2.80

Forecast as of: November 4, 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

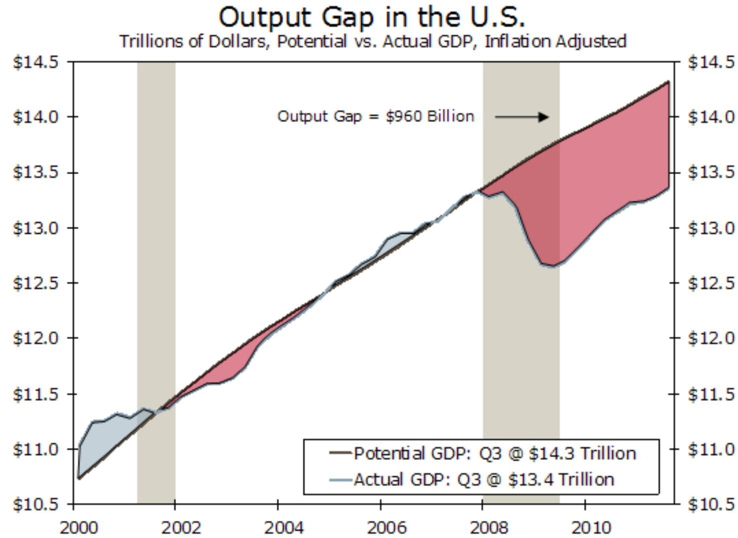
Another Small Step in the Right Direction

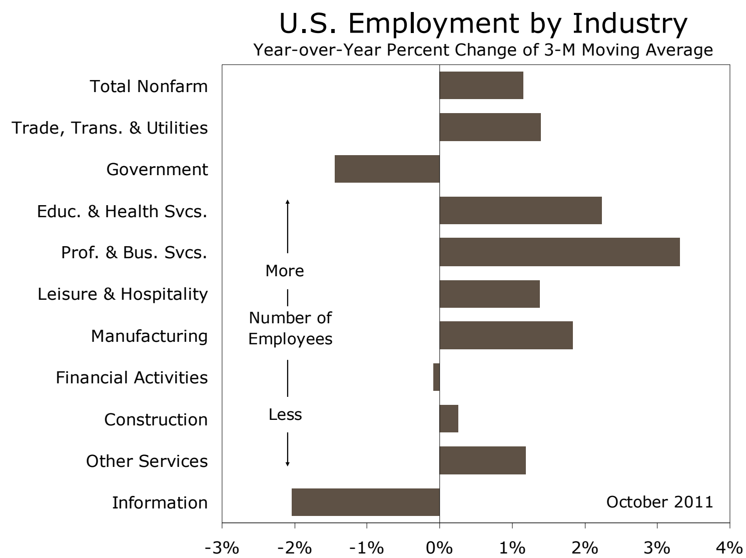
Much has been written about the problems economies face in recovering in the aftermath of financial crisis. Research by the Federal Reserve Bank of Dallas as well as others, like Carmen Reinhardt and Ken Roggoff, suggest economic growth tends to remain below the long-run trend for at least six to seven years following a financial crisis. The U.S. economy certainly appears to be on this glide path. Even the perennially optimistic forecasts from the Congressional Budget Office do not foresee the economy returning to full employment until 2017. Our own forecast suggests it will be even later than that. But every long journey begins with a first step and the latest employment data are clearly a step in the right direction. Nonfarm employment increased by 80,000 jobs in October and data for the previous two months were revised up by a combined 102,000 jobs.

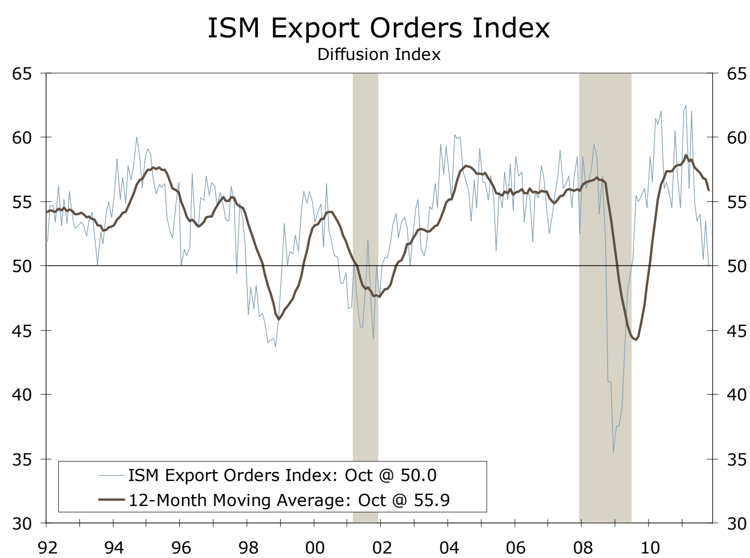
With October's increase, nonfarm employment has now risen by an average of 114,000 jobs over the past three months. Private sector payroll growth has been a little better than that, averaging a gain of 122,000 jobs per month. Both mark a slight improvement from the prior three months, when overall payrolls rose by an average of 67,000 per month and private sector payrolls rose by an average of 116,000 jobs per month. Moreover, gains over the past three months have been fairly broad based, with nearly 61 percent of the industries covered in the employment report adding jobs in September. The breadth of the gain in jobs is encouraging because it implies that the improvement in hiring is likely much more sustainable.

If there is a shortcoming in the employment data it is that a large proportion of the jobs added in recent months have tended to be in relatively lower-paying industries. Professional and business services added 32,000 jobs in October and nearly half of that gain was in temporary help. Education and health services added 28,000 jobs, with education adding 11,000 jobs and health care adding 11,600 jobs, much of them at physicians' offices. Another 4,700 jobs were added at social assistance organizations. Leisure and hospitality accounted for the next largest block of jobs, posting a gain of 22,000 positions. More than half that gain was at restaurants and bars. The large concentration of relatively low-paying jobs is one reason hours worked and earnings increased only modestly in October. The average workweek was unchanged on the month and aggregate hours worked rose just 0.1 percent. Average hourly earnings rose 0.2 percent.

The improved employment picture has helped put recession fears to rest. Europe's economic problem may cause growth to slow again, but the economy and labor market appear to be resilient enough to withstand such a hit, assuming that Europe does not completely "blow up". The latest orders and survey data from the manufacturing sector point to some slowing in exports. Domestic demand may also be cooling off. Motor vehicle sales have revved up a little recently, with most of the growth coming in luxury vehicles and trucks. The gain may simply reflect improved inventories of imported models that have been in short supply since the Japanese earthquake earlier this year.







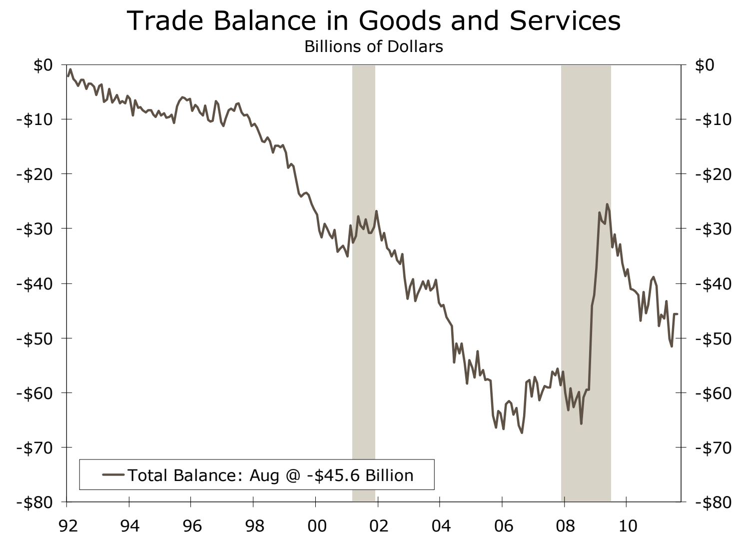
International Trade • Thursday

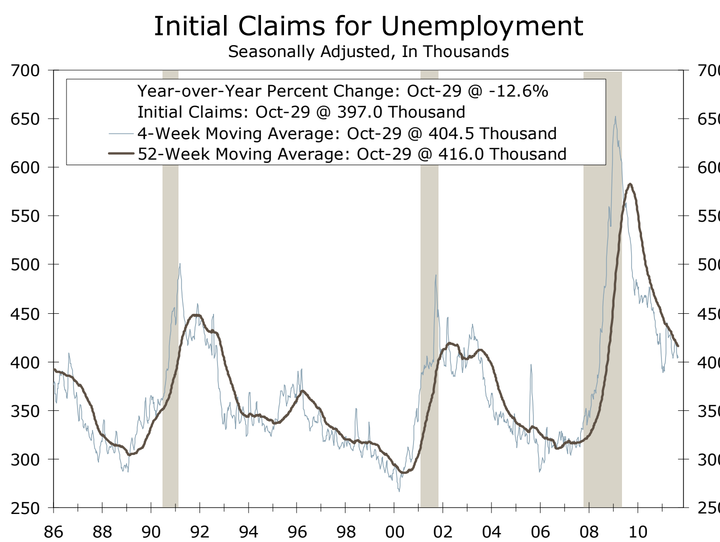
The trade deficit in August was roughly in line with consensus at $45.6 billion. Exports and imports both were essentially flat. The recent theme in the international trade numbers has been a softening in exports related to slowing global growth and weaker imports in the United States as consumer spending growth slows and as inventory building continues at a more modest pace.

Net exports were a slight boost to GDP in the third quarter, but we expect that in the context of softening growth in emerging markets and ongoing turmoil in Europe, export growth will likely slow. This should translate into a modest drag on GDP in the fourth quarter. Looking forward, we expect weak growth in consumer spending to essentially pace with slower global growth. The takeaway is that net exports will essentially not influence headline growth meaningfully one way or the other in 2012.

Previous: -$45.6B **Wells Fargo: -$44.3B**

Consensus: -46.2B





Initial Jobless Claims • Thursday

Some days the sun seems just ready to come out from behind a cloud but never seems to fully emerge and bring its warming light. The same has been true with jobless claims which have been range-bound between 400,000 and 450,000 for much of the past year.

For the most recent period, the week of Oct. 29, initial claims for unemployment insurance fell to 397,000 breaking below 400,000 for the first time since April and bringing the four-week moving average to 404,000. As the nearby graph shows, a typical number for an expansionary period in the economy is in the mid-300s. The present level of jobless claims is consistent with decent job growth, but we would need to see further improvement before we could expect to see a meaningful drop in the unemployment rate.

Previous: 397K

Consensus: 400K

Monthly Budget Statement • Thursday

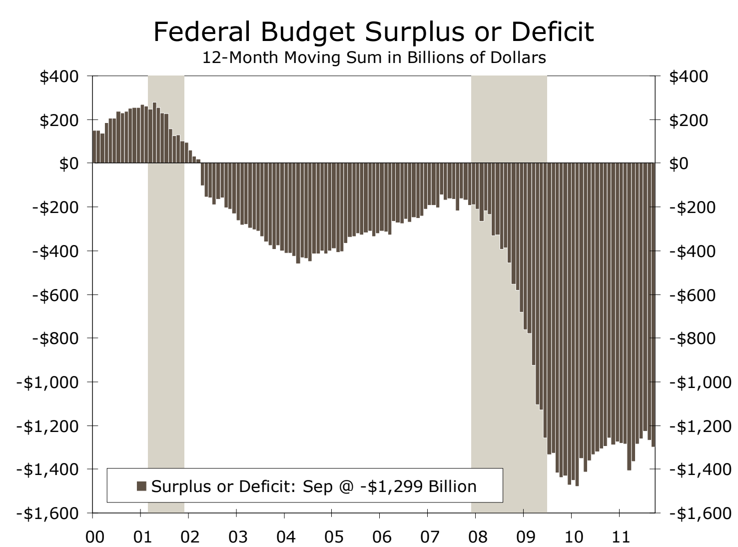
With fiscal year 2011 over, we get our first look at 2012 when the October monthly budget statement hits the wire next Tuesday.

The budget shortfall for this past year came in just shy of $1.3 trillion, which makes the deficit in 2011 the second highest on record.

The Congressional super-committee tasked with cutting $1.5 trillion in spending is due to come out with its proposals to cut spending by Nov. 23. Based on recent experience, there is little reason to expect anything from Congress well ahead of schedule. That said, the budget deficit and the long-term federal budget gap has become one of the highest priority concerns in Washington and we expect the budget deficit to eventually begin to narrow as proposals to cut spending become law.

Previous: -$140.4B

Consensus: -$110.7B



Global Review

Is This a Greek Circus or a Greek Tragedy?

Last week, the markets were celebrating what seemed to be a potential agreement to start solving the Greek and Eurozone debt crisis. However, this week's events showed that politicians are upping their bets to get more than what they had originally bargained for. The surprise, and potential unraveling of Greece's debt situation, came to a boiling point when Greek Prime Minister Papandreou said he planned to put the needed reforms to a political referendum, sending the markets into disarray.

EU leaders were openly dismayed by Papandreou's surprise announcement because it threatened to derail the entire rescue plan that was painstakingly cobbled together at last week EU summit. Indeed, the EU and the IMF said they would withhold any further assistance until the referendum was approved. Some Socialist backbenchers also abandoned Mr. Papandreou. The combination of internal and external pressure apparently was enough to cause Papandreou to scrub the planned referendum only two days after he had called it.

Markets across the world are wondering if the latest events are similar to a Greek circus or the scary chapter of a Greek tragedy. While markets originally did not like Mr. Papandreou's proposal, a referendum could open the door to a "potentially" orderly exit of a member country from the Eurozone agreement, something that does not exist today. While this issue does not solve the debt problem facing the region's banks, at least it gives the Greeks a chance to decide their future inside or outside of the Eurozone.

Nothing Has Changed

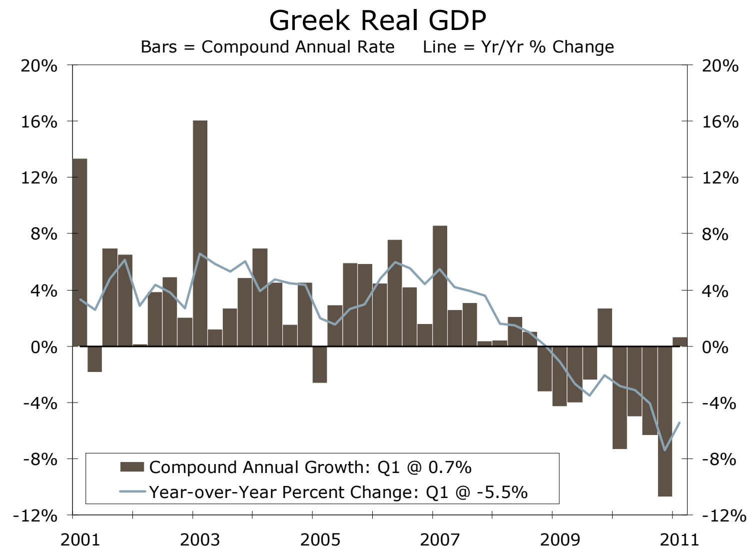
What many seem to have missed from the current discussion on the Greek and European debt crisis is that nothing has changed. The region is facing serious debt issues and if politicians are not able to come up with feasible alternatives to solve these issues, they are putting their economies, as well as the world economy, in jeopardy. And while many are just concentrating on Greece, this country is just the tip of the iceberg on a broader issue: the inability of the whole European region to grow at rates that would allow its member countries to improve their debt profile.

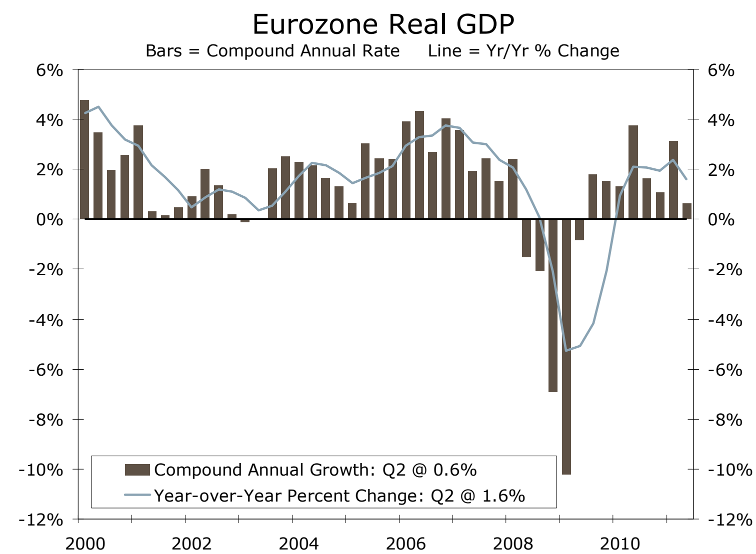
Thus, while solving the Greek situation is the first step, a solution to the region's problems would have to be broader and include reforms that will make the region's countries more competitive in the world market.

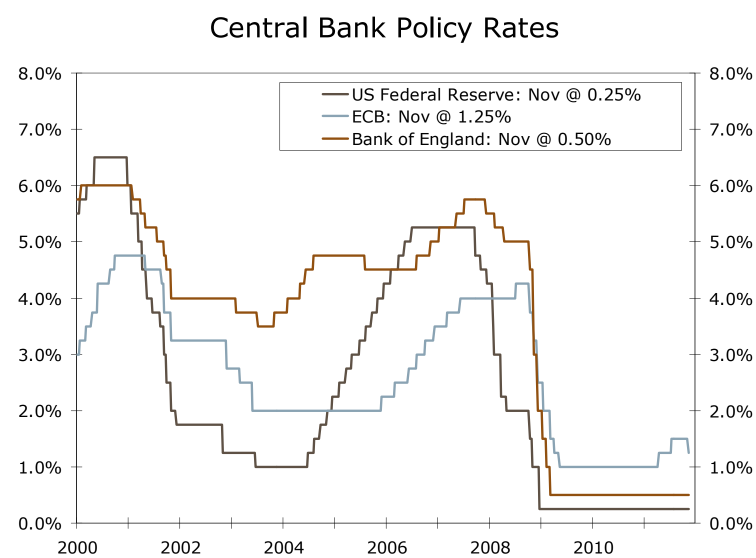
The New ECB President Delivers a Surprise

Mario Draghi, the new president of the ECB, delivered a surprise on Thursday when the ECB decided to cut interest rates by 25 bps, from 1.50 percent to 1.25 percent. While we were expecting the ECB to move during the last month of the year as the Eurozone economy was clearly showing signs of slowing down, the decision took markets by surprise as they thought the new ECB president would take some time taking over the reins of the institution and imposing his different views.

We expect the ECB to continue to decrease interest rates in the coming months, reaching 0.75 percent by the first months of next year.





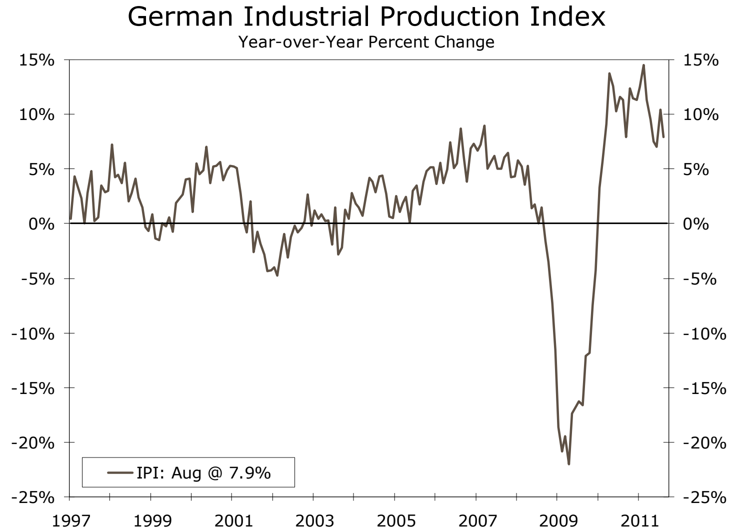


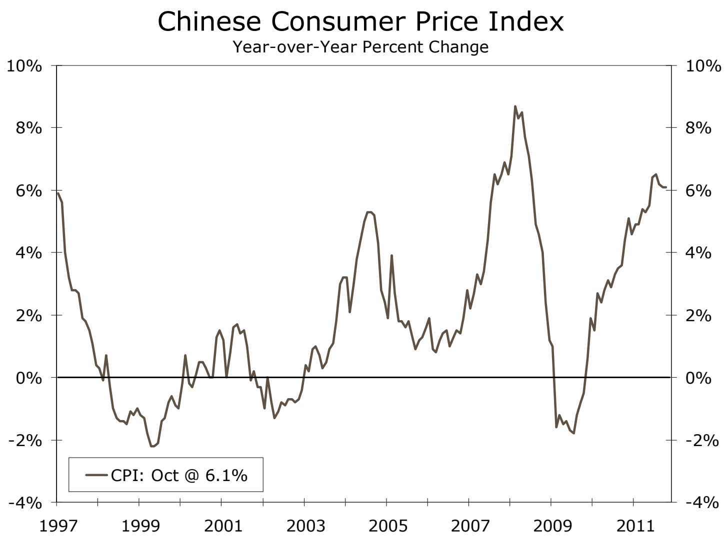
Germany Industrial Production • Monday

German industrial production fell 1.0 percent in August from the prior month, while the year-over-year rate of growth slid to 7.7 percent from 10.3 percent. Although capital goods production rose 0.2 percent on the month, production of consumer goods plunged 4.9 percent and was down 1.1 percent from a year ago. Consumer confidence has wilted in Europe's largest economy amid continued worries about the sovereign debt crisis and what the consequences may be for the region's economic growth. Germany saw the weakest economic growth in the second quarter since March 2010, and consumers are increasingly worried that things could get worse. The manufacturing PMI, which closely tracks industrial production growth, fell to 50.3 in September from 50.9 in August. This suggests industrial production likely slowed further in September. The manufacturing PMI has since dropped to 48.9 in October, meaning German manufacturing is now in contraction.

Previous: -1.0%

Consensus: -0.6% (Month-over-Month)





China CPI • Tuesday

China's inflation rate has slowed from a recent peak of 6.5 percent year over year in July to 6.1 percent in September. While non-food prices have continued to rise at a fairly steady rate of around 3.0 percent for the past several months, food price inflation has slowed from 14.8 percent in July to 13.4 percent as of September. Within non-food categories, inflation has been rising since the spring in most categories, but has been on a slowing trend over the past three months for recreation, education and housing. Thus, it has not been an across-the-board slowdown in inflation since July. Still, it appears that the central bank's attempts to cool inflation by raising interest rates and reserve requirements may finally be starting to have some effect. This, along with the gradual slowdown in economic growth, shows that China's efforts to curb inflation and engineer a soft landing are working. With credit tightening and retail sales slowing, inflation likely softened further in October.

Previous: 6.1% **Wells Fargo: 5.3%**

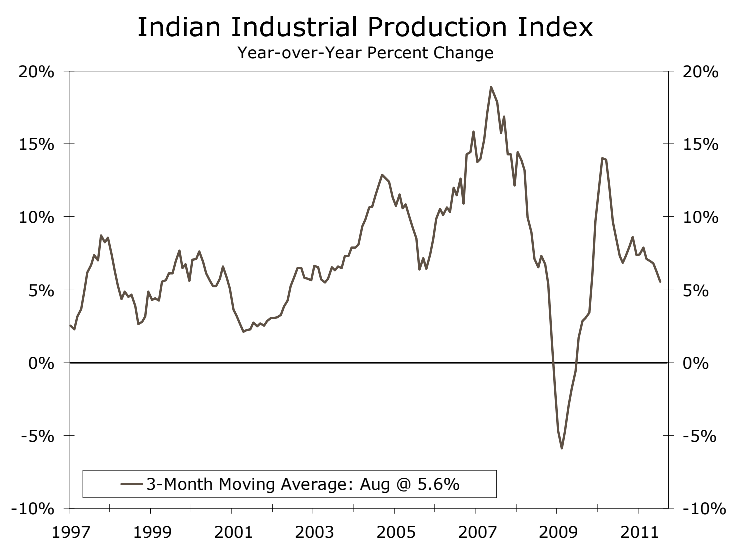
Consensus: 5.4% (Year-over-Year)

India Industrial Production • Thursday

Industrial production in India has slowed noticeably since last year after peaking at about 15.0 percent year over year in March 2010. Production growth has slowed to just 4.1 percent as of August, bringing the three-month moving average down to just 5.6 percent. This slowdown has coincided with a substantial 325-bp increase in the repo rate as the central bank has battled high inflation in one of the world's fastest-growing economies. Although consumer price inflation has been cut in half from the January 2010 peak of 16.2 percent year over year, wholesale price inflation remains near the highest in a year. This, along with a rapidly depreciating rupee, will keep the central bank vigilant on the inflation front. In fact, since August, the repo rate has been increased another 50 bps to 8.5 percent as of October. Slowing global demand and continued financial turmoil, which could further weaken the rupee and lead to higher interest rates, pose downside risks for industrial production.

Previous: 4.1% (Year-over-Year)

Consensus: N/A



Interest Rate Watch

FOMC Outlook, Market Rates

Two major developments this week should influence the path of interest rates over the next six months. First, the Federal Open Market Committee (FOMC) downgraded its expectations for economic growth, raising its inflation and unemployment expectations for 2011 and 2012. Second, the Eurozone community continued to struggle to come to a meaningful arrangement with the interim volatility of market rates and capital flows continuing.

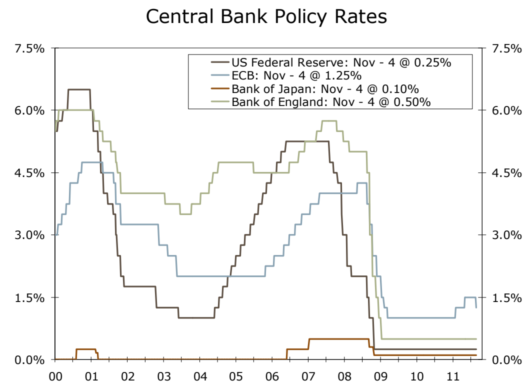
Domestic Policy

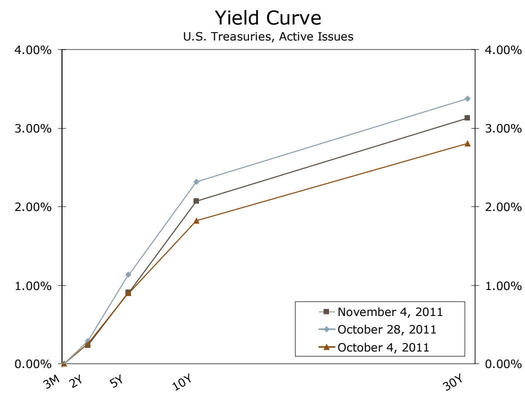
The FOMC lowered its expectations for growth in 2012, from 3.3-3.7 percent to 2.5-2.9 percent which we also see as a reasonable base case for the year ahead. Meanwhile, the unemployment rate central tendency was raised to 8.5-8.7 percent. This combination suggests to us that the FOMC will maintain its outlook for a low fed funds rate through mid-2013. In addition, the FOMC will continue with Operation Twist, which will help moderate any rise in benchmark Treasury rates in the year ahead.

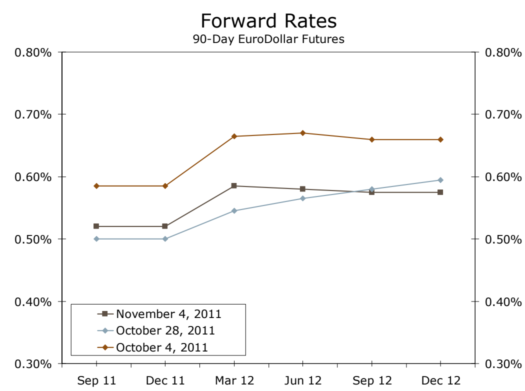
Global Issues

For many years our research has emphasized the importance of global capital flows and the market for financial capital on a worldwide scale. The experience of the Greek sovereign debt saga has reinforced our views. Greece presents decision makers with uncertainty—not risk—simply because the outcomes and the risks have no precedent that can be used as a model. Given this uncertainty, we have seen that the threat of 50 percent haircuts to private investors has no doubt prompted the rise in yield spreads of Spanish and Italian debt relative to the benchmark German rates. While the level of rates may appear modest, the problem is that the level of rates is high relative to the ability of these economies to grow and therefore is not sustainable over time.

So what is sustainable? For now, the U.S. Treasury rate appears to be the cleanest shirt in the closet. Therefore, this will also tend to limit any upward movement in Treasury rates—at least until the U.S. chooses its next fiscal policy direction.







Credit Market Insights

CMBS Lending Pullback

Total CMBS outstanding has declined 18.6 percent from its peak in October 2007 to $616.5 billion in the second quarter. Much of the retracement is due to continued volatility in the financial markets, which has caused volatility in CMBS spreads and makes issuance difficult. Indeed, our Structured Products Research Group has downgraded its CMBS issuance forecast and now expects origination to reach only $30 billion in 2011. That said, the pullback in conduit lending has opened the door for banks and insurance companies that tend to favor trophy properties in select markets. One encouraging sign, however, is that transaction activity shows that investors searching for yield could be moving beyond the safety of Class A properties. According to Real Capital Analytics (RCA), the yields for top-tier office properties in the third quarter were flat while average cap rates declined. In fact, cap rates for central business district (CBD) properties in secondary markets and suburban properties in primary markets moved sharply lower. Much of the increased activity in these markets is being done by institutional investors seeking yield. RCA further reports that the share of institutional investors in U.S. nonprimary markets in CBD is 40 percent of the total in 2011, which is up from 10 percent in 2010. With activity finally stretching beyond Class A properties, pricing in the broader markets could begin to improve.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.00%	4.10%	3.94%	4.27%
15-Yr Fixed	3.31%	3.38%	3.26%	3.72%
5/1 ARM	2.96%	3.08%	2.96%	3.47%
1-Yr ARM	2.88%	2.90%	2.95%	3.40%
MBA Applications				
Composite	665.6	664.0	734.9	787.3
Purchase	174.8	171.7	175.2	178.9
Refinance	3,539.3	3,546.7	4,019.0	4,328.8

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

Topic of the Week

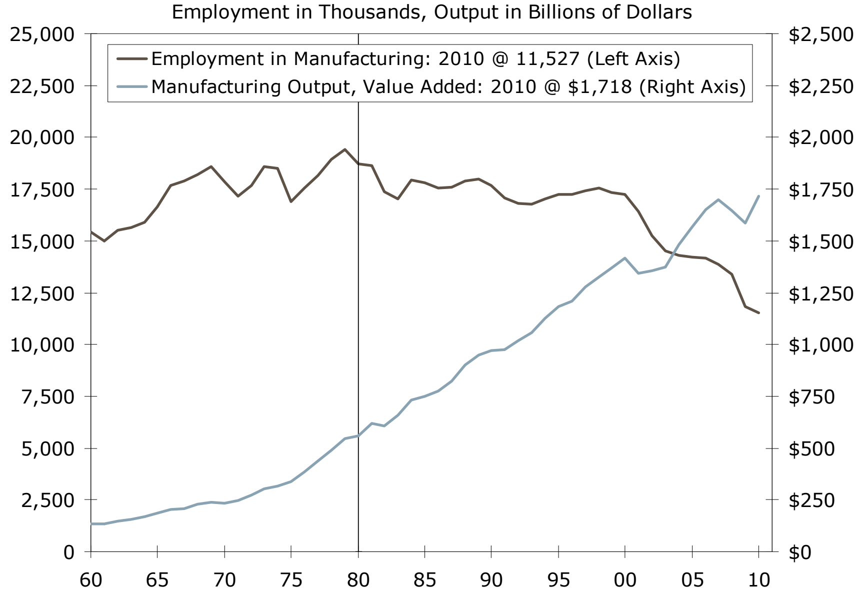
The Decline of Manufacturing?

This week our group published a special report on the state of the U.S. manufacturing sector that explores the history of the industry and provides what we believe will be opportunities for future growth within the industry. We use the structural shift in the U.S. manufacturing sector to explore recent trends in manufacturing within emerging market economies. A brief summary of our results is described below.

We found that previous measures of the health of the U.S. manufacturing sector such as employment do not accurately capture the new face of U.S. manufacturing that is now more capital-intensive in the form of technology. This adoption of technology requires fewer, more highly skilled and productive workers than in the past. We also explored the future of U.S. manufacturing in light of the increasing demand for U.S. factory technology among emerging market economies. Our findings suggest that on an output basis, the manufacturing sector of the economy remains stronger and more productive than at any other point in the past. Furthermore, the future of the U.S. manufacturing sector will likely depend more than ever on exporting our accumulated manufacturing knowledge and technologies to assist emerging market economies increase their capital intensity and productivity, and improve their manufacturing processes. We expect this trend to help support further growth in U.S. exports, which in turn will provide support to U.S. economic growth. This trend will help boost output among domestic equipment and software manufacturers in the United States along with the demand for operational management and supply chain consulting services. It is this growing demand for capital goods that leads us to the conclusion that manufacturing in the United States is not in decline, but rather the types of goods that we produce and the way we produce these goods has fundamentally changed. For further details our full report, *Is U.S. Manufacturing in Decline?*, is available on our website under the special reports section.

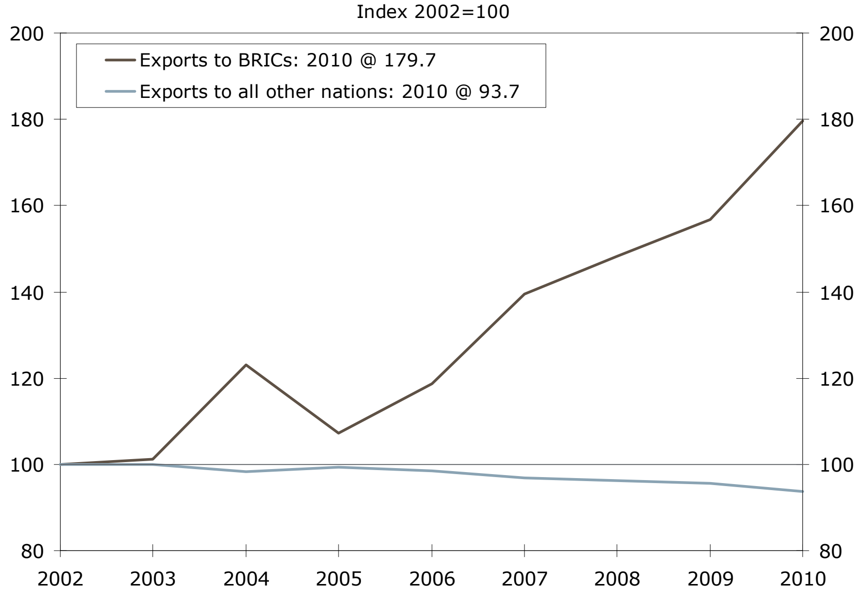
Manufacturing Employment and Output

Employment in Thousands, Output in Billions of Dollars



Growth in the Share of U.S. Industrial and Business Machinery Exports

Index 2002=100



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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 11/4/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	-0.01	0.00	0.11
3-Month LIBOR	0.44	0.43	0.29
1-Year Treasury	0.14	0.15	0.13
2-Year Treasury	0.23	0.29	0.33
5-Year Treasury	0.91	1.13	1.03
10-Year Treasury	2.07	2.32	2.49
30-Year Treasury	3.15	3.38	4.07
Bond Buyer Index	4.02	4.12	4.02

Foreign Exchange Rates

	Friday 11/4/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.376	1.415	1.421
British Pound ($/£)	1.598	1.613	1.627
British Pound (£/€)	0.861	0.878	0.873
Japanese Yen (¥/$)	78.130	75.820	80.750
Canadian Dollar (C$/$)	1.020	0.992	1.002
Swiss Franc (CHF/$)	0.888	0.863	0.958
Australian Dollar (US$/A$)	1.036	1.070	1.015
Mexican Peso (MXN/$)	13.409	12.999	12.237
Chinese Yuan (CNY/$)	6.340	6.360	6.662
Indian Rupee (INR/$)	49.111	48.766	44.211
Brazilian Real (BRL/$)	1.741	1.672	1.671
U.S. Dollar Index	77.011	75.067	75.882

Foreign Interest Rates

	Friday 11/4/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.44	1.53	0.99
3-Month Sterling LIBOR	0.99	0.99	0.74
3-Month Canadian LIBOR	1.28	1.27	1.21
3-Month Yen LIBOR	0.19	0.20	0.20
2-Year German	0.39	0.60	0.93
2-Year U.K.	0.53	0.55	0.65
2-Year Canadian	0.93	1.09	1.41
2-Year Japanese	0.14	0.14	0.14
10-Year German	1.85	2.18	2.40
10-Year U.K.	2.35	2.61	2.95
10-Year Canadian	2.19	2.43	2.81
10-Year Japanese	0.99	1.04	0.93

Commodity Prices

	Friday 11/4/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	93.80	93.32	86.49
Gold ($/Ounce)	1756.30	1743.75	1392.50
Hot-Rolled Steel ($/S.Ton)	635.00	635.00	555.00
Copper (¢/Pound)	357.45	370.20	390.65
Soybeans ($/Bushel)	12.02	11.95	12.03
Natural Gas ($/MMBTU)	3.85	3.92	3.86
Nickel ($/Metric Ton)	18,402	19,880	23,478
CRB Spot Inds.	536.05	540.03	552.70

Next Week's Economic Calendar

	Monday 7	Tuesday 8	Wednesday 9	Thursday 10	Friday 11
U.S. Data	**Consumer Credit** August -$9.501B September $5.100B (c)		**Wholesale Inventories** August 0.4% September 0.6% (c)	**Import Price Index** September 0.3% October 0.2% (W) **Trade Balance** August -$45.6B September -$44.3B (W) **Budget Statement** September -$140.4B October -$110.7B (c)	**U. of Mich. Confidence** October 60.9 November 61.0 (c)
Global Data	**Eurozone** **Retail Sales (MoM)** Previous (Aug) 0.1% **Germany** **IP (MoM)** Previous (Aug) -1.0%	**China** **CPI (YoY)** Previous (Sep) 6.1% **U.K.** **IP (MoM)** Previous (Aug) 0.2%	**Japan** **Machine Orders (MoM)** Previous (Aug) 11.0%	**Germany** **CPI (MoM)** Previous (Sep) 0.1% **India** **IP (YoY)** Previous (Aug) 4.1%	

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

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