October 8, 2010

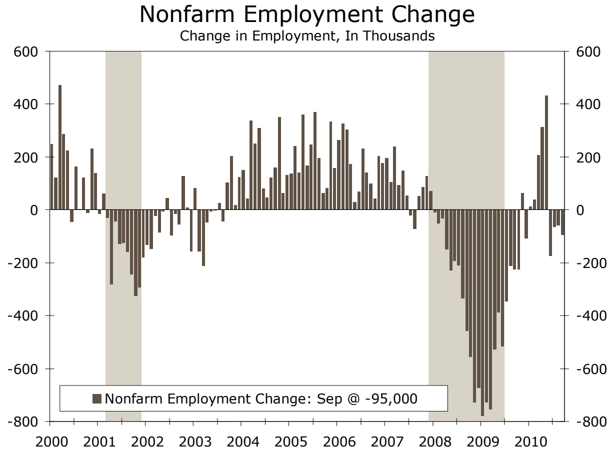
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Disappointing Jobs Report Gives Fed Ammunition

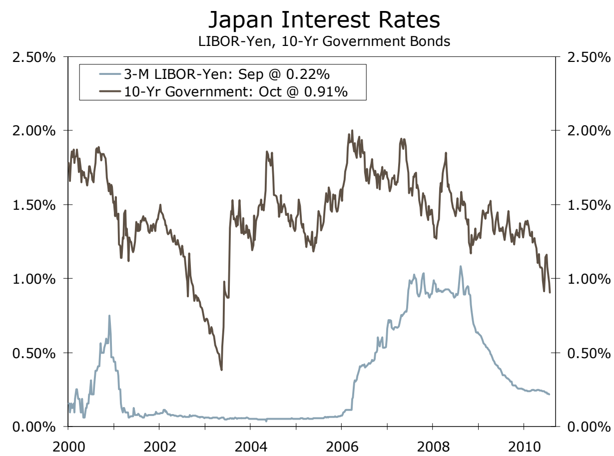
- Nonfarm employment fell sharply by 95,000 jobs in September, which was far worse than expected. The wild card factor during the month was clearly government jobs, which fell by 159,000 jobs.
- We continue to expect moderate growth, but the bevy of disappointing economic data should give the Fed the latitude necessary for more quantitative easing.
- The ISM Non-Manufacturing index came in at 53.2 due to increases in new orders, supplier deliveries and employment.



Global Review

Central Bankers Off To the Races!

- The Bank of Japan (BoJ) surprised markets with measures that could set the stage for a massive round of unorthodox monetary expansion across the developed world.
- Although the European Central Bank (ECB) and the Bank of England (BoE) did not follow the BoJ's lead this week with their own expanded quantitative easing (QE) programs, there is widespread speculation that the BoE will increase the size of its asset purchase program at some point in the next month or two.



Wells Fargo U.S. Economic Forecast

	Actual						Forecast		Actual				Forecast	
	2009				2010				2006	2007	2008	2009	2010	2011
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product [1]	-4.9	-0.7	1.6	5.0	3.7	1.6	1.6	2.3	2.7	1.9	0.0	-2.6	2.7	2.2
Personal Consumption	-0.5	-1.6	2.0	0.9	1.9	2.0	1.7	1.3	2.9	2.4	-0.3	-1.2	1.5	1.6
Inflation Indicators [2]														
"Core" PCE Deflator	1.6	1.5	1.3	1.7	1.8	1.5	1.3	1.0	2.3	2.4	2.3	1.5	1.4	1.1
Consumer Price Index	-0.2	-1.0	-1.6	1.5	2.4	1.8	1.1	0.6	3.2	2.9	3.8	-0.3	1.4	1.0
Industrial Production [1]	-17.6	-10.3	8.3	7.0	7.1	6.7	6.2	2.2	2.2	2.7	-3.3	-9.3	5.5	3.5
Corporate Profits Before Taxes[2]	-17.3	-11.4	-3.9	42.5	37.6	39.2	17.6	12.8	10.5	-6.1	-16.4	-0.4	25.8	6.8
Trade Weighted Dollar Index[3]	83.2	77.7	74.3	74.8	76.1	78.8	76.8	77.3	81.5	73.3	79.4	74.8	77.3	83.0
Unemployment Rate	8.2	9.3	9.6	10.0	9.7	9.7	9.6	9.9	4.6	4.6	5.8	9.3	9.7	9.6
Housing Starts[4]	0.53	0.54	0.59	0.56	0.62	0.60	0.55	0.60	1.81	1.34	0.90	0.55	0.59	0.81
Quarter-End Interest Rates														
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	5.25	4.25	0.25	0.25	0.25	0.31
Conventional Mortgage Rate	5.00	5.42	5.06	4.93	4.97	4.74	4.10	4.20	6.14	6.10	5.33	4.93	4.50	5.15
10 Year Note	2.71	3.53	3.31	3.85	3.84	2.97	2.50	2.60	4.71	4.04	2.25	3.85	2.98	2.98

Forecast as of: September 8, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

Inside

U.S. Review

The Door is Open for More Quantitative Easing

Nonfarm employment fell sharply by 95,000 jobs in September, which was far worse than expected. The wild card factor during the month was clearly government jobs, which fell by 159,000 with federal and local accounting for the lion's share. Municipalities continued to alleviate financial strain in September by downsizing 76,000 workers; States shed 7,000 jobs and Census layoffs accounted for another 76,000. Adding insult to injury, the Bureau of Labor Statistics expects the March 2010 preliminary annual benchmark revisions could shave an additional 366,000 from payrolls. Yet another troubling aspect of this morning's report was the decline in construction and manufacturing jobs, but seasonal factors could be at play. Even with the drop in employment, the unemployment rate remained steady at 9.6 percent, but the rate for discouraged workers jumped to 17.1 percent from 16.7 percent in August.

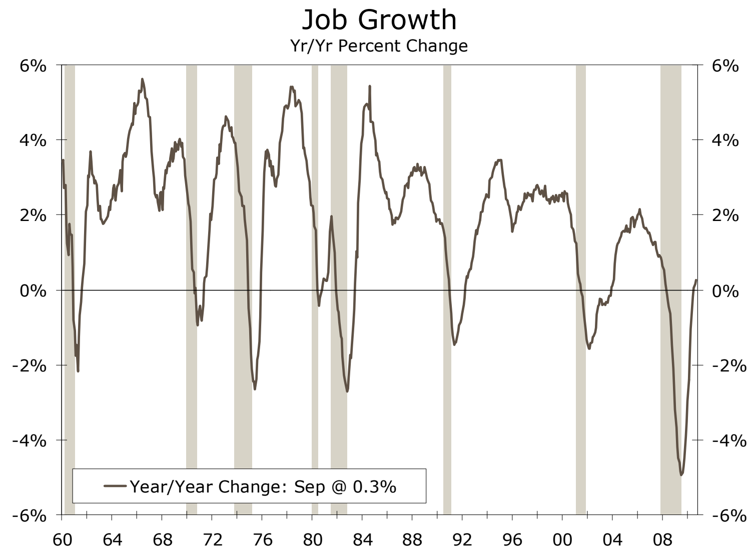
While the private sector rose by 86,000 jobs, the labor market still paints a dismal picture for economic growth. Much of the growth in the private sector was concentrated in temporary help and leisure & hospitality jobs. Moreover, the average gain in private sector employment for the past three months is around 96,000, which is well below the pace needed to reduce the unemployment rate.

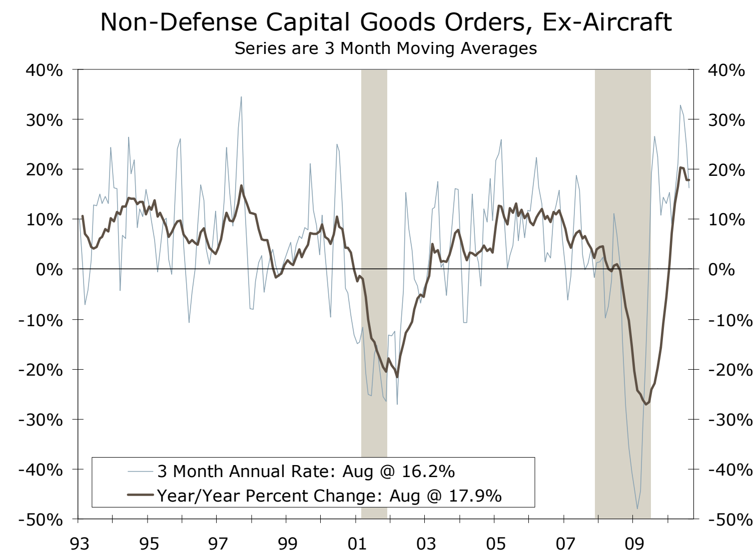
The implications for the economy are far-reaching, and we continue to expect moderate growth, but the bevy of disappointing economic data should give the Fed the latitude necessary for more quantitative easing.

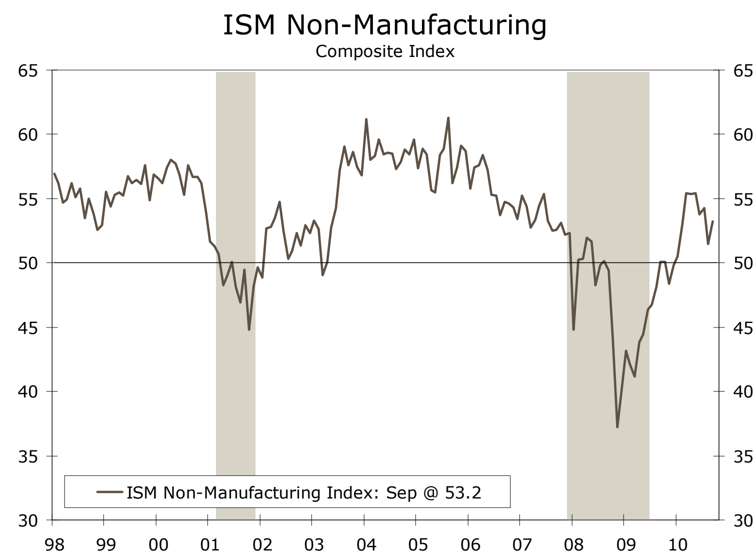
All is not gloom and doom, however. Four reliable indicators for future employment growth are the length of the workweek, temporary employment, initial jobless claims and the number of job openings relative to the size of employment. All measures have shown signs of stabilizing in recent months.

Factory orders released during the week were also somewhat discouraging. Orders fell 0.5 percent in August, but most of the decline was in the volatile transportation sector. On a more positive note, non-defense capital goods orders excluding aircraft rose 5.1 percent on the month, which continues to suggest manufacturing strength, but the pace is slowing. Inventory rebuilding has accounted for a large proportion of the improvement in factory output over the past year, and the impact from restocking is beginning to lose some steam.

While the jobs number and factory sector delivered disappointing data, the service sector provided a glimmer of hope. The ISM Non-Manufacturing index came in at 53.2 due to increases in new orders, supplier deliveries and employment. The forward looking new orders component increased to 54.9, which suggests more service sector gains are likely in the coming months. Other sub-indexes that do not factor into the headline remained expansionary, with the exception of inventories and backlog orders. The contraction in inventories is in line with the wind down of the inventory cycle.





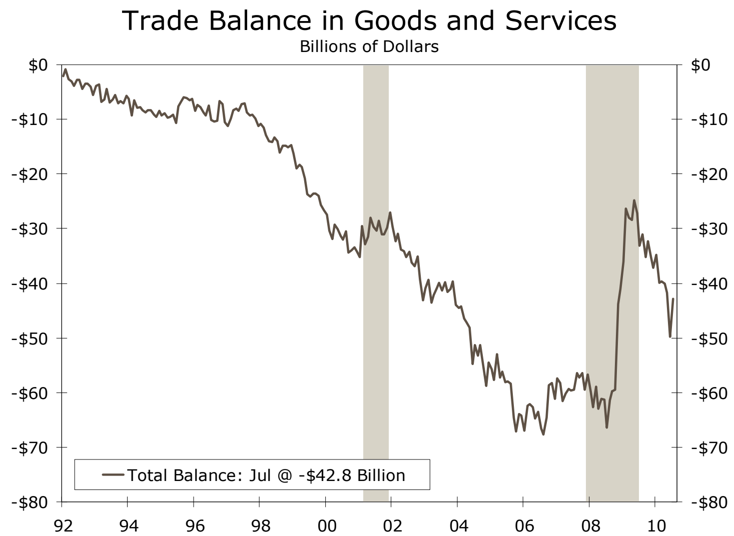


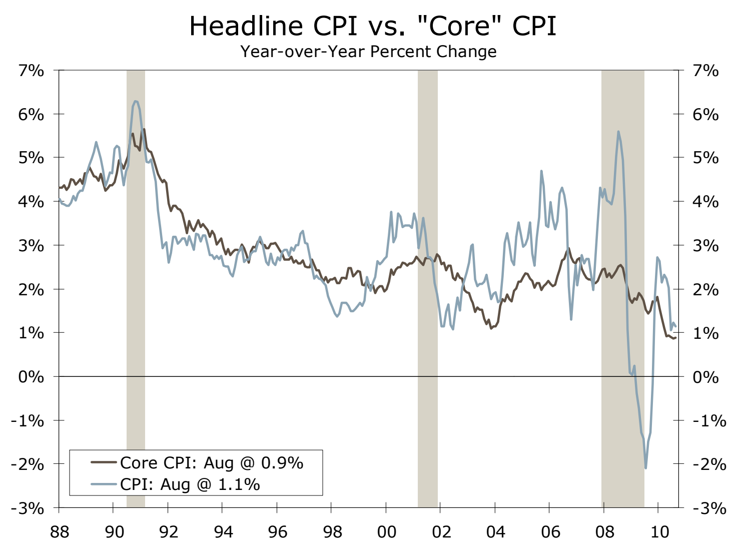
Trade Balance • Thursday

The trade deficit narrowed in July to -$42.8 billion as exports rose and imports dropped. Exports were primarily driven by civilian aircraft, which accounted for half of the increase. Industrial machines, computers and telecommunications equipment also saw increases. Exports of consumer goods contracted, however. This, along with a big contraction in imports of consumer goods, suggests companies are turning a bit more cautious with their inventories as the economy has slowed. We expect the trade deficit widened a bit in August as export growth slowed amid a pullback in civilian aircraft and further weakness in consumer goods. As trade was a huge drag on growth in the second quarter, all eyes will be on this report to decipher what impact trade might have on third quarter growth. In addition, the trade deficit with China will be closely scrutinized as the United States pushes China to allow the yuan to float.

Previous: -$42.8 B **Wells Fargo: -$46.1 B**

Consensus: -$44.5 B





Consumer Price Index • Friday

Consumer price inflation remains extremely low by historical standards. At 1.1 percent year-over-year as of August, inflation is currently running around the lower bound of Federal Reserve's comfort zone, allowing them to keep the Fed Funds rate at record lows, and giving them the flexibility to embark on a second round of quantitative easing (if necessary) to avoid deflation. Housing, which comprises 42.0 percent of the CPI, is helping to keep the overall index subdued as owners' equivalent rent remains stagnant in a weak housing market. Following three months of declines, the overall index rose over the past couple months, driven primarily by energy as dollar weakness and strength in emerging markets has kept energy prices elevated on a seasonally adjusted basis. Excluding energy, inflation has been consistently low for months, and we expect this trend continued in September.

Previous: 0.3% **Wells Fargo: 0.1%**

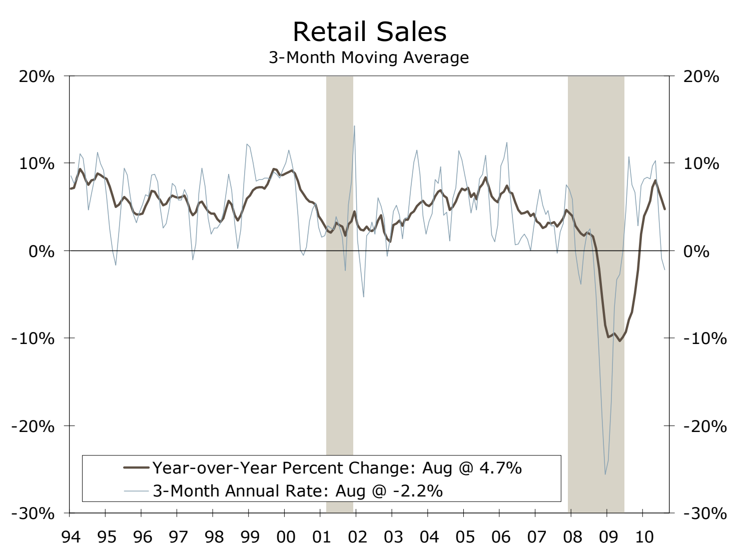
Consensus: 0.2% (Month-over-Month)

Retail Sales • Friday

After a strong rebound in 2009, retail sales have leveled off over the past few months. In addition, sales at gasoline stations have contributed the most to overall sales the past couple months as prices remained elevated. In August, vehicle sales slowed, detracting from overall sales. This was offset, however, by a large contribution from food and beverages, driven in part by the jump in grain prices amid drought and heat in Europe and central Asia. Clothing sales benefited in August from back-to-school discounts and tax holidays. We expect a strong contribution from vehicle sales as sales have rebounded in September. Sales at gasoline stations will likely contribute a bit less due to the end of the summer driving season. Food sales will probably contribute less as well following a drop in grain prices. Clothing sales will also likely not be as strong due to the end of back-to-school shopping.

Previous: 0.4% **Wells Fargo: 0.3%**

Consensus: 0.4% (Month-over-Month)



Global Review

Central Bankers Off to the Races!

After much market chatter over the past several weeks regarding the possibility of the U.S. Federal Reserve seriously considering a second round of QE, the Bank of Japan (BoJ) surprised markets with measures that could set the stage for a massive round of unorthodox monetary expansion across the developed world. One of the measures taken by the BoJ was symbolic, changing its target rate to a range that goes from 0.0 percent to 0.1 percent from 0.1 percent. However, the other measures were not symbolic and have actually opened the floodgates across the developed world.

First, the BoJ has committed to maintaining its interest rate policy until "price stability is in sight." More important, the BoJ increased the size of its asset-purchase program by ¥5 trillion (about $60 billion at the current exchange rates). The announcement had an immediate effect on long-term interest rates. For example, the yield on the 10-year Japanese government bond fell about 10 bps to end the week at less than 0.90 percent, the lowest rate in more than seven years.

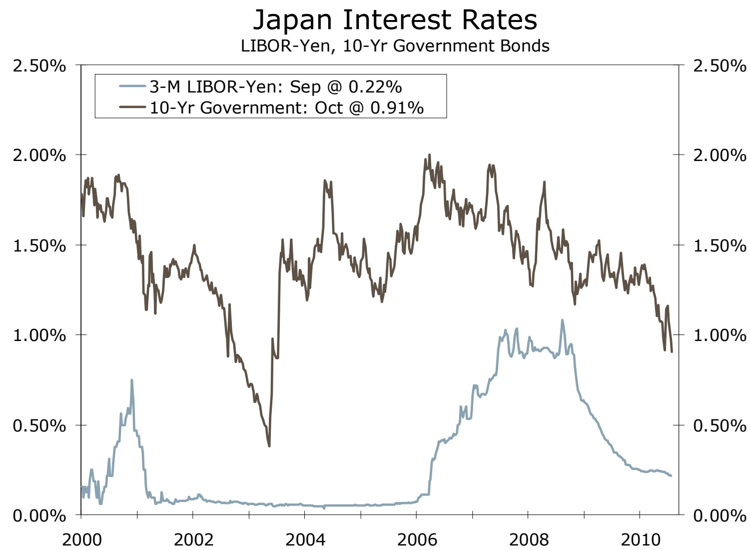
For the BoJ, this move comes after the institution intervened in the foreign exchange market to try to devalue the yen with basically less than stellar results several weeks ago. Thus, this could be seen as a further step in its efforts to weaken the yen in order to boost Japanese exports and give some breathing ground to a sagging economy.

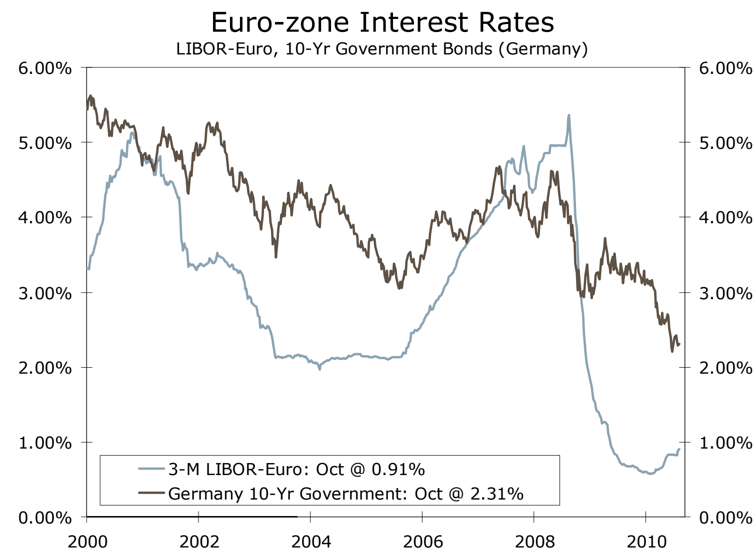
It is almost certain that other central bankers in the developed world have taken notice of the move by the BoJ and will keep a close eye on the coming attraction from the U.S. Federal Reserve. For many months, we have been expecting the U.S. Federal Reserve to move forward in its second round of quantitative easing. We expect this move to occur after the mid-term elections, but before the Thanksgiving Day holiday.

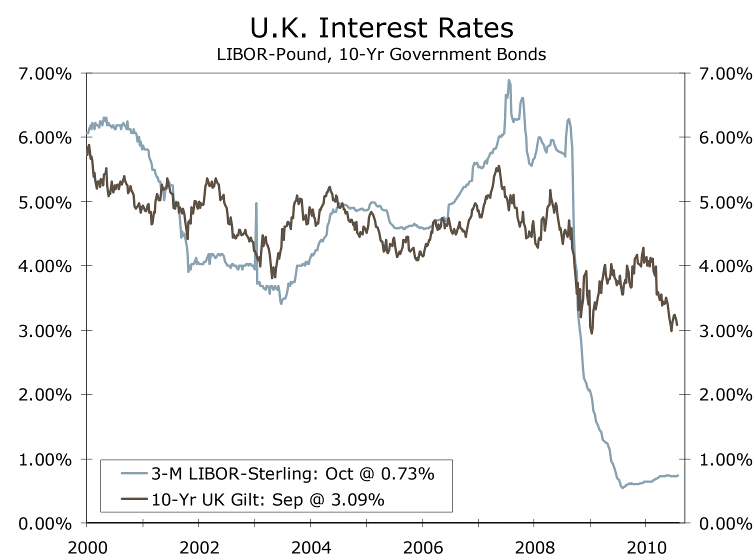
Although the European Central Bank and the Bank of England did not follow the BoJ's lead this week with their own expanded QE programs, there is widespread speculation that the BoE will increase the size of its asset-purchase program at some point in the next month or two. The real intention of quantitative easing by the developed world is to try to recreate inflation and inflationary expectations; that is, to try to inflate these economies to avoid a deflationary environment.

However, this strategy plays against some of the developing countries' currencies. This effect was clear with the recent commentaries by Brazilian officials complaining about the appreciation of the Brazilian real and the doubling of the tax on investment in fixed-income securities—a tax that went from two percent to four percent in an effort to slow down hot money coming to Brazil that is adding to the appreciating trend of the currency.

The biggest risk today is that the consequences of all these events could drive the world economy into a wall, with increasing calls to protect economies from damaging policies by countries that manipulate their currencies. This is never good for world growth.







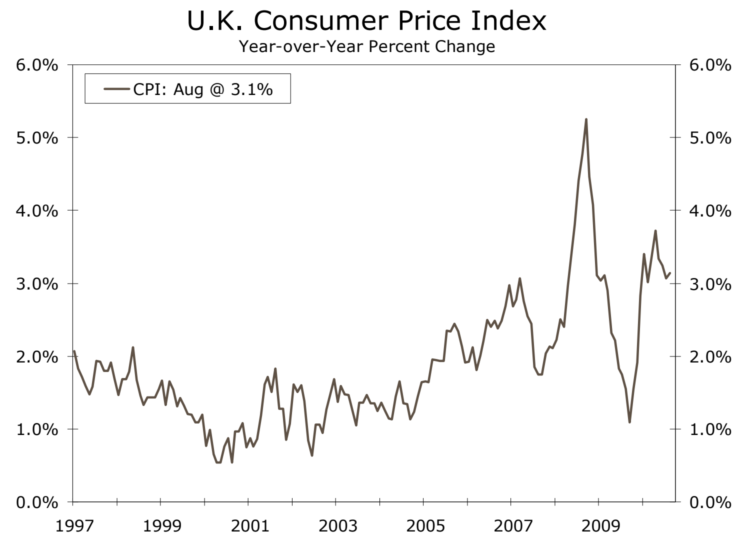
United Kingdom CPI • Tuesday

With a budding fragile recovery underway in the United Kingdom, the BoE has to strike the right balance of continuing to stimulate the economy without promoting inflation.

The overall rate of CPI inflation is well above the Bank of England's target of two percent at present. The September reading of consumer prices will become available on Tuesday and is not expected to show much of a change. Further out, the increase in the value-added tax that will go into effect on Jan. 4 should keep inflation elevated into early 2011. That said, we believe the Bank of England will refrain from raising rates until economic recovery becomes more firmly established.

Previous: 0.5%

Consensus: 0.0% (Month-over-Month)



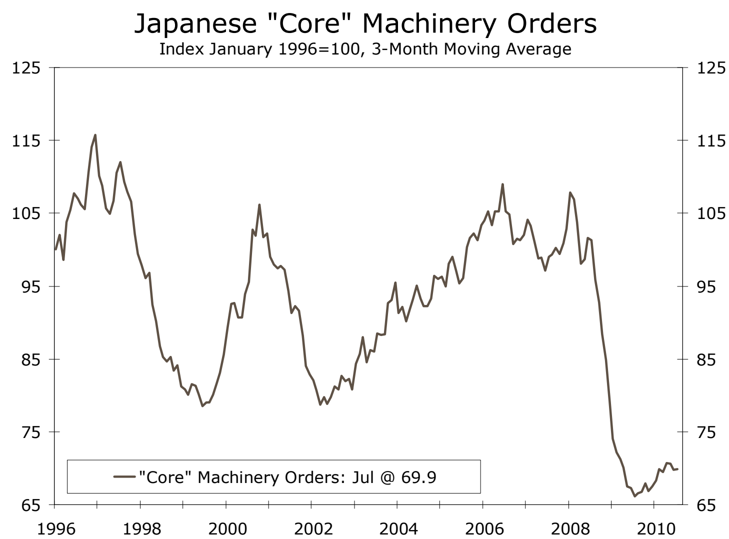
Japanese Machine Orders • Wed.

For the past several months the Japanese economy has been teetering on the brink of a double-dip recession. Mixed data in recent weeks have not been helpful in discerning the outlook as retail sales and industrial production data have failed to live up to consensus expectations, though auto production and housing starts data have been somewhat better than expected.

Machine orders have been a notable bright spot, posting back-to-back monthly increases, with the 8.8 percent jump in July exceeding expectations for a more modest 2.0 percent increase. August orders data will be reported on Wednesday. Consistent with the give-and-take nature of economic news lately, Japanese market watchers are looking for some giveback in August.

Previous: 8.8%

Consensus: -3.9% (Month-over-Month)



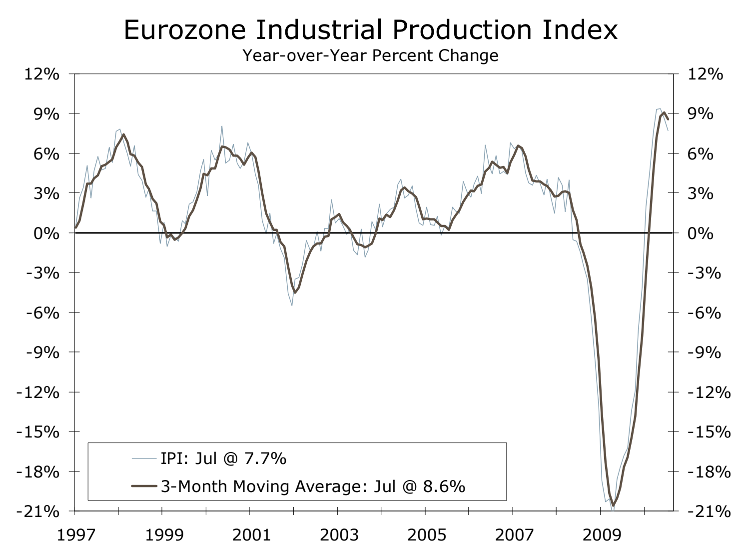
Eurozone Industrial Production • Wed.

Despite growing at a 3.9 percent annualized pace in the second quarter, the Eurozone recovery remains fragile as the 16-nation economy grapples with the implementation of austerity measures to address sovereign debt fears.

The growth in the second quarter was fueled by increased exports, as a weaker euro made European-made manufactured goods more affordable to foreign buyers. Industrial production (IP) data out of the Eurozone for July rattled financial markets as output was essentially flat, suggesting the demand for factory goods was cooling. August IP numbers will hit the wire on Wednesday and expectations are running high. A strong outturn would signal the export-led recovery has legs, while a weak output number would add to the fears that the recovery in the Eurozone will be even slower.

Previous: 0.0%

Consensus: 0.8% (Month-over-Month)



Interest Rate Watch

A Conflict of Visions

Over the past two weeks we have heard the conflicting views on monetary policy easing from various senior Federal Reserve speakers. The debate is healthy and needed given the serious implications for decision-makers.

Liquidity Is the Driver, Short-Run Is the Focus

New York Fed President Bill Dudley emphasized that the current economic situation is "wholly unsatisfactory." The economic recovery is tepid. Unemployment is high. Inflation is too low—inconsistent with the Fed's mandate for price stability. The solution is to provide more liquidity through $500 billion of security purchases. The expansion of the Fed's balance sheet should not be a concern here given the amount of slack in the economy. If a reversal in policy is needed down the road then the Fed has the tools to do this.

Well Not So Quick Pilgrim

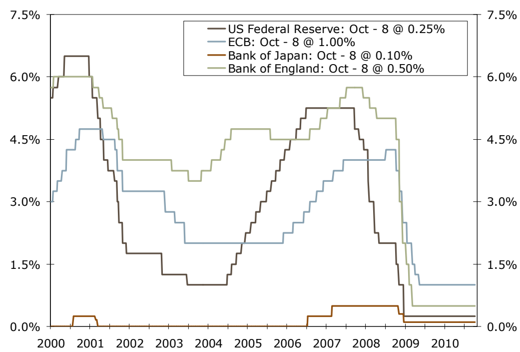
That is fine talk for an Eastern banker but out here in the West of Kansas City and Dallas we are not sure about your idea. For Presidents, Hoenig of Kansas City and Fisher of Dallas, the driver is more the inflationary impact of policy and the focus is on the long term. President Hoenig indicated that the Fed should not engage in the purchases of more assets. His focus appears to be the concern that if the Fed signals its acceptance that inflation should rise, then the creation of more liquidity may alter the pace of inflation and a rise in inflation expectations as well.

President Fisher argues this week that there is abundant liquidity in the system. Moreover, Fed actions must accord with long-term price stability. Fisher is not convinced that the efficacy of further easing has been established.

Shoot Out at the Fed Corral

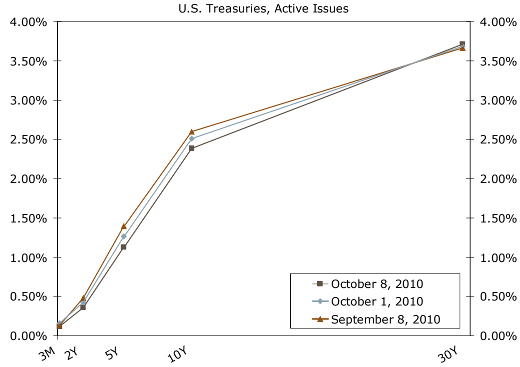
So, Nov. 2-3 is the date and the place will be at the Federal Reserve in Washington, D.C. Certainly no movie will ever be made of this shootout, but it appears that the players are in place and their intellectual guns are loaded. Our expectation is that the Fed will engage in further easing after the smoke clears.

Central Bank Policy Rates



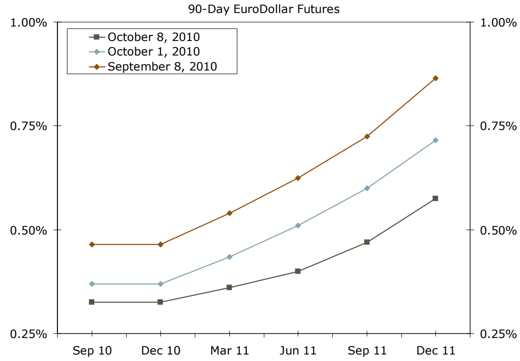
Yield Curve

U.S. Treasuries, Active Issues



Forward Rates

90-Day EuroDollar Futures



Credit Market Insights

CMBS Issuance is Ramping Up

Commercial Mortgage-Backed Securities (CMBS) issuance is projected to reach $10 billion in 2010, which is a significant improvement from the near virtual halt of the past two years. The amount, however, is well off of its peak of $230 billion reached in 2007. The packaging of commercial real estate loans into securities has become a critical funding source for borrowers and comprises 20 percent of commercial and multifamily mortgages outstanding. While CMBS origination is gearing up to provide investors searching for yield an alternative to Treasuries, credit and property fundamentals remain weak, but are showing signs of moderating. Slow economic growth will likely continue to weigh down macro drivers for commercial property fundamentals and could push delinquency rates higher.

Our Wells Fargo Structured Products Research Group projects fundamentals could remain under pressure for the next 12-18 months with office, retail and industrial properties the most beleaguered and the hotel and apartment sector likely leading the property market recovery in 2011 (please see *CMBS Weekly – Q3 Property Market Outlook*, Sept. 9, 2010). Moreover, the industry must contend with the overhang of loans coming due over the next few years and the large number of development projects that have been partially completed and continue to weigh on community bank portfolios.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.27%	4.32%	4.35%	4.87%
15-Yr Fixed	3.72%	3.75%	3.83%	4.33%
5/1 ARM	3.47%	3.52%	3.56%	4.35%
1-Yr ARM	3.40%	3.48%	3.46%	4.53%
MBA Applications				
Composite	782.6	784.0	880.0	756.3
Purchase	198.7	181.8	184.5	306.1
Refinance	4,180.8	4,288.3	4,926.5	3,377.1

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

Topic of the Week

The World is Changing, According to the IMF

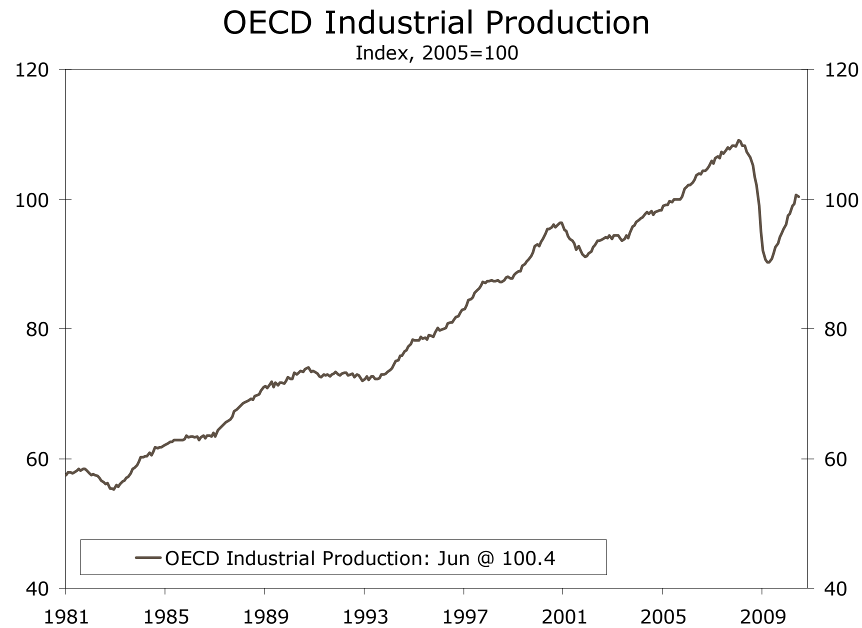
With the release of its World Economic Outlook, the IMF seems to be acknowledging the changes that have occurred throughout the world in recent years, with increased importance from the developing world driving economic growth. During the 1990s, the saying was that the U.S. economy was the locomotive of the world. Today, China, Brazil and India seem to be the machinists of the new world economic locomotive.

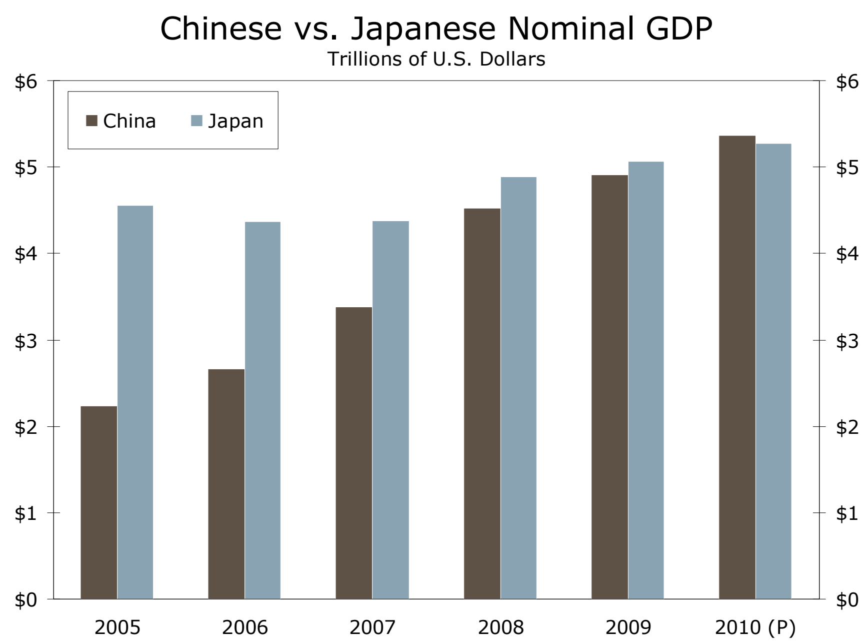
In its report, the IMF recognizes the strength of the world economy during 2010, but it also cautions that this year's growth is very fragile, with growth in developed countries lagging behind emerging market growth due to the slow recovery from the 2008 and 2009 financial crisis and ensuing recession.

Also, according to the report, the Brazilian economy advanced to the eighth place in terms of size, displacing Spain from that position as that country continues to suffer from its own housing market, financial and debt crisis. Not even the appreciation of the euro has been able to prevent the Spanish economy from losing its position in the world. One of the reasons for this is that the Brazilian currency has also appreciated considerably during this period. Thus, high economic growth in Brazil, plus an appreciating currency, has helped the Brazilian economy climb.

This report comes after the World Bank also reported several months ago that the Chinese economy had displaced Japan and has become the second largest economy in the world.

But the most important view from the report is that, while the world economy is going to post a strong growth in the near future—4.8 percent in 2010 and a 4.2 percent during 2011—this growth remains very fragile. Thus, the downside risks for the forecast are very high, especially because the developed world, that is the "old" locomotive, is still having maintenance issues. Hopefully, the new drivers of that locomotive can keep the world on track!





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 10/8/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.11	0.15	0.06
3-Month LIBOR	0.29	0.29	0.28
1-Year Treasury	0.20	0.24	0.38
2-Year Treasury	0.34	0.41	0.88
5-Year Treasury	1.08	1.26	2.22
10-Year Treasury	2.35	2.51	3.25
30-Year Treasury	3.69	3.71	4.09
Bond Buyer Index	3.84	3.83	3.94

Foreign Exchange Rates

	Friday 10/8/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.394	1.379	1.479
British Pound ($/₤)	1.595	1.582	1.607
British Pound (₤/€)	0.874	0.872	0.921
Japanese Yen (¥/$)	81.800	83.220	88.390
Canadian Dollar (C$/$)	1.017	1.020	1.052
Swiss Franc (CHF/$)	0.960	0.974	1.026
Australian Dollar (US$/A$)	0.983	0.972	0.906
Mexican Peso (MXN/$)	12.527	12.525	13.251
Chinese Yuan (CNY/$)	6.671	6.685	6.826
Indian Rupee (INR/$)	44.435	44.480	46.343
Brazilian Real (BRL/$)	1.682	1.690	1.736
U.S. Dollar Index	77.289	78.088	75.966

Foreign Interest Rates

	Friday 10/8/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.91	0.89	0.70
3-Month Sterling LIBOR	0.74	0.73	0.55
3-Month Canadian LIBOR	1.23	1.23	0.50
3-Month Yen LIBOR	0.21	0.22	0.34
2-Year German	0.80	0.85	1.25
2-Year U.K.	0.61	0.65	0.71
2-Year Canadian	1.32	1.37	1.33
2-Year Japanese	0.13	0.14	0.25
10-Year German	2.27	2.29	3.12
10-Year U.K.	2.87	2.97	3.36
10-Year Canadian	2.70	2.79	3.36
10-Year Japanese	0.87	0.97	1.27

Commodity Prices

	Friday 10/8/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	82.12	81.58	71.69
Gold ($/Ounce)	1344.35	1319.10	1055.10
Hot-Rolled Steel ($/S.Ton)	535.00	535.00	555.00
Copper (¢/Pound)	373.00	368.35	288.70
Soybeans ($/Bushel)	10.18	10.69	9.07
Natural Gas ($/MMBTU)	3.65	3.80	4.96
Nickel ($/Metric Ton)	23,864	23,406	18,570
CRB Spot Inds.	531.89	528.31	426.41

Next Week's Economic Calendar

	Monday 11	Tuesday 12	Wednesday 13	Thursday 14	Friday 15
U.S. Data		**Minutes of FOMC**	**Import Price Index** August 0.6% September -0.1% (W)	**PPI** August 0.4% September 0.2% (W) **Core PPI** August 0.1% September 0.1% (W) **Trade Balance** July -$42.8B August -$46.1B (W)	**CPI** August 0.3% September 0.1% (W) **Retail Sales** August 0.4% September 0.3% (W) **Business Inventories** July 1.0% August 0.5% (W)
Global Data		**UK** **CPI (MoM)** Previous (Aug) 0.5% **Germany** **CPI (MoM)** Previous (Aug) -0.1%	**Japan** **Machine Orders (MoM)** Previous (Jul) 8.8% **Euro-zone** **Industrial Prod. (YoY)** Previous (Jul) 7.2%	**China** **Trade Balance (USD)** Previous (Aug) $20.03B	

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

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