

# Economics Group

## Weekly Economic & Financial Commentary

### U.S. Review

#### Recovery Still Moving Ahead

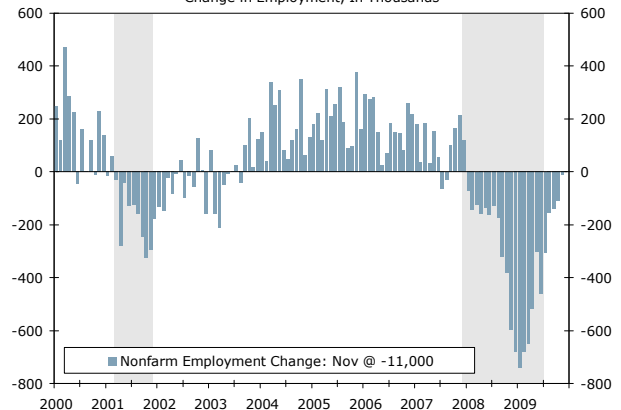
- Improvement in headline economic reports on manufacturing and employment suggest continued economic growth. For manufacturing, the gains in the ISM report reflected improvement in orders, production and employment. As for jobs, gains in temporary help and the workweek are key positive leading indicators.
- Productivity gains support our view that inflation remains low for at least the first half of next year.

### Global Review

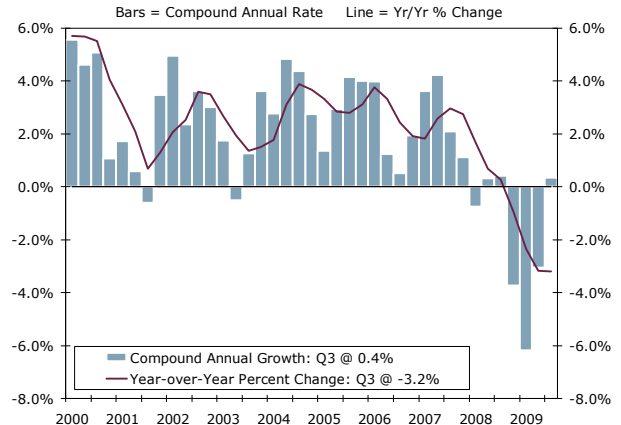
#### Canadian Economy Stronger than Q3 Growth Suggests

- After three consecutive quarters of decline, Canada managed to eke out a small positive growth rate in the third quarter. However, a big increase in imports, which reflects strength in domestic demand, helped to depress the overall GDP growth rate. In other words, the economy is stronger than it appears on the surface.
- Although the Bank of Canada will clearly tighten policy at some point, we do not look for the first rate hike for another two or three quarters due to a high unemployment rate and benign inflation at present.

Nonfarm Employment Change  
Change in Employment, In Thousands



Canadian Real GDP



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 <sup>1</sup>	-6.4	-0.7	3.5	2.0	2.7	2.7	2.5	2.2	2.7	2.1	0.4	-2.5	2.4	2.4
Personal Consumption	0.6	-0.9	3.4	-1.2	0.9	1.2	1.3	1.3	2.9	2.6	-0.2	-0.7	0.8	1.4
Inflation Indicators <sup>2</sup>														
"Core" PCE Deflator	1.7	1.6	1.3	1.4	1.4	1.2	1.2	1.3	2.3	2.4	2.4	1.5	1.3	1.6
Consumer Price Index	-0.2	-0.9	-1.6	1.2	2.0	2.0	1.5	1.4	3.2	2.9	3.8	-0.4	1.8	2.0
Industrial Production <sup>1</sup>	-19.0	-10.3	5.2	6.1	2.3	3.1	2.8	4.2	2.3	1.5	-2.2	-9.9	2.8	4.1
Corporate Profits Before Taxes <sup>2</sup>	-19.0	-12.6	-10.5	20.0	22.0	16.0	10.0	8.5	10.5	-4.1	-11.8	-7.0	13.9	8.0
Trade Weighted Dollar Index <sup>3</sup>	83.2	77.7	74.3	73.5	76.1	78.6	81.0	81.8	81.5	73.3	79.4	73.5	81.8	82.8
Unemployment Rate	8.1	9.3	9.6	10.2	10.3	10.6	10.8	10.8	4.6	4.6	5.8	9.3	10.6	10.6
Housing Starts <sup>4</sup>	0.53	0.54	0.59	0.60	0.60	0.65	0.68	0.71	1.81	1.34	0.90	0.56	0.66	0.80
Quarter-End Interest Rates														
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	5.25	4.25	0.25	0.25	0.50	3.25
Conventional Mortgage Rate	5.00	5.42	5.06	5.10	5.20	5.30	5.30	5.40	6.14	6.10	5.33	5.10	5.40	6.00
10 Year Note	2.71	3.53	3.31	3.50	3.60	3.60	3.60	3.70	4.71	4.04	2.25	3.50	3.70	4.40

Forecast as of: November 11, 2009

<sup>1</sup> Compound Annual Growth Rate Quarter-over-Quarter

<sup>2</sup> Year-over-Year Percentage Change

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Together we'll go far



## U.S. Review

### Recovery Still Moving Ahead

Improvement in headline economic reports on manufacturing and employment suggest continued economic growth. Our outlook remains for positive economic growth at 2.5 percent plus for the next four quarters with continued low inflation. For manufacturing, the gains in the Institute for Supply Management (ISM) Index reflected improvement in orders, production and employment. Sustained improvement is reflected by the index which has been over the breakeven 50 level for the last four months. During this period there have been gains in orders, production, vendor performance, and most recently, employment. This broad-based improvement suggests good support for continued growth in the manufacturing sector ahead.

Our outlook is for a 5-6 percent gain in industrial production in the second half of this year after a decline of more than 10 percent in the first half of this year. The improvement in orders is particularly important as a leading indicator for growth. The recent gains in the employment index are also important as they signal a turn in the jobs situation that has been such an economic issue for household incomes and confidence as well as a political hot potato. In addition, since July, the export orders index has exceeded the 50 breakeven point. This is a big plus for the U.S. economy and supports the recovery. Our outlook is for net exports to add about one-half of a percent to U.S. growth in the first half of next year.

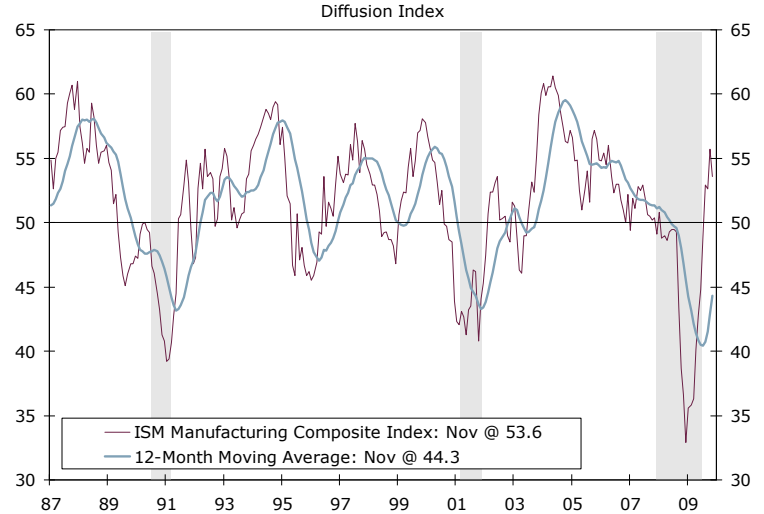
### Jobs: Improvement Continues

Employment losses continue to get smaller each month as the evidence of economic recovery is improving. November's job losses of 11,000 are likely overstating the improvement given the impact of comparisons to last November's huge drop off. Yet, no denying that over the last three months job losses averaged just 87,000—much less than earlier this year.

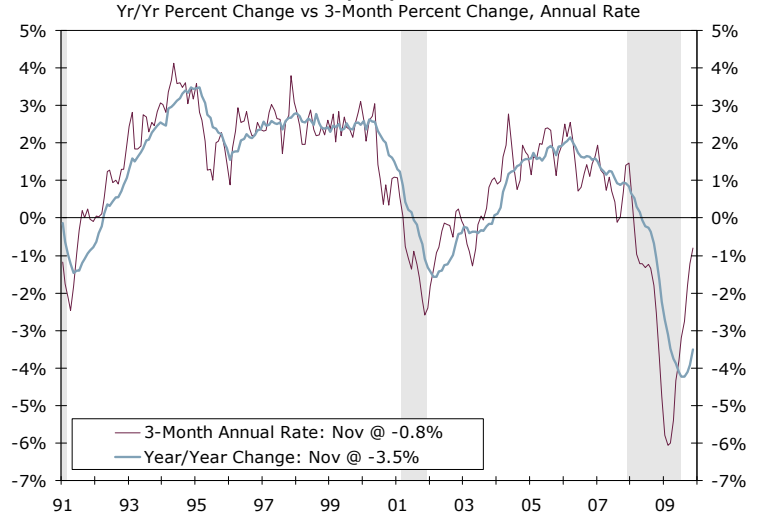
Two factors suggest that the job decline further supports our view that the recovery is in tow. First, there was a solid gain in temporary help of 52,000—this sector is often considered a leading indicator. Second, there was continued breadth in job gains. Education & health jobs improved again. Meanwhile, job losses were much less in sectors such as retail, trade & transportation, construction and manufacturing. This breadth is an important factor suggesting sustained recovery. In addition, employment in the household survey also increased providing corroborating support for a positive employment outlook. Our income proxy continues to improve. This turn suggests better consumer spending and a sustained expansion. Income is the product of jobs, hours and wages.

Productivity rose sharply in the third quarter and produced an actual decline in unit labor costs in the third quarter. Over the last four quarters, unit labor costs have risen just 1.2 percent as productivity improved 1.1 percent. Two positive outcomes for the economy come out of this. First, lower unit labor costs suggest continued minimal cost pressures and thereby little incentive to firms to raise prices. We expect inflation (CPI) at below two percent next year. Low inflation keeps the Fed on hold. Meanwhile, better productivity is a big plus for corporate profits. We expect pre-tax profits to be up 10-15 percent next year.

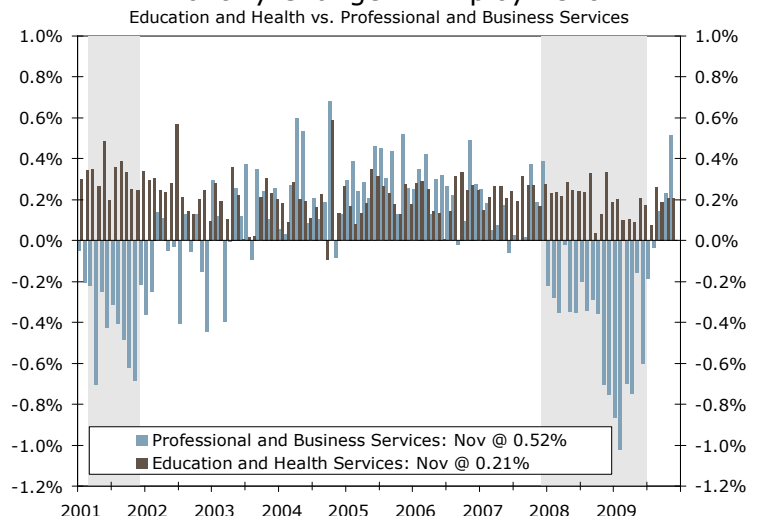
### ISM Manufacturing Composite Index



### Nonfarm Employment Growth



### Monthly Change in Employment



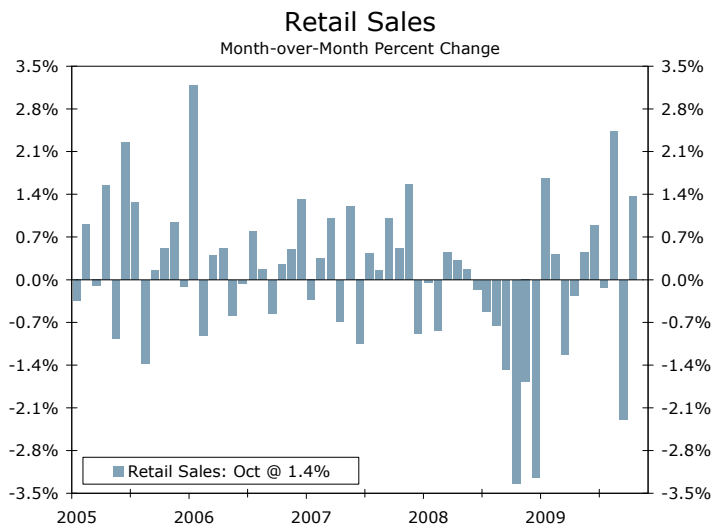
## US Trade Balance • Thursday

The U.S. trade deficit jumped \$5.6 billion to \$36.5 billion in September, as exports rebounded modestly from huge declines over the last three quarters and imports jumped 5.8 percent, largely on a sizable jump in petroleum prices. Oil and gas prices have been drifting in a tight range, and will be less of a factor in the October figures. Indeed, the trade deficit is expected to contract a bit from the September level as weak consumer spending continues to hold back import growth, and exports continue to recover on the back of accelerating global demand. Recent economic data out of Asia and Europe remain decidedly brighter than our own, suggesting continued healthy gains in U.S. exports as the dollar weakens against our major trading partners. November service PMIs for Brazil, China, and even the Euro area are now in healthy expansion territory, well above U.S. levels.

**Previous: -\$36.5B**

**Wells Fargo: -\$36.1B**

**Consensus: -\$37.1B**

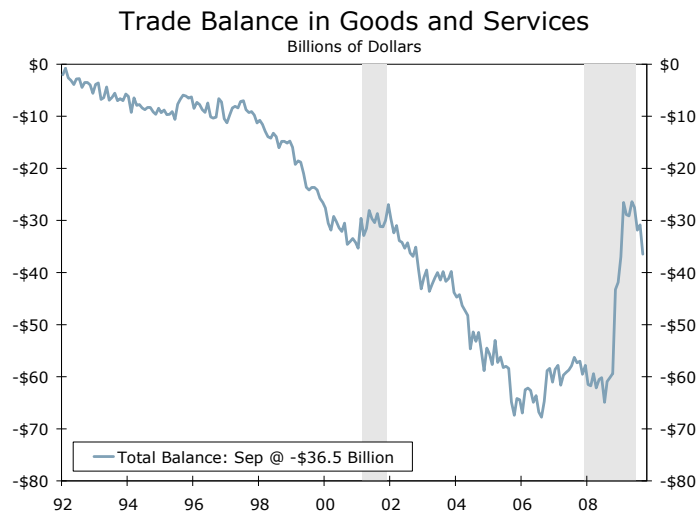


## Michigan Sentiment • Friday

Michigan consumer sentiment is expected to remain at low levels as ongoing weakness in the labor market sours consumers' moods, and their ability to spend more aggressively. Consumers are struggling with stagnating income growth from lost working hours and employment, but also from a rebound in retail gasoline prices. Michigan sentiment hit a two year high in September, but has since been losing altitude. Consumer sentiment is still at recessionary levels and nearly as bad as it got during the depths of the 1990-91 recession. Continued stock market gains may provide some solace to bruised consumer portfolios and confidence, but are not enough to significantly move the needle. Households appear to be hunkering down for a long slow recovery that likely won't be felt in the labor market for awhile.

**Previous: 67.4**

**Consensus: 68.8**



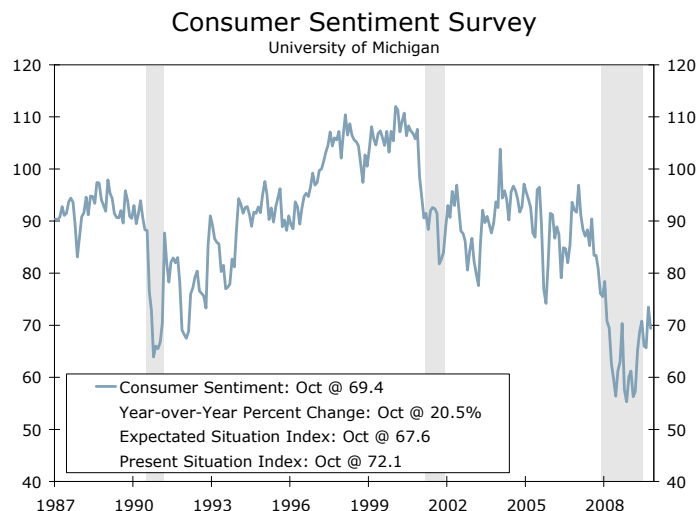
## Retail Sales • Friday

Initial readings on chain store sales for November suggest a disappointing November retail sales report. U.S. same store sales dropped 0.3 percent in November from a year ago. Department store and luxury department store sales lead the decline. Weakness was also evident in apparel and discount stores while the biggest sales gains are occurring in drug stores and wholesale clubs. A report on retail sales trends by the National Retail Federation also suggests a disappointing holiday retail environment with sales rising a modest 0.5 percent due entirely to more shoppers. On a per capita basis, retail sales over the Thanksgiving weekend were 8 percent below last year's poor numbers. Retailers are trying to put a positive spin on these grim numbers by pointing out that their inventories are far leaner and their discounts more planned and targeted than those that occurred last year.

**Previous: 1.4%**

**Wells Fargo: -0.8%**

**Consensus: 0.6%**



## Global Review

### Weak Canadian Growth Belies Underlying Resiliency

After contracting 3.3 percent on a peak-to-trough basis, real GDP in Canada rose for the first time in three quarters by edging up 0.4 percent at an annualized rate in the third quarter (graph on front page). The GDP outturn in the third quarter would make it appear that Canada has barely managed to exit its deepest downturn since the early 1980s.

However, the domestic economy is actually stronger than the "headline" growth rate suggests. For example, real consumer spending rose at an annualized rate of 3.1 percent. True, some of the increase in consumer spending was driven by Canada's "cash for clunkers" program. However, gains in consumer spending were widespread as retail spending on goods other than autos has trended higher over the past few months (top graph).

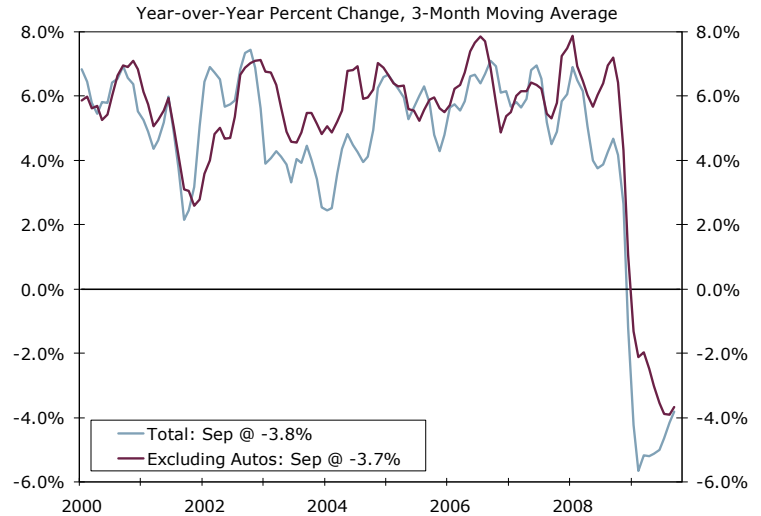
Recent developments in the labor market may be helping to support consumer spending. The Canadian economy reportedly created 79,000 jobs in November, which represents an incredible 0.5 percent monthly increase (middle chart). However, monthly employment changes have been very volatile over the past few months, so we take November's increase with a big grain of salt. That said, employment has clearly stabilized over the past few months, and less dire prospects in the labor market may be encouraging consumers to open their wallets again.

Residential investment spending grew for the second consecutive quarter. Indeed, since its nadir in April housing starts are up more than 30 percent. Business spending on equipment and machinery also grew strongly in the third quarter, jumping 25 percent (annualized rate) on a sequential basis. Despite the 14 percent drop in non-residential construction, total fixed investment spending was up nearly 9 percent during the quarter. A less rapid pace of inventory liquidation also contributed positively to the overall GDP growth rate. That said, inventories still declined in the third quarter, and further slowing in the rate of de-stocking in the quarters ahead should continue to boost growth.

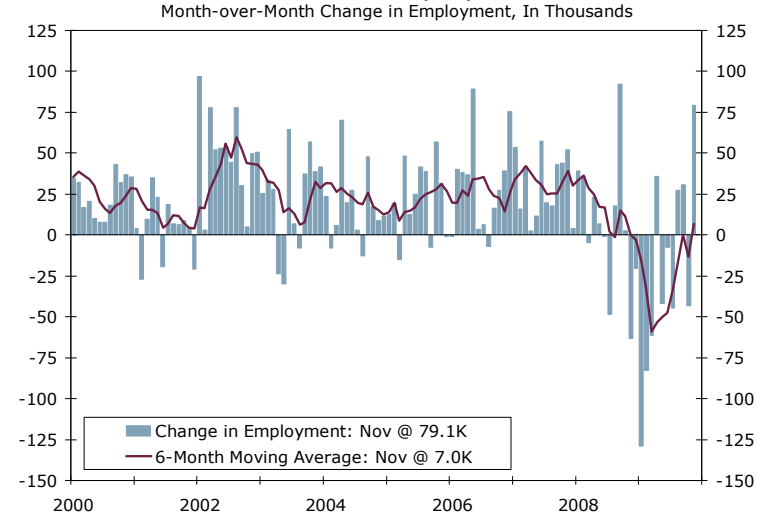
If domestic demand was so strong, then why did the economy manage to eke out such a weak overall growth rate? Answer: real imports surged 36 percent. Although gross exports rose at a solid rate of 15 percent, the big jump in gross imports caused net exports to slice more than 7 percentage points off of the overall growth rate. This sizeable increase in imports actually reflects the strength of domestic demand. That is, strong growth in consumer and fixed investment spending usually leads to higher imports. The extremely robust pace of import growth in the third quarter is clearly not sustainable, so the overall rate of GDP growth should pick up in the quarters ahead as import growth falls back. In other words, we look for continued growth, albeit at a modest pace, in the Canadian economy in the quarters ahead.

The Bank of Canada sets its monetary policy to keep the core rate of CPI inflation between 1 percent and 3 percent. Currently, the core rate of inflation is near the bottom of the Bank's target range (bottom chart). With the unemployment rate near an 11-year high and with benign inflation, we do not look for the Bank to start tightening policy anytime soon. As the recovery gains some traction next year, however, the Bank will begin to tighten policy with the first rate hike, in our view, occurring in late summer/early autumn.

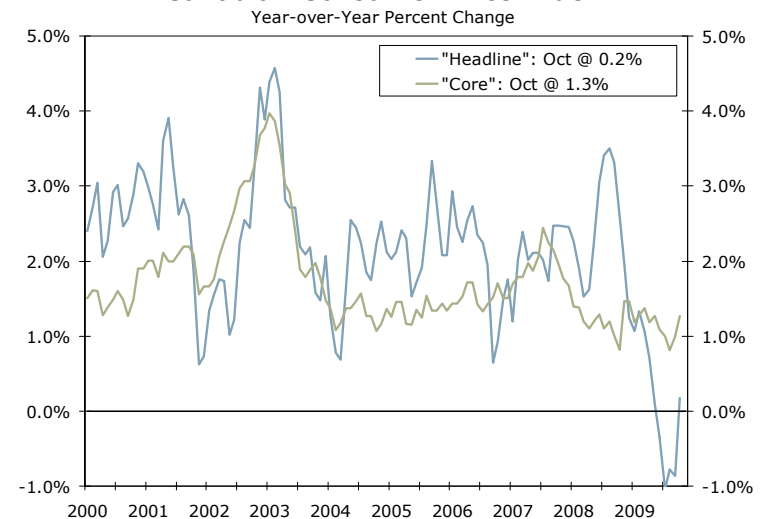
### Canadian Retail Sales



### Canadian Employment



### Canadian Consumer Price Index



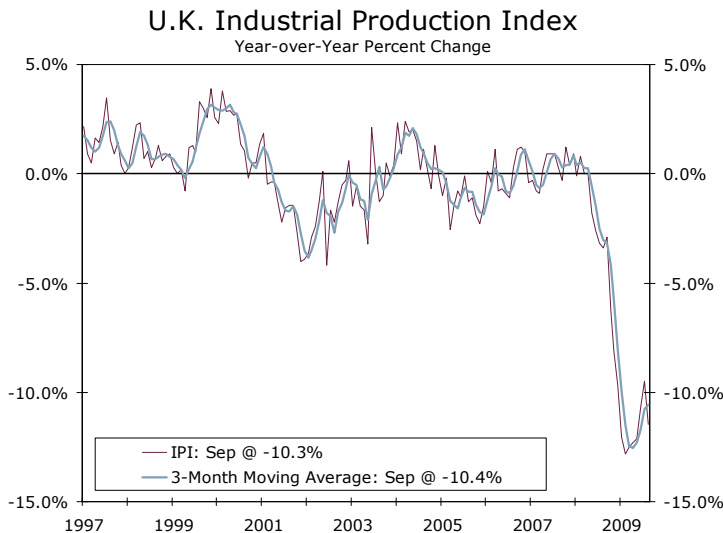
## German Industrial Production • Tuesday

Two indicators on the docket early next week—factory orders and industrial production—should give investors some insight into the current state of the German economy. Factory orders have risen 19 percent from their nadir in February. Data that will print on Monday will show whether orders increased for the eighth consecutive month in October. The rise in orders since spring has translated into stronger industrial production, although IP remains well below the peak that was set in early 2008. Data on German industrial production in October will print on Tuesday.

Industrial production in both France and Italy has also strengthened over the past few months. Did the trend continue in October? Both countries will release data on Thursday.

**Previous: 2.7% (month-on-month change)**

**Consensus: 1.0%**



## Bank of Canada Policy Rate • Tuesday

The Bank of Canada holds a policy meeting on Tuesday, and the probability that it changes its main policy rate from 0.25 percent, where it has been maintained since April is very low. However, investors will scrutinize the statement that the Bank will release at the conclusion of the meeting for clues about the stance of monetary policy in the months ahead.

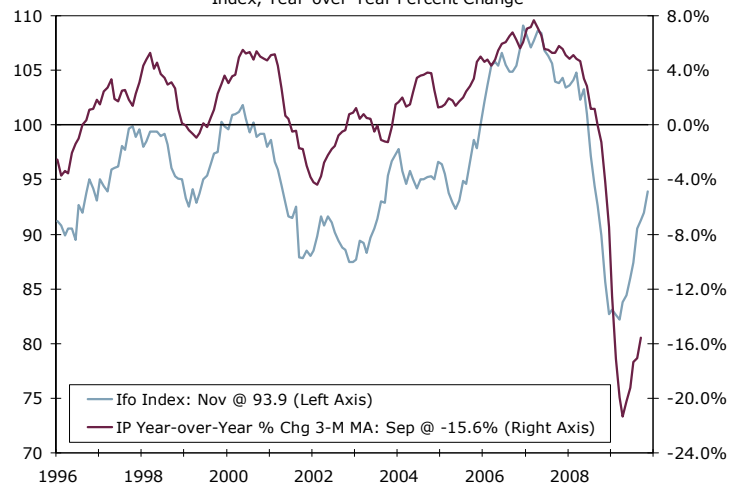
Like the United States, housing starts in Canada declined sharply over the past year or so. However, starts are up more than 30 percent since spring, and data that are slated for release on Tuesday will show whether this trend continued in November. International trade data for October will print on Thursday. Canada incurred sustained trade surpluses for years, but the black ink disappeared this year as global trade weakened and commodity prices collapsed. Surpluses should return again over the next few months.

**Current Policy Rate: 0.25%**

**Wells Fargo: 0.25%**

**Consensus: 0.25%**

**German Production Indicators**  
Index, Year-over-Year Percent Change



## U.K. Industrial Production • Tuesday

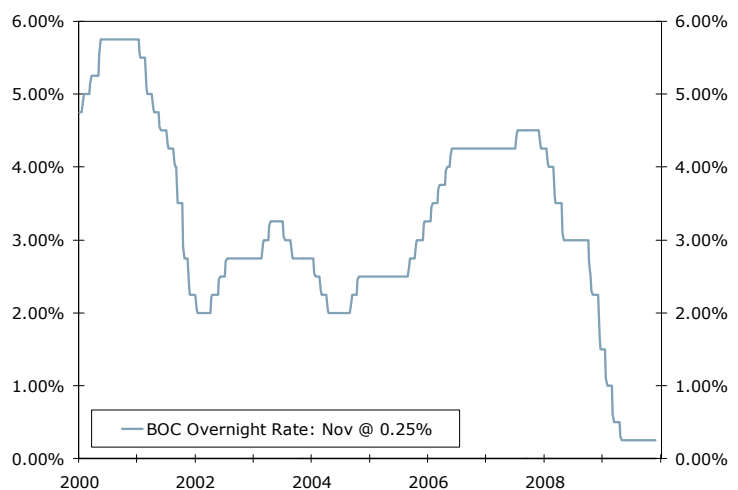
Industrial production in the United Kingdom tumbled 15 percent between February 2008 and August 2009. IP rose 1.6 percent in September, but it remains very depressed. Indeed, industrial production in the United Kingdom lags behind IP in most continental European countries. The manufacturing PMI in Great Britain has been above the “50” breakeven point for two consecutive months (Oct. and Nov.), suggesting that “hard” data on industrial production should strengthen sooner or later.

There is very little chance that the Bank of England will change its main policy rate from 0.50 percent when the Monetary Policy Committee (MPC) holds its monthly meeting on Thursday. The MPC could increase the amount of its non-conventional asset purchases, but we do not expect that outturn. Chancellor Darling will announce his preliminary budget for next year on Wednesday.

**Previous: 1.6% (month-on-month change)**

**Consensus: 0.5%**

**Bank of Canada Overnight Lending Rate**





## Interest Rate Watch

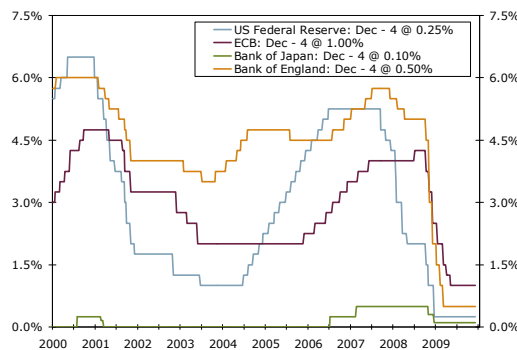
### Credit Issues Underlying Bernanke's Testimony

Beyond the grandstanding at Chairman Bernanke's hearing, there really were a number of core issues that define the path of credit markets, interest rates and the economy. First, credibility for any central bank requires both the perception and the reality of independence. Over the last thirty years, many foreign central banks have gained their independence from politics and, often, their domestic Treasury. Credibility is reflected in the market's interest rate and inflation expectations. Monetizing federal government debt is a serious threat today given the outsized federal deficits we have. Threats to Fed independence would suggest greater monetization and thereby higher interest rates and inflation.

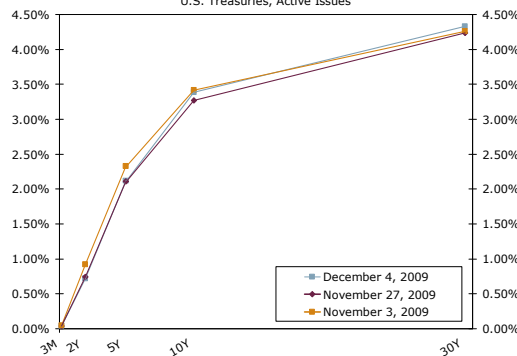
Second, should policy be conducted on a prospective or prescriptive basis? American society has grown around the concept that the law prescribes the parameters of activities and this is particularly true for the Fed. Time and time again, Chairman Bernanke deflected criticism on the basis of his inability under the law to intervene in areas the Fed was not authorized to act. In contrast, a prospective approach would dictate that the Fed take actions to address bad behavior it sees even if the institution/actor is traditionally outside its purview. This problem is particularly relevant here. Let's assume the counterfactual—suppose the Fed would have intervened to take away the punch bowl when the housing boom was underway in 2005-2007? Of course, Congress and the housing lobby would have screamed even louder than yesterday. Going forward, does the Fed do only what is allowed or do what is necessary to get the job done?

Finally, the time inconsistency problem reared up. Politicians want solutions today— or at least by Election Day in 2010. The economy has its own cycle and working out the housing correction, and the credit shortage takes time—and patience—something in very short supply in Washington. The Fed's dual mandate complicates this problem as labor and credit markets march at their own pace.

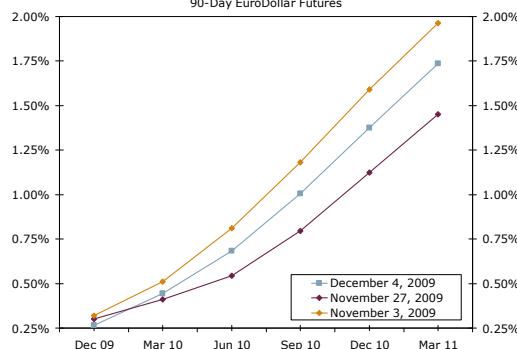
Central Bank Policy Rates



Yield Curve  
U.S. Treasuries, Active Issues



Forward Rates  
90-Day EuroDollar Futures



## Consumer Credit Insights

### Consumer Credit: Issues Behind the Rhetoric

Two core issues persist behind all the political grandstanding at Chairman Bernanke's hearing. First, there is the issue of asymmetric information. Second, is the role of the law – to guarantee process or results? Asymmetric information problems arise when the borrower and lender have different information when they enter the transaction. The traditional issue is that the borrower knows their financial/personal current housing situation better than the lender. In the current housing situation the problem revolves around two points. First, what is the borrower's real income as opposed to their stated income? Second, is the borrower actually going to live in the home or is this an investment property? This time around, an additional issue arose on the complexity of the mortgage contract. Given the innovative programs offered, the complexity of the terms may have overwhelmed both lender and borrower. As the economy changed so did the implications of the interest rate and maturity terms of the contract.

That brings us to the second issue – is the purpose of consumer credit oversight to guarantee process-fair dealing, or the result, no defaults, delinquencies or foreclosures? As you can imagine, if the purpose is process then fair dealing will go forward. But if the purpose is no foreclosures then credit will be very limited to only very good credits with little default risk.

### Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
<b>Mortgage Rates</b>				
30-Yr Fixed	4.71%	4.78%	4.98%	5.53%
15-Yr Fixed	4.27%	4.29%	4.40%	5.33%
5/1 ARM	4.19%	4.18%	4.35%	5.77%
1-Yr ARM	4.25%	4.35%	4.47%	5.02%
<b>MBA Applications</b>				
Composite	613.7	601.0	608.3	857.7
Purchase	232.3	223.1	250.3	361.1
Refinance	2,866.4	2,818.7	2,693.7	3,802.8

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

## Topic of the Week

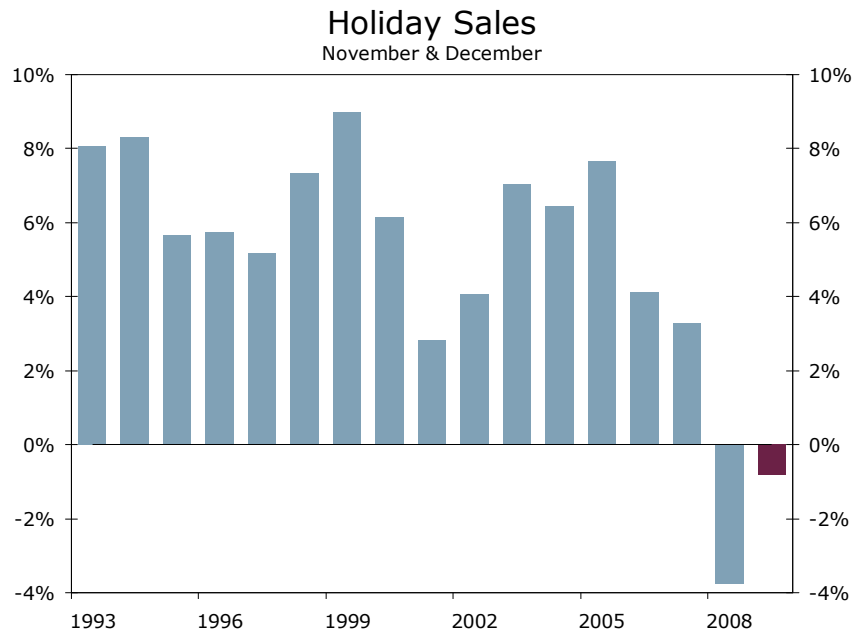
### Black Friday & Holiday Shopping

The holiday season appears off to a solid if not stellar start. Early reports on sales over the Black Friday weekend came in slightly better than our expectations for the holiday season. Reports have been varied by source, but in general have indicated a slight rise in sales versus last year. BIGresearch and the National Retail Federation (NRF) indicated a roughly half a percent gain in sales versus last year as greater numbers of holiday shoppers more than offset declines in spending per shopper.

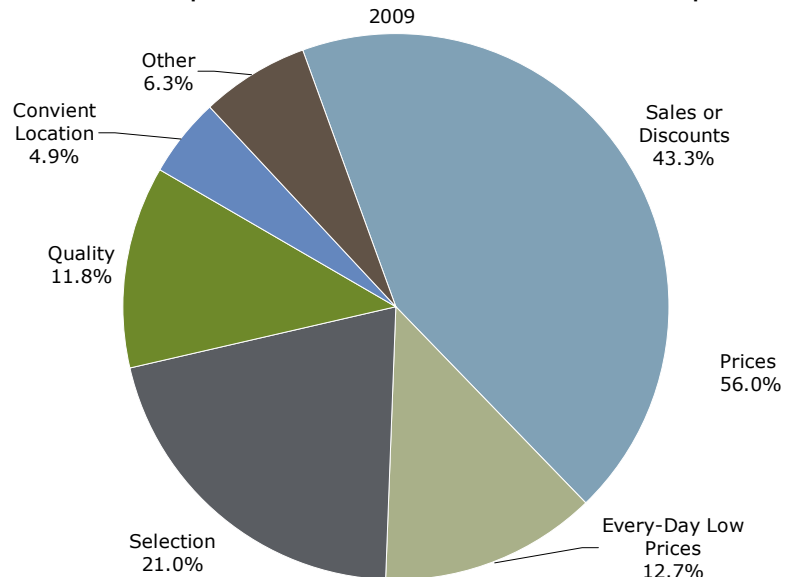
For the holiday season more broadly we are still expecting it to be a fairly tough year. We estimate holiday retail sales will decline 0.8 percent this year, marking the first back-to-back declines since records began in 1993. Even with the drop, consumers will still turn out in force and the stores will be full. Folks will simply spend a little less than they did last year, and many retailers have prepared for that by stocking lots of lower-priced merchandise. Many are also going into the holiday season with relatively lean inventories, which means deals may be more limited this year.

Last year, consumers were shell-shocked and simply too scared to shop like they normally would. Fears have subsided somewhat this year, but economic conditions are far worse. Unemployment is higher, income from wages and salaries has dropped 5.2 percent and consumer confidence is hovering near its lows for the cycle. Sales taxes have also been hiked in many states, further reducing household purchasing power. The tough economic environment means shoppers will likely be more pragmatic this holiday season. Roughly 56 percent of consumers said prices—through either sales or discounts (43.3 percent) or everyday low prices (12.7 percent)—would be the most important factor in determining where they would shop. Consumers will be willing to look far and wide for a perceived bargain.

For the full report please see *Santa Tightens His Belt Another Notch*, which is available on our website.



### Most Important Factor for Where to Shop



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## Market Data ♦ Mid-Day Friday

## U.S. Interest Rates

	Friday 12/4/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.04	0.02	-0.04
3-Month LIBOR	0.26	0.26	2.19
1-Year Treasury	0.23	0.25	0.49
2-Year Treasury	0.85	0.68	0.81
5-Year Treasury	2.27	2.04	1.51
10-Year Treasury	3.50	3.21	2.55
30-Year Treasury	4.43	4.20	3.04
Bond Buyer Index	4.24	4.33	5.58

## Foreign Exchange Rates

	Friday 12/4/2009	1 Week Ago	1 Year Ago
Euro (\$/€)	1.492	1.499	1.278
British Pound (\$/£)	1.657	1.650	1.468
British Pound (£/€)	0.901	0.909	0.871
Japanese Yen (¥/\$)	89.725	86.533	92.233
Canadian Dollar (C\$/¥)	1.050	1.062	1.276
Swiss Franc (CHF/\$)	1.011	1.006	1.195
Australian Dollar (US\$/A\$)	0.919	0.906	0.644
Mexican Peso (MXN/\$)	12.541	12.929	13.595
Chinese Yuan (CNY/\$)	6.827	6.829	6.882
Indian Rupee (INR/\$)	46.292	46.639	49.850
Brazilian Real (BRL/\$)	1.710	1.741	2.504
U.S. Dollar Index	75.248	74.996	86.444

## Foreign Interest Rates

	Friday 12/4/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.68	0.68	3.68
3-Month Sterling LIBOR	0.61	0.61	3.72
3-Month Canadian LIBOR	0.47	0.49	2.50
3-Month Yen LIBOR	0.28	0.30	0.95
2-Year German	1.35	1.25	2.14
2-Year U.K.	1.21	1.20	1.82
2-Year Canadian	1.28	1.12	1.53
2-Year Japanese	0.18	0.24	0.56
10-Year German	3.25	3.17	3.10
10-Year U.K.	3.72	3.55	3.46
10-Year Canadian	3.34	3.23	3.06
10-Year Japanese	1.30	1.26	1.38

## Commodity Prices

	Friday 12/4/2009	1 Week Ago	1 Year Ago
WTI Crude (\$/Barrel)	77.62	76.05	43.67
Gold (\$/Ounce)	1189.12	1177.63	767.00
Hot-Rolled Steel (\$/S.Ton)	465.00	465.00	660.00
Copper (¢/Pound)	323.80	309.35	145.20
Soybeans (\$/Bushel)	10.22	10.27	8.05
Natural Gas (\$/MMBTU)	4.58	5.19	6.02
Nickel (\$/Metric Ton)	15,931	16,516	9,082
CRB Spot Inds.	474.97	468.05	333.56

## Next Week's Economic Calendar

	Monday 7	Tuesday 8	Wednesday 9	Thursday 10	Friday 11
U.S. Data	<b>Consumer Credit</b> September -\$14.8B October -\$9.3B (C)		<b>Wholesale Inventories</b> September -0.9% October -0.6% (C)	<b>Trade Balance</b> September -\$36.5B October -\$36.1B (W)	<b>Retail Sales</b> October 1.4% November -0.8% (W) <b>Import Price Index</b> October 0.7% November 0.6% (W) <b>Business Inventories</b> September -0.4% October -0.5% (W)
Global Data		<b>Germany</b> <b>Industrial Prod. (MoM)</b> Previous (Sep) 2.7% <b>UK</b> <b>Industrial Prod. (MoM)</b> Previous (Sep) 1.6%		<b>UK</b> <b>BOE Announces Rates</b> Previous 0.50% <b>Japan</b> <b>Machine Orders (MoM)</b> Previous (Sep) 10.5%	
Note: (W) = Wells Fargo Estimate (c) = Consensus Estimate					



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