January 29, 2010

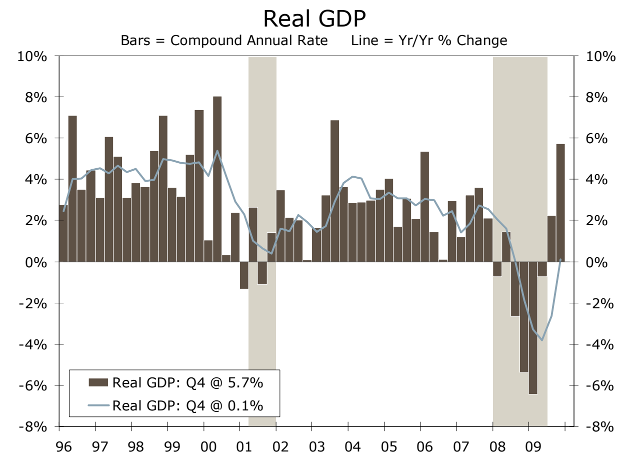
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Not All World Series are Won with Walk-off Home Runs

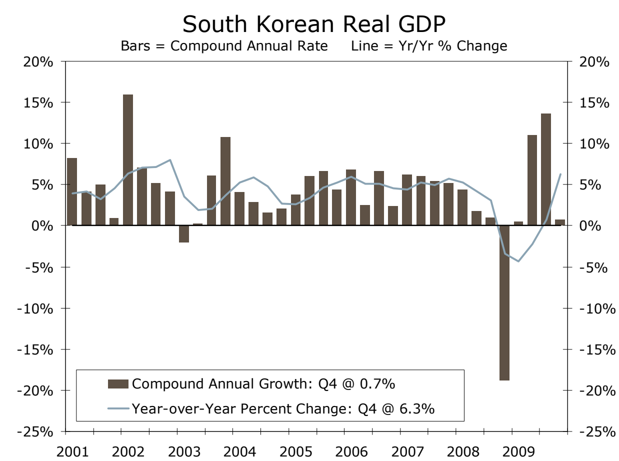
- This week's GDP release was another single on the road to the economic recovery. There is no economic boom but continued progress is making itself felt. Consumer spending and business investment are two real positives.
- Housing remains an issue. While there has been some improvement the challenge for 2010 is how mortgage markets react to the end of the Fed's liquidity injections to the secondary market. Our expectation is that mortgage rates will rise. The issue remains how much and how sensitive is housing demand to such a rise.



Global Review

South Korea's Growth Nearly Stalls Out in Q4

- The vigorous South Korean economic rebound that began in the first quarter of 2009 slowed to a crawl in the fourth quarter as GDP advanced only 0.2 percent from the third quarter.
- South Korea's exports, consumer spending and government spending all contracted from October through December, although the 12 percent annualized GDP growth over the previous two quarters made some pause in fourth quarter activity inevitable.
- South Korea's GDP rose 0.2 percent in 2009 and is expected to advance 5.0 percent in 2010.



Inside

Wells Fargo U.S. Economic Forecast

	Actual 2009				Forecast 2010				Actual			Forecast		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2006	2007	2008	2009	2010	2011
Real Gross Domestic Product [1]	-6.4	-0.7	2.2	5.6	2.3	2.2	2.4	2.3	2.7	2.1	0.4	-2.4	2.7	2.5
Personal Consumption	0.6	-0.9	2.8	1.4	1.2	1.3	1.4	1.5	2.9	2.6	-0.2	-0.6	1.4	1.8
Inflation Indicators [2]														
"Core" PCE Deflator	1.7	1.6	1.3	1.4	1.3	1.1	1.2	1.3	2.3	2.4	2.4	1.5	1.2	1.6
Consumer Price Index	-0.2	-0.9	-1.6	1.5	2.7	2.7	2.2	1.8	3.2	2.9	3.8	-0.3	2.3	2.1
Industrial Production [1]	-19.0	-10.4	6.1	6.1	5.8	4.2	3.8	7.3	2.3	1.5	-2.2	-9.8	4.3	5.9
Corporate Profits Before Taxes[2]	-19.0	-12.6	-6.6	24.0	22.0	16.0	10.0	8.5	10.5	-4.1	-11.8	-5.1	13.8	8.0
Trade Weighted Dollar Index[3]	83.2	77.7	74.3	74.7	73.6	73.4	75.0	77.1	81.5	73.3	79.4	74.7	77.1	82.5
Unemployment Rate	8.2	9.3	9.6	10.0	10.2	10.2	10.5	10.5	4.6	4.6	5.8	9.3	10.4	10.1
Housing Starts[4]	0.53	0.54	0.59	0.56	0.60	0.65	0.68	0.71	1.81	1.34	0.90	0.55	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	4.88	5.50	5.90	6.00	6.10	6.14	6.10	5.33	4.88	6.10	6.50
10 Year Note	2.71	3.53	3.31	3.85	3.80	4.00	4.20	4.40	4.71	4.04	2.25	3.85	4.40	4.90

Forecast as of: January 13, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change

U.S. Review

Economy: Hitting Singles on the Way to Recovery

Bill Mazeroski's walk-off homer was the exception in the history of the World Series. The same could be said for the beginning of the economic recovery. Usually there is a set of minor anecdotes followed by small but positive economic releases mixed with still bad news, that eventually give rise to the realization that economic growth is really here. This week's GDP release came in at 5.7 percent, which overstates the improvement, but underlying that was a gain in real final sales of 2.2 percent after prior gains of 1.5 and 0.7 percent in the prior two quarters (recall that the Mets beat the Red Sox on a long string of singles—not some glamorous grand slam). Bottom line is that the economy is recovering and we expect continued gains throughout the year ahead. Unless there is a major policy mistake in that one-time only World Series winner city in the modern era. Of course that victory could be revised away when the proper corrections are made.

Elements of a Recovery

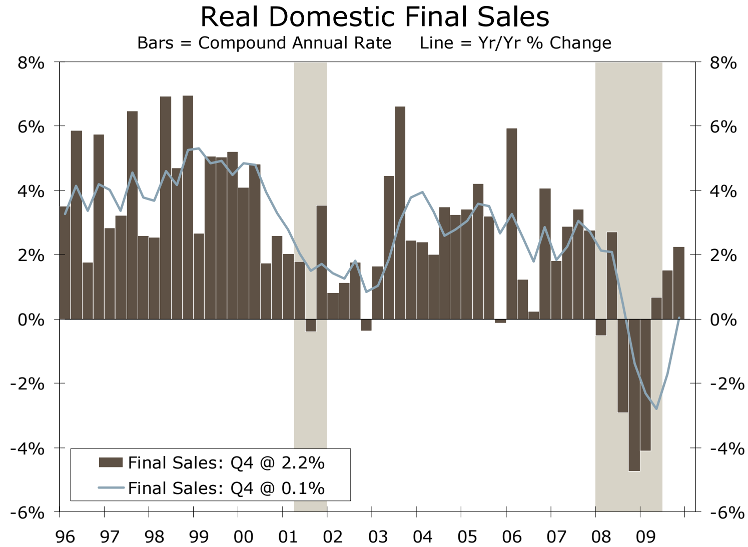
Consumer spending rose two percent with gains in nondurable goods and services—the stuff of everyday life. This improvement came after a 2.8 percent gain in the third quarter and suggests that the recovery/rally has legs. Households appear to have set a course of moderate spending that is consistent with lower expectations for income and the need to rebalance their spending/saving decisions. Our outlook for 2010 is an improvement in consumer spending at a pace of 1.4 percent compared to a decline in spending of 0.6 percent last year. This improvement reflects our expectation that job growth will turn positive early this year which will then generate continued real personal income gains. The recovery is sustainable.

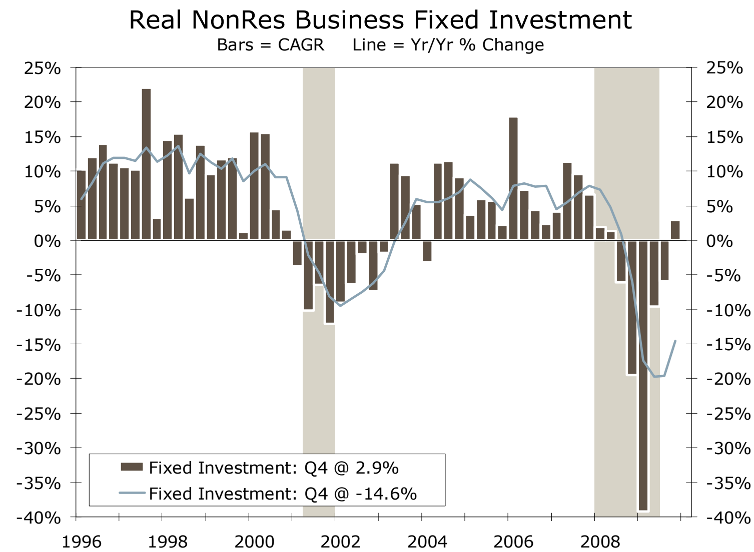
Meanwhile, the big positive (but overlooked) story is the gain in equipment and software spending—up 13.3 percent. Businesses appear to be ready to invest in equipment while interest rates are still fairly low and the firm's expectations for the economy improve. Two secular issues may also be in play. First, capital appears to be substituted for labor as many firms strive for productivity and cost control, and it appears that increasing capital is the best path to reach those goals. Second, the uncertainty of the cost of labor, driven by health care reform issues, suggests that firms are slow to hire while this and other issues are unresolved.

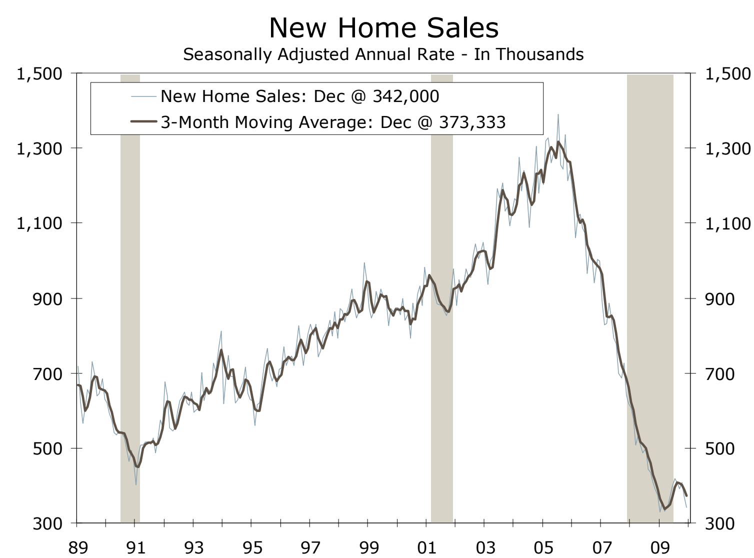
Housing: Modest Recovery Built Upon Shifting Sands

Recent data on both new home and existing home sales reflect the sensitivity of the housing recovery to federal intervention. In December, new home sales fell 7.6 percent. This likely reflected the initially anticipated end to the first time homebuyer tax credit. Meanwhile, there is some concern about the end of the Federal Reserve's mortgage-backed security purchase program, since such a termination is likely to give rise to higher mortgage rates. The impact on housing demand, given these higher rates, remains very uncertain.

For both public and private decision-makers there is a real dilemma here. What is the real demand for housing independent of all the props offered by the federal government? With excess inventory still in many markets, weak job and income growth and certainly diminished expectations on home price appreciation, there is a sense that the housing correction has some time to run—especially in selected overbuilt markets.





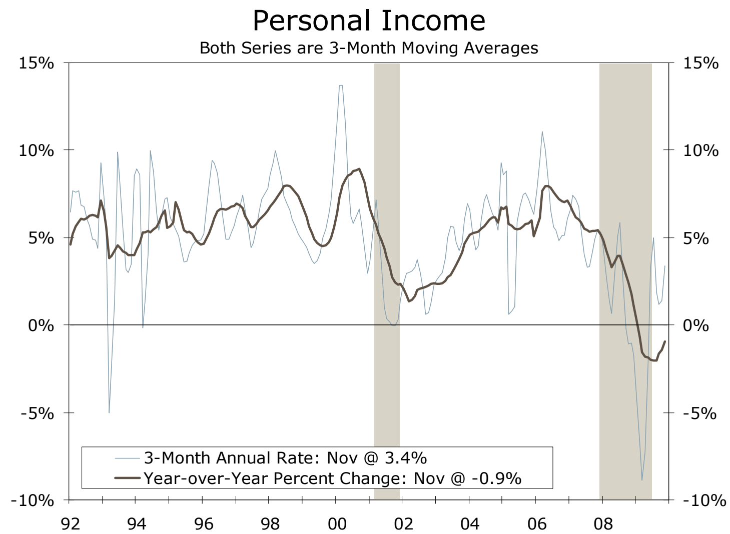


Personal Income • Monday

Personal income rose 0.4 percent in November with wage and salary income increasing 0.3 percent. Transfer receipts remained strong, growing at 0.5 percent in November, likely driven by the extension of federal unemployment benefits. Consumer spending rose 0.5 percent in nominal terms and 0.2 percent in real terms in November. We expect continued gains in December as consumer spending rose at a 2 percent annual pace in the fourth quarter contributing 1.4 percentage points to GDP growth. While consumer spending growth has been solid in the second half of 2009, we do not expect the robust gains will stick. Sustainable consumer spending requires income and therefore job and wage gains. With the unemployment rate rising and hiring still sluggish, we expect consumer spending will grow at a modest 1.4 percent annual pace in 2010.

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

Consensus: 0.3%

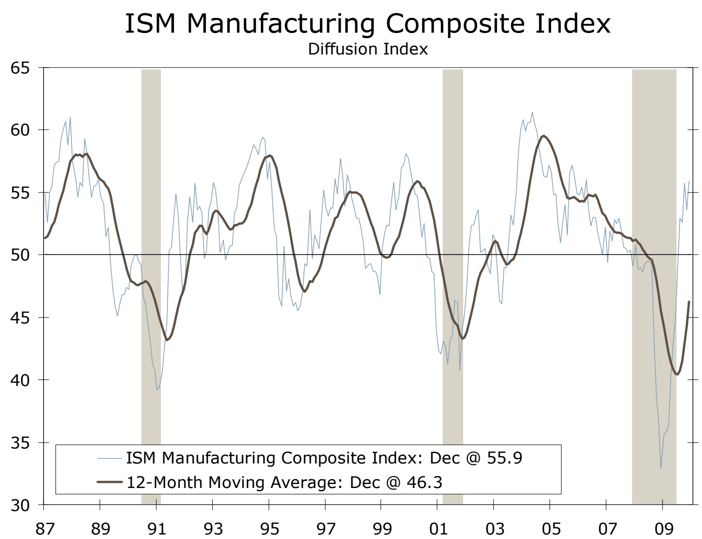


ISM Manufacturing • Monday

The Institute for Supply Management's (ISM) headline manufacturing index remained in expansionary territory for the fifth consecutive month in December. Both the Chicago purchasing managers' index and the Empire Manufacturing Index rose significantly in January suggesting headline ISM will remain in expansionary territory. The forward-looking new orders index has remained well above the threshold of 50 for six consecutive months and at 64.8, it is at its highest level in five years. With inventory levels still lean, the spread between the new orders and the inventories indexes continue to suggest further gains in production are likely in coming months. The employment index has been in expansionary territory for three consecutive months and continues to suggest stabilization in manufacturing employment. As such, we expect the ISM index to increase to 56.2 in January.

Previous: 55.9 **Wells Fargo: 56.2**

Consensus: 55.6

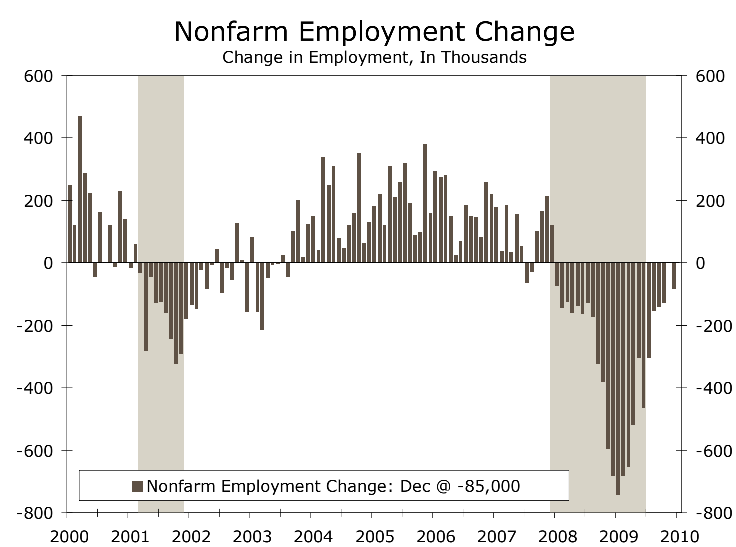


Nonfarm Employment • Friday

December's employment report was somewhat of a disappointment falling by 85,000 jobs. Revisions to previously published data produced a slight increase in November of 4,000 jobs, the first increase since the recession began. February's employment report will include benchmark revisions dating back to March 2008. The BLS previously reported the revision will be around 0.6 percent, which would result in an additional 830,000 job losses over the past two years. While revisions will suggest the labor market was weaker than expected, forward-looking indicators such as hiring at temporary staffing companies and increases in aggregate hours affirm the deterioration in the labor market is abating. Labor market conditions remain weak, however. We expect nonfarm employment will fall by 97,000 jobs in January and the unemployment rate will reach 10.1 percent.

Previous: -85K **Wells Fargo: -97K**

Consensus: 20K



Global Review

South Korea's Recovery Intact

Despite the disappointing fourth quarter results for South Korea, there appears to be plenty of momentum left in this economic expansion. Because of the strong growth in prior quarters, South Korea's GDP is still 6.0 percent above where it was a year ago at this time.

Business spending continues to drive and lead the expansion in South Korea. Gross fixed capital formation expanded at a robust 7.1 percent annualized pace in the fourth quarter, with investment in facilities rising at a 20.2 percent annualized clip.

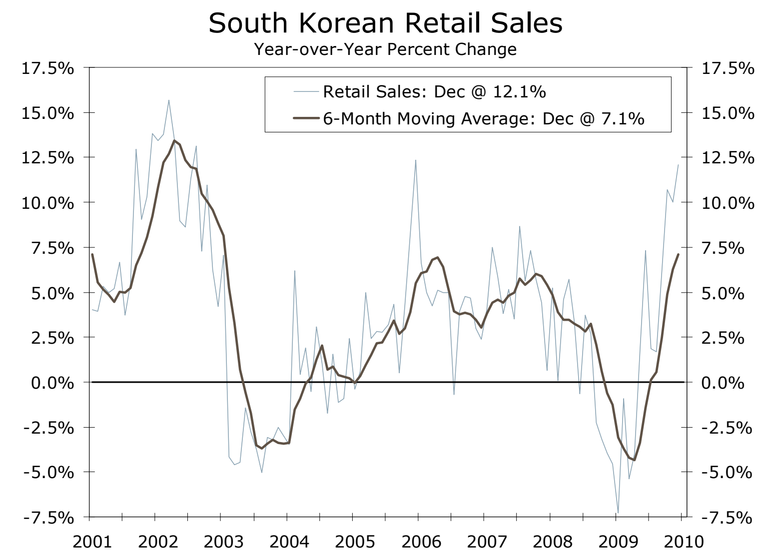
Moreover, the central government will continue to do its share to keep the recovery on track. The administration has boosted this year's budget by 3.0 percent and has promised to accelerate the distribution of funds to help maintain the expansion. The government is also planning allowances and tax incentives for small businesses to hire unemployed workers.

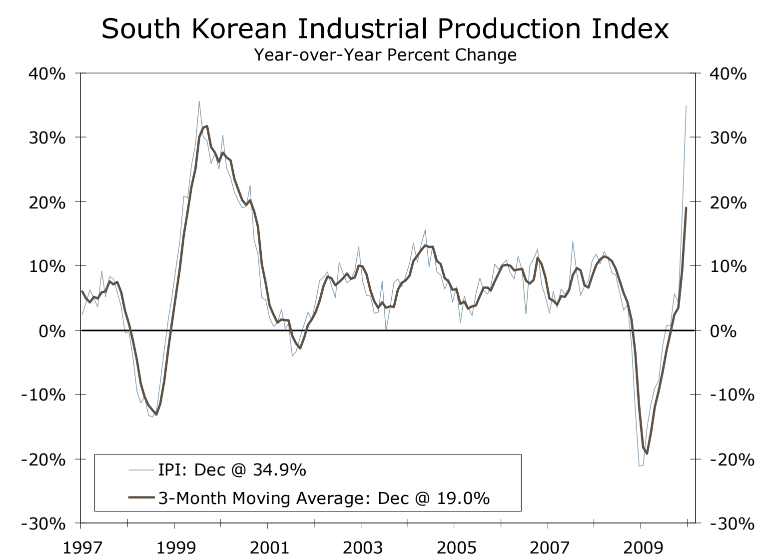
Employment growth is set to resume this year, and the unemployment rate has dropped to 3.5 percent from 4.0 percent last June. Private sector consumption should be well supported by improving labor market prospects in the year ahead. Household wealth is also boosted by Korean stock market gains that exceeded 50 percent over the past year. In addition, the Korean won appreciated about 9.0 percent against the dollar last year, bolstering households' purchasing power for foreign goods.

The weaker-than-expected fourth quarter GDP numbers do shave about two-tenths of a percentage point off our forecast for economic growth in 2010, but it does not materially change our view on South Korea's growth prospects over the next 12 months.

These fourth quarter GDP numbers may be of greater impact on the political front. It will be much harder for the Bank of Korea to make the case for imminent rate hikes, given the volatility of recent economic growth and the risk presented by a tight monetary policy in China. China's central bank has promised to manage inflation expectations, crack down on property speculation and runaway loan growth and guide interest rates higher. Breakneck growth in China has helped boost South Korea's exports by 32.8 percent from a year ago. China is Korea's largest export market, comprising about 25 percent of the country's exports. Should China err by slowing down its growth too quickly, the fallout could be substantial on South Korea's economic prospects.

The market had been pricing in a rate hike from the Bank of Korea before the end of the first quarter prior to the release of the fourth quarter GDP data. The prospect of such a move now seems much more remote today. As if to underscore this fact, the government, which has been lobbying the Bank of Korea to hold off on rate hikes, sent its Vice Finance Minister Hur Kyung Wook to attend this month's review of borrowing costs, breaking a ten-year tradition of excluding political representatives. Recovery in South Korea remains intact, but the fourth quarter data reminds us that the path to recovery is rarely smooth or without surprises.





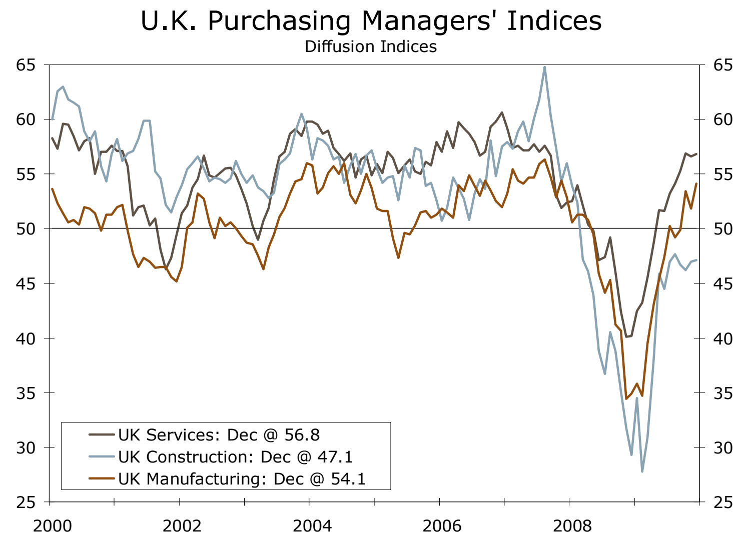
U.K. PMIs • Monday and Wednesday

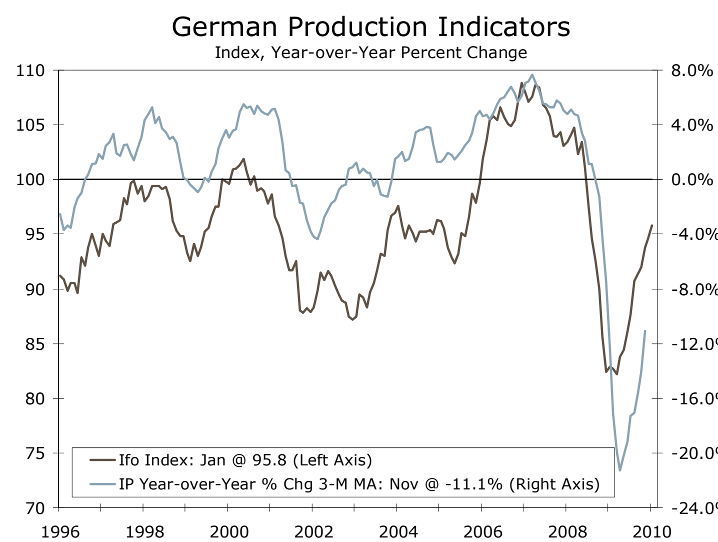
Both the manufacturing and services PMI in the United Kingdom have moved well into expansion territory in recent months. Unfortunately, "hard" data have failed to confirm, at least so far, the strength in activity that the PMIs are signaling. Indeed, real GDP data released earlier this week showed that the British economy expanded only 0.1 percent (not annualized) in the fourth quarter. In any event, the January PMIs for manufacturing (Monday) and services (Wednesday) will print next week.

The Bank of England's policy meeting next week should be uneventful. There are very few observers who expect the MPC to change its main policy rate from 0.50 percent and an increase in the size of its asset purchase program is also unlikely. Data on the money supply and credit will give market participants some insights into current lending conditions in the United Kingdom.

Current Manufacturing PMI: 54.1 **Consensus: 53.9**

Current Services PMI: 56.8 **Consensus: 56.5**





German Industrial Production • Friday

The level of German industrial production (IP) plunged 23 percent from early 2008 to early 2009. Since its nadir last April, IP has risen 9 percent and the continued climb in the Ifo index of German business sentiment, which is highly correlated with production growth, suggests that IP has strengthened further. Indeed, the consensus forecast anticipates that IP rose again in December. Factory orders, a leading indicator of production, are expected to have risen modestly in December following the strong increase of 2.8 percent the previous month.

The European Central Bank holds its monthly policy meeting on Thursday, but there is very little chance that the ECB will change its main policy rate from 1.00 percent, where it has been maintained since last May.

Previous: 0.7% (month-on-month change)

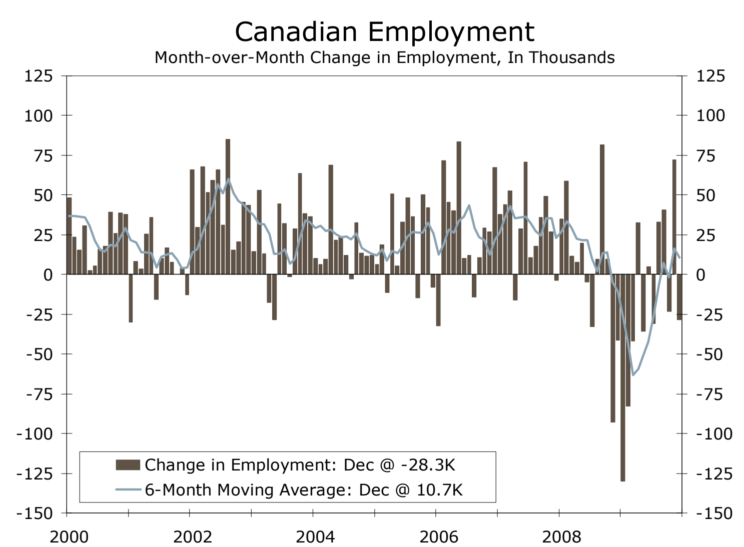
Consensus: 0.4%

Canadian Jobs Report • Friday

Economic recovery in Canada is underway, but the pace of that recovery has shown signs of slowing in recent weeks. While business spending has been remained strong, there have been signs that domestic consumer demand is softening a bit. Retail sales for November fell 0.3 percent, which was a larger decline than had been expected. Auto sales were down 6.0 percent in November, although that was actually a smaller drop than market-watchers were bracing for. The key to growth in consumer spending is a recovery in the Canadian job market. Despite a couple of negative months, the employment picture has been brightening in Canada on trend since the summer of last year. The first monthly payroll report for the new year will print on Friday, and the consensus expects that improvement to continue into the new year with an increase of 15K jobs in January.

Previous: -2.6K

Consensus: 15.0K



Interest Rate Watch

Fed Outlook: Better Growth –Light at the End of the Easing Tunnel?

Better economic times are ahead. That, at least, is the view from the Federal Open Market Committee and we would agree that the economic outlook continues to improve. Economic activity "continued to strengthen" according to the FOMC statement. Household spending continues to expand but with the drag of income, wealth and credit constraints. The story here though is the upgraded outlook by the FOMC for business spending on equipment and software. Orders and shipments reports have improved in recent months and that is consistent with increased capital spending. In the latest GDP release, real spending on equipment and software was up a solid 13.3 percent at an annual rate in the fourth quarter of 2009.

Inflation: What, Me Worry?

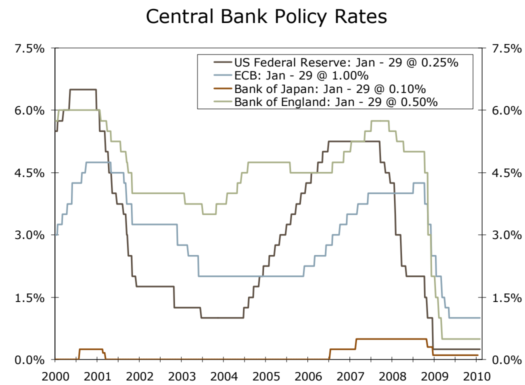
For at least the short-term, inflation remains "subdued." Resource slack, measured by unemployment and capacity utilization, remains substantial. However, inflation expectations have started to rise when gauged by the five-year/five year forward rates. The TIPS ten-year inflation expectations measure continues to rise. For now, though, these increases are modest.

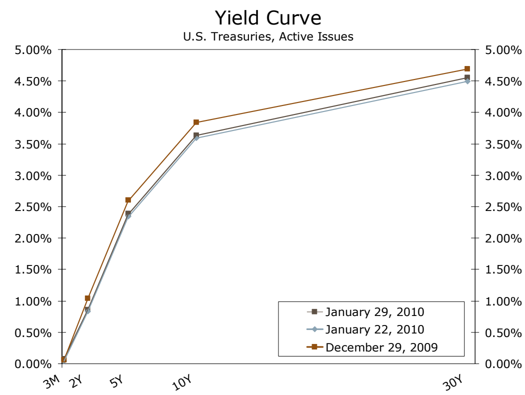
Lessons for Investors and Business Decision-makers

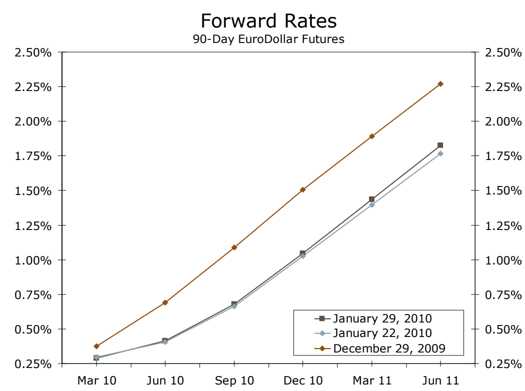
Three fundamentals suggest the outlook is for continued rising long-term rates even though we expect the Fed to retain its low federal funds rate target. First, as the outlook for growth improves the flight to safety trade will continue to decline.

Second, with expected consumer price inflation at 2 percent or more for 2010 and 2011 the 0.85 percent yield on the two-year Treasury makes no investment sense. Rising inflation expectations suggest that even some longer-term Treasury rates do not cover the inflation premium, thus investors will likely continue to move away from Treasuries across the yield curve.

Finally, Hoenig's dissent suggests that at the FOMC meeting there was some discussion about the retention of the phrase "extended period" when referring to low levels of the federal funds rate. This extended period could allow the build-up of inflation pressures that would become difficult to control thereby letting the inflation genie out of the bottle. The period of easy policy is ending.







Consumer Credit Insights

Household Rebalancing Continues

One positive sign for continued economic growth is the improvement in the household balance sheet as illustrated by the Federal Reserve's Flow of Funds Report.

In its latest release, the Fed indicated that household net worth improved in the third quarter of 2009 to $53.4 trillion dollars with gains in both financial assets (at $44 trillion) and real estate holdings ($ 16 trillion). The value of other tangible assets (cars for example) fell slightly. On the financial asset side there have been gains in pension assets, corporate bond holdings, Treasury holdings as well as equities over the past year.

Meanwhile, on the liability side, there has been a dramatic decline in total liabilities led by declines in credit market borrowing as well as home mortgages. As a result, there has been an increase in the ratio of assets to liabilities and a decline in the ratio of liabilities to disposable personal income.

Looking Ahead

Our expectation is that the continued gains in the economy will support improvement in both financial and real asset values for households. Meanwhile caution from both lenders and households will limit new liabilities and give us better consumer balance sheets on net. Over time consumer credit will improve but we expect that delinquencies and credit quality will continue to be an issue for a while. There is no quick fix for over twenty years of rising household leverage.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.98%	4.99%	5.14%	5.10%
15-Yr Fixed	4.39%	4.40%	4.54%	4.80%
5/1 ARM	4.25%	4.27%	4.44%	5.27%
1-Yr ARM	4.29%	4.32%	4.33%	4.90%
MBA Applications				
Composite	513.0	575.9	460.1	732.1
Purchase	215.6	223.0	204.7	294.3
Refinance	2,260.4	2,663.8	2,008.9	3,373.9

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

Topic of the Week

2010: Year of the Tiger or Asian Bubble?

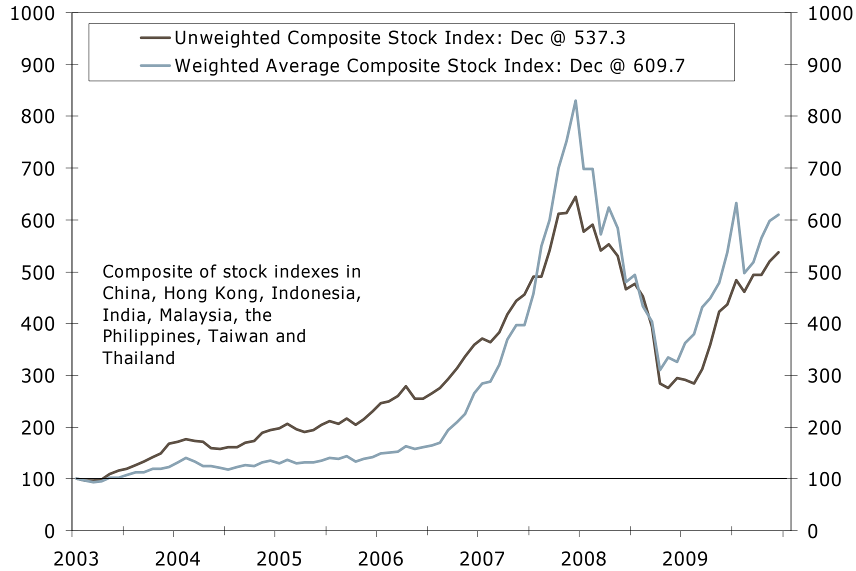
Chinese New Year will be celebrated on Feb. 14, and 2010 will be the Year of the Tiger. The sharp increase in Asian equity markets last year, and in some cases, in property markets, has some investors wondering whether 2010 will turn out to be the year of the Asian asset bubble. Are bubbles starting to inflate in Asia?

Probably not, at least not yet, in our view. Yes, some equity markets posted spectacular gains in 2009, but the increases only offset some of the outsized losses that were registered during the preceding year. Indeed, most Asian stock indexes remain well below the peaks that were reached in 2007. To help illustrate the trend in Asian stock markets, we constructed a capitalization-weighted index using some of the region's key stock markets. The index does not alarm us, at least not yet. Although this index has nearly doubled since its nadir in late 2008, it remains about 25 percent below the peak it set in December 2007. How can Asian stock markets realistically be in "bubble territory" if they have not surpassed their previous peaks yet?

Similarly, some property markets (e.g., Hong Kong, Singapore and Shanghai) have experienced significant price increases over the past year. Again, however, prices in most markets are not yet back to levels that prevailed a few years ago. Asian economies, which experienced their own financial crises a decade ago, are not overly leveraged at present. One way to measure leverage in the banking system is to look at the overall loan-to-deposit ratio. The higher the ratio, the more the banking system is relying on borrowing from abroad to finance new loans. Not only have the loan-to-deposit ratios for some major economies in the region trended lower over the past decade, but they are all comfortably below 1.0 at present. In our view, asset prices in Asia have further room to rise over the next few years as the region releverages. Although Asia probably does not have generalized asset bubbles at present, it surely could have them in a few years if monetary policy remains too accommodative for too long.

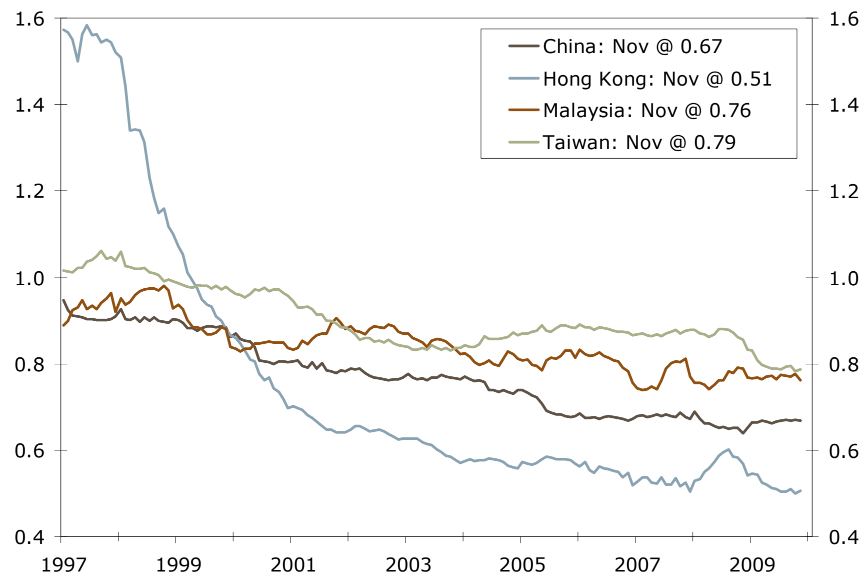
Stock Market Index of Select Asian Countries

Weighted and Unweighted Indexes by Market Cap, Jan 2003 = 100



Loan-to-Deposit Ratio of Asian Banking Systems

Ratio



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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 1/29/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.07	0.04	0.22
3-Month LIBOR	0.25	0.25	1.17
1-Year Treasury	0.29	0.23	0.42
2-Year Treasury	0.88	0.79	0.95
5-Year Treasury	2.42	2.34	1.83
10-Year Treasury	3.67	3.61	2.86
30-Year Treasury	4.56	4.53	3.61
Bond Buyer Index	4.39	4.30	5.16

Foreign Exchange Rates

	Friday 1/29/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.392	1.414	1.295
British Pound ($/₤)	1.606	1.611	1.430
British Pound (₤/€)	0.867	0.877	0.906
Japanese Yen (¥/$)	90.750	89.820	90.030
Canadian Dollar (C$/$)	1.063	1.058	1.227
Swiss Franc (CHF/$)	1.053	1.041	1.153
Australian Dollar (US$/A$)	0.892	0.901	0.652
Mexican Peso (MXN/$)	12.947	12.974	14.185
Chinese Yuan (CNY/$)	6.827	6.827	6.838
Indian Rupee (INR/$)	46.178	46.155	48.985
Brazilian Real (BRL/$)	1.865	1.825	2.294
U.S. Dollar Index	79.251	78.277	85.277

Foreign Interest Rates

	Friday 1/29/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.61	0.61	2.10
3-Month Sterling LIBOR	0.62	0.61	2.17
3-Month Canadian LIBOR	0.44	0.45	1.62
3-Month Yen LIBOR	0.26	0.25	0.68
2-Year German	1.14	1.11	1.57
2-Year U.K.	1.27	1.25	1.47
2-Year Canadian	1.22	1.17	1.40
2-Year Japanese	0.16	0.17	0.41
10-Year German	3.21	3.22	3.26
10-Year U.K.	3.92	3.92	3.69
10-Year Canadian	3.38	3.37	3.07
10-Year Japanese	1.33	1.33	1.28

Commodity Prices

	Friday 1/29/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	74.11	74.54	41.44
Gold ($/Ounce)	1083.33	1093.20	908.65
Hot-Rolled Steel ($/S.Ton)	545.00	545.00	475.00
Copper (¢/Pound)	308.90	333.85	145.00
Soybeans ($/Bushel)	9.14	9.37	9.73
Natural Gas ($/MMBTU)	5.23	5.82	4.58
Nickel ($/Metric Ton)	18,275	18,873	11,702
CRB Spot Inds.	488.92	494.87	338.53

Next Week's Economic Calendar

	Monday	Tuesday	Wednesday	Thursday	Friday
	1	2	3	4	5
U.S. Data	**ISM Manufacturing** December 55.9 January 56.2M (W) **Personal Income** November 0.4% December 0.3% (W) **Personal Spending** November 0.5% December 0.3% (W)	**Total Vehicle Sales** December 11.23M January 11.20M (W)	**ISM Non-Manufacturing** December 50.1 January 50.1 (W)	**Nonfarm Productivity** 3Q 8.1% 4Q 5.2% (W) **Unit Labor Cost** 3Q -2.5% 4Q -3.5% (W) **Factory Orders** November 1.1% December 0.4% (W)	**Nonfarm Payrolls** December -85K January -97K (W) **Unemployment Rate** December 10.0% January 10.1% (W)
Global Data	**UK** **PMI Manufacturing** Previous (Dec) 54.1		**UK** **PMI Services** Previous (Dec) 56.8	**UK** **BOE Announces Rates** Previous 0.50% **Euro-zone** **ECB Announces Rates** Previous 1.00%	**Canada** **Change in Payrolls** Previous (Dec) -2.6K **Germany** **Industrial Prod. (MoM)** Previous (Nov) 0.7%

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

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