January 08, 2010

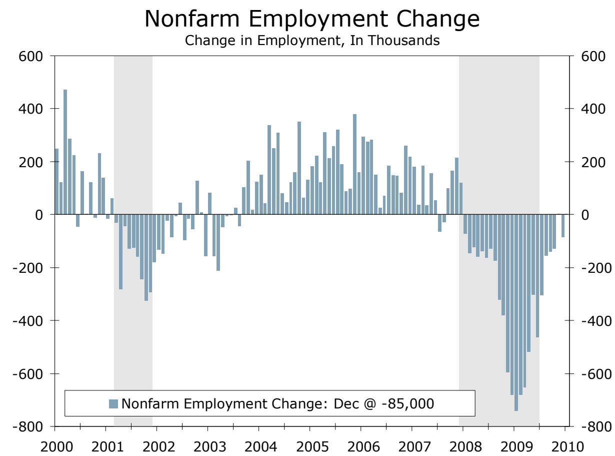
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Making Progress on the Road to Recovery

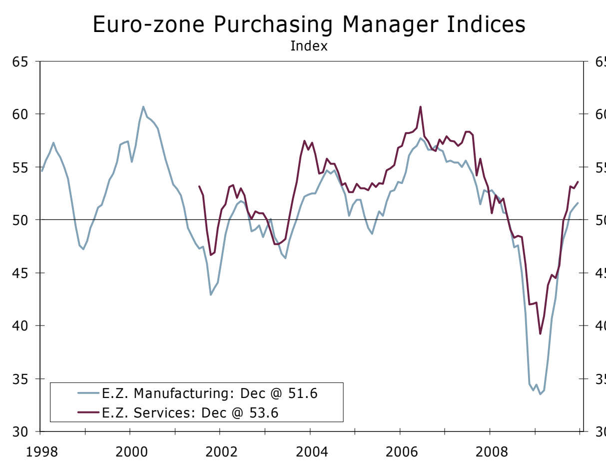
- December's employment report was generally disappointing, with a larger than expected 85,000-job decline in nonfarm payrolls and huge declines in household employment and the civilian labor force.
- Most major chain stores reported better-than-expected results for December.
- Manufacturing activity improved toward the end of 2009, with factory orders rising solidly and the ISM manufacturing survey ending the year at 55.9.



Global Review

Euro-zone: Where Is the Recovery?

- The purchasing managers' indices in the Euro-zone suggest that real GDP growth likely remained positive in the fourth quarter. However, "hard" data have been less encouraging. Although we expect that economic growth in the euro area will remain positive, we believe that the pace of expansion will remain frustratingly slow over the next few quarters.
- The core rate of inflation continues to trend lower. With benign inflation and a weak recovery, we expect that the European Central Bank will refrain from raising rates well into the second half of the year.

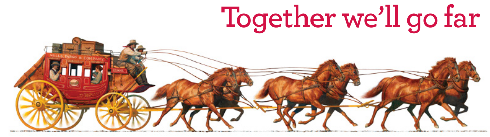


Inside

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]	-6.4	-0.7	2.8	2.6	2.2	2.5	2.4	2.0	2.7	2.1	0.4	-2.5	2.2	2.3
Personal Consumption	0.6	-0.9	2.9	1.1	0.8	1.2	1.3	1.4	2.9	2.6	-0.2	-0.6	1.2	1.4
Inflation Indicators [2]														
"Core" PCE Deflator	1.7	1.6	1.3	1.5	1.4	1.3	1.3	1.3	2.3	2.4	2.4	1.5	1.3	1.6
Consumer Price Index	-0.2	-0.9	-1.6	1.3	2.1	2.1	1.6	1.4	3.2	2.9	3.8	-0.4	1.8	2.0
Industrial Production [1]	-19.0	-10.3	5.6	4.7	2.3	3.1	2.8	4.2	2.3	1.5	-2.2	-9.9	2.6	4.1
Corporate Profits Before Taxes [2]	-19.0	-12.6	-6.7	24.0	22.0	16.0	10.0	8.5	10.5	-4.1	-11.8	-5.2	13.8	8.0
Trade Weighted Dollar Index [3]	83.2	77.7	74.3	72.9	73.9	76.4	79.1	81.6	81.5	73.3	79.4	72.9	81.6	83.2
Unemployment Rate	8.1	9.3	9.6	10.1	10.2	10.4	10.6	10.6	4.6	4.6	5.8	9.3	10.5	10.3
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	4.85	5.00	5.20	5.20	5.30	6.14	6.10	5.33	4.85	5.30	5.90
10 Year Note	2.71	3.53	3.31	3.35	3.40	3.40	3.50	3.60	4.71	4.04	2.25	3.35	3.60	4.30

Forecast as of: December 9, 2009
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change



U.S. Review

Employment Gains Are Not There Yet

December's employment report was somewhat of a disappointment. Many were expecting a small increase in employment to be reported for December, even though the consensus was calling for a small decline. Our own forecast called for a larger than consensus drop and we had repeatedly noted that the optimism so many were showing was premature. The actual data proved to be weaker than our forecast, with nonfarm payrolls declining by 85,000 in December and the household survey showing substantial drops in both employment and the labor force.

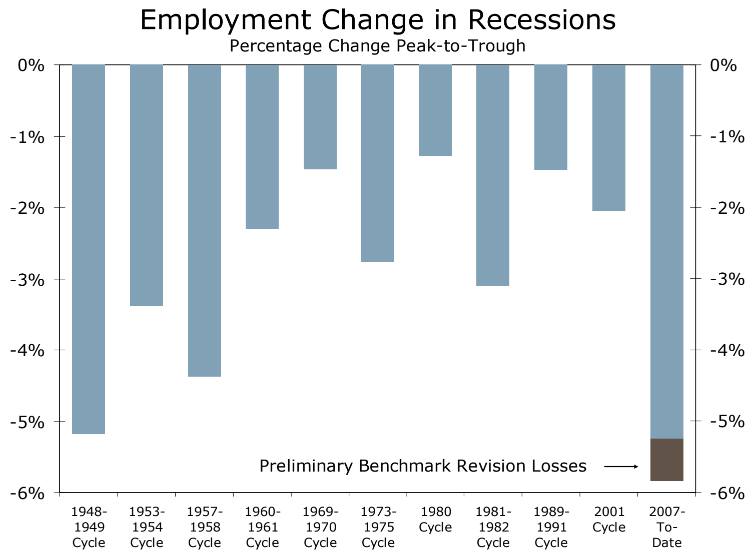
Revisions to the previously published data produced a slight increase in employment during November. The 4,000 job increase was the first since the recession began back in December 2007. Any celebration about November's increase was tempered by downward revisions to the October data. On net, the employment data were revised down for the two previous months by 1,000 jobs. Moreover, benchmark revisions will be made to the employment data next month dating back March 2008. The BLS has reported the revision would be around 0.6 percent, which would result in an additional 830,000 job losses over the past two years.

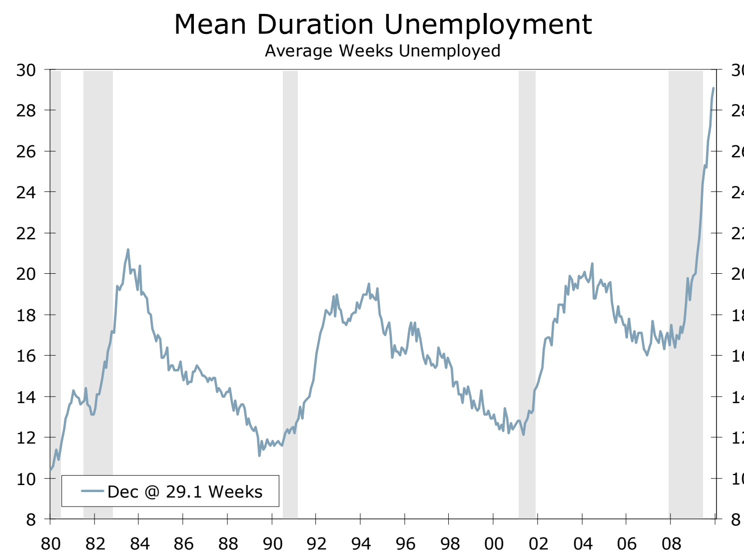
The unemployment rate was unchanged at 10.0 percent, but beneath the surface there was a great deal of weakness. Both household employment and the civilian labor force tumbled in December, with the labor force plunging 661,000 and employment declining by 589,000. In addition, both the average and median duration of unemployment increased during the month, reflecting the continued difficulty the unemployed are having finding another job.

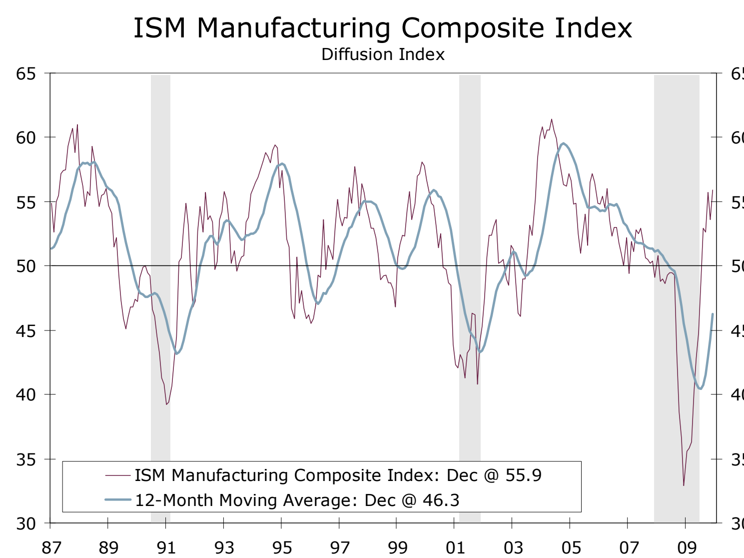
While the December employment report was disappointing there were some positive rays of hope in the report. Hiring at temporary staffing companies posted its fifth consecutive increase, with employment rising by 47,000 in December. Aggregate hours worked also held on to their strong 0.6 percent November gain and the percentage of industries adding jobs held above 40 percent for the second month in a row. All these are things that typically improve six to nine months before employment begins to rise. We continue to believe the economy is moving closer to the point where we will see consistent and meaningful gains in nonfarm payrolls, but we are not there yet.

Early reports from the holiday shopping season continue to come in ahead of expectations. Chain store sales for December rose a solid 2.8 percent over their year ago level. The increase is at least partly due to less discounting on the part of retailers, so likely reflects less of an increase in volume. The government figures due out next week will also likely show less strength as they are adjusted for holidays and Thanksgiving came early this year.

Data from the manufacturing sector is another bright spot. Business inventories have been drawn down to the point that orders and output are now rebounding, even with only minor gains in final demand.





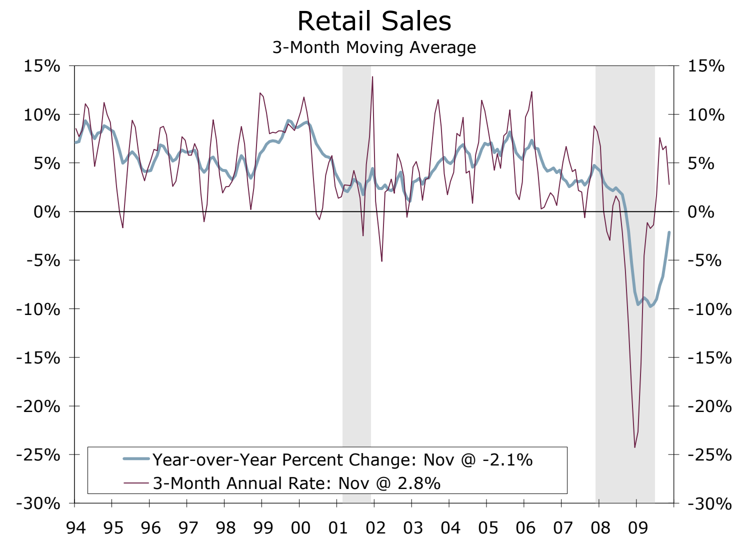


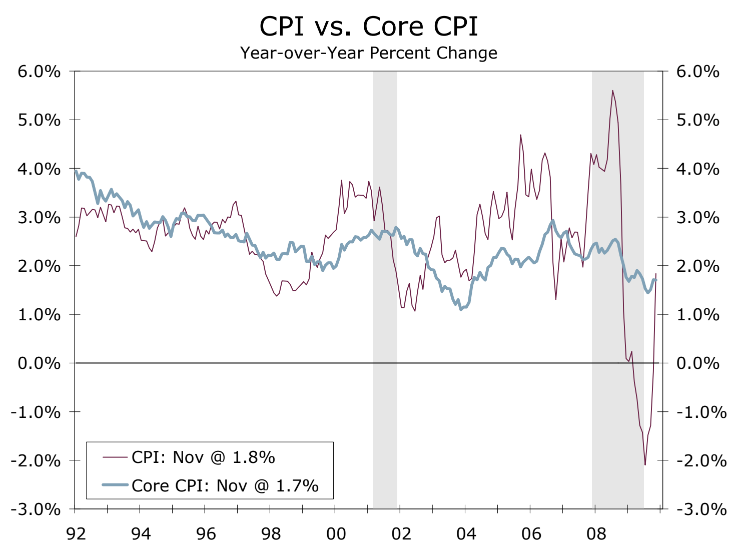
Retail Sales • Thursday

Advanced retail sales rose 1.3 percent in November with broad-based gains across most sectors. "Core" retail sales, which exclude gasoline, building materials and autos rose 0.5 percent, the fourth consecutive monthly gain. "Core" retail sales were driven by an increase in electronics which rose 2.8 percent in November. The better-than-expected gain in retail sales kicked off the holiday season above last season's levels. Due to lean inventories, retailers went into this holiday season in a far stronger position. The large discounting seen during the previous holiday season was far less prevalent. We expect headline retail sales will continue the positive momentum and will likely increase 0.6 percent, driven by increases in gasoline station and motor vehicle sales. Excluding motor vehicle sales, retail sales likely rose 0.4 in December. Chain store sales rose 2.1 on a sequential basis percent in December.

Previous: 1.3% **Wells Fargo: 0.6%**

Consensus: 0.4%





CPI • Friday

The headline Consumer Price Index (CPI) rose 0.4 percent in November largely due to increases in transportation-related prices like gasoline and motor vehicles. Core CPI, which excludes food and energy, was flat on the month. With housing in obvious oversupply, rent and owners' equivalent rent should continue to moderate in coming months keeping core consumer prices relatively tame. Goods prices are rising faster than services prices and were up 2.6 percent over the past year. The gain marks the largest increase in goods prices since the early 1990s. Core goods prices are being pulled up by stronger global economic growth, while weak domestic demand continues to restrain core services prices. We expect headline CPI to increase 0.2 percent in December and core CPI will likely register a modest increase of 0.1 percent.

Previous: 0.4% **Wells Fargo: 0.2%**

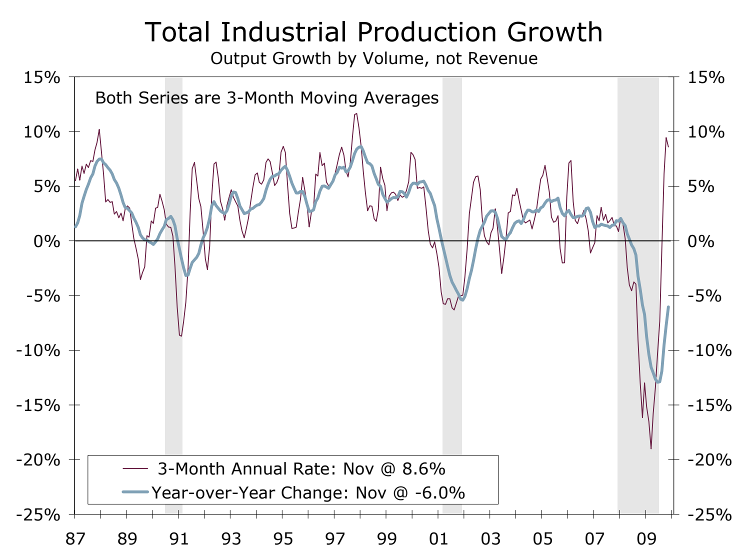
Consensus: 0.2%

Industrial Production • Friday

Industrial production rose 0.8 percent in November, the fifth consecutive monthly increase. The recovery in manufacturing remains intact with gains fairly broad-based. The headline ISM manufacturing index came in at 55.9 in December driven by gains in new orders and production suggesting more upside momentum. Forward looking new orders rose to 65.5 and suggests a sixth consecutive monthly gain in industrial production. Record cold weather in December should result in an outsized gain in utility output. We expect headline industrial production rose 0.4 percent in December. Capacity utilization, which peaked in 2006 at 81.2 percent, will likely continue its upward momentum, but is rising from very depressed levels. We expect capacity utilization will likely rise to 71.6 percent in December, but at such historic low levels, pricing power will remain minimal.

Previous: 0.8% **Wells Fargo: 0.4%**

Consensus: 0.6%



Global Review

How Strong is the Expansion in the Euro-zone?

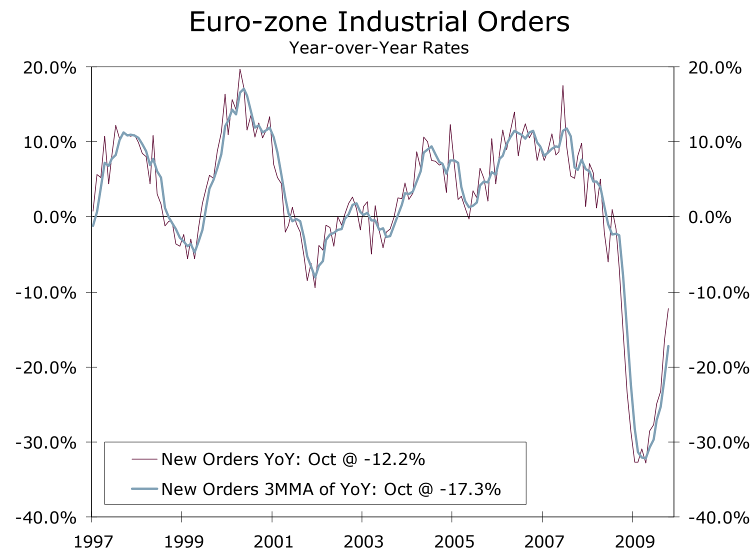
The purchasing managers' indices in the Euro-zone rose further into expansion territory in December, suggesting that real GDP growth in the euro area remained positive in the fourth quarter. Indeed, the service sector PMI rose to its highest level since autumn of 2007 (See graph on front page). Although we concur with the view that the expansion in the euro area remains intact, we believe that the pace of recovery will remain quite modest, at least in the near term. Real GDP rose at an annualized rate of only 1.7 percent in the third quarter relative to the previous quarter, and we project that the economy eked out a similar rate of expansion in the fourth quarter.

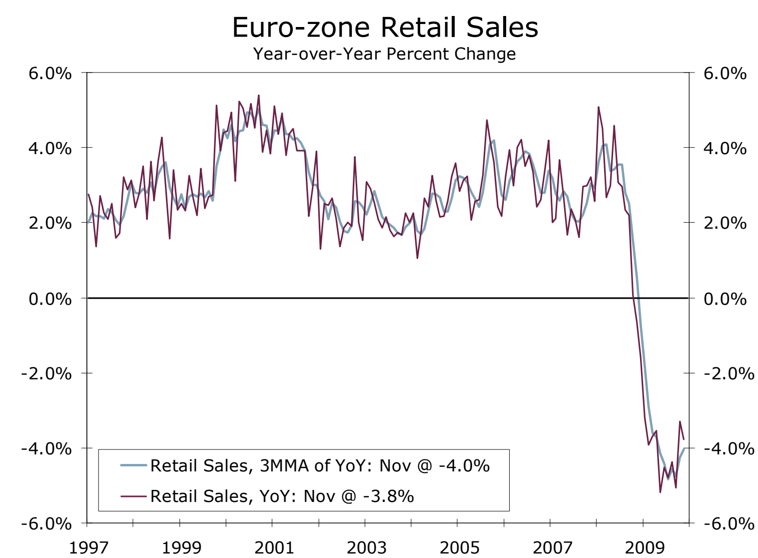
Despite solid readings in the PMIs, "hard" data from the Euro-zone have been generally disappointing lately. For example, industrial orders declined 2.2 percent in October, more than reversing the 1.7 percent increase registered during the previous month (top chart). Moreover, orders in the overall euro area have been flat on balance since July. German orders rose 0.2 percent in November relative to the previous month, which holds out hope that orders in the Euro-zone also edged up in November, but the outturn can hardly be characterized as robust.

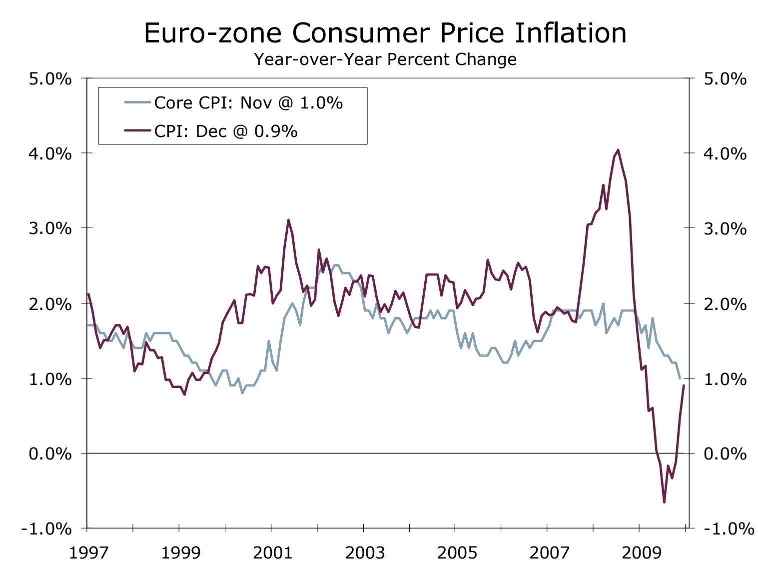
Flatness in orders over the past few months has translated into softness in industrial production (IP). Indeed, the fourth quarter got off to a weak start as Euro-zone IP dropped 0.6 percent in October relative to the previous month. In Germany, IP in November retraced some of its large decline in October, which suggests that IP in the overall euro area may also have bounced back somewhat during the month. (Official data will be released next week – see page 5). Weakness in the production of consumer goods has helped to weigh on Euro-zone IP recently.

In that regard, retail spending in the Euro-zone remains weak. Indeed, the volume of retail spending (excluding autos) in the overall euro area was nearly 4 percent below its year-ago level in November (middle chart). It is not often that we apply the term "strong" when we refer to consumption expenditures in Germany and Italy, but consumer spending in these two countries is holding up better (in relative terms) than in most other economies in the Euro-zone. Real retail spending in Italy is essentially flat while German consumer spending is down "only" 3 percent. In Spain and Ireland, which are both reeling from the fallout of their burst housing bubbles, real retail sales are down about 6 percent. Greek consumer spending is down an incredible 15 percent on a year-ago basis.

CPI inflation in the Euro-zone recently returned to positive territory due to the rise in energy prices from their lows last year (bottom chart) However, the "core" rate of CPI inflation has declined to its lowest rate in nearly nine years due to economic weakness in the Euro-zone (bottom chart). As we discuss on page 5, the European Central Bank holds a regularly scheduled policy meeting next week, and the probability that the Governing Council hikes rates next week is miniscule. Indeed, we believe that the ECB will be on hold well into the second half of the year.







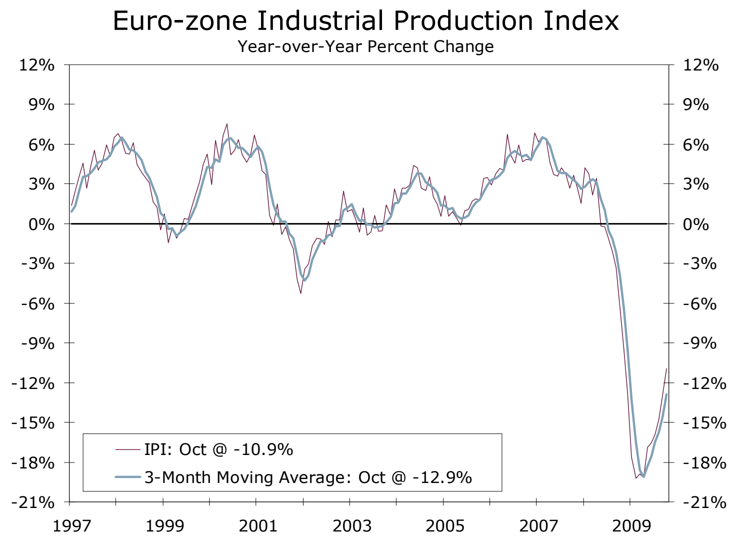
Euro-zone IP • Wednesday

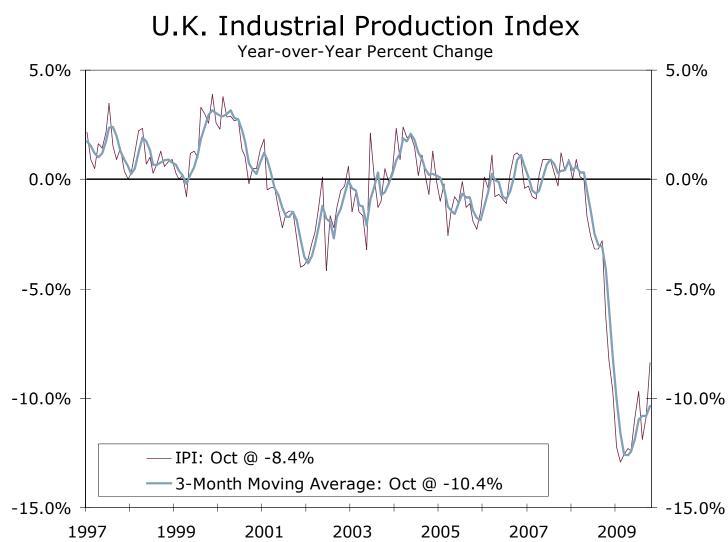
From its peak in April 2008 to its nadir a year later, industrial production in the Euro-zone plunged 20 percent. IP has subsequently ground higher, but it remains 18 percent below its peak. Moreover, the fourth quarter got off to a weak start as production declined 0.6 percent in October relative to the previous month. November data for France and Italy as well as the overall euro area will offer further insights into the current state of the economy. In that regard, Germany reported this week that IP rose 0.7 percent in November relative to the previous month.

The European Central Bank (ECB) holds its monthly policy meeting on Thursday, and there is very little chance that the ECB will change its main policy rate from its current setting of 1.00 percent. Not only is the Euro-zone economy weak at present, but the core rate of inflation has dropped to a 9-year low of only 1.0 percent.

Previous: -0.6% (month-on-month change)

Consensus:





U.K. Industrial Production • Wednesday

As in the case of the Euro-zone, industrial production in Great Britain tanked in late 2008/early 2009. Although British IP has stabilized, it has yet to exhibit much of an upward trend. However, the manufacturing PMI has been above the demarcation line that separates expansion from contraction for three consecutive months, suggesting that production should increase sooner or later. Indeed, the consensus forecast anticipates that industrial production rose 0.3 percent in November relative to October.

The widely followed NIESR estimate of GDP growth will also be released on Wednesday. In the September - November period, real GDP was estimated to have increased 0.2 percent (not annualized) relative to the previous three-month period. If December's outturn is also positive, it would add to the growing body of evidence that the British economy is starting to expand again.

Previous: 0.0% (month-on-month change)

Consensus: 0.3%

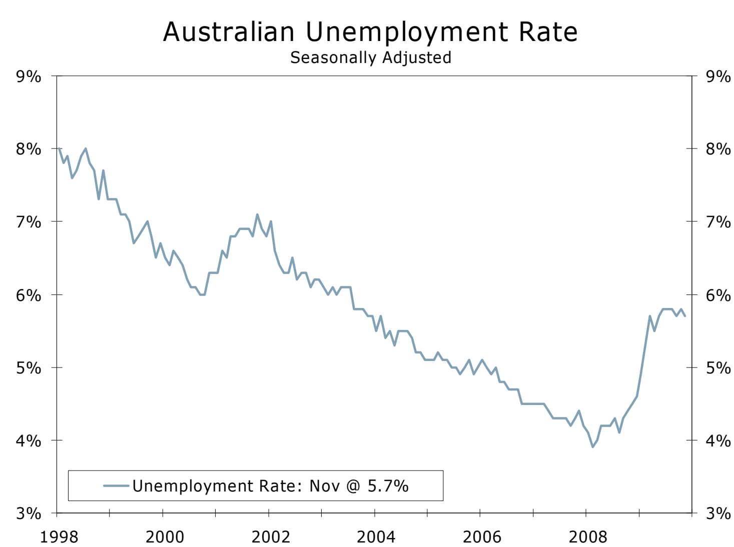
Australian Unemployment Rate • Thursday

The downturn in Australia was relatively mild compared to what was experienced in many other foreign economies. Public infrastructure spending is helping to jumpstart the economy and three consecutive months of payroll growth has started to spark domestic demand. Retail sales have posted two straight months of gains, and the 1.4 percent jump in November was much stronger than the 0.3 percent gain that the consensus had expected. Market watchers down-under will have their eyes on the Australian employment report on Thursday of next week as the consensus is expecting a fourth month of job growth.

In mid-December, the deputy governor of the Reserve Bank of Australia (RBA) indicated that monetary policy has moved into a "neutral" range, which has led some investors to question whether the RBA would hike rates again at its next policy meeting on Feb 2.

Previous: 5.7%

Consensus: 5.8%



Interest Rate Watch

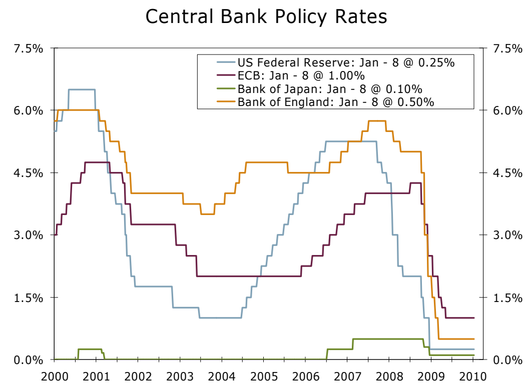
Into The Fray of Monetary Policy

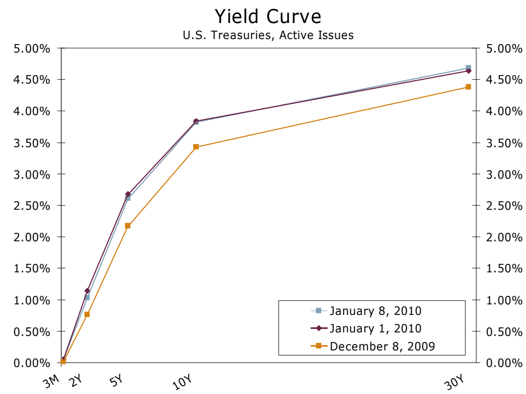
The latest episode in the current saga of monetary policy in the Unites States happened last week between the Fed Chairman Ben Bernanke and "Taylor's Rule" proponent John Taylor. The latter argues that monetary policy was at the heart of the causes of the last recession, while Bernanke argues that lack of regulation, not lax monetary policy, was the problem.

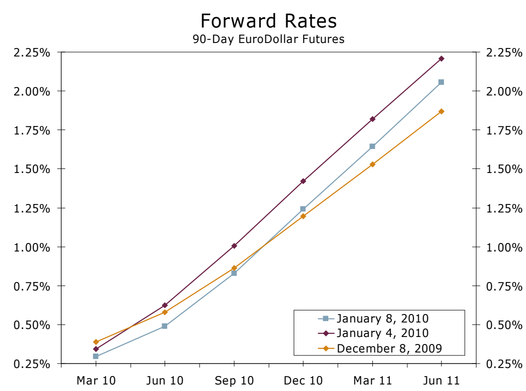
This is nothing new. Economists are still arguing about what caused the Great Depression back in the 1930s. The only thing that is clear is that when you generate economic activity by pushing interest rates too low it causes the economy to grow faster than its long-run sustainable rate. At the beginning of the cycle demand outpaces supply and when supply catches up and many times surpasses demand, something unexpected happens. This could be a shock to the economy, like a reversal in capital flows, or a sudden collapse of the financial sector, etc., and the house of cards collapses.

This is what happened to the East Asian countries (the so called Asian Tigers) back in the late 1990s. They put forward a development model that was dependent on exports and very low, subsidized interest rates. This policy of very low interest rates pushed demand over its sustainable limit and supply way over this limit.

Monetary policy exists to support economic activity but if this policy is not also conducive to sustainable growth, the responsible monetary institution or central bank has to adjust its course. And it is very difficult to argue that interest rates were not extremely low during the preceding period in the United States and that housing demand was not growing without bound. True, the Fed was arguing that a "world awash in savings" was the problem, not Fed policy. This gives the impression that the Fed has lost its ability to influence monetary variables. Both Bernanke and Taylor have good arguments, but the question remains, why did the institutions not work to prevent the crisis?







Consumer Credit Insights

Did the Holidays Lead to Credit Use?

Consumers have been cutting their outstanding credit balances at unprecedented rates. Consumer credit balances outside of mortgage loans have been cut in 13 of the 15 months through October 2009—with an aggregate decline of $98.7 billion. At the same time the personal saving rate has remained well above the levels we saw during the last expansion. However, did consumers change their minds about credit use again during the holiday season? Perhaps just as importantly, did banks change their minds on credit standards in the early stages of the recovery?

Holiday sales have come in better than expected than in early reports. November retail sales were considerably better than originally anticipated and reports from retailers have been generally positive on December sales as well. The question about credit providers remains: did consumers use savings, income or credit accounts to finance this year's holiday buying? We get an early reading late on Friday afternoon with November consumer credit data. The market is looking for another drawdown in outstanding balances of $5 billion.

Strong gains in outstanding credit are unlikely before the labor market shows more meaningful improvement. And while gains are likely on trend within the next few months, December data showed an unexpected setback.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	5.09%	5.14%	4.81%	5.01%
15-Yr Fixed	4.50%	4.54%	4.32%	4.62%
5/1 ARM	4.44%	4.44%	4.26%	5.49%
1-Yr ARM	4.31%	4.33%	4.24%	4.95%
MBA Applications				
Composite	462.2	460.1	665.6	1,143.8
Purchase	212.1	204.7	241.5	344.2
Refinance	1,976.9	2,008.9	3,185.9	5,904.5

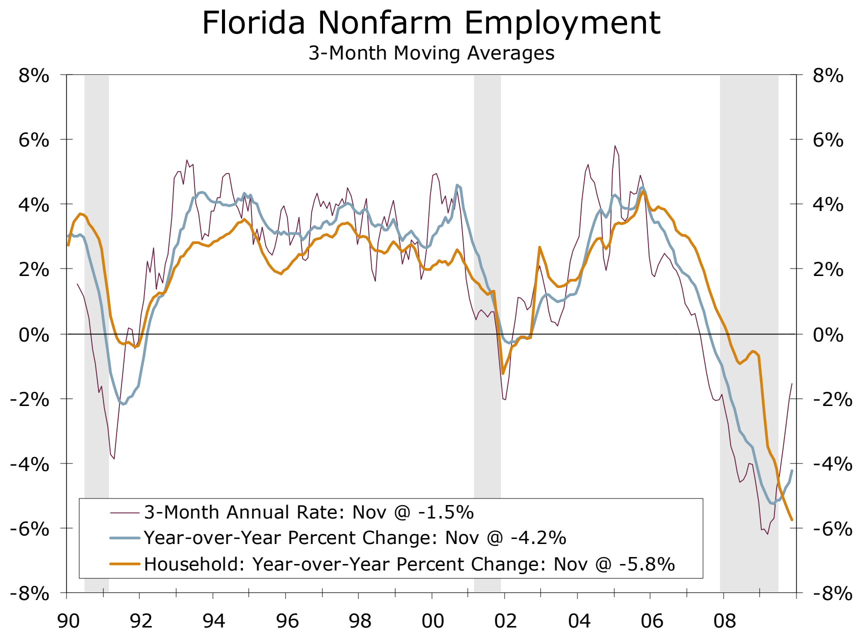
Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

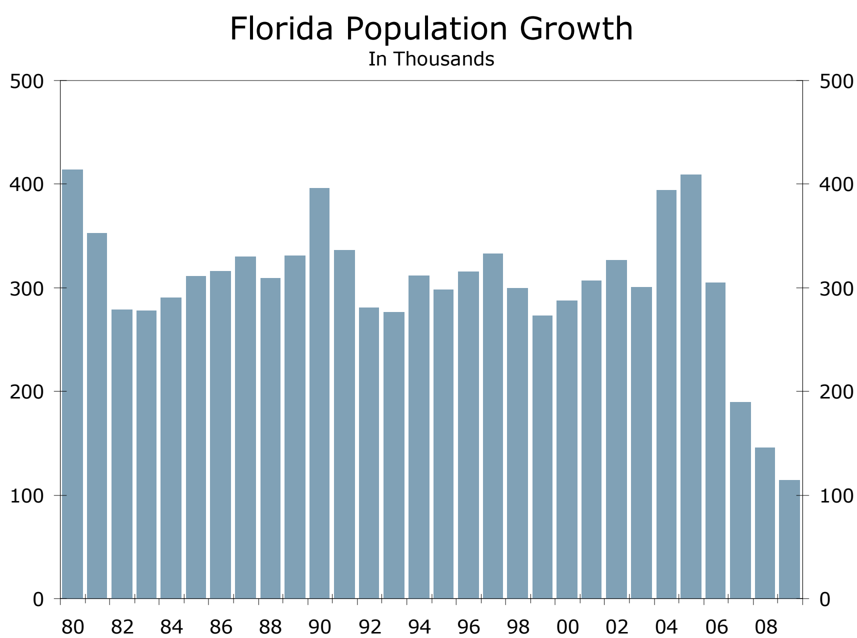
Topic of the Week

Fear Not, the Sun Will Shine Again in Florida

Florida's economic recovery looks like it will take a little longer to build momentum than much of the rest of the country. The Sunshine State is much more dependent on the continued inflow of new residents from other parts of the country to drive economic growth, and migration trends turned exceptionally negative during this recession. Florida saw its first domestic net out-migration since the immediate aftermath of World War II during 2008 and 2009, with residents increasingly relocating to other Sunbelt states, such as Georgia, the Carolinas, Tennessee and Texas. Population still increased, however, with gains from international immigration and a small natural increase offsetting the net loss of state-to-state migration. The primary reasons Florida is losing residents to other states is the dramatic increase in housing costs, including the price of insurance and property taxes, as well as the state's greatly diminished employment prospects. Nonfarm employment declined 9.1 percent over the past two and a half years, producing a net loss of more than 736,000 jobs. The unemployment rate has shot up more than 8.0 percentage points from its pre-recession lows, hitting a modern era high of 11.5 percent in November.

Efforts have been made to diversify Florida's economy away from its historical dependence on tourism and population inflows. Much of Florida's existing base of industries is tied to servicing Floridians. One notable exception has been international trade, which has been a key growth area. Trade has led to enormous growth at several of the state's major port facilities and South Florida is home to hundreds of Latin American headquarters for major U.S. and global multinational companies. Efforts have also been made to bolster the healthcare and biomedical industries in South Florida and central Florida. While these efforts hold great long-term promise, the immediate impact has been limited, and the size of these industries is still relatively small compared to the overall Florida economy. Please visit our website for our complete Florida Chartbook.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 1/8/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.04	0.06	0.07
3-Month LIBOR	0.25	0.25	1.35
1-Year Treasury	0.35	0.42	0.41
2-Year Treasury	0.95	1.14	0.83
5-Year Treasury	2.56	2.68	1.59
10-Year Treasury	3.80	3.84	2.44
30-Year Treasury	4.69	4.63	3.05
Bond Buyer Index	4.31	4.25	5.02

Foreign Exchange Rates

	Friday 1/8/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.442	1.432	1.370
British Pound ($/£)	1.603	1.615	1.522
British Pound (£/€)	0.900	0.887	0.900
Japanese Yen (¥/$)	92.554	93.035	91.205
Canadian Dollar (C$/$)	1.030	1.053	1.180
Swiss Franc (CHF/$)	1.023	1.035	1.093
Australian Dollar (US$/A$)	0.925	0.898	0.712
Mexican Peso (MXN/$)	12.697	13.101	13.677
Chinese Yuan (CNY/$)	6.828	6.827	6.835
Indian Rupee (INR/$)	45.771	46.620	48.765
Brazilian Real (BRL/$)	1.727	1.745	2.295
U.S. Dollar Index	77.369	77.860	81.536

Foreign Interest Rates

	Friday 1/8/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.65	0.66	2.72
3-Month Sterling LIBOR	0.61	0.61	2.50
3-Month Canadian LIBOR	0.46	0.47	1.81
3-Month Yen LIBOR	0.27	0.28	0.79
2-Year German	1.24	1.33	1.59
2-Year U.K.	1.27	1.32	1.68
2-Year Canadian	1.31	1.48	1.15
2-Year Japanese	0.18	0.15	0.38
10-Year German	3.39	3.39	3.13
10-Year U.K.	4.06	4.02	3.22
10-Year Canadian	3.62	3.61	2.88
10-Year Japanese	1.37	1.30	1.31

Commodity Prices

	Friday 1/8/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	83.23	79.36	41.70
Gold ($/Ounce)	1137.78	1096.95	857.40
Hot-Rolled Steel ($/S.Ton)	505.00	505.00	515.00
Copper (¢/Pound)	339.45	332.75	146.30
Soybeans ($/Bushel)	10.01	10.14	9.75
Natural Gas ($/MMBTU)	5.70	5.57	5.58
Nickel ($/Metric Ton)	18,386	18,829	12,213
CRB Spot Inds.	495.44	488.77	342.03

Next Week's Economic Calendar

	Monday 11	Tuesday 12	Wednesday 13	Thursday 14	Friday 15
U.S. Data		**Trade Balance** October -$32.9B November -$34.4B (W)		**Retail Sales** November 1.3% December 0.6% (W) **Import Price Index** November 1.7% December 0.0% (W) **Business Inventories** October 0.2% November 1.0% (W)	**CPI** November 0.4% December 0.2% (W) **Industrial Production** November 0.8% December 0.4% (W) **Capacity Utilization** November 71.3% December 71.6% (W)
Global Data			**UK** **Industrial Prod. (MoM)** Previous (Oct) 0.0% **Euro-zone** **Industrial Prod. (MoM)** Previous (Oct) -0.6%	**Australia** **Employment Change** Previous (Nov) 31.2K **Japan** **Machine Orders (MoM)** Previous (Oct) -4.5%	**Euro-zone** **CPI (YoY)** Previous (Nov) 0.5%

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

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