October 1, 2010

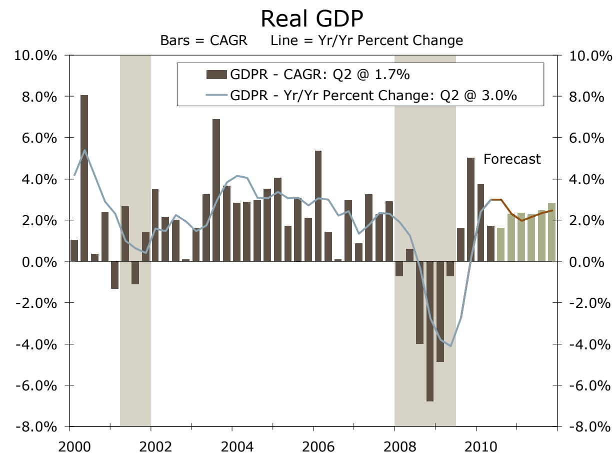
# Economics Group

Weekly Economic & Financial Commentary

## U.S. Review

### Slow Growth Is Still the Order of the Day

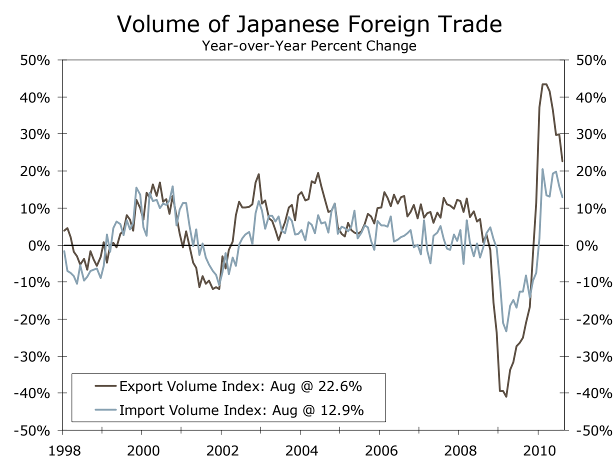
- Second-quarter real GDP was revised up slightly to a 1.7 percent annual pace. The modest upward revision in personal consumption more than offset declines in structure and government outlays.
- The Consumer Confidence Index remained exceptionally low in September, falling 4.7 points to 48. Most of the drop in the index was in the expectations component.
- Personal income and spending both posted better-than-expected gains in August. Much of the increase, however, is likely due to the extension of unemployment benefits.




## Global Review

### Japan's Economy Stumbles as Export Growth Fades

- Economic data released from Japan this week did little to dispel fears about a double-dip recession in Japan. Export growth is fading fast and industrial production sank for the third consecutive month in August.
- Japan's domestic demand isn't faring much better. Retail sales for large stores are still contracting, down 1.9 percent from a year ago in August, compared to a 1.3 percent contraction on a year-ago basis in July. Expect more direct intervention from monetary authorities in the yen market and additional quantitative easing. Downside risks still dominate our growth forecast.




## 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] | -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

## U.S. Review

### The U.S. Economy Is Proving to Be More Resilient

While some indicators released during the week were weaker than expected, worries that real GDP could slip into negative territory seem to be overblown. Second-quarter real GDP was revised up slightly to a 1.7 percent annual pace. The modest upward revision in personal consumption more than offset declines in structure and government outlays.

Our current forecast has the economy expanding at around a 2.0 percent annual rate in the second half of the year and just 2.2 percent in 2011. Moderate growth in the second half of the year reflects continued positive contributions from consumer spending, equipment and software outlays and government purchases. While some progress has been made, the economy still faces huge challenges.

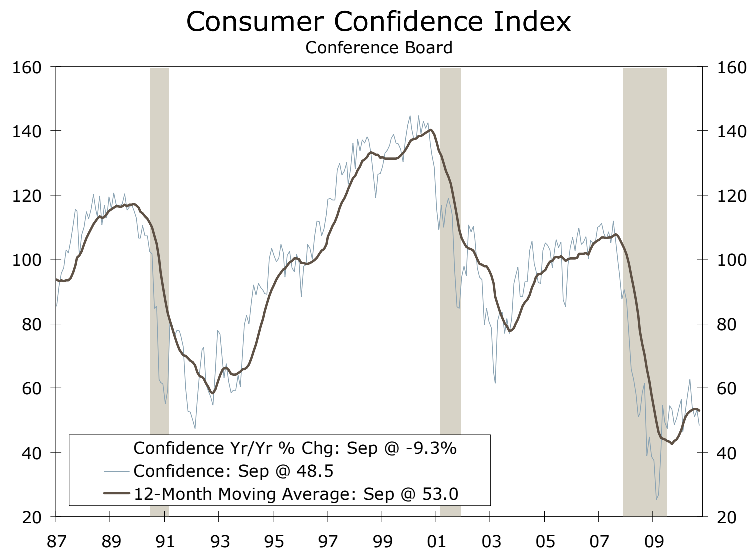
The Consumer Confidence Index remained exceptionally low in September, falling 4.7 points to 48. Most of the drop in the index was in the expectations component, which dropped 6.6 points. The present situation component also fell and has remained near decades' lows for almost two years. The present situation index typically needs to rise above the expectations index before a self-sustaining recovery takes hold.

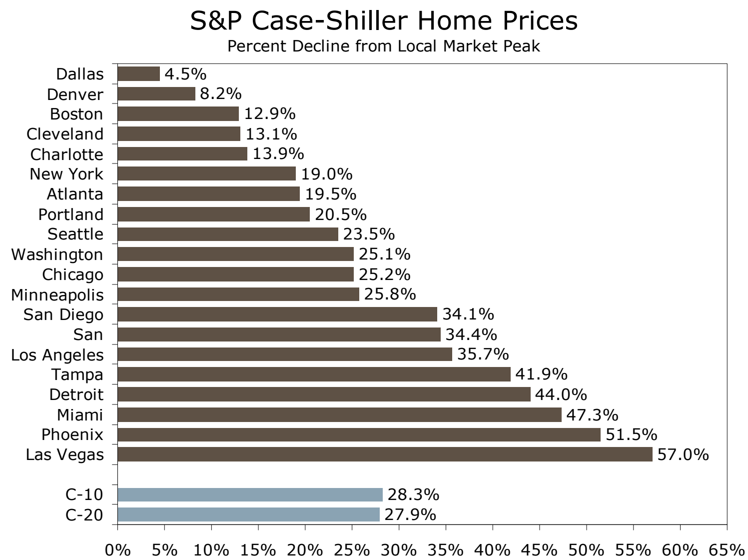
At this point in the past two expansions, consumer confidence averaged 70. The persistent low levels suggest consumer spending will continue to grow, but at a tepid pace. Consumers are still deeply concerned about employment and income prospects. The share of households reporting that jobs are difficult to get rose for the third consecutive month, while the percentage reporting that jobs are plentiful remains near its all-time low at just 3.8. The expectations for employment and income six months from now both weakened in September, further confirming the slow economic growth outlook.

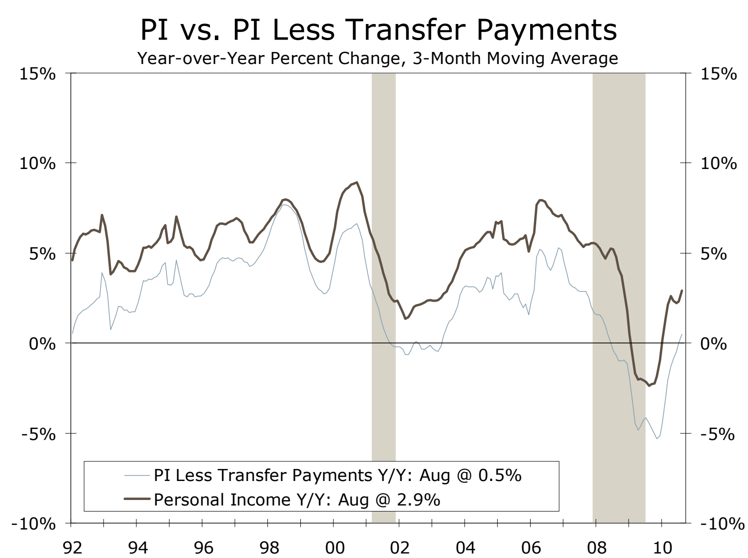
Another hurdle for consumer spending will be the outlook for housing prices. The S&P Case-Shiller Index of home prices was released this week and showed prices in the 20 largest metropolitan areas fell 0.13 percent on a seasonally adjusted basis, the first decline since March. The decline is not a surprise, because recent gains in home prices have been driven by a rise in sales volume fueled by the homebuyers' tax credit.

Home prices will likely remain under pressure in coming months as foreclosures and distressed transactions account for a larger portion of total sales. On a trend basis, states with the highest percentage of seriously delinquent mortgages and high vacancy rates are seeing the largest declines.

On a positive note, personal income and spending both posted better-than-expected gains in August. Personal income grew 0.5 percent on the month, the largest increase since the recession began. Much of the increase, however, is likely due to the extension of unemployment benefits. Personal income excluding transfer payments was flat for the second consecutive month. Transfer payments likely put a floor on income growth, which suggests true income gains could have little upside momentum.



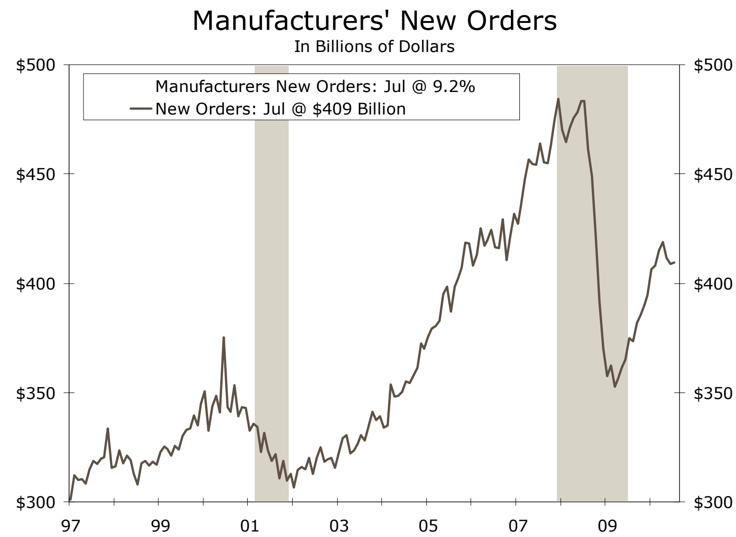



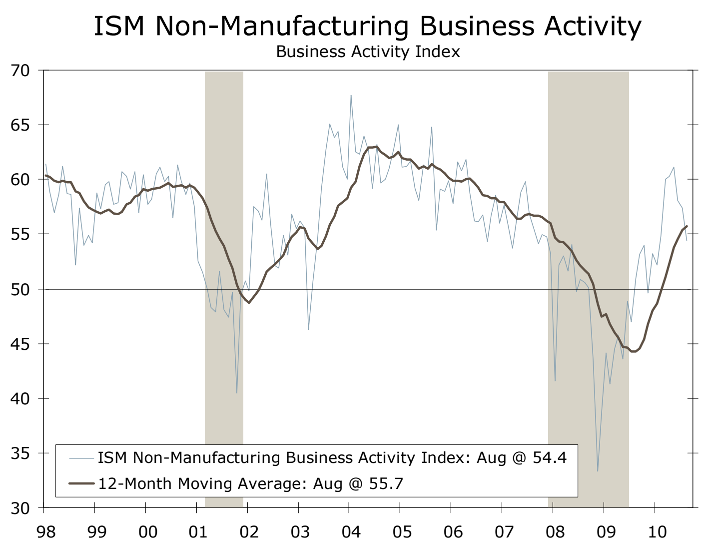
## Factory Orders • Monday

Factory orders fell off a cliff during the recession as U.S. manufacturers scaled back production and drew down inventory to survive lean economic times. But as the global recovery spawned demand for U.S. manufactured goods, inventory managers realized the shelves were nearly empty. That sparked a recovery in orders that recouped roughly half of the orders volume lost in the recession. But by the spring of this year, the bulk of the inventory rebuilding had run its course and the sovereign debt crisis in Europe sparked concerns about the pace of the global recovery. In May, factory orders fell almost 2 percent—the first decline in eight months. Bookings fell again in June and were roughly flat in July. On Monday, we'll get a look at factory orders for August. While another decline seems to be in the cards, we still maintain that business spending will pick up modestly through year-end.

**Previous: 0.1%** **Wells Fargo: -0.4%**

**Consensus: -0.4%**




## ISM Non-Manufacturing • Tuesday

The drop in the ISM non-manufacturing survey in August was larger than expected, but the index remains in expansion territory, consistent with our outlook for very slow growth. The employment component of the survey fell back into contraction territory. While this is a setback, this measure has only climbed above 50 twice since the outset of the recession in January 2008. We are not terribly concerned by this reading. Even though this measure was once a fairly reliable gauge for nonfarm hiring, it has been less accurate lately. The ISM non-manufacturing survey for September will hit the wire on Tuesday. Consistent with our outlook for a painfully slow recovery, we would not be surprised to see this measure of business sentiment tread water around its present level for the next few months—just above the 50 line that separates growth from expansion.

**Previous: 51.5** **Wells Fargo: 52.5**

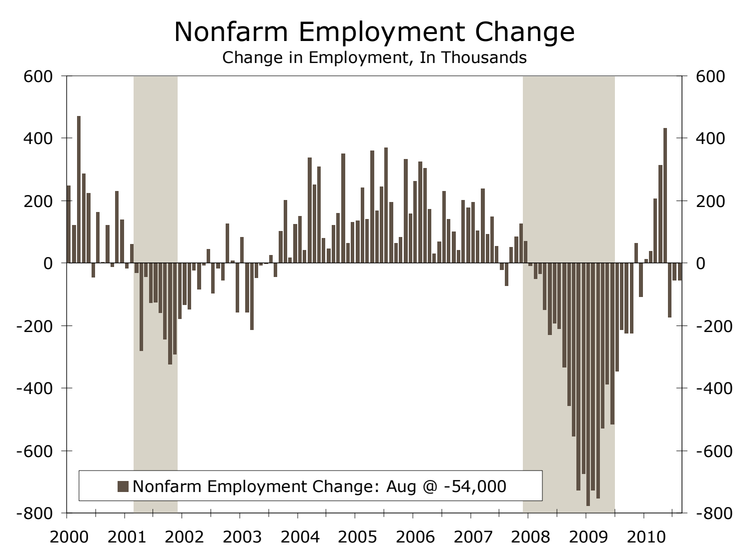
**Consensus: 52.0**

## Employment Report • Friday

What census giveth, census taketh away. The hiring for the decennial census has been playing games with the employment numbers all year. Earlier this spring, it goosed the hiring numbers, giving the appearance of a more robust job market than we actually had. But in recent months, as employees roll off the census payrolls, the headline number presents perhaps a weaker assessment of the job market. Next week on employment Friday, we expect to see total nonfarm payrolls edge out a very modest gain, but the underlying detail will likely reveal a faster pace of growth in private employer payrolls overcoming the drag from census hiring. Further out, we would expect businesses to remain cautious in hiring as employment moves gradually higher. But with initial jobless claims still at elevated levels and the employment measures in various PMIs still low, substantial job growth seems a long way off.

**Previous: -54K** **Wells Fargo: 2K**

**Consensus: 5K**



## Global Review

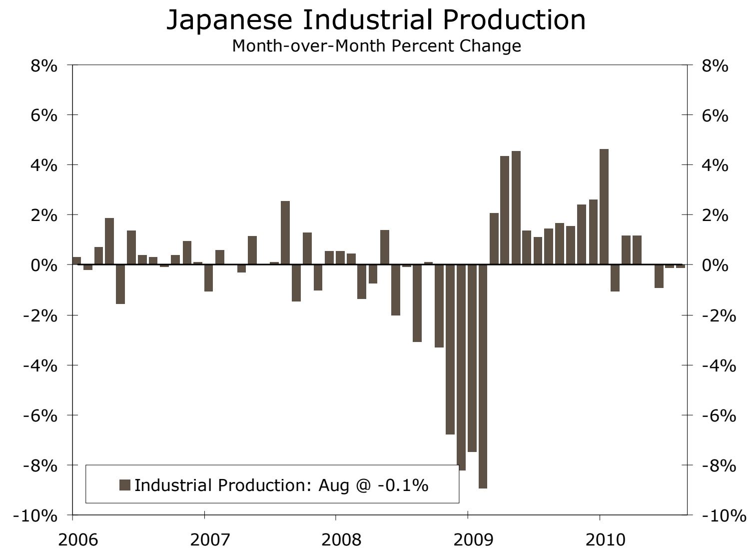
### Japan's Growth Engine Faltering

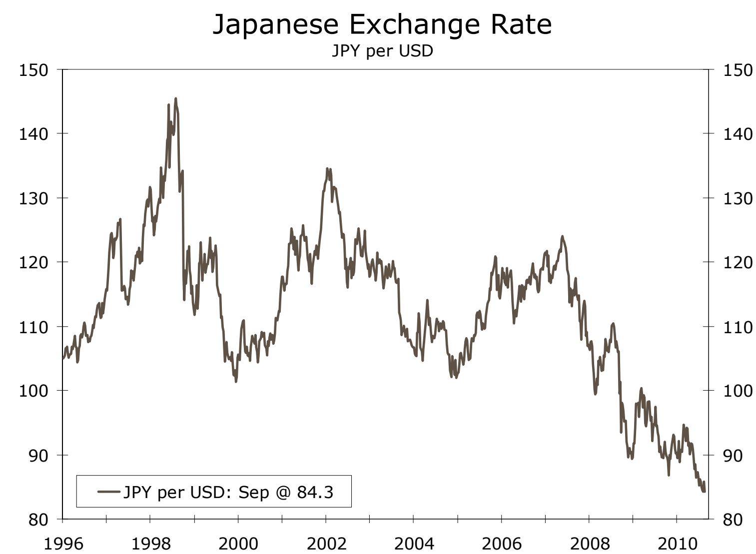
Japan actually has bigger economic problems at the moment than a temporary halt in mineral shipments from China. While recent sovereignty disputes between Japan and China quickly morphed into a minor trade war, Japan's economic data took another turn for the worse, prompting more forceful action to stave off an impending double dip.

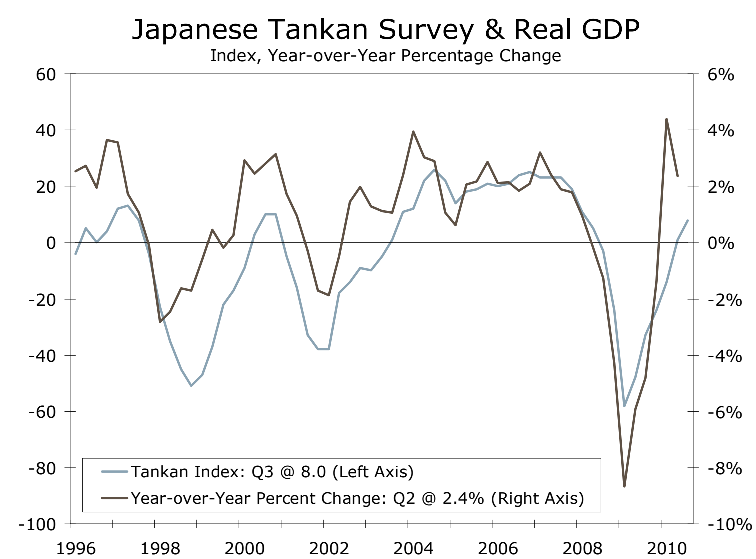
Robust export growth over the past year has been the primary driver of Japan's economic recovery to date, but over the past six months that export engine has been losing altitude fast. Export volumes in yen terms have fallen for four consecutive months and in six of the past seven months. The plunge began as a trickle in the second quarter when exports dropped at a 4.3 percent seasonally adjusted annualized rate. But by the first two months of the third quarter, Japan's export volumes were down 19.5 percent on a seasonally adjusted annualized basis from the second-quarter average.

A strong yen, which has appreciated 12 percent against the U.S. dollar this year, is certainly hurting Japan's ability to export its way back to economic recovery. The yen hit a new 15-year high against the U.S. dollar on Sept. 15, prompting the Japanese government to directly intervene in the yen currency market for the first time since 2004. The ministry of finance recently reported that it sold 2.12 trillion yen ($25 billion) through Sept. 28. The central bank is trying the bolster the stimulatory effects of this intervention by leaving the extra cash in the banking system rather than sterilizing it. Deposits of financial institutions held at the Bank of Japan climbed by 2 trillion yen on Sept. 17. The intervention caused the yen to weaken about 3.0 percent verses the U.S. dollar, but the yen has since regained its strength and is again only half a percentage point away from the level that triggered the initial intervention. The Bank of Japan meets next week, when it is widely expected to expand its 30 trillion yen credit program, but further intervention may be necessary to fully jumpstart the economy.

Japan's industrial production for August and Q3 Tankan data reinforce the fragile position of the Japanese recovery. August industrial production unexpected slumped 0.3 percent. The consensus had been expecting a 1.1 percent increase. Japan's industrial production has declined for three consecutive months now. On a brighter note, the September Tankan survey improved to +8 from +1 in June, but the confidence measure for large manufacturers is expected to fall back to -1 in December. Japan's auto manufacturers appear most worried about the yen's rise. The sector expects a 38-point decline in its Tankan index in three months. A government survey also reported that Japanese manufacturers expect to cut production 0.1 percent in September and 2.9 percent in October, led by auto manufacturers. Retail sales declines appear to already be accelerating in some areas. Same-store sales for Japanese department stores fell 3.0 percent from a year ago in August.



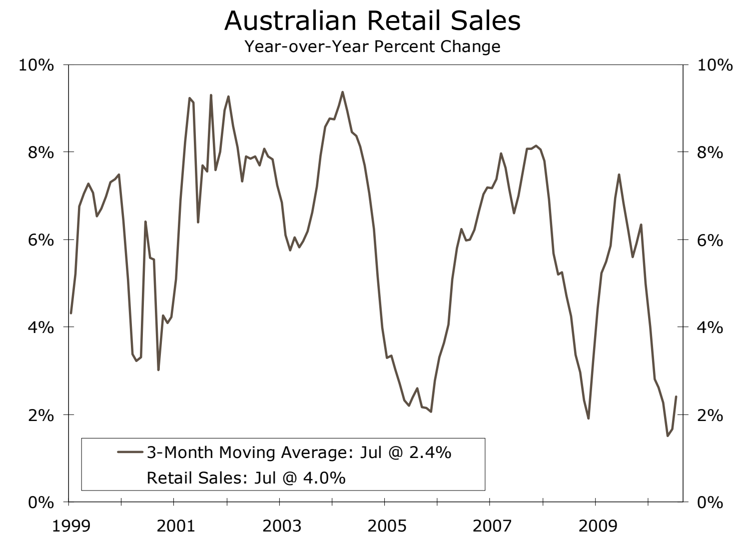



## Australia Retail Trade • Monday

Australia releases August retail sales on Monday. A solid 0.5 percent gain is expected following a 0.7 percent increase in July. Australia's retail sales appear to have strengthened since June, led by increased sales at cafes and restaurants, food, apparel and other retailing. Australia's second-quarter GDP revealed broad-based robust growth. Consumer spending and capital formation are both contributing almost equally to GDP growth. Australia's central bank was one of the first to begin removing monetary accommodation as growth has rocketed back over the past year. But given the uncertain environment in growth abroad, the central bank has held pat since May. The central bank sees monetary policy as generally neutral at the moment, as interest rates are near average levels borrowers have seen over the past decade. Should inflation pick up pace, this could be a trigger for another round of monetary tightening.

**Previous: 0.7%**

**Consensus: 0.5%**

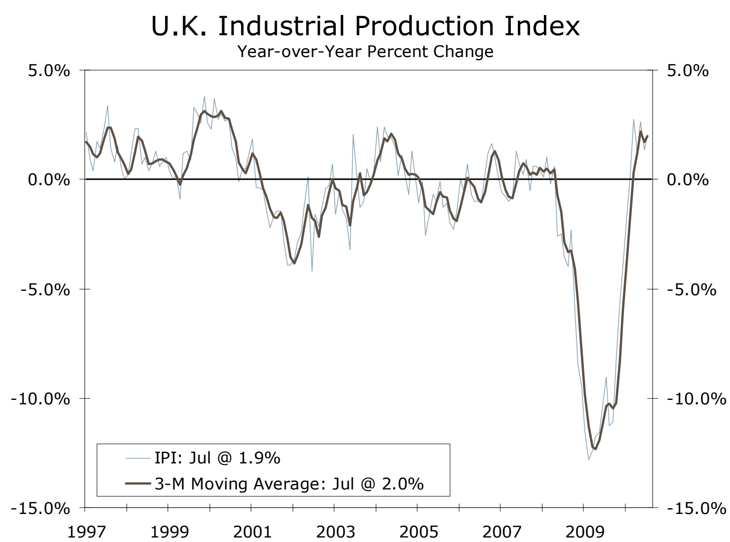



## U.K. Industrial Production • Thursday

U.K. industrial production is expected to lose some momentum in August as monthly growth slows to 0.1 percent from 0.3 percent in July. The July 0.3 percent gain in manufacturing production left manufacturing growth up 4.9 percent from a year ago, the highest growth rate for the United Kingdom since December 1994. Recent manufacturing surveys, however, suggest that growth is slowing. The U.K. PMI index from August slipped to 54.2 from a downwardly revised 56.9 in July. The U.K. PMI index was the weakest reading on this measure since June 2009. At this point, it only appears that industrial production growth is slowing down and not about to rollover. However, the European debt crisis and fiscal austerity measures from continental Europe continue to pose a downside risk to the forecast.

**Previous: 0.3%**

**Consensus: 0.1%**

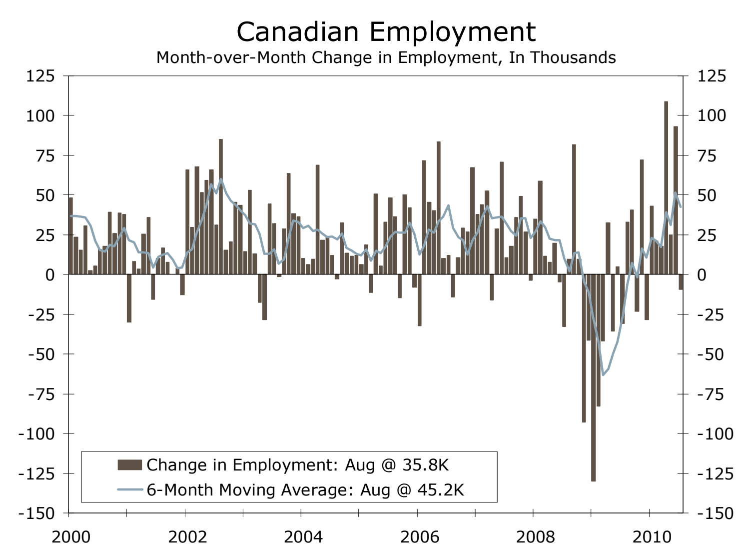



## Canada Employment • Friday

Canadian employment is expected to increase by 30,000 jobs in September, a slightly slower pace of growth than August's 35,800 gain and the six-month average gain of 45,000 jobs a month. Even so, steady modest job gains are expected to push the Canadian unemployment rate down another 0.1 percent to 8.0 percent. A strong Canadian dollar and weaker growth in the United States is increasingly weighing on the ability of Canada to create new jobs. Canada has seen two consecutive months of negative private sector job growth. Notably net jobs have begun to decline again in retail trade and manufacturing sectors. The markets will be anxious to see if job losses in these important sectors are accelerating or leveling off. One area of strength in recent months has come from service sector hiring as both healthcare and education have increased hiring.

**Previous: 35.8K**

**Consensus: 30.0K**



## Interest Rate Watch

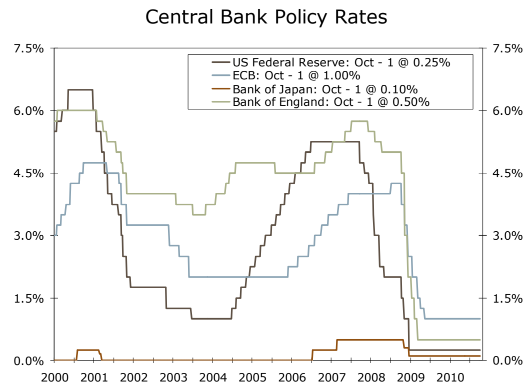
### Better News Will Not Stop the Fed

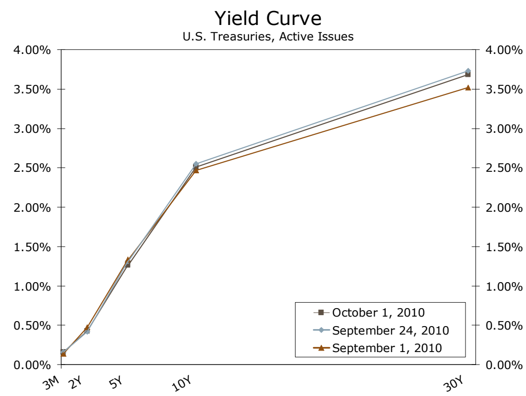
This week's better-than-expected reports from regional purchasing managers' associations and the larger-than-expected drop in weekly jobless claims have folks second guessing as to whether the Fed will go through with a second quantitative easing. Market participants would be wise to remember that the economic data are backward looking and the Fed has its eyes on future economic conditions and the risks to them. We still believe more securities purchases are on the Fed's shopping list and look for a plan to be announced before the start of the holiday season.

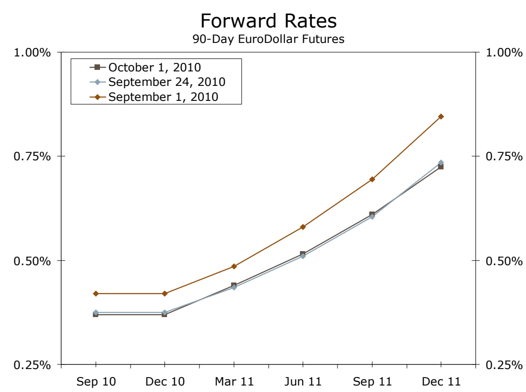
The economic news is only marginally better than had been expected. Reports from the manufacturing sector continue to show surprising resiliency, particularly given anecdotal reports that inventories are now back in line with expectations for final sales. We continue to expect the numbers to soften up a bit over coming months, with the unemployment rate likely headed back up toward 10 percent, the ISM index headed back down to 50 and home prices headed broadly lower as a rising tide of foreclosure sales, short sales and bank sales pull prices down 6–8 percent by year-end.

The Fed's actions will continue to be driven by the economy's near-term performance versus the Fed's expectations and its assessment of the risks to growth and inflation. Currently, unemployment is running too high, and the predominant risk is that it will rise higher, while inflation is running too low, with the risks solidly on the downside. In addition, credit availability does not appear to be improving near enough, which means additional securities purchases may be needed to further tighten credit spreads and spur credit demand from credit-worthy borrowers.

We continue to believe the yield curve will flatten going into year-end, with the yield on the Treasury's 10-year note retesting its recent lows around 2.40 percent. We would expect that the markets will react more forcefully to weaker economic news than they have reacted to the better-than-expected news the past few weeks.




## Credit Market Insights

### Mortgage Spreads Have Rebounded

Four factors influence mortgage rates: the 10-year Treasury yield, the spread above Treasuries (risk premium required by investors) on mortgage-backed securities (MBS), the spread between MBS yields and the MBS coupon rate (determined by demand for MBS) and the spread between the MBS coupon rate and the mortgage rate (the cut taken by the GSEs to cover servicing and guarantee fees).

From April through June, a slowing economy and European debt concerns lured investors into Treasuries, driving yields lower. Meanwhile, the spread between MBS yields (which fell in tandem with the 10-year Treasury yield) and the coupon rate widened as MBS became increasingly favored by investors and as the MBS coupon rate rose slightly. These two factors were the reason the spread between the 30-year mortgage rate and the 10-year Treasury yield widened during this period. Since June, this spread has continued to widen, but for different reasons. Although 10-year yields have declined further and the weighted-average MBS coupon rate has declined, what has prevented mortgage rates from falling even further has been a rebound in MBS yields as investor appetite for the securities has abated. In addition, the GSEs have been taking a bigger cut for fees. Thus, the Fed's efforts to drive mortgage rates lower from here could be partially offset by rising risk premiums or fading demand for MBS, as well as higher cuts taken by the GSEs for fees.

### Mortgage Data

| | Current | Week Ago | 4 Weeks Ago | Year Ago |
|---|---|---|---|---|
| Mortgage Rates | | | | |
| 30-Yr Fixed | 4.32% | 4.37% | 4.32% | 4.94% |
| 15-Yr Fixed | 3.75% | 3.82% | 3.83% | 4.36% |
| 5/1 ARM | 3.52% | 3.54% | 3.54% | 4.42% |
| 1-Yr ARM | 3.48% | 3.46% | 3.50% | 4.49% |
| MBA Applications | | | | |
| Composite | 784.0 | 790.6 | 893.8 | 649.6 |
| Purchase | 182.0 | 177.6 | 173.6 | 270.4 |
| Refinance | 4,288.0 | 4,357.4 | 5,085.3 | 2,857.3 |

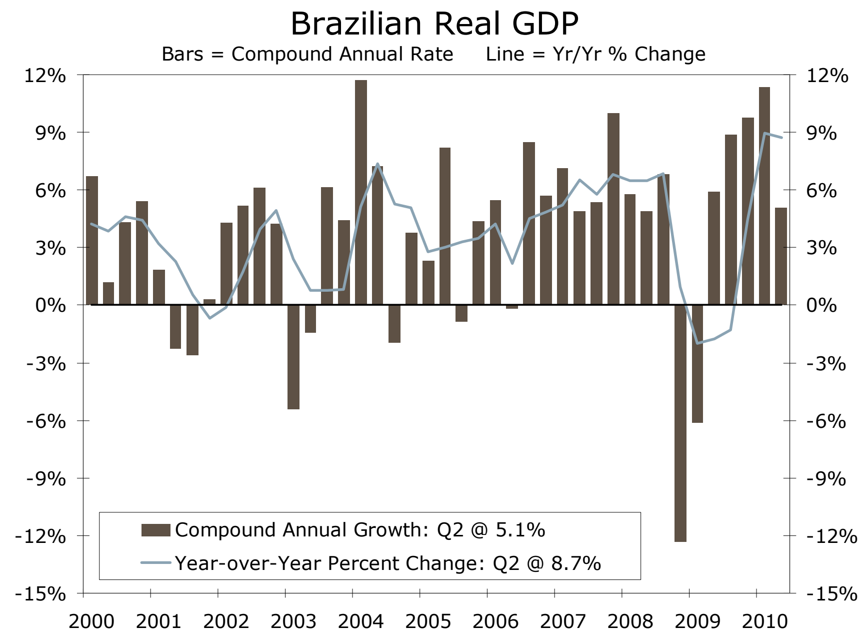
Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

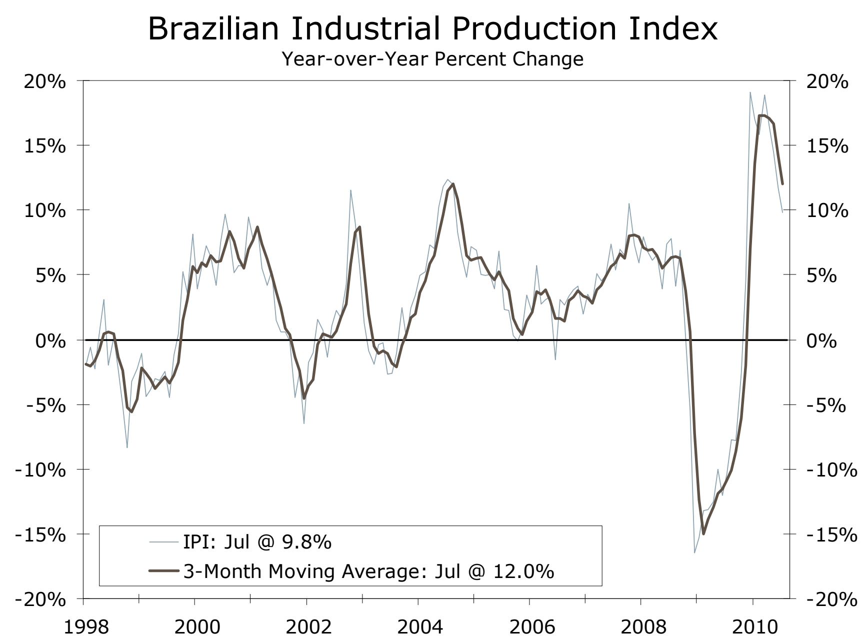
## Topic of the Week

### Brazilians Head to the Polls

On Sunday, the Brazilian presidential elections will be held as part of the country's general election. In this election, Brazilians will choose the successor to current President Luiz Inácio Lula da Silva, of the Workers' Party, who is hugely popular in Brazil, but has served the maximum number of terms and is not permitted to seek reelection. He has nominated and thrown his support behind his chief of staff, Dilma Rousseff, a political unknown who will face off against the candidate of the Party of Brazilian Social Democracy (PSDB), Jose Serra, a time-tested politician who has held many important elected and nonelected positions within his party and in the country. There are other candidates and if no one receives more than 50 percent of the votes there will be a run-off election at the end of the month. Another interesting dynamic is that "Lula" can, according to Brazilian law, return to politics to run for president again in 2014, where he could take office in time to preside over the 2016 Rio de Janeiro Olympics.

From an economic perspective the election has focused on the role of government. Rousseff was the standard bearer of big government in the "Lula's" administration and has pledged to rebuild Brazil's roads, ports and railways as well as continuing a program known as PAC-2, which is expected to invest $546 billion during 2011–2014. The challenge will be finding the money for such projects without increasing the budget deficit, which Rousseff has pledged to balance during the same period. Some analysts believe Serra would contain expenditures more effectively. However, Rousseff has made mention of intentions to tighten fiscal policy herself and is considering Lula's first finance minister, António Palocci, to be her chief of staff. Palocci was known for running a tight budget in the early years of the Lula administration. Although Rousseff is expected to win, neither candidate presents a threat to the Brazilian economic recovery. See our Web site for our complete Brazilian election update.

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## Market Data ♦ Mid-Day Friday

### U.S. Interest Rates

| | Friday 10/1/2010 | 1 Week Ago | 1 Year Ago |
|---|---|---|---|
| 3-Month T-Bill | 0.15 | 0.14 | 0.09 |
| 3-Month LIBOR | 0.29 | 0.29 | 0.28 |
| 1-Year Treasury | 0.24 | 0.25 | 0.44 |
| 2-Year Treasury | 0.42 | 0.44 | 0.87 |
| 5-Year Treasury | 1.28 | 1.35 | 2.18 |
| 10-Year Treasury | 2.53 | 2.61 | 3.18 |
| 30-Year Treasury | 3.73 | 3.79 | 3.96 |
| Bond Buyer Index | 3.84 | 3.83 | 3.94 |

### Foreign Exchange Rates

| | Friday 10/1/2010 | 1 Week Ago | 1 Year Ago |
|---|---|---|---|
| Euro ($/€) | 1.376 | 1.349 | 1.455 |
| British Pound ($/₤) | 1.583 | 1.583 | 1.596 |
| British Pound (₤/€) | 0.869 | 0.853 | 0.912 |
| Japanese Yen (¥/$) | 83.370 | 84.210 | 89.600 |
| Canadian Dollar (C$/$) | 1.021 | 1.024 | 1.084 |
| Swiss Franc (CHF/$) | 0.976 | 0.983 | 1.041 |
| Australian Dollar (US$/A$) | 0.971 | 0.959 | 0.870 |
| Mexican Peso (MXN/$) | 12.559 | 12.540 | 13.762 |
| Chinese Yuan (CNY/$) | 6.685 | 6.690 | 6.827 |
| Indian Rupee (INR/$) | 44.480 | 45.255 | 47.755 |
| Brazilian Real (BRL/$) | 1.682 | 1.711 | 1.787 |
| U.S. Dollar Index | 78.240 | 79.395 | 77.188 |

### Foreign Interest Rates

| | Friday 10/1/2010 | 1 Week Ago | 1 Year Ago |
|---|---|---|---|
| 3-Month Euro LIBOR | 0.89 | 0.82 | 0.70 |
| 3-Month Sterling LIBOR | 0.73 | 0.73 | 0.54 |
| 3-Month Canadian LIBOR | 1.23 | 1.24 | 0.50 |
| 3-Month Yen LIBOR | 0.22 | 0.22 | 0.35 |
| 2-Year German | 0.85 | 0.73 | 1.23 |
| 2-Year U.K. | 0.64 | 0.69 | 0.77 |
| 2-Year Canadian | 1.38 | 1.47 | 1.21 |
| 2-Year Japanese | 0.14 | 0.14 | 0.25 |
| 10-Year German | 2.29 | 2.34 | 3.16 |
| 10-Year U.K. | 2.97 | 3.04 | 3.49 |
| 10-Year Canadian | 2.80 | 2.87 | 3.26 |
| 10-Year Japanese | 0.97 | 1.01 | 1.30 |

### Commodity Prices

| | Friday 10/1/2010 | 1 Week Ago | 1 Year Ago |
|---|---|---|---|
| WTI Crude ($/Barrel) | 81.42 | 76.49 | 70.82 |
| Gold ($/Ounce) | 1316.75 | 1295.95 | 999.20 |
| Hot-Rolled Steel ($/S.Ton) | 535.00 | 535.00 | 555.00 |
| Copper (¢/Pound) | 367.35 | 361.35 | 272.55 |
| Soybeans ($/Bushel) | 10.69 | 10.66 | 9.20 |
| Natural Gas ($/MMBTU) | 3.80 | 3.88 | 4.47 |
| Nickel ($/Metric Ton) | 23,406 | 22,766 | 17,819 |
| CRB Spot Inds. | 528.50 | 523.93 | 426.38 |

## Next Week's Economic Calendar

| | Monday 4 | Tuesday 5 | Wednesday 6 | Thursday 7 | Friday 8 |
|---|---|---|---|---|---|
| U.S. Data | **Factory Orders**<br>July 0.1%<br>August -0.4% (W) | **ISM Non-Mfg Index**<br>August 51.5<br>September 52.5 (W) | | **Consumer Credit**<br>July -\$3.6B<br>August -\$3.0B (C) | **Nonfarm Payrolls**<br>August -54K<br>September 2k (W)<br>**Unemployment Rate**<br>August 9.6%<br>September 9.8% (W) |
| Global Data | **Australia**<br>**RBA Cash Target**<br>Previous 4.50%<br>**UK**<br>**PMI Construction**<br>Previous (Aug) 52.1 | **Japan**<br>**BOJ Target Rate**<br>Previous 0.10%<br>**Euro-zone**<br>**Retail Sales**<br>Previous (Jul) 0.1% | **Canada**<br>**Ivey PMI**<br>Previous (Aug) 65.9 | **UK**<br>**BOE Announces Rates**<br>Previous 0.50%<br>**Euro-zone**<br>**ECB Announces Rates**<br>Previous 1.00% | **Canada**<br>**Change in Employment**<br>Previous (Aug) 35.8K |

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

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