October 29, 2010

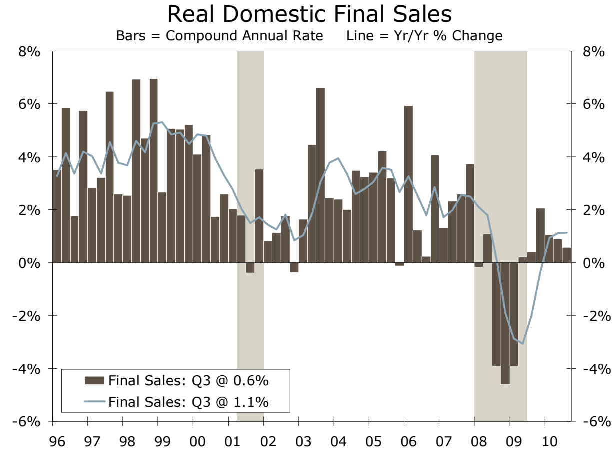
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

A Sigh of Relief from Third-Quarter Real GDP

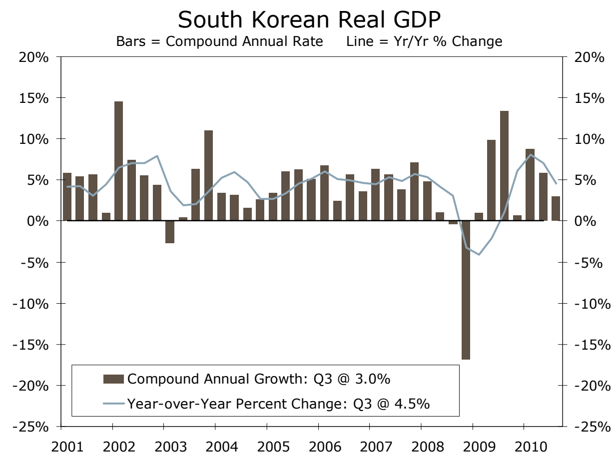
- Most market watchers and analysts have their eyes firmly fixed on next week's outcome for the FOMC meeting and midterm elections. Markets have already priced in a second round of quantitative easing to the tune of a $500 billion purchase of long-term Treasuries over the next six months.
- Real GDP came in at a 2.0 percent annual pace, which is still not enough to bring down the unemployment rate. Much of the rise in GDP was due to an increase in consumer spending and inventory accumulation.



Global Review

Third-Quarter GDP Growth Slows in South Korea

- The release this week of third-quarter GDP for South Korea showed a mixed picture of moderating economic growth. Exports slowed markedly, while growth in private consumption and gross fixed investment accelerated.
- The Bank of Korea, which met on monetary policy earlier this month, decided to refrain from another rate hike even though consumer price inflation jumped 1.1 percent in September and is running above the central bank's comfort zone at 3.6 percent from a year ago.



Wells Fargo U.S. Economic Forecast

	Actual			Forecast					Actual			Forecast		
	2010				2011				2007	2008	2009	2010	2011	2012
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q						
Real Gross Domestic Product [1]	3.7	1.7	2.0	1.5	1.9	2.2	2.3	2.6	1.9	0.0	-2.6	2.7	2.0	2.9
Personal Consumption	1.9	2.2	2.6	2.1	1.5	1.5	1.6	2.6	2.4	-0.3	-1.2	1.6	1.8	1.7
Inflation Indicators [2]														
"Core" PCE Deflator	1.8	1.5	1.4	1.1	1.0	1.1	1.1	1.2	2.9	2.3	1.5	1.4	1.1	1.4
Consumer Price Index	2.4	1.8	1.2	0.8	0.7	1.2	1.3	1.4	2.3	3.8	-0.3	1.6	1.2	1.7
Industrial Production [1]	7.1	7.0	4.8	1.2	2.0	3.2	4.2	5.5	81.3	-3.3	-9.3	5.4	3.2	5.2
Corporate Profits Before Taxes [2]	37.6	37.0	17.0	12.0	7.8	5.6	6.0	6.5	-6.2	-16.4	-0.4	24.9	6.5	6.9
Trade Weighted Dollar Index [3]	76.1	78.8	73.6	72.0	72.5	74.0	76.0	78.0	0.0	74.3	77.7	75.1	75.1	80.5
Unemployment Rate	9.7	9.7	9.6	9.8	10.0	9.8	9.7	9.5	1.3	5.8	9.3	9.7	9.7	9.0
Housing Starts [4]	0.62	0.60	0.59	0.62	0.6	0.7	0.8	0.9	16.09	0.90	0.55	0.61	0.77	1.04
Quarter-End Interest Rates [5]														
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	5.30	1.88	0.25	0.25	0.25	0.50
Conventional Mortgage Rate	4.97	4.74	4.35	4.20	4.80	5.00	5.20	5.60	4.48	6.04	5.04	4.57	5.15	5.60
10 Year Note	3.84	2.97	2.53	2.30	2.20	2.30	2.40	2.50	4.84	3.66	3.26	2.91	2.35	2.98

Forecast as of: October 29, 2010
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Major Currency Index, 1973=100 - Quarter End
[4] Millions of Units
[5] Annual Numbers Represent Averages

Inside

Together we'll go far

U.S. Review

Moderate Growth Continues to Move Ahead

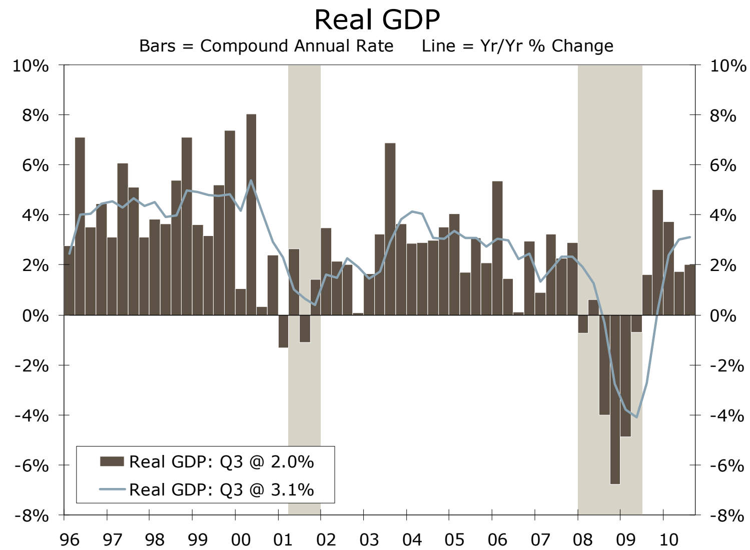
Modest economic growth and a low and falling inflation rate continue to be a recipe for market uncertainty, but they keep the door open for more stimulus. As such, most market watchers and analysts have their eyes firmly fixed on next week's outcome for the FOMC meeting and midterm elections. For the most part, markets have already priced in a second round of quantitative easing to the tune of a $500 billion purchase of long-term Treasuries over the next six months. While some calculations consider up to $2 trillion of purchases, there is likely not enough consensus at the Fed for a shock-and-awe approach. The elections, however, could hold some surprises.

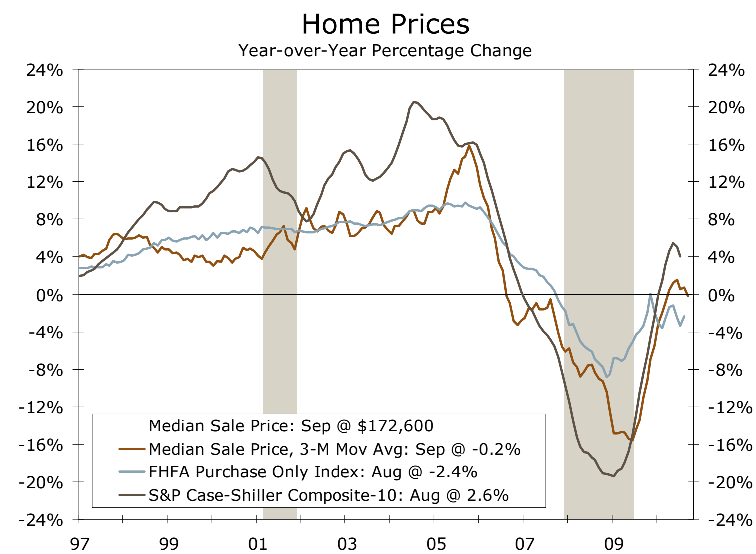
Right now, the market expects Republicans to win a majority in the House of Representatives and Democrats to maintain control of the Senate. If this outcome comes to fruition, the potential for policy gridlock becomes more realistic, but this may not be bad for the markets. As noted, in a recently published report by Wells Fargo Securities Integrated Research and Economics, "A Congress Divided?," the election could have historical significance as there has not been a Democratic president with a divided Congress in the past 100 years. More importantly, the potential for gridlock in the coming years could help reduce some of the policy uncertainty, which is welcomed in light of moderate growth projected through 2011.

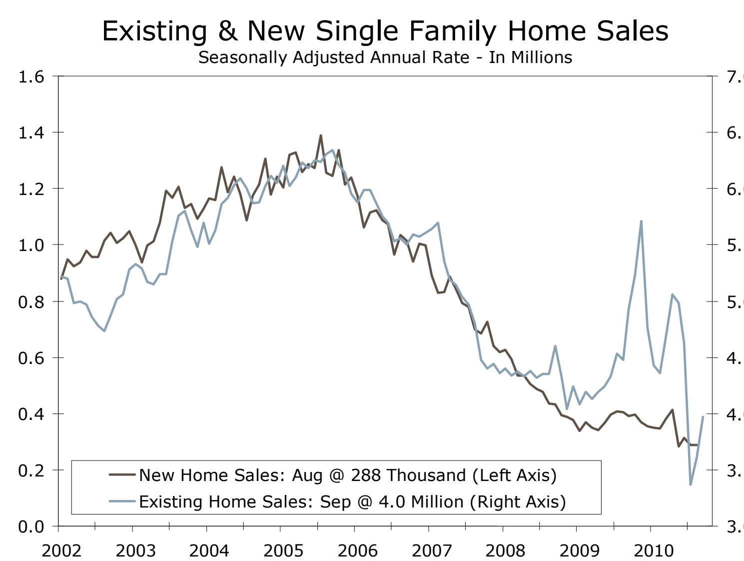
While the first look at third-quarter economic growth went a long way to also quell some uncertainty, a 2.0 percent annual pace is still not enough for a sustainable recovery to take hold. Much of the increase in real GDP was due to a rise in consumer spending and inventory accumulation. Growth in real final sales, however, remains extremely low at just 0.6 percent. Typically, at this stage in the recovery, as the inventory cycle winds down, domestic demand picks up. We are certainly in uncharted territory as the handoff from inventories to the consumer continues to be impeded by a deleveraging consumer. As expected, residential investment plummeted 29.1 percent, which was payback from the homebuyers' tax credit in the second quarter. The housing market should continue to correct in coming quarters, but we expect a long and agonizingly slow housing recovery.

This week's economic releases were chocked full of housing indicators. The S&P/Case Shiller Home Price Index slid 0.28 percent in August, its second consecutive monthly drop. With many first-time buyers pulled forward into the first half of the year, foreclosures and short sales are now accounting for a larger share of overall sales, which is dragging prices lower.

Sales of existing and new homes both rose in September, but increases should not be seen as a genuine housing recovery. Sales normally weaken during the fall on a non-seasonally adjusted basis. With sales at such depressed levels, they will likely not fall as much as they would during a "typical" cycle. This means seasonally adjusted data may show modest gains. We do not expect to see a genuine recovery in housing until the spring homebuying season.

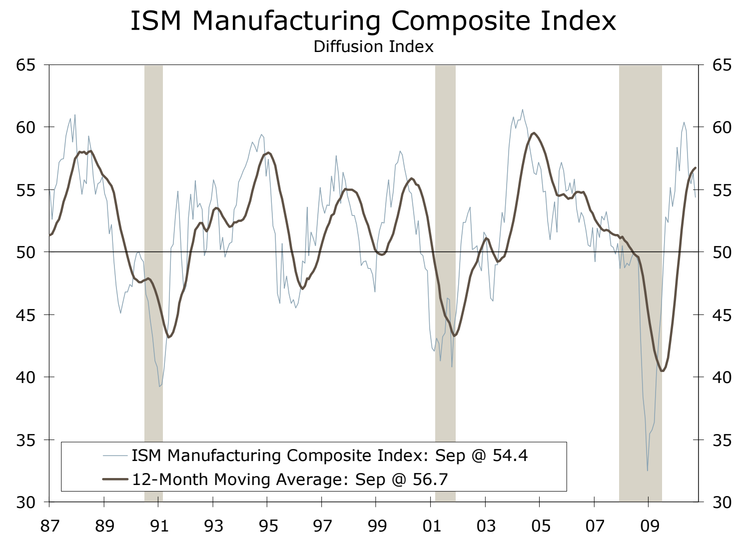






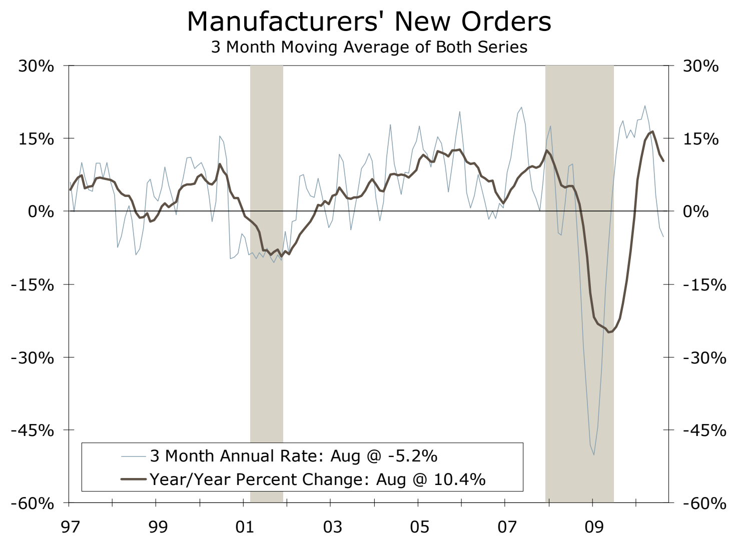
ISM Index • Monday

In April, the ISM manufacturing index briefly rose above 60, a level that rivaled the highest levels reached in the past 20 years. The enthusiasm on the part of purchasing managers captured in those months was likely a reflection of the bullwhip effect on the manufacturing supply chain as businesses first started rebuilding inventories in the wake of the recession. Now, as that stockpile rebuilding has run its course, the euphoria has faded. Still, the ISM index remains above the 50 line that separates expansion from contraction. While we forecast an acceleration in the index for October, we would not be surprised to see the index trend closer to 50 over the coming months. Such a move would be consistent with our forecast for a slower pace of growth in the factory sector than we saw in the first half of this year.



Previous: 54.4 **Wells Fargo: 55.5**

Consensus: 54.0



Factory Orders • Wednesday

Speaking of the factory sector, September orders data for U.S. factories are to be released on Wednesday. The factory orders report supplements the September data we already received for durable goods orders. The durables report showed that orders jumped 3.3 percent on the month, fueled by a huge increase in aircraft orders. Stripping away aircraft and autos orders, the non-transportation measure of durable goods orders actually fell 0.8 percent on the month.

The key yardstick of business spending, nondefense capital goods orders ex-aircraft, seemed to lose some momentum in September as well. We will be watching to see if we get an upward revision to the 0.6 percent decline first reported in the durables report.

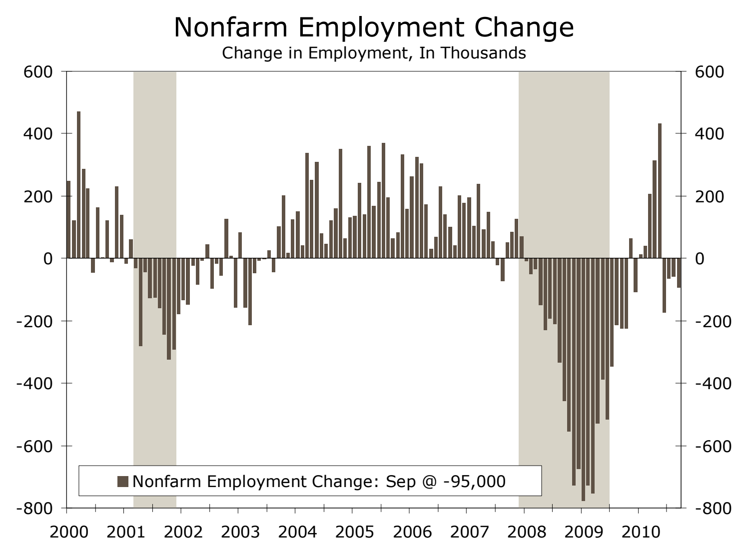
Previous: -0.5% **Wells Fargo: 1.6%**

Consensus: 1.2%

Employment Report • Friday

While nonfarm payrolls have been negative for four straight months, private payrolls have been on the rise. Government employment has been the drag on job growth, and there are two factors that explain why. The first is that people hired temporarily for census jobs are now rolling off the government payroll. The second is that as state and local governments try to come to grips with budget shortfalls caused by smaller tax receipts, these government employers are letting people go to cut costs. It was this second dynamic with state and local government in September that caused the actual number to come in far below consensus estimates.

Although the drag from state and local layoffs will weigh on total nonfarm payrolls, we still expect to see an increase in jobs for October when that number is reported on Friday.



Previous: -95k **Wells Fargo: 29k**

Consensus: 60k

Global Review

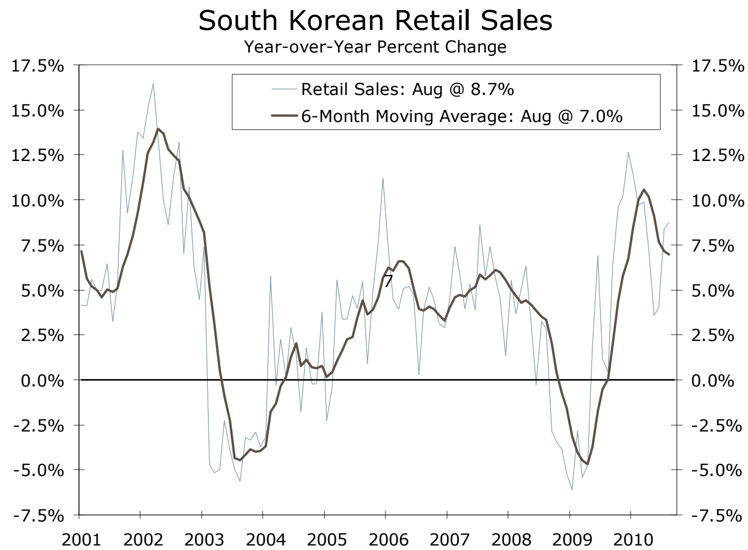
Muddled Growth and Accommodative Policy

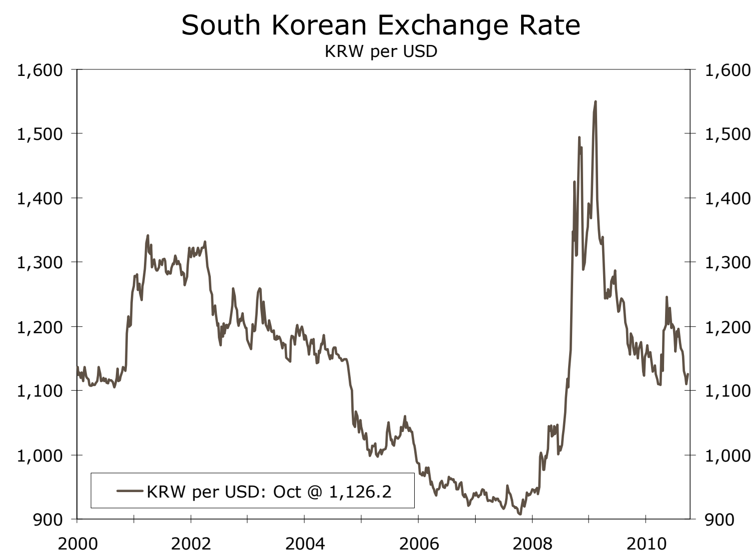
The economic data coming out of South Korea in recent weeks are turning more mixed, but do not fundamentally alter our view of the South Korean economic outlook through 2011. The advanced estimate of third-quarter GDP came in 0.7 percent higher (not annualized) than the second quarter. This is the second consecutive quarter of slower GDP growth in South Korea, following the sizzling 2.1 percent increase in the first quarter. The South Korean economy has been growing now for seven consecutive quarters. South Korean growth year-on-year moderated to 4.5 percent in the third quarter, after peaking in the first quarter at an 8.1 percent growth rate. By economic sector, growth in the third quarter was led by a 2.0 percent gain in manufacturing production centered on general machinery and transportation equipment production. Growth in the construction sector also turned positive after declines last quarter, rising 0.4 percent over the quarter on stronger civil engineering activity. Growth also improved a bit in the services sector as healthy gains were reported to retail and wholesale trade, restaurants and hotels and financial services firms.

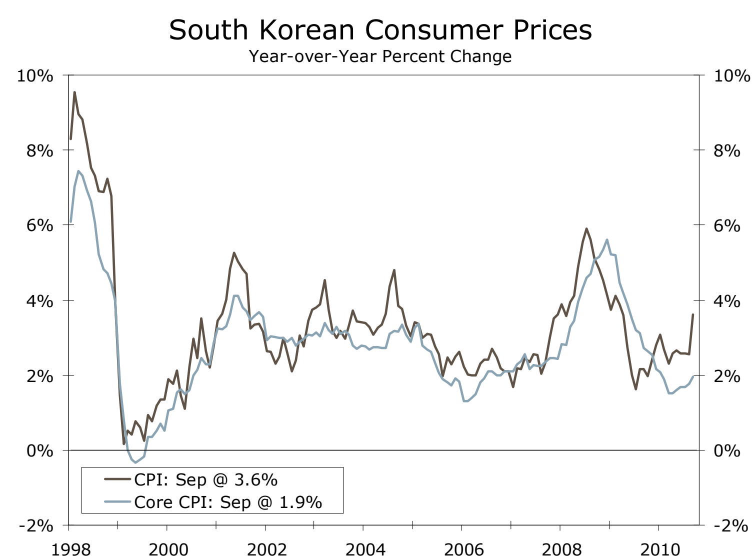
Domestic demand in South Korea showed impressive resilience in the face of slower overseas demand in the third quarter. Growth in business investment and consumption both accelerated noticeably from the second quarter. Business investment jumped a stronger-than-expected 3.5 percent in the third quarter, led by aggressive gains in semiconductor manufacturing equipment and precision equipment expenditures. Private consumption expanded a respectable 1.3 percent from the second quarter on solid durable goods demand for mobile phones and automobiles. Softer consumer spending growth is expected going forward, however. Consumer confidence in South Korea peaked in July and has been trending lower on weaker current and future expectations for three consecutive months now. Moreover, the South Korean unemployment rate has increased by half a percentage point to 3.7 percent from 3.2 percent in May. Both of these trends suggest the consumers will turn a bit more cautious in their spending.

South Korea's export engine looks decidedly fragile as slower growth in the United States and China dent South Korea's export growth. It doesn't help that foreign portfolio investment flows are pushing the Korean won higher against the dollar, making South Korea's exports relatively more expensive. Export of goods rose 1.9 percent in the third quarter after advancing 7.0 percent in the second quarter. Export gains in petrochemicals, semiconductors and automobiles led the way in the third quarter.

It appears the Monetary Policy Committee of the Bank of Korea did the right thing in holding off on another rate hike at the October meeting, despite consumer inflation that jumped to 3.6 percent in September, primarily due to a spike in volatile food products. The committee expects heightened volatility in economic activity and exchange rates in the global economy and signaled it will keep policy generally accommodative for now.







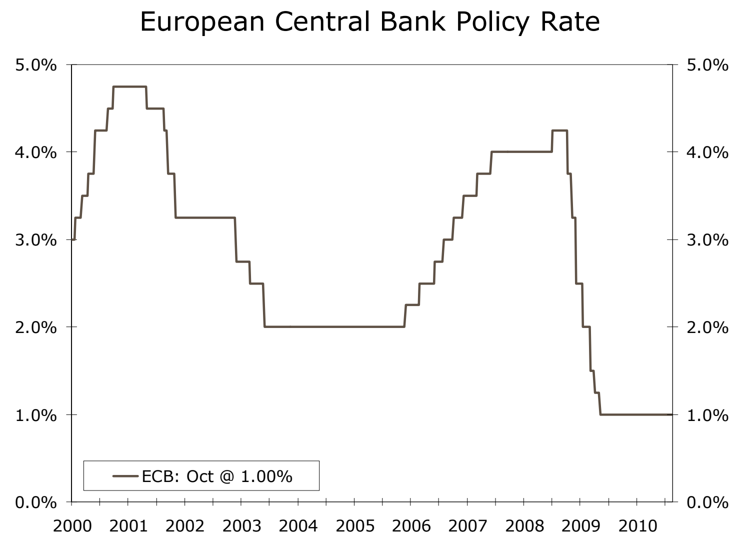
ECB Policy Meeting • Thursday

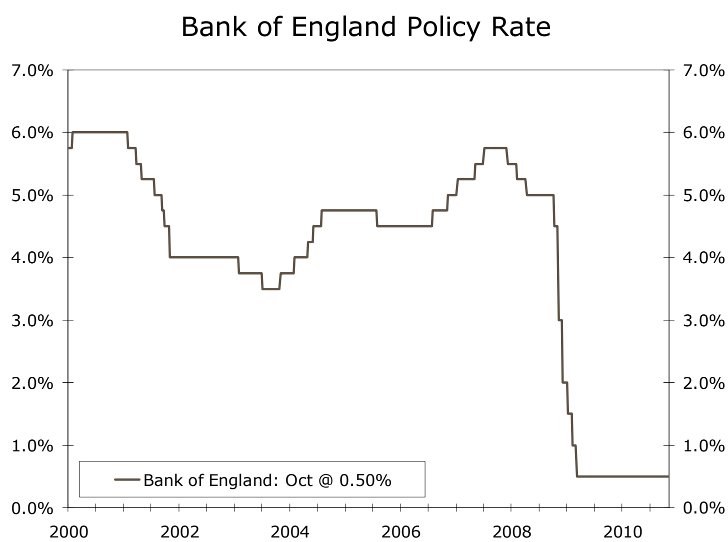
The European Central Bank (ECB) is expected to leave interest rates unchanged on Thursday as the Eurozone economy continues to show signs of positive economic growth. We also do not expect the central bank to expand its quantitative easing scheme, but it will be interesting to see the reaction of the ECB if the U.S. Federal Reserve moves ahead with its own quantitative easing program when it meets next week.

Both the euro area and the U.S. economy are facing uncertain short- to medium-term environments that would probably call for more monetary policy measures. However, it is clear that the ECB's stance remains more hawkish than the U.S. Federal Reserve stance, especially after the government bonds purchases it made earlier this year during the sovereign debt crisis. The tone of the ECB release will probably give some hints into the future.

Previous: 1.00% **Wells Fargo: 1.00%**

Consensus: 1.00%





Bank of England Policy Meeting • Thursday

The Bank of England (BoE) will announce its decision regarding interest rates on Thursday, and we also expect the bank to keep its policy rate unchanged at 0.50 percent. However, as is the case in the United States, the BoE will announce its target for asset purchases with markets estimating it to be unchanged at £200 billion.

The BoE knows that if it wants to stimulate growth in the coming quarters it will need to do so alone, because the government has decided to tighten fiscal policy significantly due to the unsustainable path that Britain's fiscal accounts was following. In our view, it is much more likely that the BoE will eventually undertake a second round of quantitative easing than its counterpart in Frankfurt.

Previous: 0.50% **Wells Fargo: 0.50%**

Consensus: 0.50%

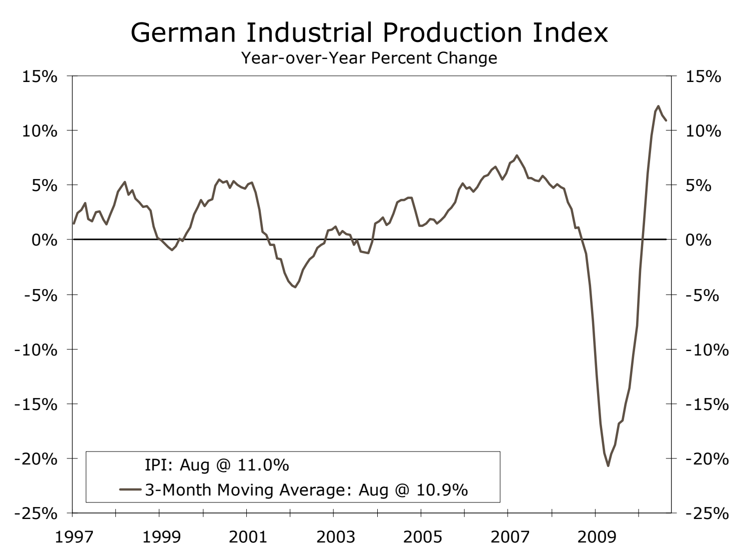
Germany Factory Orders • Friday

We suspect German factory orders remained relatively strong in September as the economy continues to surprise on the upside. The latest such development was this week's unemployment report, which showed the ranks of the jobless declined for the 16th consecutive month. It is clear that Germany's export sector continues to lead the way despite the recent appreciation of the euro. Strong economic growth in developing countries has helped to boost Germany's capital goods suppliers.

We believe the German economy will continue to lead the way in the Eurozone even if the government also tries to reign in expenditures during 2011. However, we also believe that economic growth will be lower in 2011 than in 2010 as many of the Eurozone countries also reign in spending to bring down fiscal deficits and debt levels.

Previous: 3.4%

Consensus: 0.5% (Month-on-Month Change)



Interest Rate Watch

QE2—Actually QE 0.5

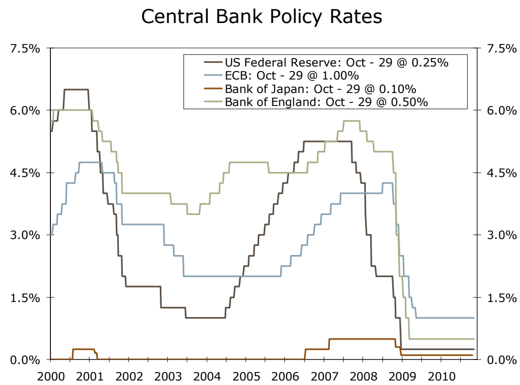
Hype takes a hike. The hype of $2 trillion was fun but completely misleading. The guidance from Bill Dudley, president of the New York Federal Reserve Bank, of $500 billion and the institutional history of the Fed suggests that a gradual injection of reserves was the likely path.

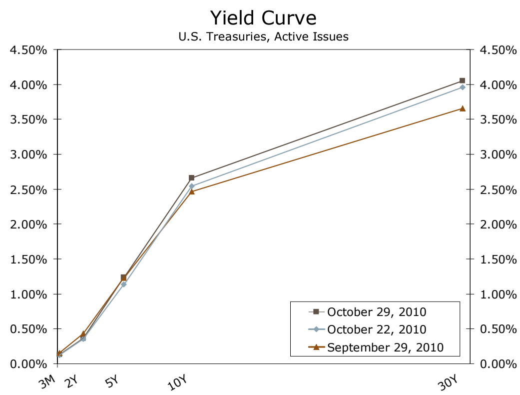
Jon Hilsenrath's essay in *The Wall Street Journal* earlier this week caught the "shock & awe" end of the expectations distribution for Fed policy off-guard. First, from the institutional history of the Fed, shock and awe is the rare action, the major exception being Paul Volker's Saturday surprise in 1979. Instead, Fed policymakers appear to appreciate that they are moving into uncertain territory. Comments by regional presidents Hoenig, Plosser and Fisher suggest some concern about the quantitative easing approach and they certainly would object to a shock treatment for the economy. A "shock" treatment for the economy would likely have been met with several dissents at the FOMC meeting coming up, and certainly, the Federal Reserve would want to appear to avoid the appearance of division as the Fed moves into new policy territory.

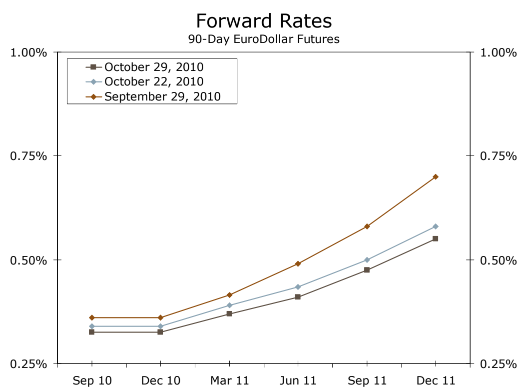
Second, as an economic matter, the gradual approach is better suited for an economy that is showing moderate growth with low inflation and very limited signs of deflation. The Fed may be concerned about the possibility of deflation, but as of yet, there are no signs of that deflation. Moreover, a gradual pattern of buying Treasury securities and injecting reserves into the financial system will allow the Fed to ease and watch the results without the risk of doing too much and trying to pull it all back later. As President Hoenig of the Kansas City Fed said in a recent speech, the Fed simply does not have the knowledge or even the capabilities to fine-tune the economy such that just a little more inflation would be the precise outcome of a quantitative easing move.

The Outlook

Our view is that short rates remain low, while longer-term Treasury rates drift up with stronger growth and higher inflation.







Credit Market Insights

A Savings Bubble?

The past decade could easily be thought of as the decade of bubbles. From oil, food and commodities to housing, stocks and bonds, it feels like we've been following the bubble trail for years, trying in desperation to figure out when the next "big one" will pop. Generally speaking, whenever a bubble pops, it is not good news, unless you are on the short side of the trade, of course. But, there may be yet another bubble brewing out there, one which could not only be beneficial when it pops, but could fuel a very strong period of growth down the road...a savings bubble. Everyone knows that credit across the economy is on a downward trajectory. But while this has been happening, consumer spending has been on an upward trend since the end of the recession. In an era of stubbornly high unemployment and little in the way of job growth, what has propelled consumer spending? The answer is savings. During the recession, consumers pulled way back, building up a war chest of savings. Since the beginning of the recession in December 2007, personal savings have nearly tripled, and are currently nearly twice as high as the average seen during the prior 50 years on an inflation-adjusted basis. Like water seeping through a failing dam, little trickles have come out of savings here and there to support spending despite a weak labor market. But, when consumers finally start to feel confident again, the bursting of the savings bubble could be a powerful tailwind for the economy...and tinder for inflation.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.23%	4.21%	4.32%	5.03%
15-Yr Fixed	3.66%	3.64%	3.75%	4.46%
5/1 ARM	3.41%	3.45%	3.52%	4.42%
1-Yr ARM	3.30%	3.45%	3.48%	4.57%
MBA Applications				
Composite	828.9	803.4	784.0	562.3
Purchase	176.4	169.7	181.8	254.9
Refinance	4,626.1	4,491.1	4,288.3	2,352.5

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

Topic of the Week

Austerity á là Mode

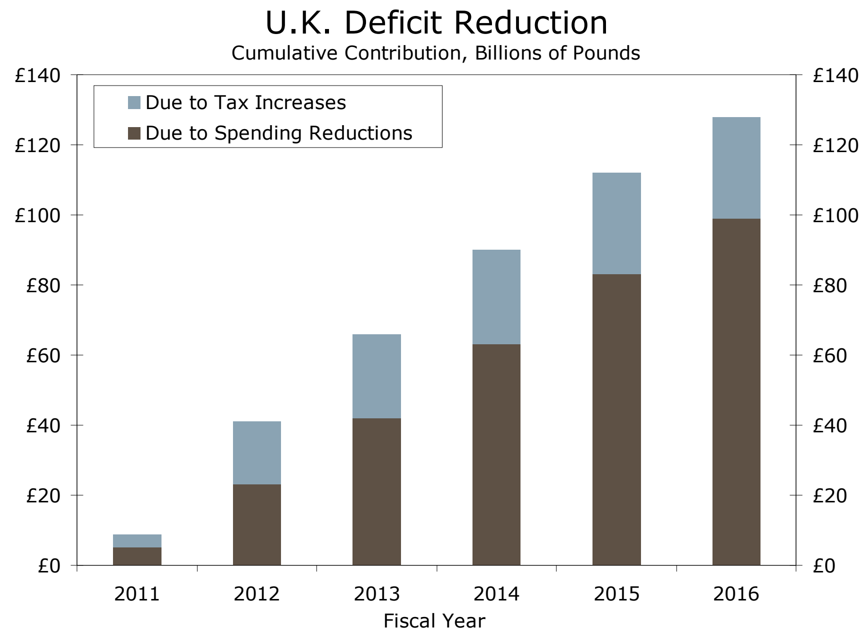
As the recovery takes hold in the developed economies of the world, much of the economic discourse has shifted away from stimulus and toward austerity. In essence, developed nations are beginning to face the daunting task of paying for the momentous wave of fiscal stimulus deployed since 2008.

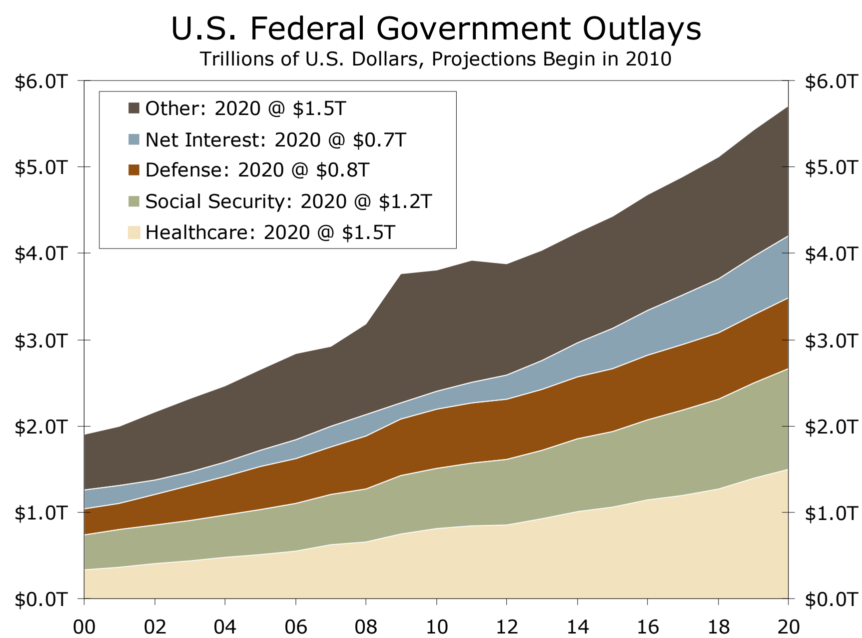
The United Kingdom is a notable example, where David Cameron's young government has recently released the details of an austerity plan that would cut deeper than Thatcher's measures in the 1980s. However, there are valid concerns that significant fiscal retrenchment could cause the modest British recovery to stall.

The upcoming U.S. midterm congressional elections are likely to weaken Democratic holdings in the Senate and House, forcing the Obama administration to feature a stronger Republican voice in matters, such as the growing budget deficit and the burgeoning recovery. Increased fiscal discipline and a plan to tackle the country's crippling debt will be central to a Republican legislative agenda, but the success and extent of any deficit agenda depends heavily the gains made this Tuesday.

Unfortunately, the United States is not likely to benefit from the experience of austerity programs, past and present, in other countries. Any serious U.S. fiscal reform package would have to directly tackle ballooning entitlement obligations, whereas the bulk of U.K. spending cuts will be felt in discretionary categories. The United States also lacks significant flexibility in monetary policy, which Canada enjoyed during its fiscal reform in the 1990s. Canada had another key advantage when reducing government spending: It could rely on exports to make up ground lost in government expenditures. In addition, the IMF has voiced concerns that concerted austerity measures in developed economies could stunt the fledgling global recovery.

For more information, see our recent Special and International reports regarding austerity programs.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 10/29/2010	1 Week Ago	1 Year Ago
3-Month T-Bill	0.11	0.12	0.05
3-Month LIBOR	0.29	0.29	0.28
1-Year Treasury	0.14	0.22	0.40
2-Year Treasury	0.35	0.35	0.98
5-Year Treasury	1.18	1.15	2.44
10-Year Treasury	2.62	2.55	3.50
30-Year Treasury	4.01	3.93	4.34
Bond Buyer Index	3.96	3.84	4.39

Foreign Exchange Rates

	Friday 10/29/2010	1 Week Ago	1 Year Ago
Euro ($/€)	1.388	1.395	1.482
British Pound ($/£)	1.600	1.568	1.655
British Pound (£/€)	0.868	0.889	0.896
Japanese Yen (¥/$)	80.480	81.380	91.410
Canadian Dollar (C$/$)	1.020	1.026	1.067
Swiss Franc (CHF/$)	0.985	0.977	1.019
Australian Dollar (US$/A$)	0.978	0.983	0.915
Mexican Peso (MXN/$)	12.342	12.337	13.064
Chinese Yuan (CNY/$)	6.671	6.659	6.828
Indian Rupee (INR/$)	44.428	44.590	47.209
Brazilian Real (BRL/$)	1.698	1.706	1.733
U.S. Dollar Index	77.317	77.472	75.917

Foreign Interest Rates

	Friday 10/29/2010	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.99	0.97	0.67
3-Month Sterling LIBOR	0.74	0.74	0.59
3-Month Canadian LIBOR	1.22	1.22	0.50
3-Month Yen LIBOR	0.20	0.20	0.33
2-Year German	0.99	1.00	1.36
2-Year U.K.	0.67	0.64	0.90
2-Year Canadian	1.42	1.39	1.47
2-Year Japanese	0.15	0.14	0.27
10-Year German	2.51	2.47	3.32
10-Year U.K.	3.07	2.95	3.67
10-Year Canadian	2.82	2.75	3.50
10-Year Japanese	0.94	0.90	1.41

Commodity Prices

	Friday 10/29/2010	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	81.08	81.69	79.87
Gold ($/Ounce)	1347.35	1328.45	1047.00
Hot-Rolled Steel ($/S.Ton)	505.00	505.00	515.00
Copper (¢/Pound)	373.00	379.15	302.10
Soybeans ($/Bushel)	11.83	11.49	9.64
Natural Gas ($/MMBTU)	3.96	3.33	5.06
Nickel ($/Metric Ton)	23,029	23,485	17,723
CRB Spot Inds.	545.55	544.41	437.84

Next Week's Economic Calendar

	Monday 1	Tuesday 2	Wednesday 3	Thursday 4	Friday 5
U.S. Data	**ISM Manufacturing** September 54.4 October 55.5 (W) **Personal Income** August 0.5% September 0.2% (W) **PCE Deflator** August 1.5% September 1.5% (W)		**FOMC Rate Decision** Previous 0.25% Expected 0.25% (W) **ISM Non-mfg** September 53.2 October 53.2 (W) **Factory Orders** August -0.5% September 1.6% (W)	**Nonfarm Productivity** 2Q -1.8% Q3 1.1% (W) **Unit Labor Cost** 2Q 1.1% Q3 1.5% (W)	**Nonfarm Payrolls** September -95K October 29K (W) **Unemployment Rate** September 9.6% October 9.6% (W)
Global Data	**China** **PMI Manufacturing** Previous (Sep) 53.8 **UK** **PMI Manufacturing** Previous (Sep) 53.4		**UK** **PMI Services** Previous (Sep) 52.8	**UK** **BOE Announces Rates** Previous 0.50% **Euro-zone** **ECB Announces Rates** Previous 1.00%	**Canada** **Net Change Employ.** Previous (Sep) -6.6K **Germany** **Factory Orders (MoM)** Previous (Aug) 3.4%

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

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