December 18, 2009

Economics Group

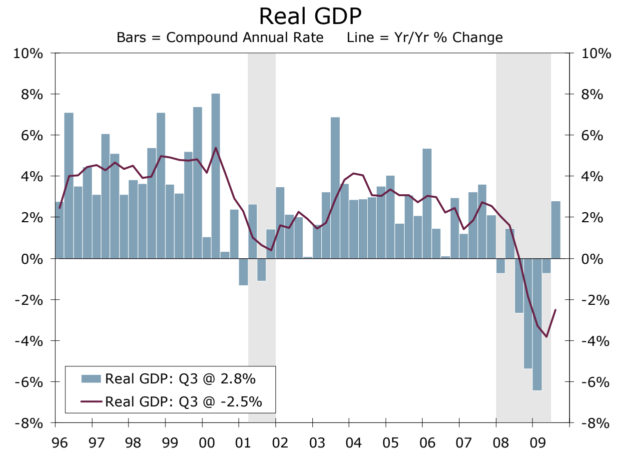
WELLS FARGO SECURITIES

Weekly Economic & Financial Commentary

U.S. Review

Recovery Continues: Jump in Fourth Quarter GDP

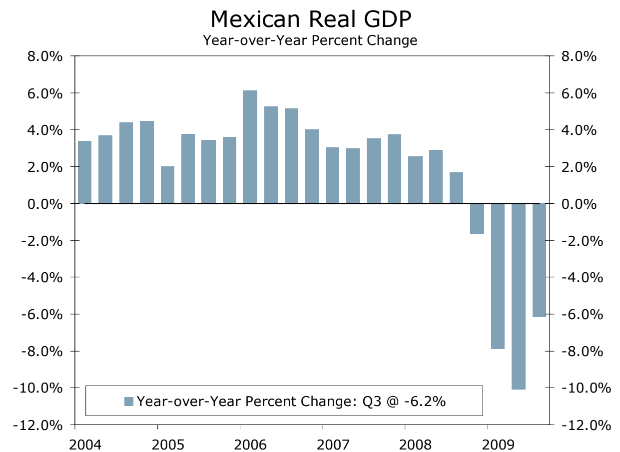
- Economic recovery continues with gains this week reported in industrial production, housing starts and leading indicators. There was, however, a bit of a cautionary breeze coming from an inflationary direction.
- Our anticipated inventory correction appears to be showing up in the fourth quarter; when GDP is reported in January, it will likely be up more than 4 percent. Gains in net exports and retail sales this week also support the case for a strong GDP release.



Global Review

"Poor Mexico, so far from God, so close to the United States!"

- The most important risk rating agencies have been lowering Mexico's credit ratings. Weak fiscal sector revenues and an extreme reliance on revenue from the state owned petroleum monopoly, PEMEX, is problematic. Oil production continues to fall due to lack of investment.
- Some blame the problems on the weak U.S. economy, but Mexico has the solution to its problems within its country limits, not outside of them.



Wells Fargo U.S. Economic Forecast

	Actual			Forecast					Actual			Forecast		
	2009				2010									
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2006	2007	2008	2009	2010	2011
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

Inside

U.S. Review 2
U.S. Outlook 3
Global Review 4
Global Outlook 5
Point of View 6
Topic of the Week 7
Market Data 8

Together we'll go far

U.S. Review

Recovery Continues: Jump in Fourth Quarter GDP

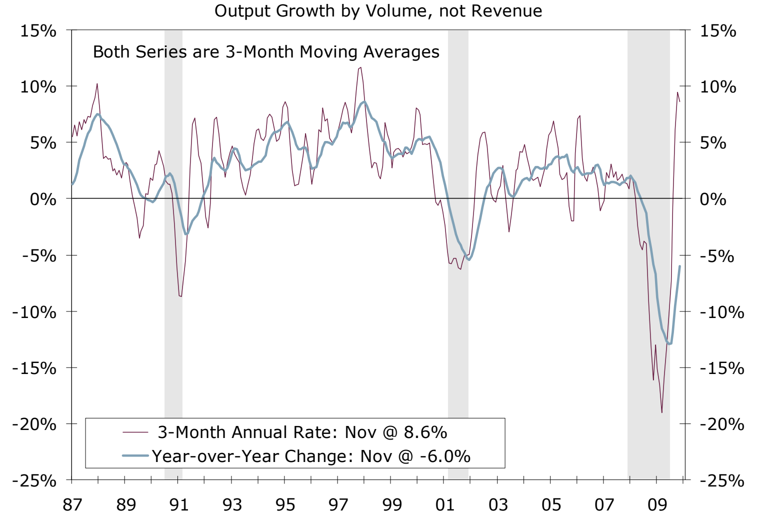
Economic recovery remains the baseline outlook. This week gains were reported in industrial production, housing starts and leading indicators. There was, however, a bit of a cautionary breeze coming from an inflationary direction. Industrial production rose 0.8 percent with manufacturing alone up 1.1 percent with improvement in motor vehicles, machinery and computer sector output. Over the past three months at an annual rate, industrial production, a coincident indicator, is up more than 8 percent, consistent with an economic recovery that began in the third quarter. Capacity utilization has also risen over the past five months, consistent with gains in profits over the second half of this year. Our outlook is for a gain of 3 percent for industrial production in 2010 compared to a decline of 9 percent this year.

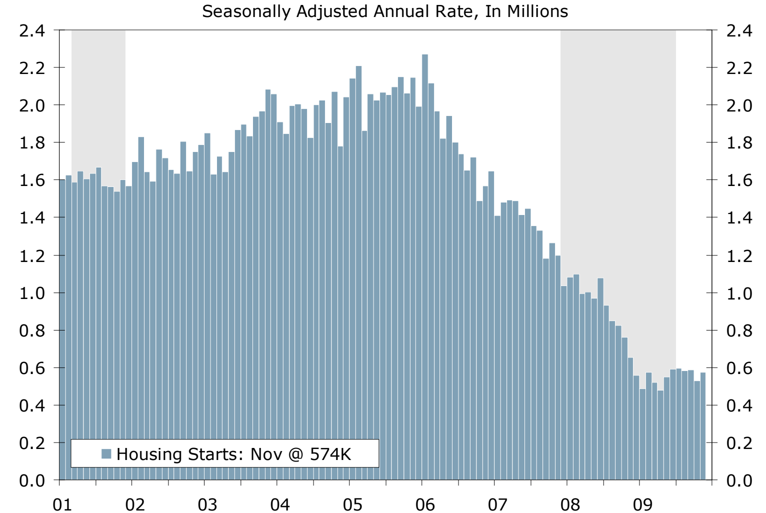
Housing starts rose to 574,000 in November compared to average starts of 540,000 in the second quarter. Leading indicators for housing are also positive. Expected buyer traffic is up in response to the first-time home buyer tax credit. Single-family permits are running ahead of starts which suggests starts are sustainable at current levels. Yet, we remain cautious. Our outlook is for just 660,000 housing starts in 2010—not the 1.3 million of 2007. Household income growth remains modest and credit standards are tighter. Household expectations for home prices and the state of the market remain very subdued. The calculus of home buying and finance has changed.

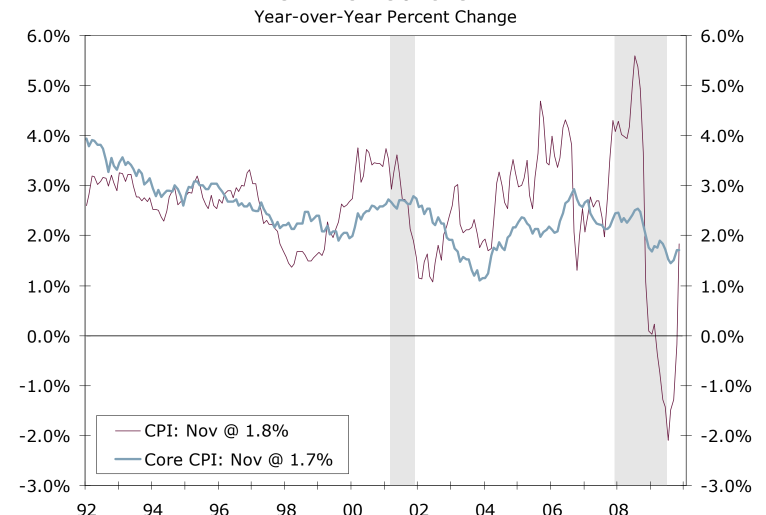
Leading indicators increased 0.9 percent in November and are up more than 9 percent over the past six months. These are very good signals for continued economic recovery. Over the last three months, there has been solid improvement in the average workweek, jobless claims and consumer goods orders. On the financial side there have been gains in stock prices, the money supply and interest rate spreads. These broad-based improvements suggest continued growth. However, leading indicators do not tell us the pace of this growth. We expect growth of more than 4 percent in the fourth quarter with gains led by inventories, trade and federal and consumer spending. But after the inventory adjustment, which may continue in the first quarter, the pace of growth will be subpar due to the ongoing economic adjustments to realign demand and financial realities.

Inflation: A Note of Caution

This week's consumer price report introduced an element of caution that we had expected. Inflation, while "low" is not flat. Over the past year, core goods CPI is up 2.6 percent compared to a year ago. The overall CPI is up 1.8 percent compared to 1.1 percent a year ago. With two, three and five year Treasuries all yielding below three percent these inflation numbers suggest negative, real after-tax rate of returns for investors. Meanwhile, average hourly earnings are up just 2.2 percent suggesting that rising inflation will put a damper on real income growth. Finally, rising inflation brings into question if the Fed can maintain its 2.0 percent inflation target in the face of political pressure to keep monetary easing with unemployment above nine percent.





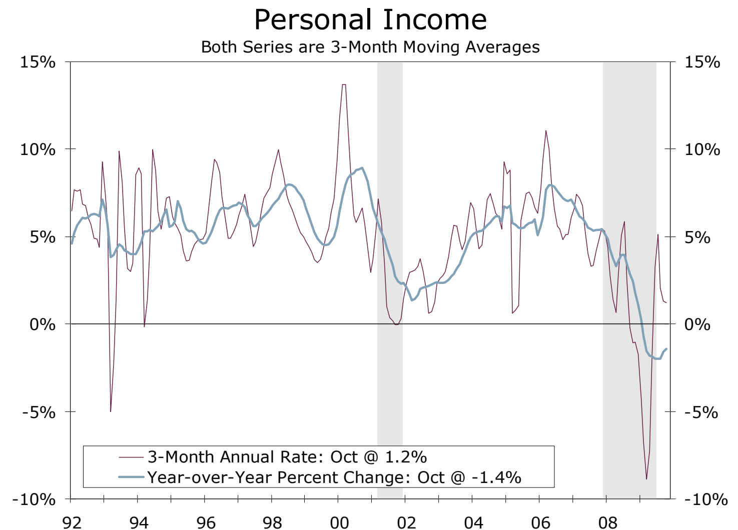


Personal Income • Wednesday

Personal income rose a modest 0.2 percent in October and is now up 1.2 percent at a three-month annualized rate. Despite weak income growth, personal consumption expenditures were up 0.7 percent in October due at least in part to a bounce-back in auto sales. We expect consumer spending rose 0.6 percent in November. Sustainable consumer spending requires income and therefore job and wage gains. While the four-week moving average for jobless claims continues to decline, at 467,500 it remains above the level needed to add jobs to the economy. Jobless claims would need to drop below 400,000 on a sustained basis for nonfarm payrolls to post consistent gains. Further, while layoffs have subsided, hiring has not picked up. Firms tend to hoard labor in a recession due to concerns about the cost and availability of skilled labor as the recovery begins.

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

Consensus: 0.5%

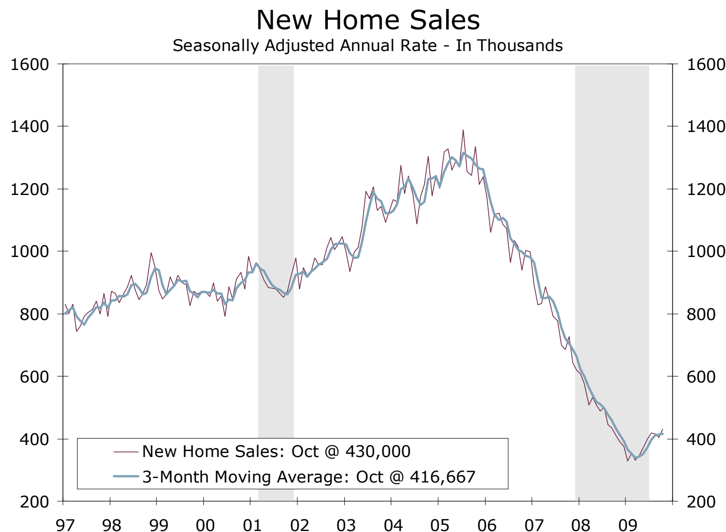


New Home Sales • Wednesday

Sales of new homes regained their footing in October, increasing around 6 percent to an annual pace of 430,000, after uncertainty around the scheduled expiration of the first-time home buyer tax credit likely pushed sales lower in September. The recent extension and expansion of the tax credit will likely help support sales in coming months, but we expect a retracement in November. New home sales are measured based on contract signings and home buyers needed to sign a contract well before the tax credit expired. We expect new home sales likely fell 3.5 percent in November to an annual pace of 415,000. Inventory levels of unsold homes have continued to improve and have reached levels not seen in nearly 40 years. Once sales rise on a consistent basis, the sustained low levels of inventory suggest a pick up in new construction in coming months.

Previous: 430K **Wells Fargo: 415K**

Consensus: 440K

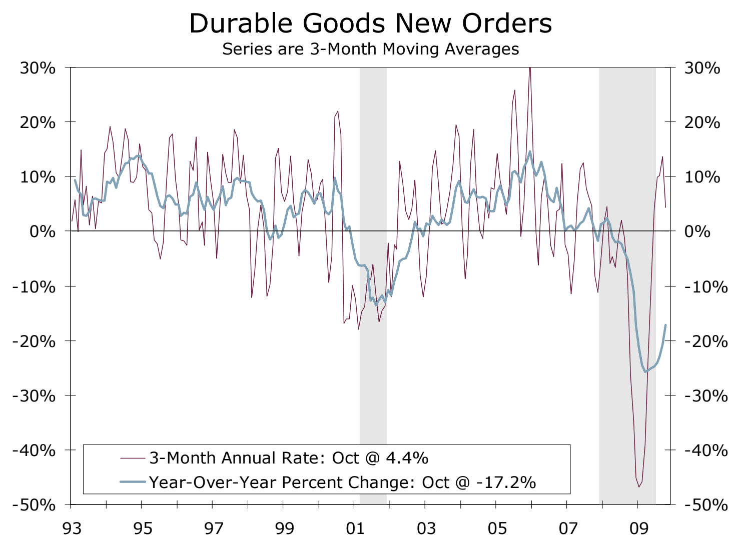


Durable Goods • Thursday

New orders for durable goods fell 0.6 percent in October driven by a significant decline in defense orders. While the "headline" tends to be extremely volatile on a month-to-month basis, the three-month annual rate of new nondefense capital goods orders excluding aircraft is a better gauge of manufacturing activity. That figure has remained positive for five consecutive months. Recent gains in industrial production and the ISM Manufacturing Index suggest a similar trend in new durable goods orders in November. We expect orders rose 1.8 percent in November. Furthermore, the continued depletion of inventories and expected increase in shipments suggest manufacturing activity will continue its positive momentum in coming months.

Previous: -0.6% **Wells Fargo: 1.8%**

Consensus: 0.3%



Global Review

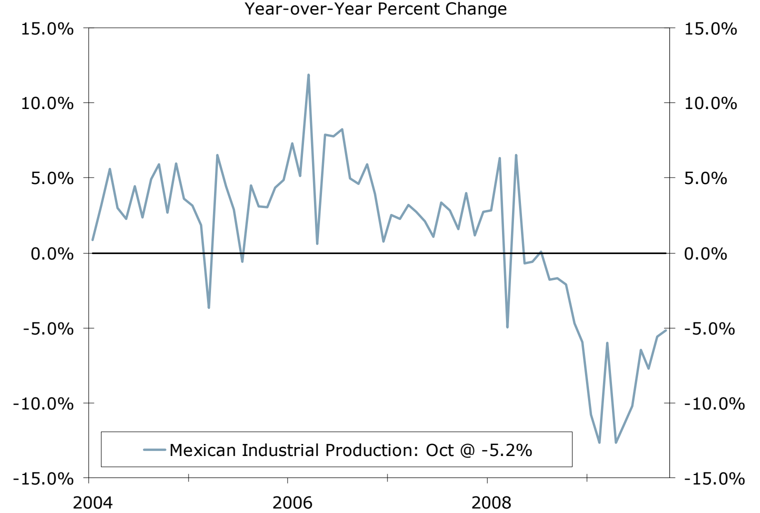
"Poor Mexico, so far from God, so close to the United States!"

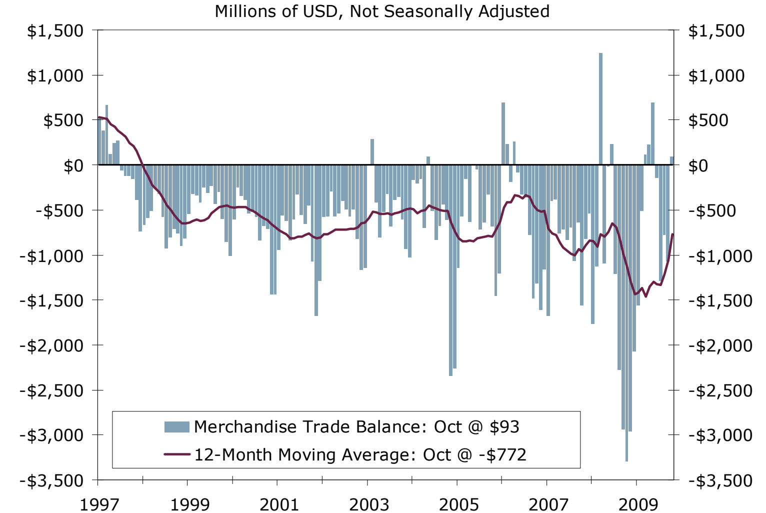
Mexicans always call upon this famous quote from a former president of Mexico, Porfirio Diaz, to explain away the problems they face internally. And once again during this crisis, we have been hearing Mexican analysts complaining about their close ties with the U.S. economy. They cite this as the reason the economy has deteriorated during the past couple of years. And at some level they may be right, as Mexicans have put almost all their eggs in one basket. Their economy is so tied to the U.S. economy that if the U.S. economy sneezes, the Mexican economy catches pneumonia. For example, almost 90 percent of Mexican exports are destined to the U.S. consumer and/or producer market. Production and demand for automobiles, one of the most troubled sectors in the United States is a big determinant of Mexican economic strength. In some way Mexicans have little leeway on choosing who invests and what industries come to the country. The majority of the investment coming into Mexico is dedicated to producing for the U.S. consumer market. In good or normal times, this was a sure thing. However, lately the U.S. consumer market has not served the Mexican economy well. The closeness of both economies and their interdependence has aggravated the economic situation south of the border. But that is the end of the "blame the U.S. bandwagon."

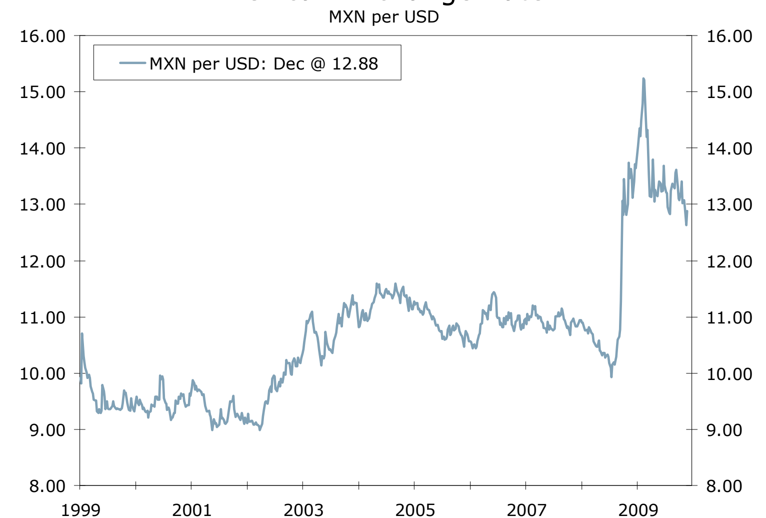
Much of the responsibility for Mexico's troubles today has Mexican roots. The reforms necessary to protect their economy from a weak U.S. economy have been postponed and delayed for almost a century. Mexico's inability to collect taxes from its citizens and businesses is at the heart of today's problems. Without taxes coming from the state-owned petroleum monopoly, PEMEX, tax revenues collected by the Mexican government amount to approximately 10 percent of GDP compared to almost 20 percent for the United States and much more for other developed economies.

Meanwhile, the constitutional prohibition for private capital to invest in the Mexican petroleum industry has hampered the ability of the Mexican economy to take advantage of surging petroleum prices over the past several years. In fact, Mexican petroleum production has been declining and there are no prospects for this situation to change any time soon even though the country has huge amounts of proven reserves in the ground. PEMEX has no money to extract them. In fact, PEMEX is one of the few petroleum companies in the world that consistently loses money.

Thus, Mexicans should not be surprised at the latest downgrades being handed out by risk rating agencies and markets should not be surprised if problems in the country continue for the near future. Mexico's problems are not just its high fiscal deficits as many argue. Mexico's problems are not only due to its closeness or its dependence on the U.S. economy. Mexico's problems also stem from its inability to collect taxes and guarantee and secure the payment of its debts. Only the political system can fix those problems.







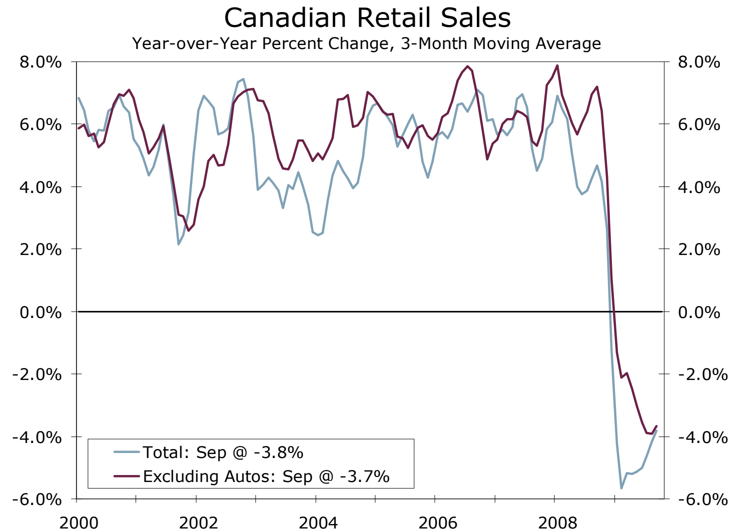
Canadian Retail Sales • Monday

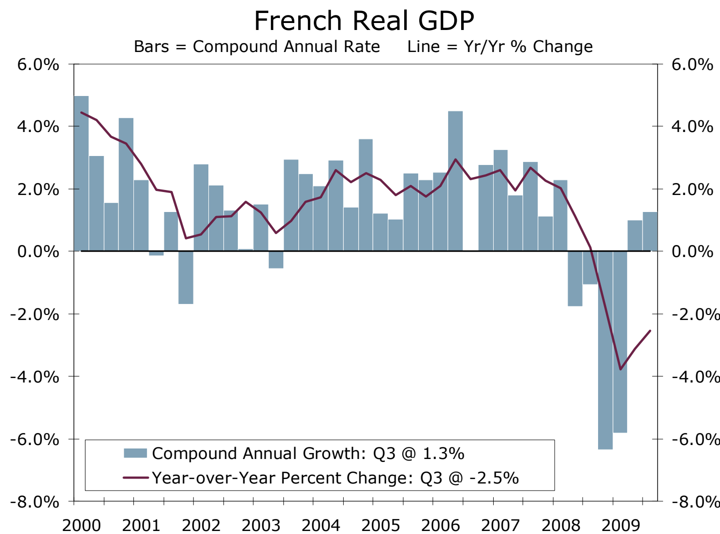
Canadian retail spending fell off a cliff last year as the global economy went down the tubes. On a year-over-year basis, overall retail sales were down 3.8 percent in September. However, sales are growing again on a sequential basis, and are up 5.6 percent from their nadir last December. Part of the increase in the overall level of retail spending reflects the country's cash-for-clunkers program that lifted auto sales earlier this year. That said, retail sales excluding autos have also risen this year, and data that will be released Monday will show whether the trend remained intact.

Real GDP in Canada rose only 0.4 percent (annualized) in the third quarter, but the quarter ended on a strong note as GDP grew 0.5 percent (not annualized) during September. GDP data for October, which are on the docket on Wednesday, will show how the last quarter of the year started.

Previous: 1.0% (month-on-month change)

Consensus: 0.8%





French Consumer Spending • Wednesday

French consumer spending strengthened in September and October, and data that are slated for release on Wednesday will show whether November made it three-in-a-row. The market expects a 0.5 percent gain following last month's 1.1 percent increase. This pace is decidedly improved from a year ago, up at least 3 percent. France will print data on producer prices on Tuesday of next week, giving us a feel of inflation further up the supply chain. The market expects a small 0.1 percent increase, month over month, but prices remain down significantly on a year-over-year basis.

Italian retail sales for October will also print on Wednesday, along with consumer confidence data for December. An improved consumer outlook would bode well for the rest of the year's sales data.

Previous: 1.1% (month-on-month change)

Consensus: 0.5%

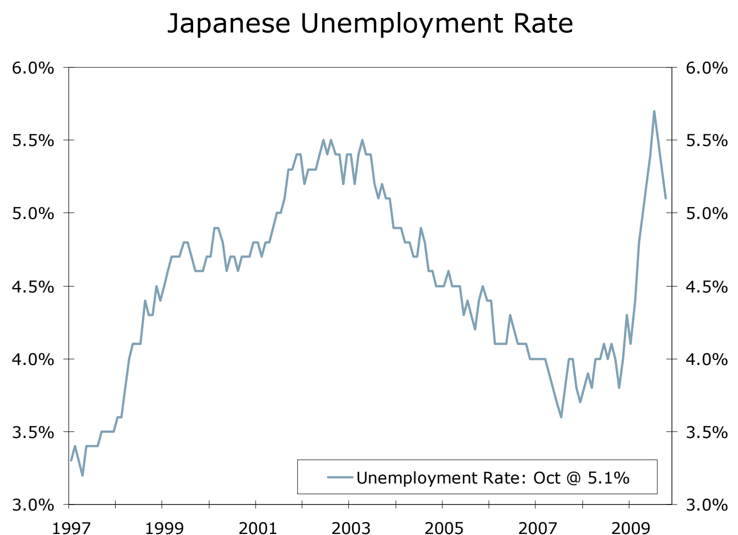
Japanese Unemployment Rate • Thursday

The unemployment rate in Japan rose to 5.7 percent in July, the highest rate since records began in 1953, but it has subsequently fallen to 5.1 percent. Although some of the drop in the unemployment rate reflects a small increase in employment, the decline in the labor force over the past few months has also helped to pull the rate lower. Therefore, the consensus forecast anticipates that the unemployment rate edged higher in November.

Data on consumer prices in November will print on Friday. Prices fell 2.5 percent in October, the sharpest rate of deflation that Japan has experienced. Although the rate of deflation should slow in November—on a year-over-year basis oil prices were higher in November 2009 than they were 12 months earlier—nobody is looking for runaway inflation in Japan anytime soon.

Previous: 5.1%

Consensus: 5.2%



Interest Rate Watch

FOMC: "Extended Period" Stays

This week's Federal Open Market Committee (FOMC) minutes indicated that the Fed will keep the federal funds rate on hold at the current 0-25 basis point range for an "extended period." This is consistent with our annual outlook which looks for the FOMC to maintain its current policy at least through the first half of 2010.

Three factors support the FOMC's decision at this time. First, we agree with the FOMC that economic activity has "continued to pick up." In fact, we anticipate that fourth quarter GDP could exceed 4 percent given the inventory adjustment and better trade and retail sales data. We also agree with the FOMC that household spending "appears to be expanding" and that the housing sector "has shown signs of improvement."

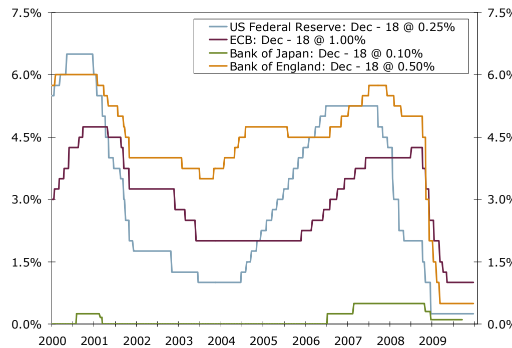
Second, inflation, as expressed by the FOMC "will remain subdued for some time" given its reason that "substantial" resource slack remains as indicated by "elevated" unemployment and low capacity utilization. Our outlook is for the core personal consumption deflator measure of inflation to remain below 2 percent next year and for unemployment to remain above 10 percent.

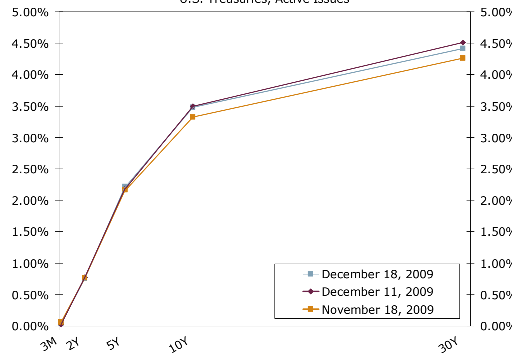
Financial Market Improvements

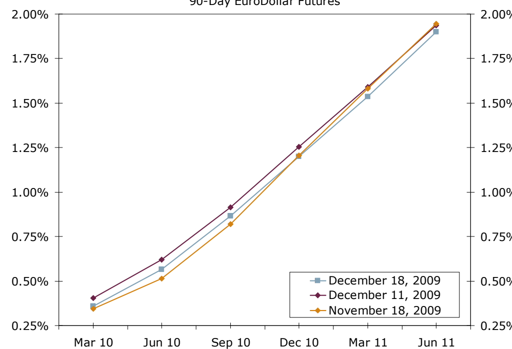
According to the FOMC "financial market conditions have become more supportive" of economic growth. We agree. In our weekly meetings, reports continue to suggest that corporate high-grade and high-yield issuance has improved over the past three months. Credit default swap rates also remain low.

But the Real Test is Ahead

As the economic recovery proceeds and Treasury continues to issue debt interest rates will rise at the long end. The real test for policy and the markets will be if/when the Fed ends MBS purchases by the end of the first quarter/mid-year next year.







Consumer Credit Insights

Flow of Funds/Employment Pluses

Turnarounds in household financial and job situations suggest an improvement in the quantity and quality of consumer credit next year. On the financial side, household asset values have improved. Financial assets, which are about 60 percent of household assets, have risen over the past two quarters with gains in the equity market leading the way. Meanwhile, household real assets have also improved although they remain below levels of a year ago. Real estate assets remain about 30 percent of all assets.

Meanwhile, household liabilities have declined dramatically over the past two years. Both home mortgage credit and consumer credit have shrunk dramatically with mortgage credit registering its first declines since the early 1980s.

Employment Turnaround: Income Gains

Meanwhile, recent declines in jobless claims and improvements in housing and manufacturing surveys suggest that job gains are increasingly likely by the second quarter of next year. Our outlook is for positive gains beginning on a sustained basis by the second quarter.

Positive job gains are usually associated with a longer work week, higher hourly earnings and therefore real income gains given the current low level of inflation. On net, this suggests positive consumer spending and an increase in consumer credit demand ahead.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.83%	4.91%	5.00%	6.04%
15-Yr Fixed	4.32%	4.36%	4.43%	5.73%
5/1 ARM	4.25%	4.29%	4.40%	5.87%
1-Yr ARM	4.35%	4.46%	4.54%	5.29%
MBA Applications				
Composite	611.7	627.5	641.0	398.6
Purchase	210.6	220.9	268.8	248.5
Refinance	2,955.4	2,998.2	2,808.0	1,281.2

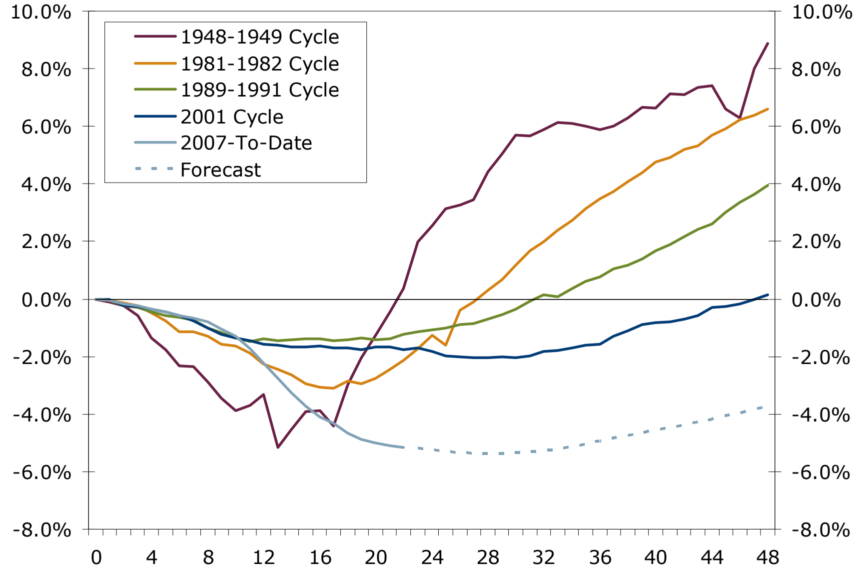
Source: Freddie Mac, Mortgage Bankers Association and Wells Fargo Securities, LLC

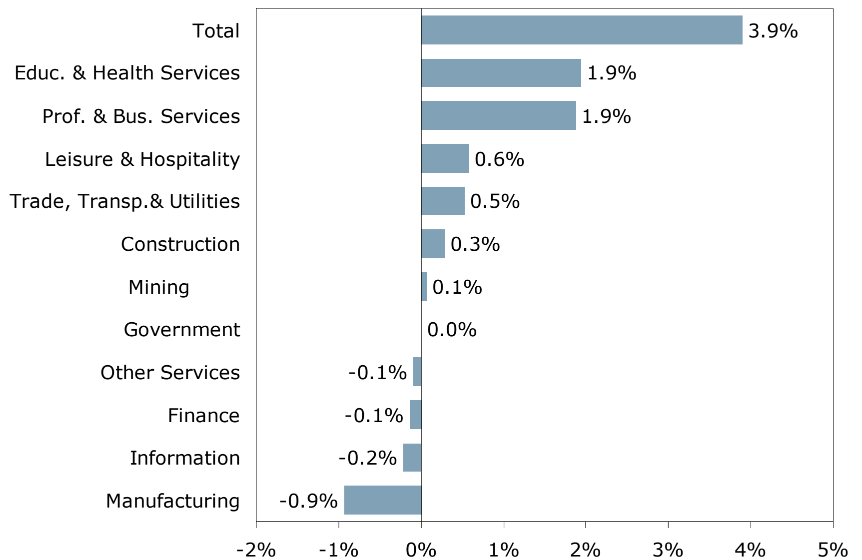
Topic of the Week

Labor Markets Troubles to Persist in Recovery

Recessions have many consequences for the economy, and in this cycle the disruption of the labor market has been one of the most dire. The economy has shed more than 7 million jobs to date, and adding those jobs back will be an arduous process. Further slowing the recovery are the unusual length and depth of the recession, such that a return to employment levels seen before the bust will not occur over our forecast horizon, significantly underperforming previous recovery timelines. While there are many reasons for this outcome, part of the labor market's troubles stem from the secular decline of manufacturing employment that has defined the sector since the late 70s. More than 2 million of the jobs lost over the course of the recession have been in the manufacturing sector; our concern is that they are not coming back. This is a national story, but certain parts of the United States feel the implications of the demise in manufacturing employment more acutely than others.

Pennsylvania is an area where manufacturing has historically been more important than it has been to the national economy, but the state's dependence on the sector (now just 10 percent of employment) has diminished as other sectors have increased in importance. The flexibility of an economy can be a valuable asset—indeed it has allowed Pennsylvania to add jobs in education & health services and other service sectors, offsetting some of the loss from manufacturing. This adjustment is essential, as most of the 90,000 manufacturing jobs that have disappeared in Pennsylvania over the past two years are likely not coming back—employment growth will emanate primarily from service industries, while manufacturing employment will continue to erode. Labor market weakness will persist for longer than we would like, but adjusting to new economic realities will smooth the transition from recession to recovery. For a more detailed look at Pennsylvania's labor market, please see our recently published report, "Pennsylvania Economic Outlook: Spotlight on Jobs."





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 12/18/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.04	0.02	0.01
3-Month LIBOR	0.25	0.25	1.53
1-Year Treasury	0.27	0.27	0.11
2-Year Treasury	0.78	0.80	0.68
5-Year Treasury	2.25	2.25	1.26
10-Year Treasury	3.50	3.55	2.08
30-Year Treasury	4.42	4.50	2.52
Bond Buyer Index	4.18	4.19	5.46

Foreign Exchange Rates

	Friday 12/18/2009	1 Week Ago	1 Year Ago
Euro ($/€)	1.434	1.462	1.424
British Pound ($/£)	1.617	1.626	1.501
British Pound (£/€)	0.886	0.899	0.949
Japanese Yen (¥/$)	90.327	89.103	89.435
Canadian Dollar (C$/$)	1.065	1.060	1.205
Swiss Franc (CHF/$)	1.043	1.034	1.083
Australian Dollar (US$/A$)	0.889	0.913	0.687
Mexican Peso (MXN/$)	12.927	12.887	13.163
Chinese Yuan (CNY/$)	6.828	6.828	6.829
Indian Rupee (INR/$)	46.725	46.545	46.950
Brazilian Real (BRL/$)	1.797	1.759	2.427
U.S. Dollar Index	77.787	76.573	79.467

Foreign Interest Rates

	Friday 12/18/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.67	0.68	3.11
3-Month Sterling LIBOR	0.60	0.61	3.01
3-Month Canadian LIBOR	0.47	0.47	2.39
3-Month Yen LIBOR	0.28	0.28	0.94
2-Year German	1.15	1.26	1.85
2-Year U.K.	1.14	1.23	1.27
2-Year Canadian	1.32	1.24	1.21
2-Year Japanese	0.17	0.18	0.46
10-Year German	3.14	3.21	2.97
10-Year U.K.	3.79	3.86	3.18
10-Year Canadian	3.39	3.39	2.80
10-Year Japanese	1.24	1.29	1.27

Commodity Prices

	Friday 12/18/2009	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	74.37	69.87	36.22
Gold ($/Ounce)	1103.58	1115.40	852.91
Hot-Rolled Steel ($/S.Ton)	465.00	465.00	550.00
Copper (¢/Pound)	309.50	311.00	126.95
Soybeans ($/Bushel)	9.97	10.00	8.52
Natural Gas ($/MMBTU)	5.84	5.16	5.55
Nickel ($/Metric Ton)	17,002	16,193	9,683
CRB Spot Inds.	478.83	476.48	322.31

Next Week's Economic Calendar

	Monday 21	Tuesday 22	Wednesday 23	Thursday 24	Friday 25
U.S. Data		**GDP** 2009:Q3 (2nd) 2.8% 2009:Q3 (3rd) 2.8% (W) **Existing Home Sales** October 6.10M November 6.30M (W)	**Personal Income** October 0.2% November 0.4% (W) **Personal Spending** October 0.7% November 0.6% (W) **New Home Sales** October 430K November 415K (W)	**Durable Goods Orders** October -0.6% Novemver 1.8% (W) **Durables Ex Transp.** October -1.3% Novemver 0.9% (W)	**Christmas Day** (US Markets Closed)
Global Data	**Canada** **Retail Sales (MoM)** Previous(Sep) 1.0%		**France** **Consumer Spending** Previous (Oct) 1.1%		**Japan** **Jobless Rate** Previous (Oct) 5.1% **Japan** **CPI (YoY)** Previous (Oct) -2.5%

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

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