October 16, 2009

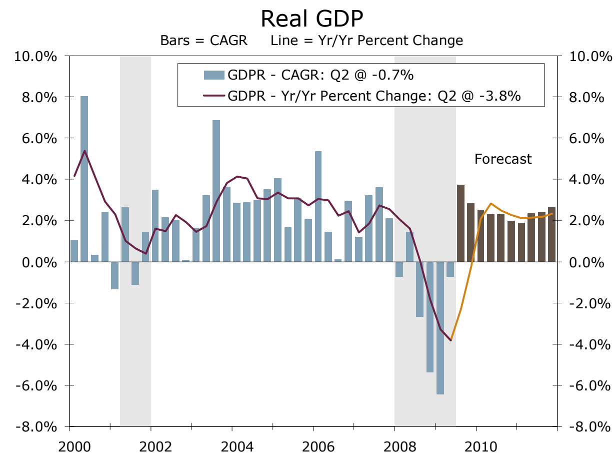
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

No Straight Line Expansion

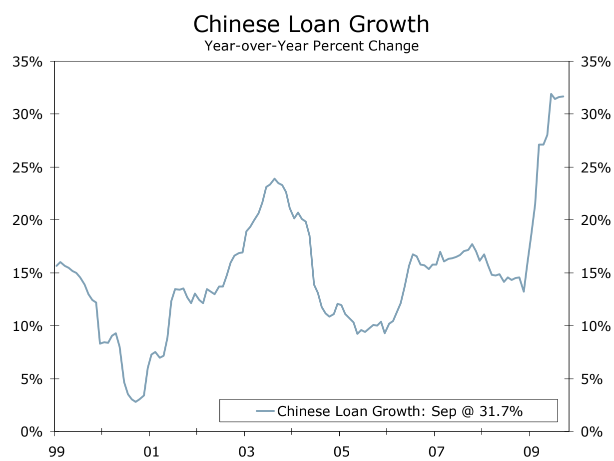
- For the next six months, adjustments in fiscal policy, inventories and the Fed's exit strategy will create a tricky pattern of economic growth and financial changes.
- For decision-makers, this pattern suggests increased volatility in growth and interest rate expectations. Information on both the economy and policy will reinforce this volatility pattern.
- The patterns of growth and interest rates will differ by sector as cyclical and structural changes continue to influence the information landscape.



Global Review

Chinese Growth Probably Strengthened in Q3

- Recent monthly indicators, including industrial production, exports and bank lending suggest that overall GDP growth in China strengthened in the third quarter. Official GDP data will be released next week.
- Could China experience its own credit market implosion over the next year or so? Probably not. While some of the new loans ultimately will go bad, the Chinese economy is not overly leveraged at present. Although a lending bust could surely happen, such an eventuality will probably not occur for a number of years.



Wells Fargo U.S. Economic Forecast

	Actual 2008 1Q	2Q	3Q	4Q	2009 1Q	2Q	Forecast 3Q	4Q	Actual 2006	2007	2008	Forecast 2009	2010	2011
Real Gross Domestic Product [1]	-0.7	1.5	-2.7	-5.4	-6.4	-0.7	3.7	2.8	2.7	2.1	0.4	-2.4	2.4	2.2
Personal Consumption	-0.6	0.1	-3.5	-3.1	0.6	-0.9	2.3	0.0	2.9	2.6	-0.2	-0.8	1.0	1.4
Inflation Indicators [2]														
"Core" PCE Deflator	2.4	2.5	2.6	2.0	1.7	1.6	1.3	1.4	2.3	2.4	2.4	1.5	1.2	1.6
Consumer Price Index	4.2	4.3	5.2	1.5	-0.2	-0.9	-1.5	0.9	3.2	2.9	3.8	-0.4	1.6	2.0
Industrial Production [1]	0.2	-4.6	-9.0	-13.0	-19.0	-10.5	3.2	1.7	2.3	1.5	-2.2	-10.4	1.6	3.9
Corporate Profits Before Taxes [2]	-4.9	-12.0	-5.4	-25.1	-19.0	-12.6	-11.0	3.5	10.5	-4.1	-11.8	-10.6	7.8	9.8
Trade Weighted Dollar Index [3]	70.3	71.0	76.1	79.4	83.2	77.7	74.7	76.0	81.5	73.3	79.4	76.0	81.8	85.3
Unemployment Rate	4.9	5.4	6.1	6.9	8.1	9.3	9.6	10.0	4.6	4.6	5.8	9.2	10.4	9.9
Housing Starts [4]	1.06	1.02	0.87	0.66	0.53	0.54	0.60	0.60	1.81	1.34	0.90	0.57	0.66	0.80
Quarter-End Interest Rates														
Federal Funds Target Rate	2.25	2.00	2.00	0.25	0.25	0.25	0.25	0.25	5.25	4.25	0.25	0.25	1.25	3.25
Conventional Mortgage Rate	5.97	6.32	6.04	5.33	5.00	5.42	5.19	5.00	6.14	6.10	5.33	5.00	5.50	6.00
10 Year Note	3.45	3.99	3.85	2.25	2.71	3.53	3.31	3.40	4.71	4.04	2.25	3.40	3.80	4.40

Forecast as of: October 7, 2009
[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

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U.S. Review

No Straight Line Expansion.

Markets seldom move in a straight line and it is much the same for an economy. For the next six months, adjustments in fiscal policy, inventories and the Fed's exit strategy will create a tricky pattern of economic growth and financial changes. Fiscal policy will be front and center as the federal deficit continues to reflect a pattern of weak revenues and steady spending. This pattern will bias interest rates upward and weaken the dollar if nothing else changes. However, investors, especially global investors, do expect a change. The testing time for the economy will be in early February when the Obama administration presents its budget proposals. We are watching for signals that the administration will be focused on long-term fiscal discipline and how that discipline is to be achieved. Are the out-year deficit estimates reliable and do they suggest smaller deficits over time? What is the balance between tax increases and spending cuts to achieve these smaller deficits? Market disappointment here would suggest higher interest rates and a weaker currency.

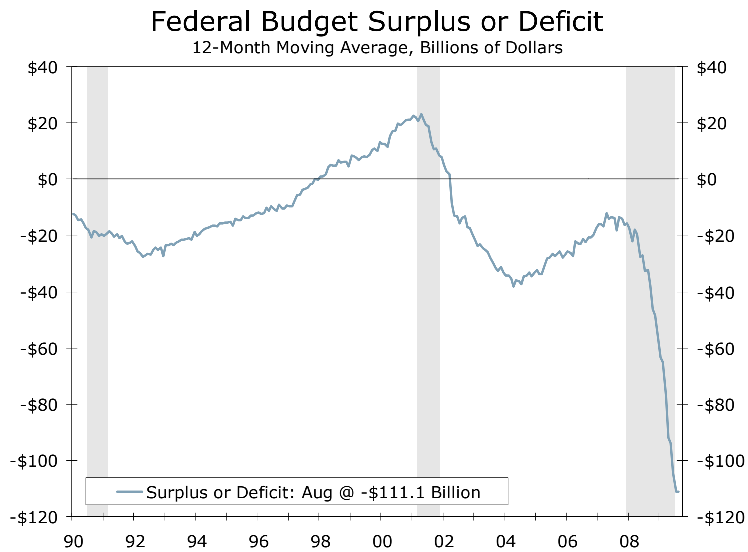
Slower inventory depletion should boost growth in the second half of this year as firms move closer to matching inventories to final sales. However, this boost to growth will diminish over time. Volatility here is likely, however, since the pace of final sales is still very uncertain and matching sales and inventories is notoriously difficult.

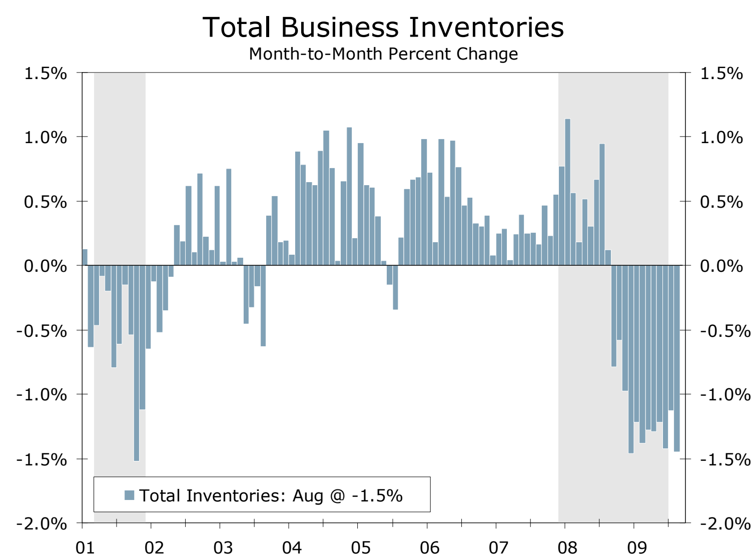
Finally, the Fed's exit strategy will have a very uncertain impact on the capital markets given the state of the economy and the large size of recent Fed interventions. Volatility here is also likely to be significant given the uncertain nature of market expectations, and the Fed's response to the market's reaction to the exit strategy.

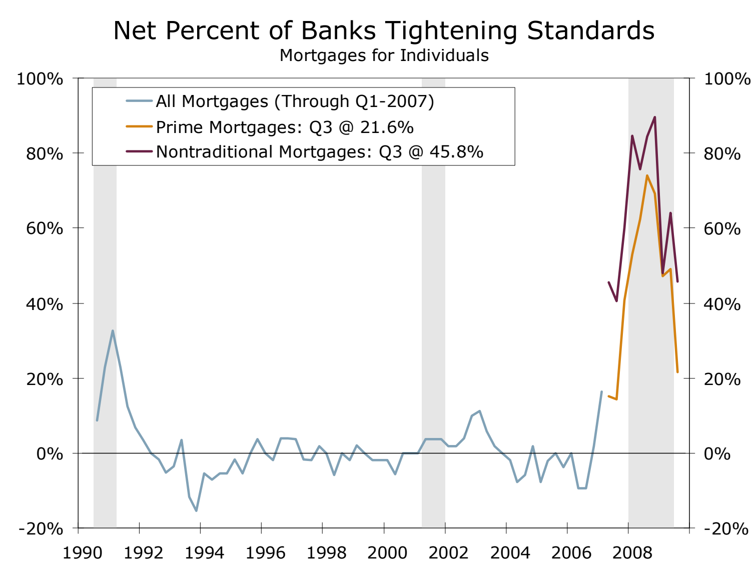
For decision-makers, these three factors suggest increased volatility in growth and interest rate expectations. Information on both the economy and policy will reinforce this volatility pattern. What makes all this susceptible to unusual volatility is the unique size and variety of fiscal and monetary intervention that is being unwound. Moreover, the patterns of growth and interest rates will differ by sector as cyclical and structural change continues to influence the information landscape. Interest rate variability will impact housing and auto sales in different ways, and will affect housing in weak markets (Florida for example) differently than in strong markets such as Washington, D.C.

Our outlook remains for moderate economic recovery and low inflation for the year ahead. However, the pattern of the recovery could be very volatile from quarter to quarter given the complex interactions between market expectations and policy actions.

For anyone developing their annual outlook at this time, the economic background is anything but a straight line. Therefore the wise choice is to allow for a range of possible scenarios that would recognize that the economic path would likely be volatile around both a pessimistic and optimistic scenario. The range of outcomes is wide and our strategic vision for the year ahead must allow for that.





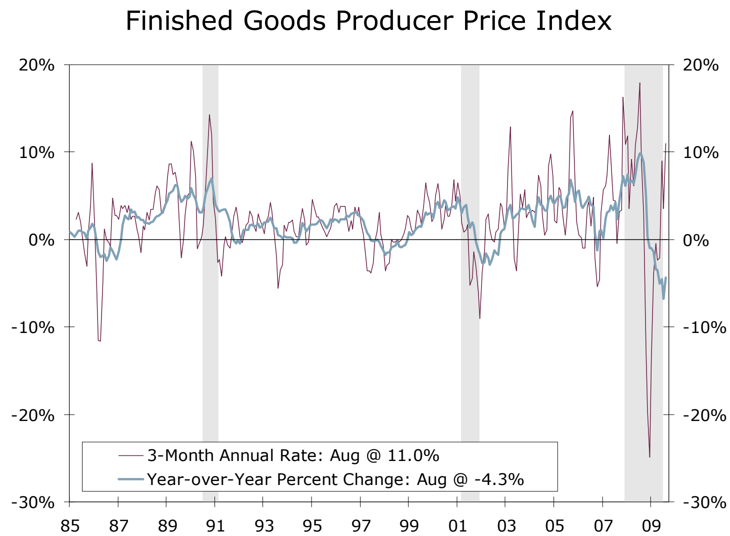


Producer Price Index • Tuesday

The Producer Price Index (PPI) for total finished goods rose 1.7 percent in August driven by an out-sized gain in wholesale gasoline prices, which were up 23.0 percent on the month. The recent decline in wholesale gasoline prices, however, should help pull the headline number down significantly in September. Food prices, which also tend to be volatile, rose in August, but should give back some of the gain. Food prices were down 4.1 percent in August from year-ago levels. We expect headline PPI likely fell 0.8 percent in September. Core intermediate and core raw materials prices have had a string of gains recently, but much of the increase is due to a rise in commodity prices. Increases in iron and steel scrap, aluminum and copper prices have been trending higher due to increased global demand, but surplus capacity should help keep pipeline inflationary pressures benign.

Previous: 1.7% **Wells Fargo: -0.8%**

Consensus: 0.1%

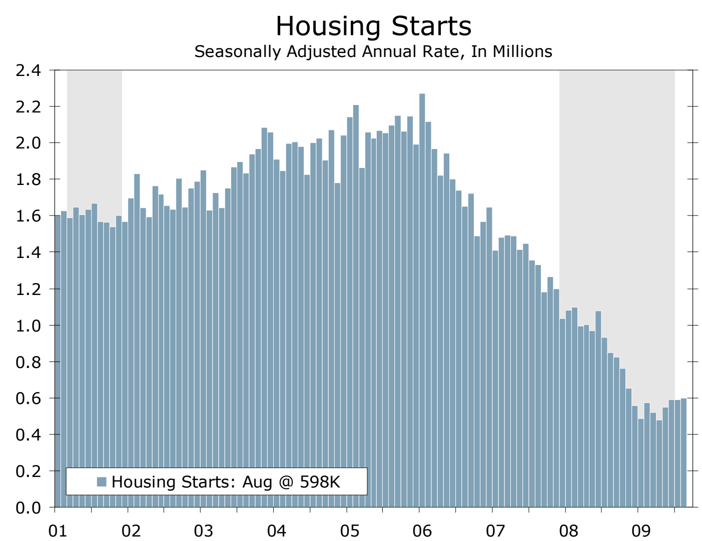


Housing Starts • Tuesday

Housing starts rose 1.5 percent in August with multi-family starts accounting for all of the increase. Multi-family starts tend to be extremely volatile and spiked at 25.3 percent, while single family starts fell 3.0 percent in August. Multi-family starts, however, will likely give back part of its gain in September. Single-family starts should rise due to builders attempting to meet the needs of first-time homebuyers. Buyers must close on purchases by November 30 to qualify for the first-time homebuyer's tax credit. Before dipping in August, single family starts rose five consecutive months. Moreover, starts of single-family homes fell to modern era lows in January and February, as homebuilders were unable to get credit to start new projects. Recent gains suggest a bottom was formed earlier in the year. Homebuilding should make a slight contribution to economic growth in the second half of the year. The impact, however, may be muted by the larger share of smaller homes being built for first-time home buyers.

Previous: 598K **Wells Fargo: 620K**

Consensus: 610K

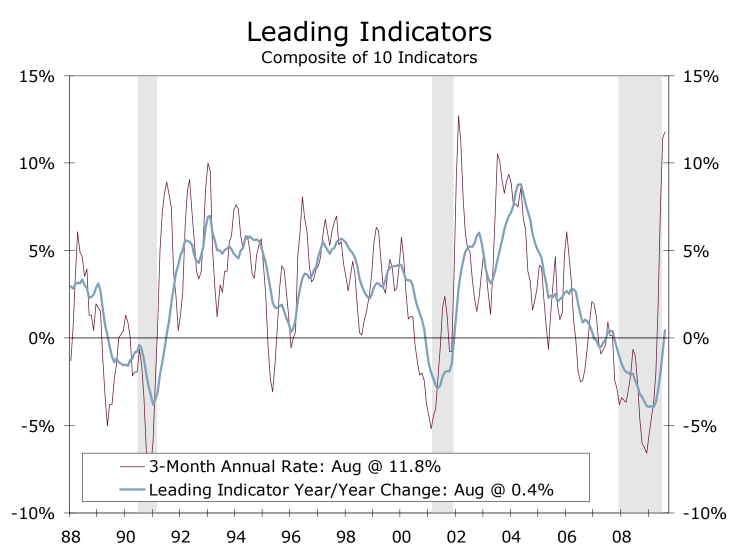


Leading Economic Index • Thursday

The Leading Economic Index (LEI) rose 0.6 percent in August, the fifth consecutive monthly gain. Most of the rise in the August index was driven by increases in stock prices, supplier deliveries and the yield curve. Since the cycle low in March, the LEI has risen 4.7 percent. We expect seven of the 10 indicators to contribute to LEI in September with the largest contribution likely coming from the steeper yield curve. Other likely contributors to the September LEI are consumer expectations which had the highest monthly gain since before the Lehman Brothers collapse and the ISM index for supplier deliveries. Stock prices, housing permits, and the money supply will also likely make a positive contribution. Orders for capital goods and the average workweek will likely detract from the LEI, while consumer goods orders may be flat. The continued increases in the LEI are consistent with a modest economic recovery.

Previous: 0.6% **Wells Fargo: 0.9%**

Consensus: 0.8%



Global Review

Growth in China Appears to Have Strengthened

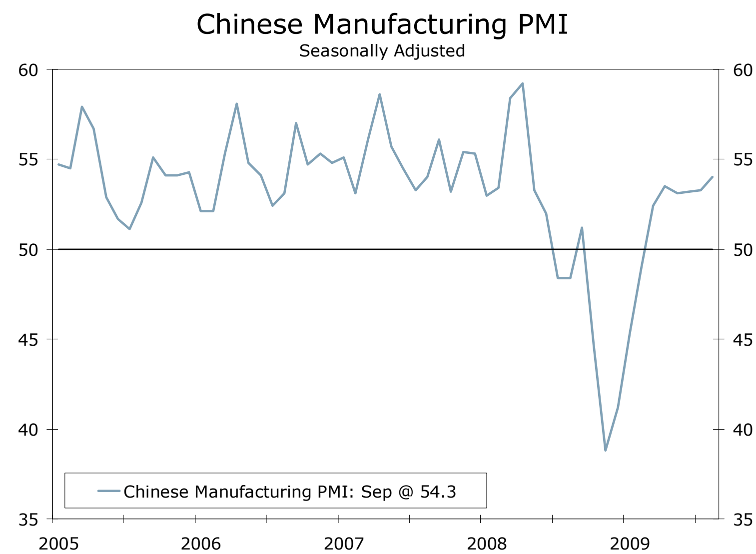
Real GDP growth in China, which matched a 10-year low in the first quarter of 2009, strengthened in the second quarter and recent monthly indicators point in the direction of further acceleration (see chart on front page). Therefore, most analysts expect that official GDP data for the third quarter, which will be released next week, will show the year-over-year growth rate rising to about 9 percent. If China does indeed post a stronger growth rate, it will not be the first Asian economy to do so. In Singapore, real GDP growth rose from 0.5 percent in the second quarter to 0.8 percent in the third quarter.

Returning to China, growth in industrial production (IP) rose to 12.3 percent in August, the strongest growth rate since the global credit meltdown last autumn, and the rise in the Chinese manufacturing PMI in September suggests that IP strengthened further (middle chart). In addition, exports appear to have risen as well in September. Yes, the value of Chinese exports is still down on a year-over-year basis (bottom chart). On a seasonally adjusted basis, however, it appears that exports rose at a very strong rate in September relative to the previous month. Presumably, a sharp increase in exports would have translated into stronger growth in industrial production in September.

However, exports are not the only reason for stronger growth in China. Domestic investment spending has also been very robust due in part to a surge in bank lending this year. As shown in the graph on the front page, bank loans are up more than 30 percent relative to last year. This sharp rise in bank lending has raised concerns among some observers that China may be setting the stage for its own credit bubble. Although we have some sympathy for these concerns, we do not lay awake at night worrying about a near-term credit market implosion in China.

First, about a half of the new lending appears to have been used to finance infrastructure spending. Although there is a danger that some "bridges to nowhere" may be built, most of the infrastructure spending will end up as a productive investment in China's economy. Second, as we showed in a recent report, the Chinese economy, especially the consumer sector, is not overly-leveraged at present. (See "Is China the Next Bubble?", which is posted on our website.) Could some of the loans that have been extended in recent months end up going bad? Sure. Will enough loans go bad to trigger a complete meltdown of the Chinese financial system during the next year or so? Probably not. Although China could eventually experience another banking crisis—it had a lending boom in the late 1980s/early 1990s that was followed by a bust—we believe that any banking system meltdown, should one indeed occur, is still years in the future.

In the meantime, the Chinese economy should continue to accelerate. The government will eventually begin to remove monetary and fiscal stimulus, which will lead to some slowing next year, everything else equal. By that time, however, recoveries in many foreign economies should lead to stronger growth in Chinese exports.



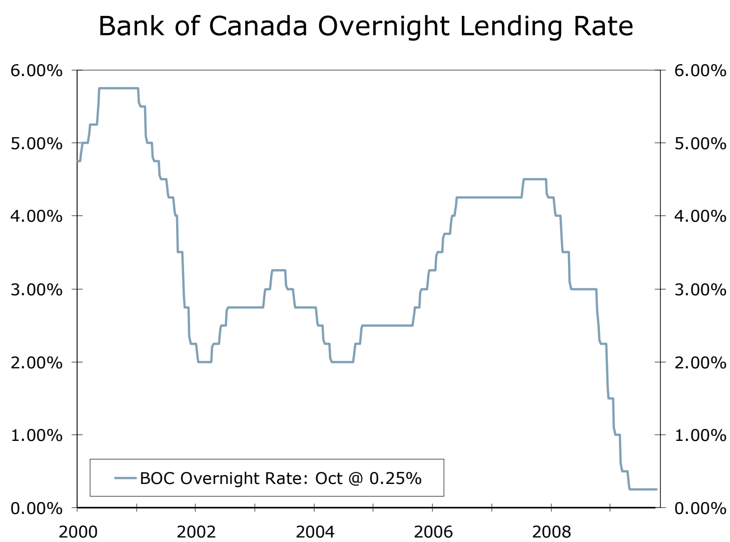
Chinese GDP Growth • Thursday

As discussed on page 4, it appears that Chinese economic growth strengthened in the third quarter. Indeed, the consensus forecast expects that the year-over-year GDP growth rate rose from 7.9 percent in the second quarter to 9.0 percent in the third quarter. Official GDP data will print on Thursday.

Monthly data from September will also be released on Thursday. The year-over-year rate of industrial production growth is expected to rise to 13.1 percent from 12.3 percent in August, and retail sales growth likely held steady around 15.5 percent. Strong loan growth probably will show up as a 33 percent rise in fixed urban investment. Consumer prices are down on a year-over-year basis, but the rate of contraction likely slowed between August and September.

Previous: 7.9% (year-over-year rate) **Wells Fargo: 9.2%**

Consensus: 9.0%



Canada Policy Rate • Thursday

On Tuesday of next week, the Bank of Canada (BoC) will release its most recent Monetary Policy Report, and then the larger Fall Monetary Policy Report will print on Thursday. We do not expect a change in the BoC's main policy target rate, but the details of the two reports will provide insight into the BoC's economic outlook. In addition it may provide much-awaited comments about the Bank's view of the run-up in the value of the Canadian dollar.

After a tough stretch for the Canadian job market, payrolls rose by 58,000 in August and September. Relative to many developed economies, the labor market has held up relatively well in Canada, putting less downward pressure on income growth and helping to support consumer spending. Perhaps that is why the consensus is looking for a modest pickup in sales when the retail sales report is released on Thursday.

Current Policy Rate: 0.25% **Wells Fargo: 0.25%**

Consensus: 0.25%

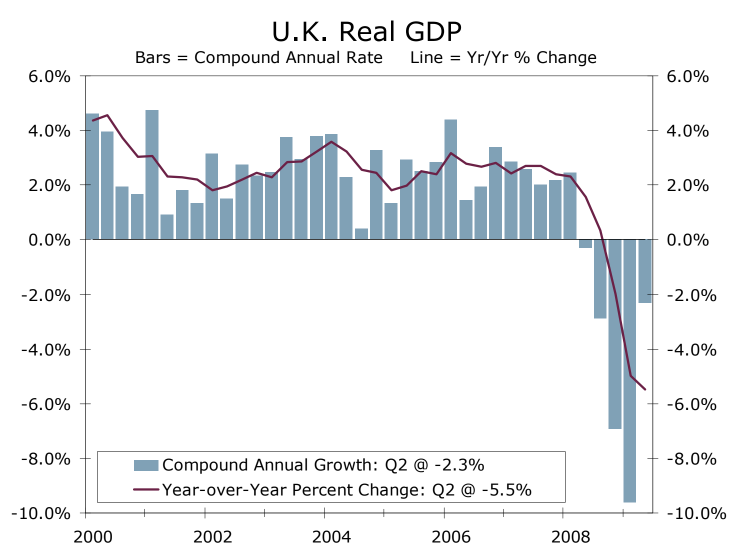
U.K. GDP Growth• Friday

Over the past year-and-a-half, the British economy has endured its deepest recession in decades. Although there are tentative signs that the slump may be ending, growth does not appear to have come roaring back either. Indeed, most analysts (ourselves included) expect that GDP eked out only a small rise in the third quarter. The GDP data will print on Friday.

Other data that are slated for release next week will give investors further insights into the current state of the U.K. economy. A widely followed index of British housing prices comes out on Sunday night, and data on retail spending in September is on the docket on Thursday. The minutes of the Bank of England's policy meeting that was held earlier this month will be released on Wednesday, which will shed some light on the MPC's current thinking.

Previous: -0.6% (non-annualized) **Wells Fargo: 0.2%**

Consensus: 0.2%



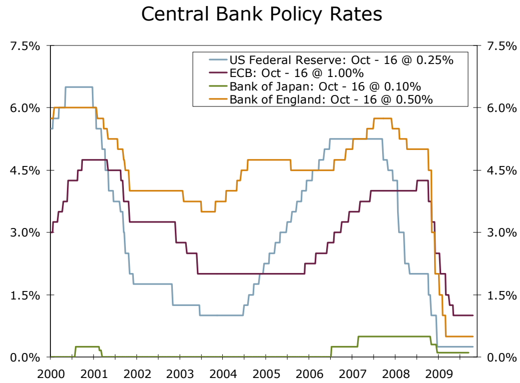
Interest Rate Watch

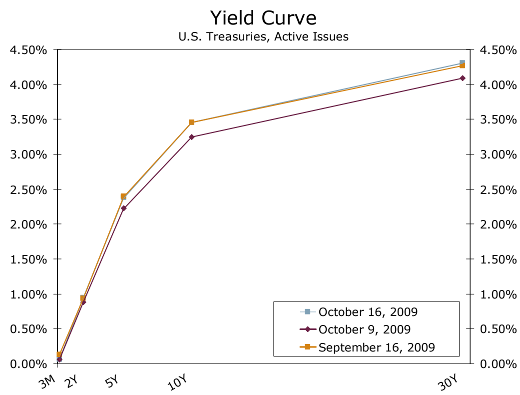
Normal Interest Rate Cycle: Long Rates will Lead Short Rates

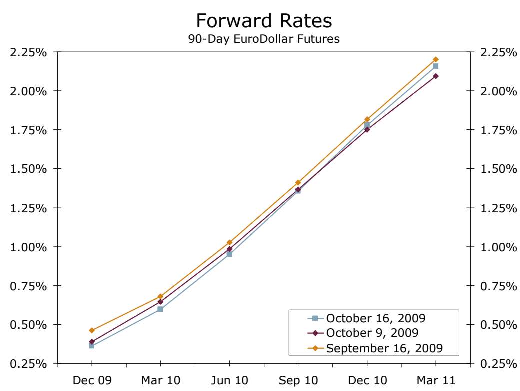
Long term interest rates are expected to rise during the next six months as the Fed is expected to keep short-term interest rates anchored by the current low Federal funds rate. Investor expectations of growth, federal deficit supply/demand imbalances and the end to quantitative easing should work together to boost long-term rates. As emphasized in Fed Vice Chairman Kohn's speech this week, the outlook for the economy is one of slow, non-inflationary, growth and thereby, by inference, a long period for an unchanged fed funds rate.

Higher long-term rates will first reflect the diminished interest in the flight-to-safety trade that is typical of an economic recovery. Economic growth offers opportunity for investors who then shift portfolios away from Treasuries toward corporate bonds and equities. We have seen both of these movements in the last month. Second, Federal deficits continue and with those deficits arrive a steady supply of Treasury securities. Third, however, the Federal Reserve has indicated that it will discontinue its special program of quantitative easing of direct Treasury purchases at the end of this month. This will immediately push the market into a testing period to see what impact on long Treasury rates will appear with the end of the Fed special purchase program. The net of all this suggests that long-term rates will rise over the next six months, although the extent of the rise will be limited as inflation remains subdued.

As for short rates, Kohn's presentation earlier this week suggests that the Federal Reserve sees no case for an increase in the funds rate anytime soon. Kohn emphasized that inflation is not a problem and that, in contrast, deflation remains a possibility given that the economy is expected to grow far-below potential for a while. Unemployment rates north of nine percent certainly remain far above anyone's estimate of full employment. Therefore, our expectations remain that the Federal funds rate will remain at the current target rate through mid-2010 while long rates drift up over the same period.







Consumer Credit Insights

Credit Demand will Be Limited

Three fundamentals will limit consumer credit demand for the next six months. Real disposable income gains are expected to average 1.5 percent over the next six months compared to a gain of 2.2 percent in 2007 before the credit crisis. In recent months there has been continued weakness in hours worked and average hourly earnings for workers. In addition, job losses are expected to continue for the next six months and this will weigh on consumer confidence and will limit consumer spending as well.

Household wealth rose $2 trillion in the second quarter of after six consecutive quarters of declines. Over the last four quarters, household wealth is down over $7 trillion and, that would suggest a roughly $200 billion drop in consumer spending. The wealth gain in the second quarter was across the board in real estate, equities and pension fund/mutual fund assets. There is still a long way to go.

This week's retail sales data showed some improvement in spending yet continued weakness in sales of furniture, appliances and restaurants—areas frequently financed by installment credit or revolving credit. Retail sales ex-auto and gasoline were up 1.8 percent over the last three months, so there is progress.

There is a recovery going on in the economy, but consumer credit will lag along with income and job gains.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.92%	4.87%	5.04%	6.46%
15-Yr Fixed	4.37%	4.33%	4.47%	6.14%
5/1 ARM	4.38%	4.35%	4.51%	6.14%
1-Yr ARM	4.60%	4.53%	4.58%	5.16%
MBA Applications				
Composite	742.9	756.3	592.8	489.3
Purchase	290.9	306.1	272.9	313.5
Refinance	3,374.6	3,377.1	2,454.5	1,514.2

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

Topic of the Week

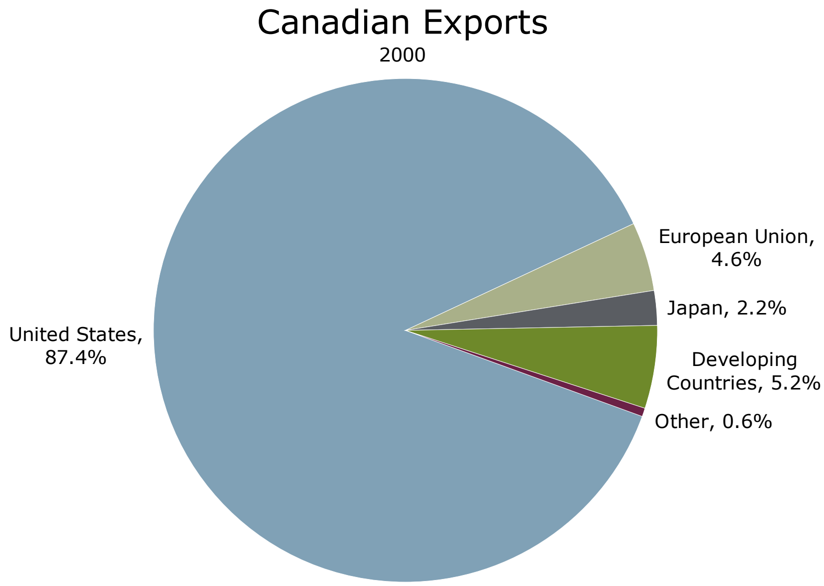
Beyond America, Canadian Economic Prospects

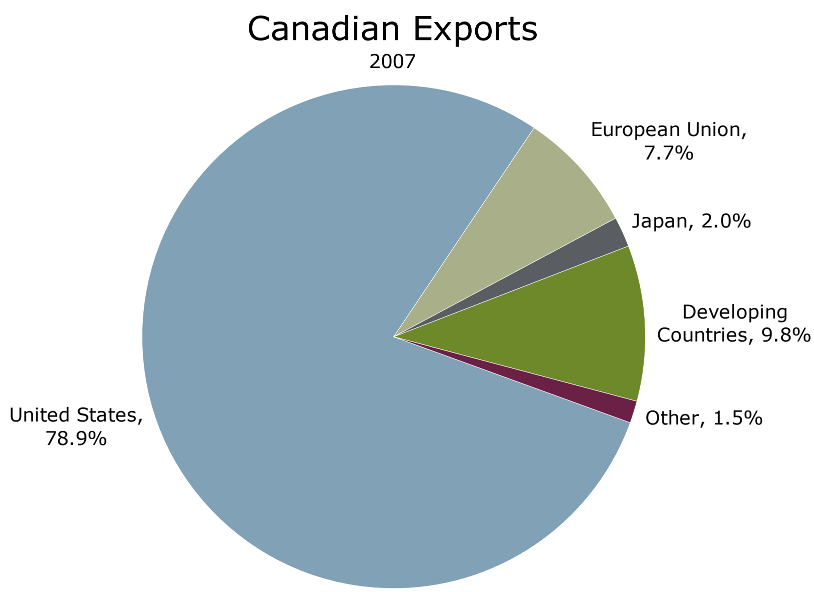
Close geographic proximity and a common culture have encouraged extensive trade and investment ties between Canada and the United States in the post-World War II era. About 10 years ago, the United States was the destination for nearly 90 percent of Canada's exports and Americans accounted for two-thirds of the foreign direct investment holdings within Canada. Over the past decade, however, Canada has developed deeper trade ties with the European Union and the share of foreign direct investment accounted for by Europeans has grown to 30 percent. Due to strong economic growth in the developing world, Canada's exports to those economies have nearly trebled since 2000.

The Canadian economy was pulled into recession at the end of last year due largely to the deep downturn in the United States. However, there are signs that Canada is emerging from its recent slump, and we look for the Canadian economy to modestly outperform its southern neighbor over the next few years. Will Canada ever "de-couple" from the United States? Probably not. Geographic proximity, cultural bonds and a common language ensure that the two economies will remain highly integrated, and economic and financial shocks in the United States will continue to be felt north of the border. However, the high-water mark of Canadian-American economic integration has probably been reached already. Economies other than the United States will become increasingly important, at least at the margin, for Canada in the years ahead.

Specific economic dynamics such as trade and foreign investment contribute to the shared fate of these neighboring countries. There have also been various changes in the way Canada does business with foreign economies other than the United States over the course of the past decade, which may make the country's economic and financial situation somewhat less dependent on the U.S. economy in the years ahead.

We explore these dynamics and consider the economic outlook for Canada in the context of a broader global recovery in a recent special commentary, "Beyond America, Canadian Economic Prospects," which is available on our website.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 10/16/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.05	0.06	0.43
3-Month LIBOR	0.28	0.28	4.50
1-Year Treasury	0.45	0.38	1.23
2-Year Treasury	0.98	0.96	1.62
5-Year Treasury	2.39	2.35	2.84
10-Year Treasury	3.45	3.38	3.96
30-Year Treasury	4.28	4.22	4.26
Bond Buyer Index	4.32	4.06	6.01

Foreign Exchange Rates

	Friday 10/16/2009	1 Week Ago	1 Year Ago
Euro ($/€)	1.489	1.473	1.346
British Pound ($/£)	1.635	1.584	1.730
British Pound (£/€)	0.910	0.930	0.778
Japanese Yen (¥/$)	91.021	89.785	101.575
Canadian Dollar (C$/$)	1.039	1.042	1.178
Swiss Franc (CHF/$)	1.019	1.031	1.138
Australian Dollar (US$/A$)	0.917	0.904	0.691
Mexican Peso (MXN/$)	13.115	13.307	12.834
Chinese Yuan (CNY/$)	6.827	6.826	6.830
Indian Rupee (INR/$)	46.308	46.417	48.845
Brazilian Real (BRL/$)	1.709	1.741	2.134
U.S. Dollar Index	75.757	75.966	82.455

Foreign Interest Rates

	Friday 10/16/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	0.69	0.70	5.08
3-Month Sterling LIBOR	0.57	0.56	6.18
3-Month Canadian LIBOR	0.50	0.50	3.81
3-Month Yen LIBOR	0.33	0.34	1.06
2-Year German	1.42	1.37	2.90
2-Year U.K.	0.88	0.81	3.77
2-Year Canadian	1.65	1.33	2.28
2-Year Japanese	0.25	0.25	0.80
10-Year German	3.29	3.20	4.07
10-Year U.K.	3.61	3.45	4.72
10-Year Canadian	3.53	3.36	3.75
10-Year Japanese	1.34	1.27	1.59

Commodity Prices

	Friday 10/16/2009	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	77.39	71.77	69.85
Gold ($/Ounce)	1048.08	1049.25	804.60
Hot-Rolled Steel ($/S.Ton)	555.00	555.00	915.00
Copper (¢/Pound)	282.70	282.85	209.90
Soybeans ($/Bushel)	9.78	9.07	8.18
Natural Gas ($/MMBTU)	4.64	4.77	6.70
Nickel ($/Metric Ton)	18,735	19,423	11,675
CRB Spot Inds.	433.26	425.54	409.39

Next Week's Economic Calendar

	Monday 19	Tuesday 20	Wednesday 21	Thursday 22	Friday 23
U.S. Data		**Housing Starts** August 598K September 620K (W) **PPI** August 1.7% September -0.8% (W) **Core PPI** August 0.2% September 0.0% (W)		**Leading Indicators** August 0.6% September 0.9% (W)	**Existing Home Sales** August 5.1M September 5.2M (W)
Global Data				**China** **Real GDP (YoY)** Previous (2Q) 7.9% **Canada** **Retail Sales (MoM)** Previous (Jul) -0.6%	**UK** **GDP (QoQ)** Previous (2Q) -0.6% **Germany** **IFO-Business Climate** Previous (Sep) 91.3

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

Wells Fargo Securities, LLC Economics Group

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