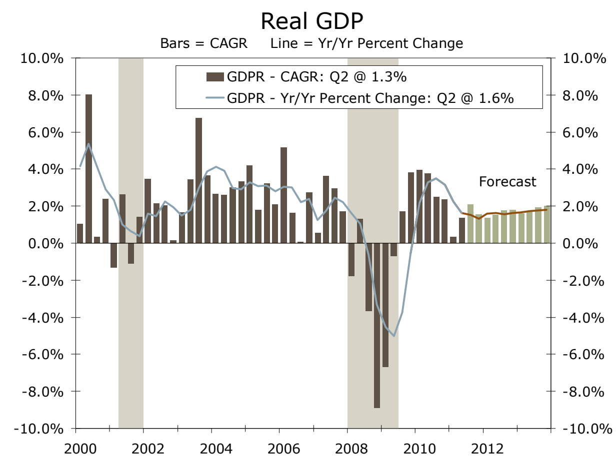
Economics Group

Weekly Economic & Financial Commentary

U.S. Review

Neither Doom nor Boom: Moderate Growth Is the Story

- The triumph of thoughtful analysis over hype continues. This week's data on leading indicators, jobless claims, housing starts and the Philadelphia Fed survey suggest moderate growth ahead.
- Yes, problems do remain—existing home sales—and other problems persistent beyond the expectations (promises?) of policymakers—inflation and high unemployment.
- On balance, the outlook remains for moderate economic growth with the accompanying three problems of housing, employment and government restructuring.



Global Review

Chinese Growth Slows, German Confidence Fades

- Chinese economic growth slowed to 9.1 percent year over year in the third quarter, continuing the slowing trend that started in the second quarter of 2010. The central bank has been raising interest rates and reserve requirements to cool the economy, and it appears that those efforts are paying off.
- Amid slowing economic growth and growing concerns about the European debt crisis, German investor confidence plunged to a three-year low in October. Conflicting reports of progress and division regarding a solution to the crisis have kept markets on edge.

Wells Fargo U.S. Economic Forecast

	Actual		Forecast						Actual		Forecast		
	2011				2012				2009	2010	2011	2012	2013
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product [1]	0.4	1.3	2.1	1.6	1.4	1.5	1.8	1.8	-3.6	3.0	1.7	1.6	1.7
Personal Consumption	2.1	0.7	1.8	1.6	1.3	1.4	1.3	1.3	-2.0	2.0	2.2	1.5	1.3
Inflation Indicators [2]													
"Core" PCE Deflator	1.1	1.3	1.7	1.9	1.9	1.8	1.6	1.6	1.5	1.4	1.5	1.7	1.6
Consumer Price Index	2.2	3.3	3.8	3.7	2.9	2.3	2.0	1.9	-0.3	1.6	3.3	2.3	2.0
Industrial Production [1]	4.8	0.5	5.1	2.0	1.9	2.6	2.8	2.8	-11.1	5.3	3.9	2.5	3.1
Corporate Profits Before Taxes [2]	8.8	8.5	6.5	6.4	6.2	6.0	6.4	6.6	7.9	32.2	7.5	6.3	7.0
Trade Weighted Dollar Index [3]	70.6	69.4	72.8	74.0	75.0	76.0	76.5	77.0	77.7	75.6	71.7	76.1	78.6
Unemployment Rate	8.9	9.1	9.1	9.2	9.3	9.4	9.4	9.4	9.3	9.6	9.1	9.4	9.2
Housing Starts [4]	0.58	0.57	0.62	0.55	0.57	0.60	0.63	0.65	0.55	0.58	0.58	0.61	0.74
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	0.25	0.25	0.25	0.25	0.25
Conventional Mortgage Rate	4.84	4.51	4.11	4.10	4.10	4.10	4.10	4.10	5.04	4.69	4.39	4.10	4.25
10 Year Note	3.47	3.18	1.92	2.20	2.20	2.20	2.30	2.40	3.26	3.22	2.69	2.28	2.55

Forecast as of: October 21, 2011
[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

U.S. Review

Cyclical Recovery-Structural Drags

This week's economic data on leading indicators, jobless claims, housing starts and the Philadelphia Fed survey suggest that the cyclical recovery continues even though the pace remains moderate and thereby disappointing to many.

Leading indicators rose 0.2 percent in September and have risen 5.3 percent over the past three months. This pattern is consistent with continued economic expansion—certainly not a recession. The gains in the index were led by financial indicators—money supply and the yield curve—as well as production indicators, such as consumer goods orders and supplier deliveries. Jobless claims continue to drift down, suggesting modest, painfully slow, improvement in the labor market. The four-week moving average for claims has declined for the past several weeks and now stands just above the 400,000 threshold. Housing starts rose in September led by the multifamily segment. This supports our economic outlook that nonresidential construction/apartments would contribute to growth going forward. Finally, on Thursday, the Philadelphia Fed index jumped back into positive territory with a nice gain in new orders, which we view as a leading indicator for the economy.

The weight of this week's evidence suggests continued moderate growth ahead, with gains of 1.5 percent for the second half of this year and the first half of next year.

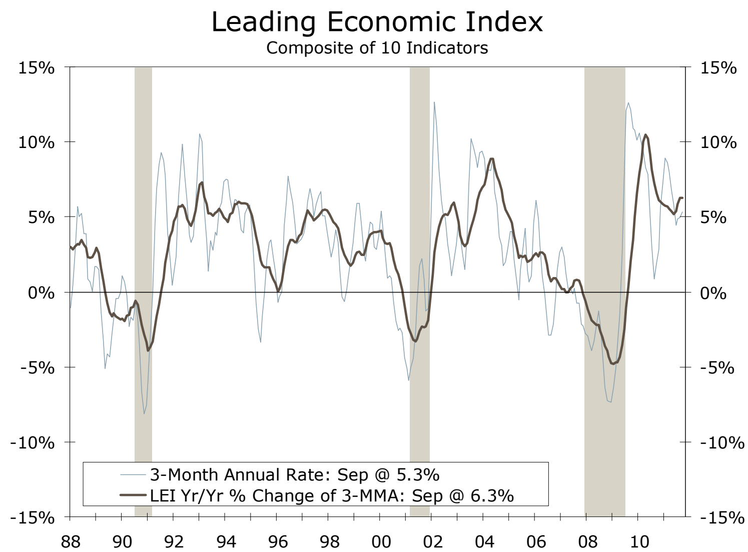
Structural Drags

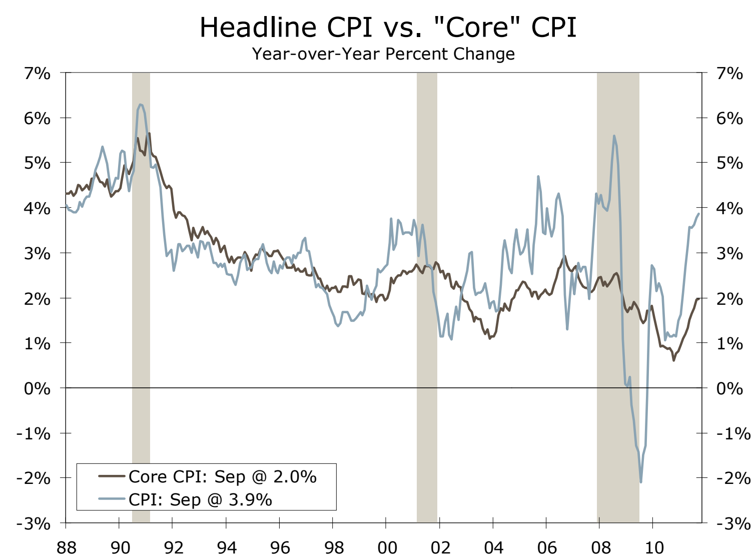
Problems do remain as evidenced by the existing home sales report. Reports of contract cancellations have risen sharply in recent months—18 percent of National Association of Realtors members reported a cancellation in September. Thirty percent of sales are distressed and prices continue to fall. These issues continue to drag economic growth as losses in household wealth for some households is being recognized and the confidence of other households is undermined.

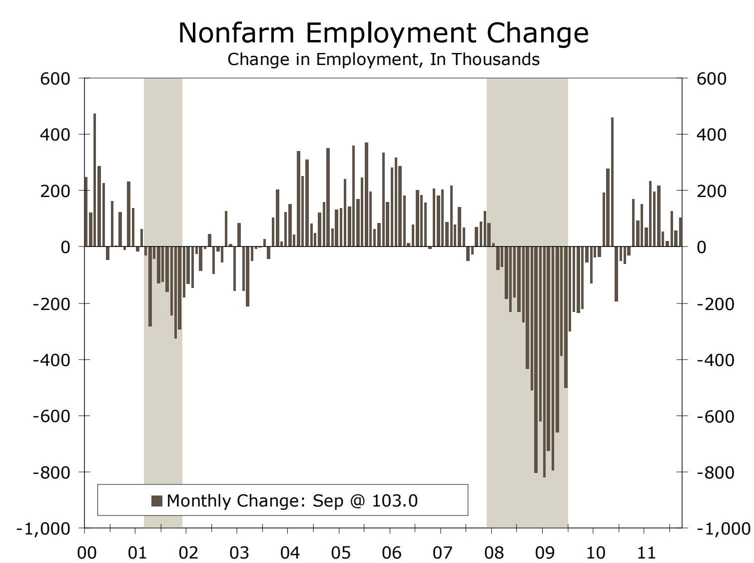
Meanwhile, the inflation data undermines the real disposable income of households. This week's consumer price report came in at 3.9 percent year over year, and this surely is a hit to real incomes. As a result, consumer spending in our outlook remains subpar compared to earlier economic recoveries.

This subpar outlook is reinforced by the three problems of housing, employment and government restructuring that has accompanied this recovery. Housing has been a strong contributor to growth in earlier recoveries and yet we expect housing starts to improve slowly, averaging 740,000 next year compared to 610,000 this year. Second, job gains remain far below prior recoveries and we expect job gains to average 100,000 in the year ahead while a typical recovery would average 250,000 mid-cycle. Finally, the restructuring of both the federal and the state-local governments leads us to posit that government purchases will subtract from growth for all of 2012.

Economic activity reflects the influence of cyclical and structural adjustments—unfortunately our adjustments have a ways to go.







Consumer Confidence • Tuesday

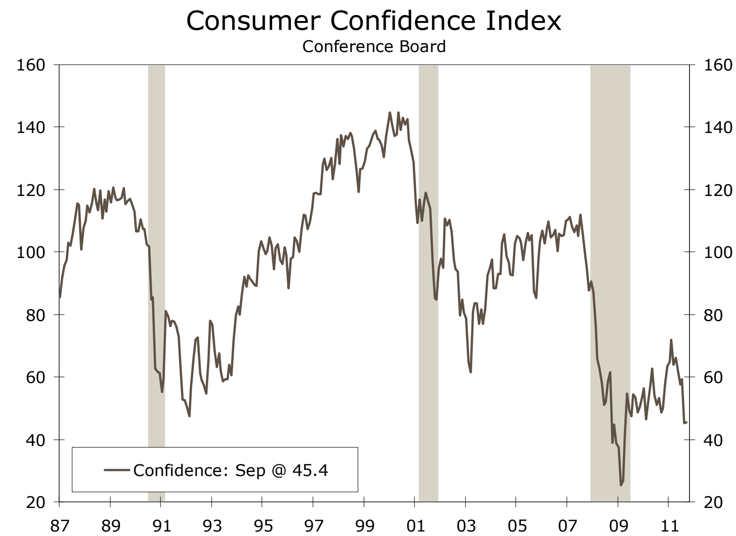
The Conference Board's measure of consumer confidence topped out in this cycle in February at 72 and has been trending down ever since. Indeed, the September reading of 45.4 is below the lowest levels measured in the recession of the early 2000s. Some market watchers have pointed the finger at the congressional standoff over the debate about raising the debt ceiling for the deterioration in sentiment. But given the stubbornly high unemployment rate and stagnant income growth, there is no shortage of explanations.

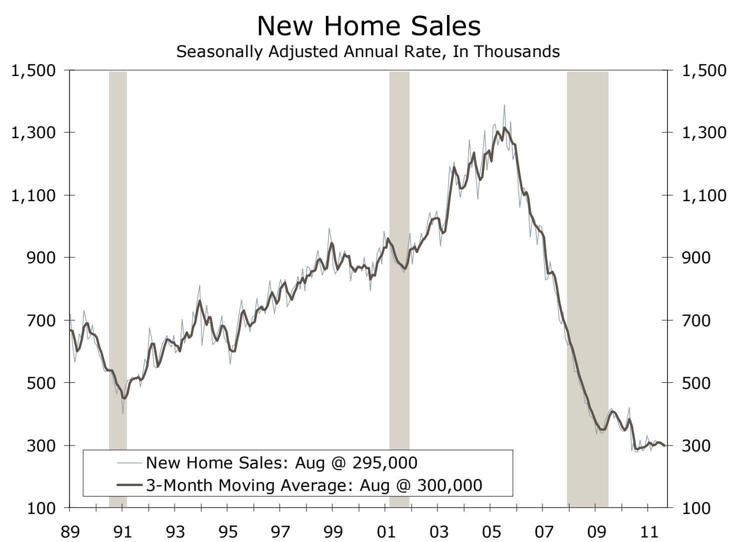
So far the lack of confidence has not kept shoppers away from the stores. Recent retail sales data confirm growth at department stores and clothing stores during the back-to-school month of September.

We will get the October reading of consumer confidence from the Conference Board on Tuesday.

Previous: 45.4 **Wells Fargo: 47.2**

Consensus: 46.0





New Home Sales • Wednesday

The 2.3 percent drop in sales of new homes brings the number of monthly declines to four straight—the longest losing streak since 2009. That said, the declines have been rather small. As the nearby chart shows, the annualized rate of new home sales has been on cruise control at roughly 300,000 for the better part of the past year.

To put that number in perspective, consider this: from the Kennedy administration until May 2010, the annualized pace of new home sales never fell below 335,000 in a single month. Since May 2010, the pace of sales has never risen above 335,000. We do not see a catalyst for a meaningful recovery for the beleaguered residential construction market in the near future.

New home sales data for September will print on Wednesday; we expect to see a modest uptick in the month.

Previous: 295K **Wells Fargo: 306K**

Consensus: 300K

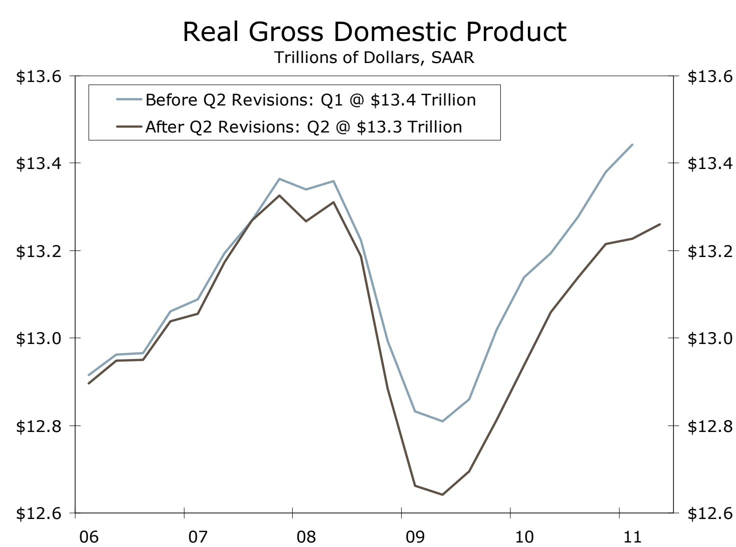
Gross Domestic Product • Thursday

Back in July when we got our first look at GDP figures for the second quarter, we learned that the recession was worse than initially reported and that the recovery was not as far along as we had first been told. We wrote at the time that it was a "game-changing" report and indeed it kicked off a fresh round of speculation about whether or not the U.S. economy was headed for a double dip.

After growing at just a 1.3 percent annualized rate in the second quarter, we suspect that U.S. economic growth likely accelerated to a 2.1 percent rate in the third quarter. The official numbers will hit the wire on Thursday morning. Despite terribly weak consumer sentiment, spending by consumers likely contributed to growth in the quarter as did a faster pace of growth in business fixed investment spending.

Previous: 1.3% **Wells Fargo: 2.1%**

Consensus: 2.5% (Q/Q Annualized)



Global Review

Volatility Continues Amid Dizzying Array of News

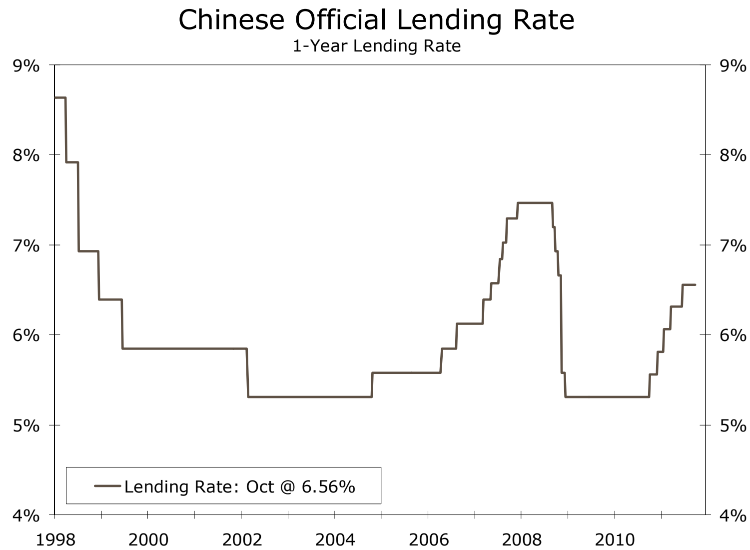
Global markets got off to a rough start on Monday, Oct. 17, after German Finance Minister Wolfgang Schaeuble warned that investors should not expect a silver bullet solution to Europe's debt crisis at the Oct. 23 European Union summit. Investors had been hoping this might be the case after German Chancellor Angela Merkel and French President Nicolas Sarkozy promised on Oct. 9 to unveil a comprehensive plan to tackle the market's No. 1 ill. Furthermore, Merkel's spokesman, Steffen Seibert, suggested the search for a resolution would extend well into next year. Adding more anxiety to markets was Moody's warning of a possible downgrade of France's credit rating due to "the deterioration in debt metrics and the potential for further contingent liabilities to emerge."

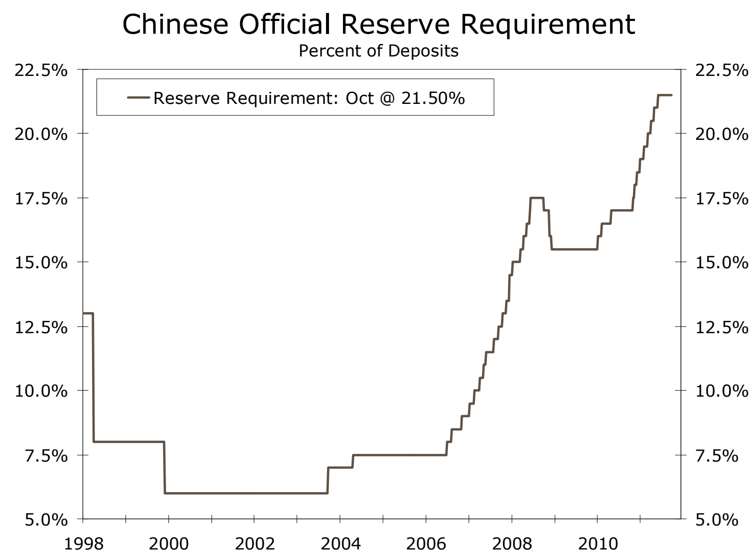
October 17 also brought the release of China's third-quarter GDP, which showed growth slowing to 9.1 percent year over year from 9.5 percent in the second quarter. The central bank has been trying to cool the economy by aggressively raising interest rates and bank reserve requirements since late 2010 amid increasing inflation. Inflation has finally begun to ease, slowing for the second straight month in September to 6.1 percent year over year. Ebbing inflation and three straight quarters of moderating economic growth show efforts to engineer a soft landing are paying off.

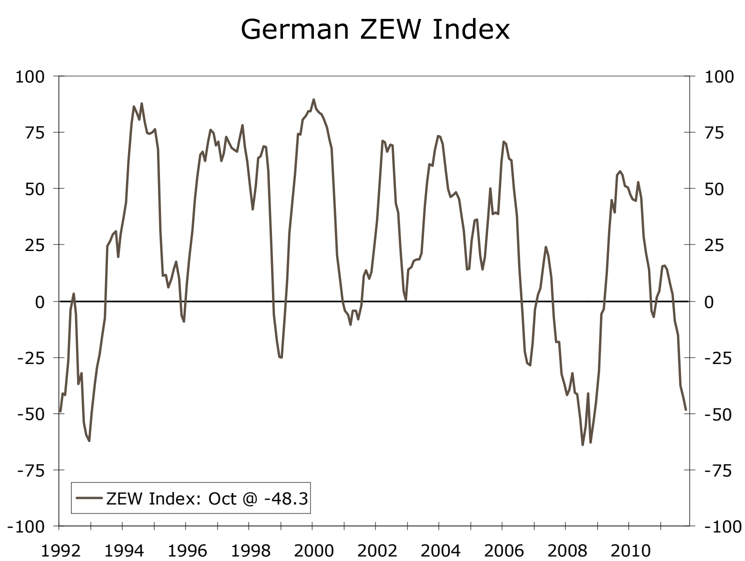
The same could also be said of China's efforts to deflate its housing bubble. On Oct. 18, the government reported that 17 cities saw month-over-month declines in new home prices in September, compared to 16 in August. In Wenzhou, prices were even down from a year ago. In addition, in 24 cities that saw price increases, the biggest increase was just 0.3 percent. While the end of an unsustainable surge in Chinese home prices is somewhat good news, it comes at a time when export growth is slowing as China's important export markets, namely the United States and the Eurozone, are experiencing a drop in demand. Still, since China's banks are not nearly as exposed to the housing market as were banks in the developed world during the financial meltdown, a Chinese housing slowdown is unlikely to lead to a banking crisis as it did in the developed world.

Despite rising optimism in global markets for a European debt solution, a report on Oct. 18 showed the ZEW Index of German investor confidence plunged in October to -48.3, the lowest since November 2008 (bottom chart). The effects already being felt from the debt crisis, reflected in the weakest economic growth in Germany in the second quarter since the first quarter of 2009, as well as concerns about future effects in the event that the crisis is not contained, have clearly rattled investors. Weak growth and waning investor confidence in Europe's largest economy do not bode well for the rest of the continent.

Conflicting reports of progress and division regarding a solution to the debt crisis have kept markets volatile. Investors hope that European leaders can agree very soon on Greek debt reduction, capital cushions for banks and an increase in the rescue fund.







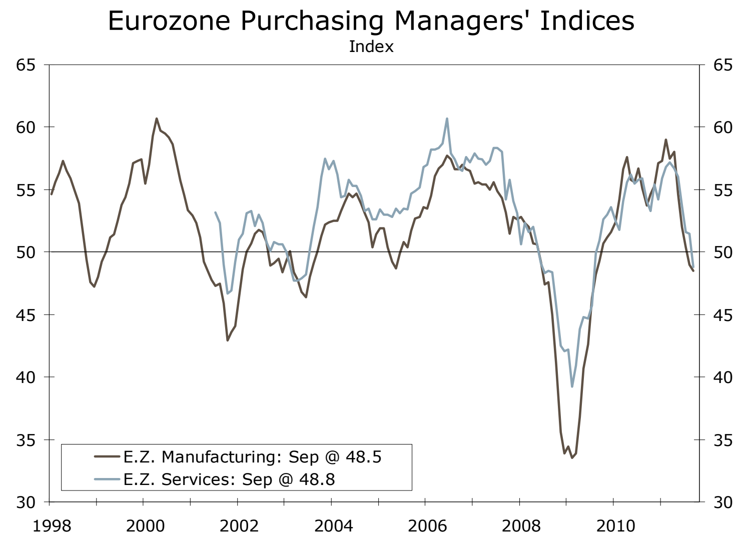
Eurozone PMIs • Monday

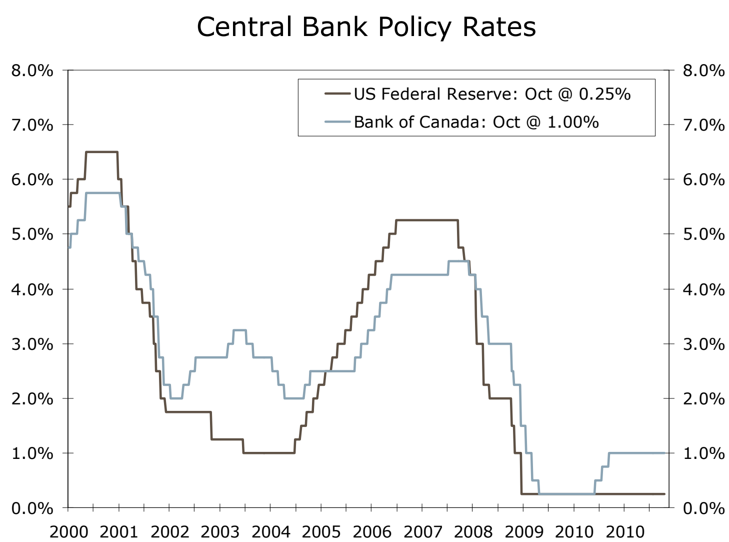
Business sentiment in the Eurozone has been trending down for the better part of the past year. In August the manufacturing PMI slipped into contraction territory and in September, the services measure followed suit. Our first look at October sentiment is due out on Monday, though the consensus is not expecting much of a rebound in sentiment given the ongoing uncertainty about the debt crisis in Europe and expectations for weaker global growth.

This particular month, financial markets will be less focused on these numbers as they might be in a different month. The reason for that is that these numbers hit the wire the day after the Oct. 23 meeting of European leaders about the debt crisis. For more on what we expect to see there, please turn to page 7 of this report and look at our Topic of the Week which focuses on the next crucial step for European markets.

Previous: Manufacturing: 48.5, Services: 48.8

Consensus: Manufacturing: 48.0, Services: 48.5





Bank of Canada Rate Decision • Tuesday

The Canadian consumer price index came in at 3.1 percent for September, just above the Bank of Canada's (BoC) target.

Meanwhile, core consumer prices increased by only 0.1 percent during September and remain stable at 2.0 percent on a year-over-year basis. The Bank of Canada has indicated that it expects inflation to decline in the coming months, as higher food and energy prices unwind.

After a weaker-than-expected GDP print for Q2, some market watchers were concerned that a slowdown in Canadian economic growth might increase pressure on the BoC to ease policy somewhat. But generally stronger economic reports in recent weeks, particularly a strong September jobs report, take the notion of any potential easing off the table in our view. The Bank likely will be on hold for the foreseeable future.

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

Consensus: 1.00%

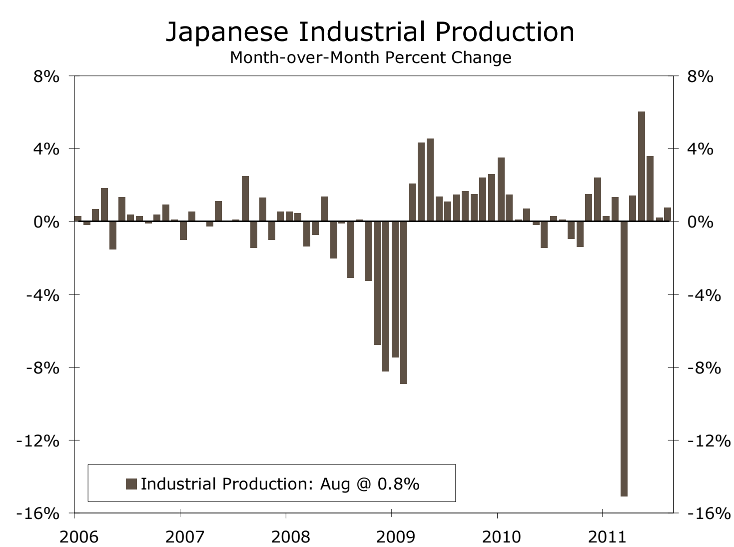
Japanese Industrial Production • Friday

After falling off a cliff in March following the tsunami, Japanese industrial production has been steadily coming back on line. Manufacturing output has increased for five straight months. The slower rate of growth is no longer a reflection of supply chain disruptions but rather reflects the pullback in economic activity across the world. September Industrial Production data are due out on Friday of next week.

Third-quarter GDP may be bolstered somewhat by the bounceback in manufacturing activity, even if the growth is not very strong. Japanese real GDP fell at an annualized rate of 2.1 percent in Q2, but we project that growth turned positive again in Q3. A stronger-than-expected number next week could lead to some upward revisions for Japanese GDP growth.

Previous: 0.8%

Consensus: -2.1% (Month-over-Month)



Interest Rate Watch

Ceteris Paribus and Default Risk

Two aspects of financial reporting appear regularly and, unfortunately, are very misleading to investors and decision makers.

First, there is a tendency to associate a movement in one economic variable with the movement or lack thereof of another to suggest cause and effect. The latest misconstruction appeared this week with the argument that perhaps Operation Twist was working because the 30-year Treasury rate rose in value. Huh? Yes, that was our response.

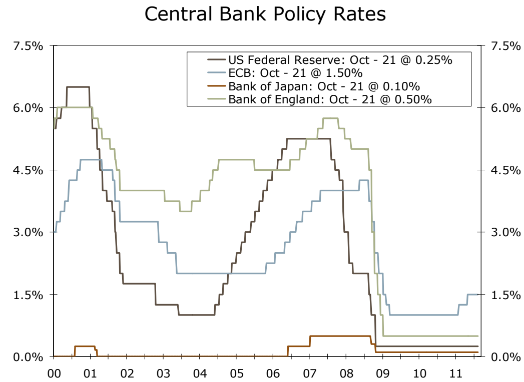
Operation Twist was suppose to lower the long end of the yield curve not raise the 30-year yield, so the premise of the article is all wrong. More importantly, the article fails to appreciate the importance of ceteris paribus—all else held constant.

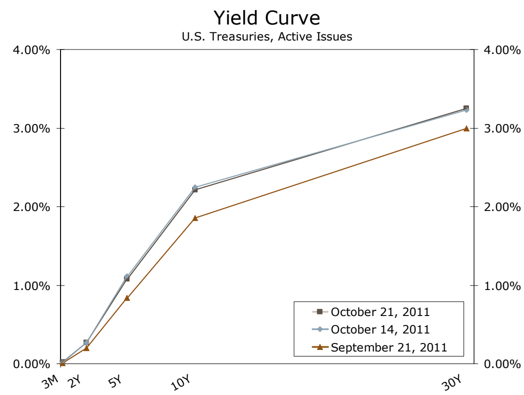
While the Federal Reserve was discussing Operation Twist, something else more important was happening—market expectations on the economy were changing. In particular, the outlook was becoming less negative as retail sales, employment and, most recently this week, the Philadelphia Fed index all were better than market expectations. From our viewpoint, it was this change in economic expectations that altered the path of long-term rates and most likely obscured any impact from Operation Twist.

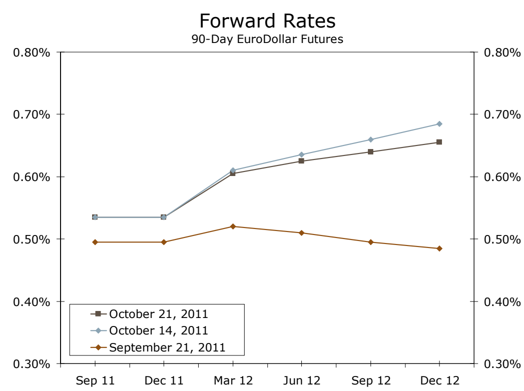
Treasury Debt Is Not Risk Free

Unfortunately, U.S. Treasury debt is not risk free, as is frequently asserted in both written and televised commentary. Treasury debt may be default-risk free but for anyone familiar with the history of credit markets from the 1970s on Treasury debt is very risk-full due to the uncertainties of inflation, currency and therefore interest rate fluctuations.

Inflation destroys the real return on Treasuries, and with consumer prices rising at 3%+, the real value of the return on Treasuries is negative—a very risky proposition. Dollar depreciation is a risk for foreign investors. The experience of 1994-1995 is a dramatic example of interest rate risk. Today's low Treasury rates are a bet on many factors—not just default.







Credit Market Insights

State Budgets Reflect Balance

After a summer of contentious political wrangling over state budgets there is some light at the end of the tunnel for those states that made the tough choice of deeply cutting expenditures. The balance between slower revenue growth and public spending has returned to many states. The budget reforms and fiscal policy actions in light of more conservative revenue forecasting and budget cuts has setup many states for a much better fiscal year ahead. New data indicate that state tax collections are increasing and, in some cases, exceeding originally forecasted estimates. While the rebound in state revenues is welcomed news, there is still a long way to go before states fully return to the revenue growth experienced before the recession. As a result of revenues exceeding forecasted amounts, state budget shortfalls will likely be much lower in the 2013 state fiscal year, which for most states begins next July. The National Conference of State Legislatures estimates that state budget gaps should fall to around $31.9 billion for fiscal year 2013, down from $91.0 billion in the current 2012 fiscal year. While much improved from previous years, there are ongoing risks to state budgets as the federal government prepares its plans to cut spending that will likely further affect state budgets in the next cycle. But the fact that states have managed to strike a new balance between spending and revenues should benefit these governments in the form of lower borrowing costs in the future.

Mortgage Data

	Current	Week Ago	4 Weeks Ago	Year Ago
Mortgage Rates				
30-Yr Fixed	4.11%	4.12%	4.09%	4.27%
15-Yr Fixed	3.38%	3.37%	3.29%	3.72%
5/1 ARM	3.01%	3.06%	3.02%	3.47%
1-Yr ARM	2.94%	2.90%	2.82%	3.40%
MBA Applications				
Composite	633.1	744.3	702.7	803.4
Purchase	161.4	177.1	172.2	169.7
Refinance	3,396.1	4,072.3	3,813.2	4,491.1

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

Topic of the Week

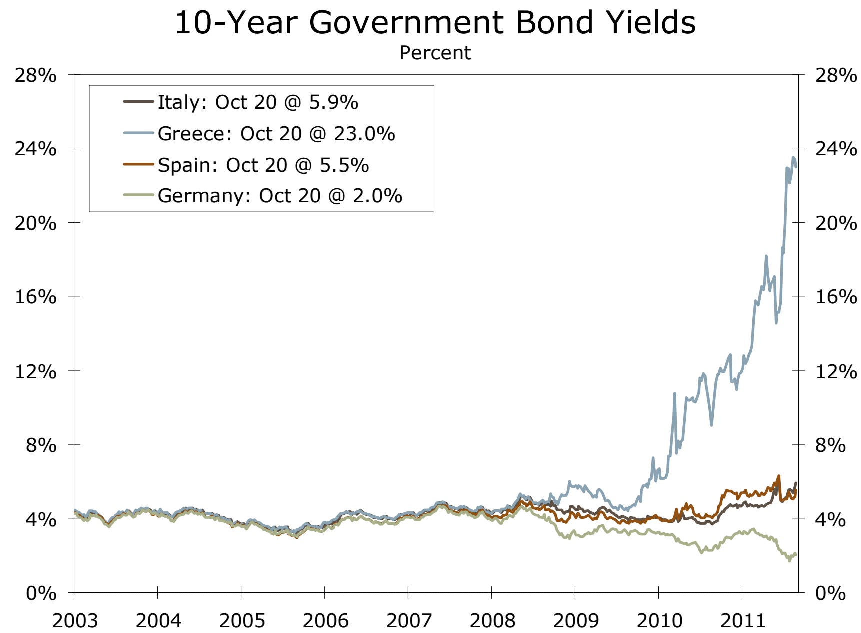
Come Monday, Will It Be Alright?

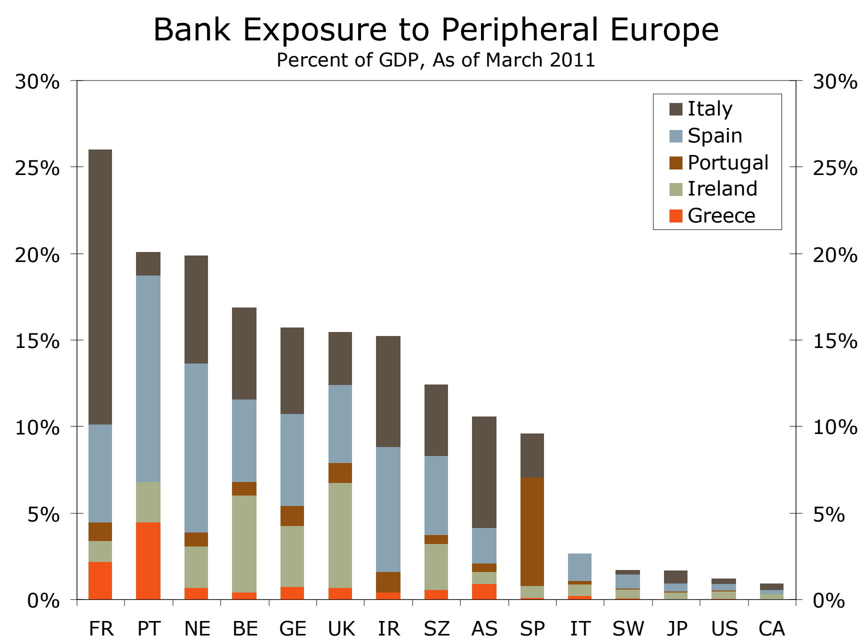
The sovereign debt problem in Europe has evolved from an "issue" on the periphery to a front and center "crisis." This weekend, European leaders are getting together for what seems to be the highest stakes meeting yet to address the crisis. It is not yet clear what they will discuss, but leaks to the media suggest an itinerary that will focus primarily on a recapitalization of the banking system and devising a way to lever the assets set aside in the European Financial Stability Facility (EFSF). So, heading into this crucial meeting, we lay out what to watch for in terms of an outcome. We would add however, that full details of the meeting may not be available until the middle of next week.

The moving parts here are the number of systemic banks that would be recapitalized and what capital ratio would be used. An IMF report suggested a package of this magnitude might cost €200 billion-€250 billion, but some of the details leaked to the press suggest a package of €100 billion, which may disappoint financial markets.

The second consideration is the extent to which European leaders agree to lever the newly expanded EFSF. With some of the €440 billion already pledged, the EFSF can only do so much good in its present form. But the fund could cover more assets if it secured only a specified percentage of the amount covered. Instead of purchasing government bonds of troubled Euro-member states outright in the secondary market, EFSF funds could be used to provide partial guarantees through a "first loss" insurance plan. Covering first losses up to 25 percent of face value, for example, could enable €250 billion of EFSF funds to cover €1 trillion of bonds. It is not yet clear whether or not that will be enough to calm markets.

The final factor is the northern European economies will want to make sure the Greeks and other ESFS recipients feel the pain in terms of accepting necessary austerity measures. This will likely include more labor reform as well as raising the retirement age. Considering the riots in Greece, these measures are sure to face opposition.





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Market Data ♦ Mid-Day Friday

U.S. Interest Rates

	Friday 10/21/2011	1 Week Ago	1 Year Ago
3-Month T-Bill	0.02	0.01	0.12
3-Month LIBOR	0.42	0.40	0.29
1-Year Treasury	0.14	0.15	0.23
2-Year Treasury	0.27	0.27	0.35
5-Year Treasury	1.08	1.11	1.13
10-Year Treasury	2.21	2.25	2.55
30-Year Treasury	3.25	3.23	3.96
Bond Buyer Index	4.08	4.17	3.84

Foreign Exchange Rates

	Friday 10/21/2011	1 Week Ago	1 Year Ago
Euro ($/€)	1.389	1.388	1.392
British Pound ($/₤)	1.593	1.582	1.570
British Pound (₤/€)	0.872	0.877	0.886
Japanese Yen (¥/$)	76.150	77.220	81.330
Canadian Dollar (C$/$)	1.009	1.010	1.027
Swiss Franc (CHF/$)	0.884	0.892	0.968
Australian Dollar (US$/A$)	1.035	1.034	0.977
Mexican Peso (MXN/$)	13.646	13.243	12.391
Chinese Yuan (CNY/$)	6.384	6.380	6.650
Indian Rupee (INR/$)	50.025	49.024	44.305
Brazilian Real (BRL/$)	1.775	1.733	1.697
U.S. Dollar Index	76.327	76.623	77.418

Foreign Interest Rates

	Friday 10/21/2011	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.52	1.51	0.96
3-Month Sterling LIBOR	0.98	0.97	0.74
3-Month Canadian LIBOR	1.24	1.22	1.22
3-Month Yen LIBOR	0.20	0.20	0.20
2-Year German	0.65	0.66	1.00
2-Year U.K.	0.60	0.62	0.60
2-Year Canadian	1.08	1.06	1.40
2-Year Japanese	0.15	0.14	0.14
10-Year German	2.11	2.20	2.48
10-Year U.K.	2.56	2.61	2.94
10-Year Canadian	2.35	2.40	2.76
10-Year Japanese	1.01	1.02	0.89

Commodity Prices

	Friday 10/21/2011	1 Week Ago	1 Year Ago
WTI Crude ($/Barrel)	88.02	86.80	80.56
Gold ($/Ounce)	1645.55	1680.73	1325.68
Hot-Rolled Steel ($/S.Ton)	660.00	669.00	562.00
Copper (¢/Pound)	305.45	330.25	378.85
Soybeans ($/Bushel)	11.95	12.22	11.60
Natural Gas ($/MMBTU)	3.57	3.70	3.37
Nickel ($/Metric Ton)	17,969	18,416	23,879
CRB Spot Inds.	535.61	538.95	538.64

Next Week's Economic Calendar

	Monday 24	Tuesday 25	Wednesday 26	Thursday 27	Friday 28
U.S. Data		**Consumer Confidence** September 45.4 October 47.2 (W) **Home Price Index** July 0.8% August 0.2% (c)	**Durable Goods Orders** August -0.1% September -0.5% (W) **New Home Sales** August 295K September 306K (W)	**GDP (Q/Q Annualized)** Q2 1.3% Q3-A 2.1% (W) **Core PCE (QoQ)** Q2 2.3% Q3-A 2.2% (c) **Pending Home Sales** September -1.2% October 0.3% (c)	**Personal Income** August -0.1% September 0.3% (W) **Personal Spending** August 0.2% September 0.5% (W) **Employment Cost** Q2 0.7% Q3 0.7% (W)
Global Data	**Eurozone** **Manufacturing PMI** Previous (Sep) 48.5 **Eurozone** **Services PMI** Previous (Sep) 48.8	**Canada** **BoC Rate Decision** Previous 1.00%	**Japan** **Retail Trade (YoY)** Previous (Aug) -2.6%	**Germany** **CPI (MoM)** Previous (Sep) 0.1% **Japan** **CPI (YoY)** Previous (Aug) 0.2%	**Japan** **IP (MoM)** Previous (Aug) 0.8%

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

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 715-0314	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economist	(704) 374-4407	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 715-0569	michael.a.brown@wellsfargo.com
Joe Seydl	Economic Analyst	(704) 715-1488	joseph.seydl@wellsfargo.com
Sarah Watt	Economic Analyst	(704) 374-7142	sarah.watt@wellsfargo.com
Kaylyn Swankoski	Economic Analyst	(704) 715-0526	kaylyn.swankoski@wellsfargo.com