

Economics Group

MONTHLY OUTLOOK

U.S. Overview

A Five-Handle for Fourth Quarter Real GDP?

Our estimate for fourth quarter real GDP has been raised significantly as a result of October and November's stronger inventory numbers. We are still expecting a \$20 billion drop in inventories, so there is some upside risk. The slower pace of inventory liquidations is expected to add around 4 percentage points to real GDP growth during the fourth quarter, which should send the headline GDP number up at a 5.6 percent pace.

Fourth quarter GDP growth in the 5 percent plus range will lead to plenty of proclamations that the recession is over. That would not mark a significant change, however, as we have stated repeatedly we believe the recession ended around the middle of 2009. Any further conclusions, however, are decidedly less clear. One thing certain is the unusually long inventory cycle that began shortly after housing prices peaked in 2006 is finally drawing to an end. Inventories will likely move back into positive territory in coming quarters, but the impact on the quarterly GDP numbers will diminish.

Following a blowout number for the fourth quarter, real GDP growth will more closely follow final sales. Final sales are expected to rise at around a 1.5 percent annual rate through the middle of 2010. That pace is still close to our earlier forecast.

Final demand continues to be restrained by weak employment conditions. Unemployment is expected to remain above 10 percent for all of 2010. Nonfarm employment will likely move back into positive territory this spring, helped by the hiring of hundreds of thousands of temporary Census workers.

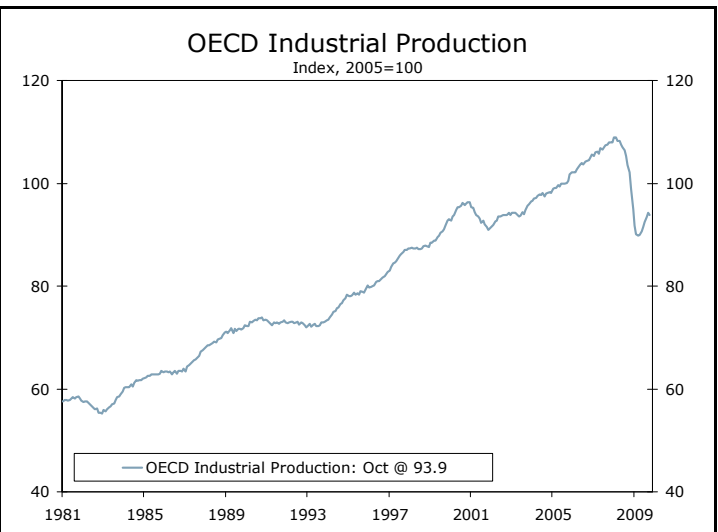
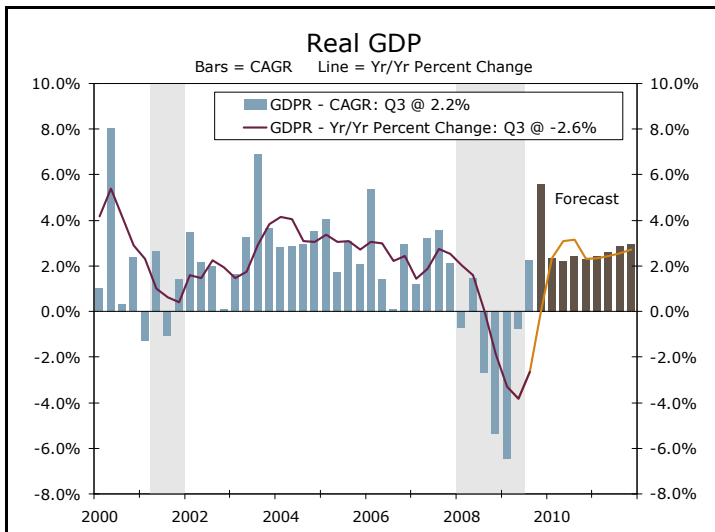
International Overview

Global Recovery Has Continued into 2010

After falling into its deepest recession in decades, the global economy started to grow again in mid-2009 and most indicators suggest that the expansion continued into the fourth quarter of last year. That said, economic activity in most countries remains well below peaks that were reached in early 2008, and it likely will be some time before these previous peaks are surpassed.

Asia is leading the way in the global recovery. Not only did most Asian governments respond to the financial crisis with large fiscal stimulus programs, but the financial systems of most Asian economies did not blow up in the autumn of 2008 because they were not highly levered at that time. Most central banks in Asia probably will start to tighten policy over the next few months. Many economies in South America are also bouncing back.

Europe appears to be lagging other regions at present. Although purchasing managers' indices have been in expansion territory for a number of months, "hard" data have generally been less encouraging. Indeed, real retail spending in the Euro-zone has not yet broken the downward trend that has been in place since May 2008. Due to the weak economy and the benign rate of inflation, we believe that the ECB will not hike rates until late this year. Likewise, the Bank of England likely will refrain from tightening until the second half of the year because the British economy is only now emerging slowly from its six quarter slump.



Source: OECD, U.S. Department of Commerce and Wells Fargo Securities, LLC



So Much Growth, Yet So Few Jobs

Real GDP growth is expected to rise at a 5.6 percent annual rate during the fourth quarter, as a dramatic slowdown in the rate of inventory liquidations adds around 4 percentage points to growth. Stronger real GDP growth did not translate into employment gains. Nonfarm employment fell by 208,000 jobs during the fourth quarter and the unemployment rate averaged 10 percent, up from 9.6 percent during the previous quarter.

There were a few rays of hope in the employment data. The rate of decline in nonfarm payrolls slowed significantly during the fourth quarter and November actually now shows a 4,000-job gain. Unfortunately, the benchmark revisions scheduled to be released next month are expected to significantly increase the size of earlier job losses. After the revisions, we expect nonfarm payrolls to show a net loss of 8.1 million jobs since the recession began, which is a loss of 830,000 more jobs than currently reported.

Our forecast now calls for a slight gain in employment during the first quarter of 2010, marking the first positive quarter for nonfarm employment since the fourth quarter of 2007. Employment gains during 2010 will be helped by the hiring of hundreds of thousands of temporary Census workers. As a result, the apparent improvement in employment will likely produce only minor gains in wage and salary income.

Aside from the hiring of Census workers, overall job growth is expected to remain exceptionally lean. Businesses are still concerned about the staying power of the recovery and are also uncertain as to what the outcome of the health care legislation will be. The health care debate has put hiring and investment decisions in a holding pattern. Once a plan is passed or it is determined that a bill will not pass, hiring and investment will both likely increase and we have a gradual recovery in nonfarm payrolls building momentum over the forecast period. A similar situation occurred during the buildup to the Iraq War

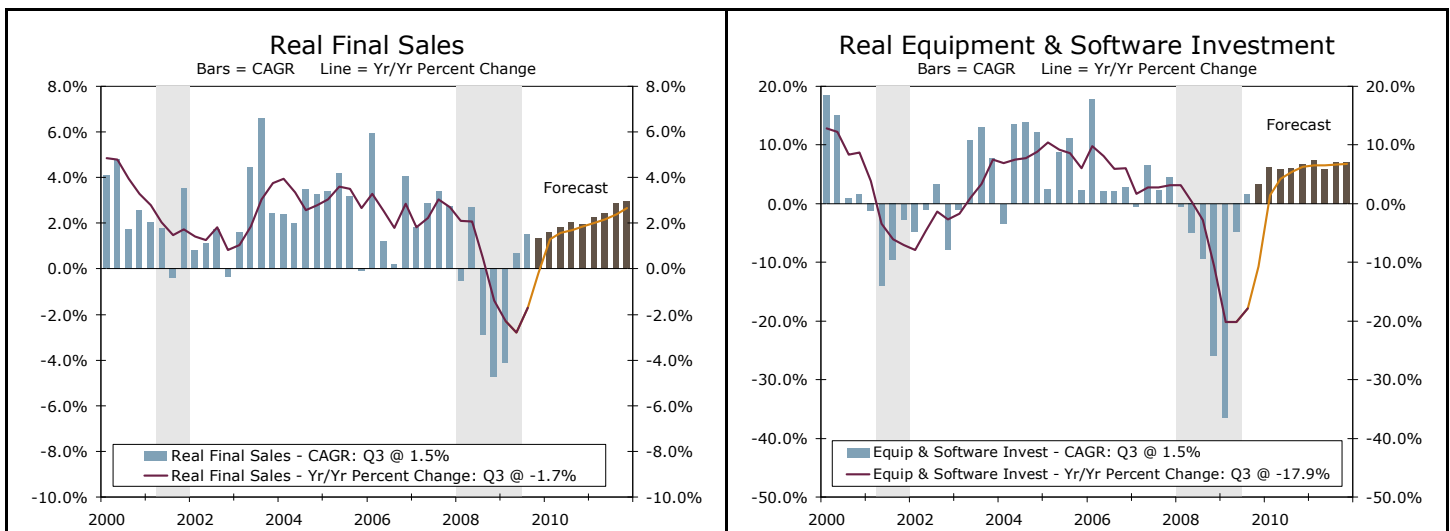
and activity picked up once hostilities began and businesses knew what the operating environment would be.

Weak employment conditions will continue to restrain income and spending. After a slightly better-than-expected holiday shopping season, real personal consumption expenditures are expected slow during the first quarter and growth is expected to average just a 1.4 percent pace for all of 2010. Consumers face a number of hurdles going into the New Year. In addition to high unemployment and sluggish income growth, prices have picked up for a number of key household necessities, including food, gasoline and household utilities. State and local taxes and user fees are also expected to rise more rapidly.

We expect consumer spending to gradually build momentum over the course of 2010, reflecting a slight improvement in nonfarm employment. Spending for big-ticket discretionary items will not likely improve meaningfully until the unemployment rate starts declining in 2011.

The outlook for business fixed investment has improved slightly from our previous forecast. Spending for equipment and software is benefitting from strong demand for handheld communications devices. Spending for structures remains depressed, however, with double-digit declines expected through the middle of 2010. Outlays for other business equipment, including trucks and commercial airliners, should boost investment spending in 2011.

We have slightly raised our interest rate projections to incorporate our improved forecast for 2011 economic growth and slightly higher inflation. Core inflation should remain well behaved early in the forecast period but is expected to gain momentum in 2011. Bond yields are expected to rise in anticipation of stronger economic growth. The Fed is expected to hike short-term interest rates in late 2010, possibly at the November FOMC meeting, which ends the day after the mid-term elections.



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Wells Fargo U.S. Economic Forecast

	Actual																Forecast																
	2008				2009				2010				2011				2007		2008		2009			2010			2011						
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q																	
Real Gross Domestic Product (a)	-0.7	1.5	-2.7	-5.4	-6.4	-0.7	2.2	5.6	2.3	2.2	2.4	2.3	2.4	2.6	2.9	3.0	2.1	0.4	-2.4	2.7	2.5												
Personal Consumption	-0.6	0.1	-3.5	-3.1	0.6	-0.9	2.8	1.4	1.2	1.3	1.4	1.5	1.9	2.0	2.1	2.2	2.6	-0.2	-0.6	1.4	1.8												
Business Fixed Investment	1.9	1.4	-6.1	-19.4	-39.2	-9.6	-5.9	-2.1	0.4	0.9	2.5	3.8	5.9	4.8	6.1	6.5	6.2	1.6	-18.1	-1.0	4.6												
Equipment and Software	-0.5	-5.0	-9.4	-25.9	-36.4	-4.9	1.5	3.3	6.3	5.9	6.1	6.6	7.4	5.8	7.0	7.0	2.6	-2.6	-17.4	4.3	6.6												
Structures	6.8	14.5	-0.1	-7.2	-43.6	-17.3	-18.4	-16.0	-13.0	-11.0	-6.5	-3.5	1.5	2.0	3.5	5.0	14.9	10.3	-19.7	-12.9	-0.8												
Residential Construction	-28.2	-15.8	-15.9	-23.2	-38.2	-23.2	18.9	4.0	4.0	9.0	10.0	10.0	10.0	10.0	12.0	12.0	-18.5	-22.9	-20.5	5.8	10.3												
Government Purchases	2.6	3.6	4.8	1.2	-2.6	6.7	2.7	2.6	1.9	1.6	2.8	1.5	1.2	1.2	1.8	1.0	1.7	3.1	2.1	2.4	1.5												
Net Exports	-550.9	-476.0	-479.2	-470.9	-386.5	-330.4	-357.4	-357.1	-348.0	-340.8	-340.0	-342.4	-346.3	-344.4	-339.8	-330.4	-647.7	-494.3	-357.9	-342.8	-340.2												
Pct. Point Contribution to GDP	0.4	2.4	-0.1	0.5	2.6	1.7	-0.8	0.0	0.3	0.2	0.0	-0.1	-0.1	0.1	0.1	0.3	0.6	1.2	1.0	0.1	0.0												
Inventory Change	0.6	-37.1	-29.7	-37.4	-113.9	-160.2	-139.2	-20.0	2.5	15.0	28.0	40.0	45.0	50.0	50.0	50.0	19.5	-25.9	-108.3	21.4	48.8												
Pct. Point Contribution to GDP	-0.2	-1.3	0.3	-0.6	-2.4	-1.4	0.7	3.7	0.7	0.4	0.4	0.4	0.1	0.1	0.0	0.0	-0.3	-0.3	-0.6	1.0	0.2												
Nominal GDP	1.0	3.5	1.4	-5.4	-4.6	-0.8	2.6	6.5	3.3	3.3	3.7	3.8	4.2	4.4	4.8	5.0	5.1	2.6	-1.3	3.6	4.2												
Real Final Sales	-0.5	2.7	-2.9	-4.7	-4.1	0.7	1.5	1.4	1.6	1.8	2.1	1.9	2.3	2.4	2.9	3.0	2.5	0.8	-1.7	1.6	2.3												
Retail Sales (b)	2.6	2.4	0.3	-8.3	-8.9	-9.5	-6.7	1.6	3.9	4.9	4.3	4.2	4.3	4.8	4.8	4.9	3.3	-0.8	-6.0	4.3	4.7												
Inflation Indicators (b)																																	
"Core" PCE Deflator	2.4	2.5	2.6	2.0	1.7	1.6	1.3	1.4	1.3	1.1	1.2	1.3	1.4	1.5	1.6	1.7	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	-1.6	1.5	2.7	2.7	2.2	1.8	1.7	2.0	2.2	2.4	2.9	3.8	-0.3	2.3	2.1												
"Core" Consumer Price Index	2.4	2.3	2.5	2.0	1.7	1.8	1.5	1.7	1.6	1.2	1.1	1.1	1.2	1.4	1.6	1.7	2.3	2.3	1.7	1.2	1.5												
Producer Price Index	7.2	7.6	9.5	1.4	-2.2	-4.0	-5.2	1.8	4.4	4.5	3.9	2.5	2.2	2.2	2.4	2.4	3.9	6.4	-2.4	3.8	2.3												
Employment Cost Index	3.3	3.1	2.9	2.6	2.1	1.8	1.5	1.6	1.9	1.6	1.6	1.7	1.8	1.7	1.7	1.8	3.4	3.0	1.8	1.2	1.7												
Real Disposable Income (a)	-2.4	9.8	-8.5	3.4	0.2	6.2	-1.4	0.7	1.1	1.5	1.8	2.0	2.2	2.4	2.6	2.7	2.2	0.5	1.2	1.2	2.2												
Nominal Personal Income (b)	3.7	4.0	2.9	1.1	-1.6	-2.0	-1.7	-0.3	2.7	2.7	3.4	3.5	4.0	4.1	4.1	4.3	5.6	2.9	-1.4	3.1	4.1												
Industrial Production (a)	0.2	-4.6	-9.0	-13.0	-19.0	-10.4	6.1	6.1	5.8	4.2	3.8	7.3	6.4	6.1	6.0	5.0	1.5	-2.2	-9.8	4.3	5.9												
Capacity Utilization	80.1	78.9	76.9	74.2	70.4	68.7	69.9	71.2	72.0	72.5	73.0	74.3	75.3	76.2	76.9	77.4	80.6	77.6	70.0	72.9	76.4												
Corporate Profits Before Taxes (b)	-4.9	-12.0	-5.4	-25.1	-19.0	-12.6	-6.6	24.0	22.0	16.0	10.0	8.5	8.0	7.5	8.0	8.5	-4.1	-11.8	-5.1	13.8	8.0												
Corporate Profits After Taxes	6.6	-3.7	4.8	-15.8	-19.7	-15.3	-9.7	34.0	32.0	20.0	15.0	9.0	8.5	9.0	10.5	11.0	-4.0	-2.0	-4.6	18.2	9.8												
Federal Budget Balance (c)	-205.9	26.9	-168.9	-332.5	-448.9	-304.9	-330.8	-336.7	-591.8	-176.2	-255.4	-275.2	-436.9	-168.3	-219.6	-180.0	-161.5	-454.8	-1417.1	-1360.0	-1100.0												
Current Account Balance (d)	-179.3	-187.7	-184.2	-154.9	-104.5	-98.0	-108.0	-125.0	-130.0	-130.0	-130.0	-135.0	-130.0	-130.0	-125.0	-125.0	-726.6	-706.1	-435.5	-525.0	-510.0												
Trade Weighted Dollar Index (e)	70.3	71.0	76.1	79.4	83.2	77.7	74.3	74.7	73.6	73.4	75.0	77.1	79.5	80.8	81.6	82.5	73.3	79.4	74.7	77.1	82.5												
Nonfarm Payroll Change (f)	-113	-153	-208	-553	-691	-428	-199	-69	40	80	-30	110	130	135	150	165	96	-257	-347	50	145												
Unemployment Rate	5.0	5.3	6.0	7.0	8.2	9.3	9.6	10.0	10.2	10.2	10.5	10.5	10.4	10.2	10.0	9.6	4.6	5.8	9.3	10.4	10.1												
Housing Starts (g)	1.06	1.02	0.87	0.66	0.53	0.54	0.59	0.56	0.60	0.65	0.68	0.71	0.74	0.77	0.82	0.88	1.34	0.90	0.55	0.66	0.80												
Light Vehicle Sales (h)	15.2	14.1	12.9	10.5	9.5	9.6	11.5	10.8	11.0	11.0	11.0	11.3	11.6	11.9	12.2	12.5	16.1	13.2	10.3	11.1	12.1												
Crude Oil - WTI - Front Contract (i)	97.90	123.98	117.98	58.74	43.08	59.62	68.30	76.19	79.00	82.00	80.00	80.00	82.00	84.00	87.00	90.00	72.31	99.65	61.80	80.25	85.75												
Quarter-End Interest Rates																																	
Federal Funds Target Rate	2.25	2.00	2.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	1.25	2.00	2.75	3.25	4.25	0.25	0.25	0.50	3.25												
3 Month LIBOR	2.69	2.78	4.05	1.43	1.19	0.60	0.29	0.25	0.30	0.35	0.55	0.80	1.50	2.35	3.10	3.60	4.70	1.43	0.25	0.80	3.60												
Prime Rate	5.25	5.00	5.00	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.50	4.25	5.00	5.75	6.25	7.25	3.25	3.25	3.50	6.25												
Conventional Mortgage Rate	5.97	6.32	6.04	5.33	5.00	5.42	5.06	4.88	5.50	5.90	6.00	6.10	6.10	6.20	6.30	6.50	6.10	5.33	4.88	6.10	6.50												
3 Month Bill	1.38	1.90	0.92	0.11	0.21	0.19	0.14	0.06	0.10	0.10	0.30	0.55	1.25	2.10	2.85	3.35	3.36	0.11	0.06	0.55	3.35												
2 Year Note	1.62	2.63	2.00	0.76	0.81	1.11	0.95	1.14	1.10	1.30	1.50	1.70	2.20	2.80	3.40	3.90	3.05	0.76	1.14	1.70	3.90												
5 Year Note	2.46	3.34	2.98	1.55	1.67	2.54	2.31	2.69	2.60	2.70	3.00	3.20	3.30	3.60	3.80	4.30	3.45	1.55	2.69	3.20	4.30												
10 Year Note	3.45	3.99	3.85	2.25	2.71	3.53	3.31	3.85	3.80	4.00	4.20	4.40	4.50	4.60	4.70	4.90	4.04	2.25	3.85	4.40	4.90												
30 Year Bond	4.30	4.53	4.31	2.69	3.56	4.32	4.03	4.63	4.70	4.90	5.10	5.20	5.30	5.40	5.50	5.70	4.45	2.69	4.63	5.20	5.70												

Forecast as of: January 13, 2010

Notes: (a) Compound Annual Growth Rate Quarter-over-Quarter

(b) Year-over-Year Percentage Change

(c) Quarterly Sum - Billions USD; Annual Data Represents Fiscal Yr.

(d) Quarterly Sum - Billions USD

(e) Federal Reserve Major Currency Index, 1973=100 - Quarter End

(f) Average Monthly Change

(g) Millions of Units

(h) Quarterly Data - Average Monthly SAAR; Annual Data - Actual Total Vehicles Sold

(i) Quarterly Average of Daily Close

Global Recovery Has Continued into 2010

As we have written previously, the global economy endured its deepest recession in decades during the last two years. Between the peak in February 2008 and the trough in March 2009, industrial production (IP) in the 30 economies that comprise the Organization for Economic Cooperation and Development (OECD)—essentially the 30 most advanced economies in the world—plunged 18 percent. Through October, IP in the OECD countries had bounced back only 5 percent, leaving it 14 percent below its pre-recession peak (see graph on front page). That said, the global economy is growing again, and it is unrealistic to expect it to immediately climb out of the deep hole into which it fell in the aftermath of the global financial meltdown. Moreover, purchasing managers' indices suggest that the manufacturing and service sectors in most economies continued to expand through the rest of the fourth quarter.

Asia appears to be the strongest economic region of the world at present. For example, growth in Chinese IP has come roaring back (bottom chart). Not only did most Asian governments respond to the financial crisis with large fiscal stimulus programs, but the financial systems of most Asian economies did not blow up in the autumn of 2008 because they were not highly levered at that time. Therefore, bank lending in most countries in the region has remained fairly strong.

Growth has also returned to many South American economies as well. In Brazil, IP in the October-November period was up 3.8 percent (not annualized) relative to the third quarter, which in turn had shot up 4.8 percent relative to the second quarter. The Central Bank of Chile's economic activity index, which is a close proxy for GDP growth, was up 3.1 percent on a year-ago basis in November.

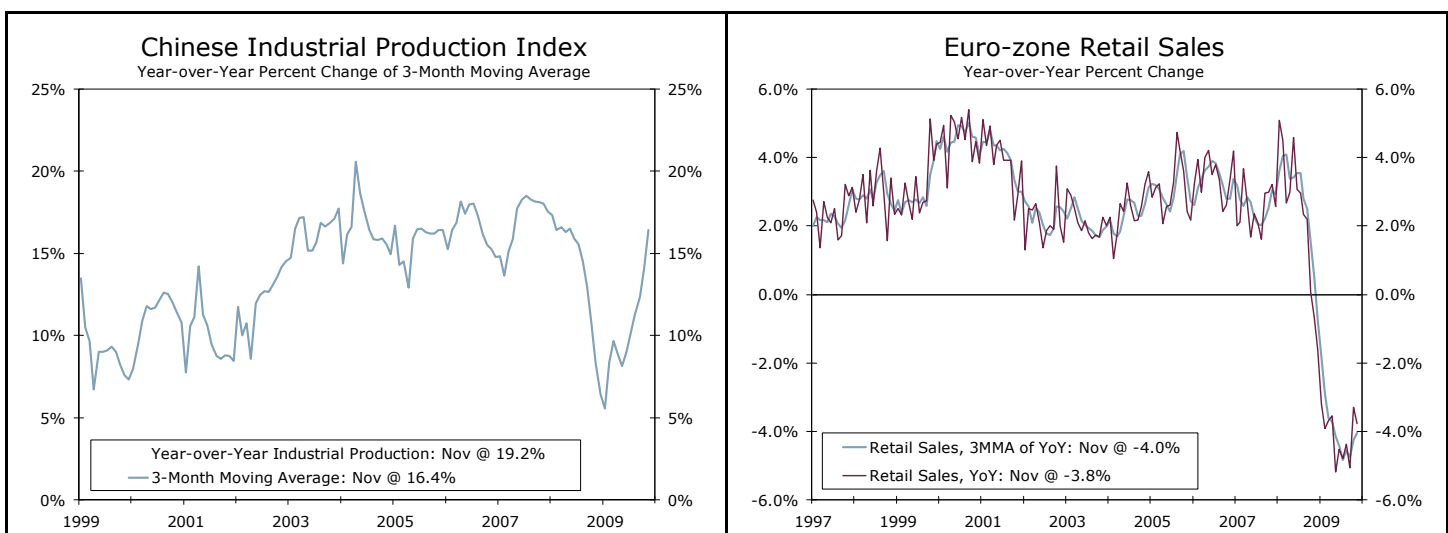
In contrast, growth in Europe has not been as strong. In the Euro-zone, the sequential rate of real GDP growth in the third quarter printed at 0.4 percent (not annualized), and the

purchasing managers' indices suggest that growth remained positive in the fourth quarter. However, "hard" data have been less encouraging. Industrial orders in the overall euro area were flat on balance between July and October, and lackluster orders have translated into softness in IP. Part of the problem with euro-area production reflects sluggish consumer spending (bottom chart). Indeed, the volume of retail sales in the Euro-zone has not yet broken the downward trend that has been in place since May 2008. Greece has endured a horrific 20 percent drop in real retail sales over that period.

Monetary Tightening Will Not Be Synchronous

As the global economy crawls further out of its hole, it is natural to ask when central banks will begin to take back the extraordinary amount of stimulus they applied in late 2008 and early 2009 to keep the global financial system from imploding. Actually, some central banks have already begun to tighten policy. For example, the Norwegian central bank has lifted its main policy rate by 50 bps since late October, and the Reserve Bank of Australia has hiked rates by 75 bps. Given the underlying strength of most Asian economies, central banks in the region will tighten policy sooner or later. Because inflation rates in some Asian countries are beginning to creep higher again, we look for tightening cycles to commence over the next few months.

However, we maintain that it will be some time—probably late this year—before the European Central Bank contemplates a rate hike. As noted above, economic activity in the euro area remains weak, and the core rate of CPI inflation has declined to a nine-year low of only 1.0 percent. Likewise, the Bank of England likely will refrain from tightening until the second half of the year because the British economy is only now emerging slowly from its six quarter slump.



Source: IHS Global Insight and Wells Fargo Securities, LLC

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2009	2010	2011	2009	2010	2011
Global (PPP weights)	-0.7%	4.0%	4.2%	2.7%	4.1%	4.1%
Global (Market Exchange Rates)	-1.9%	2.8%	3.0%	n/a	n/a	n/a
Advanced Economies ¹	-3.3%	2.4%	2.6%	-0.3%	1.7%	1.8%
United States	-2.4%	2.7%	2.5%	-0.3%	2.3%	2.1%
Eurozone	-3.9%	1.6%	2.6%	0.3%	1.5%	1.5%
United Kingdom	-4.8%	1.7%	2.5%	2.1%	2.5%	2.0%
Japan	-5.2%	2.2%	1.6%	-1.3%	-0.6%	0.5%
Korea	0.4%	5.2%	3.6%	2.8%	2.7%	2.9%
Canada	-2.6%	2.2%	2.8%	0.3%	2.3%	1.9%
Developing Economies ¹	2.4%	5.9%	6.0%	6.4%	6.9%	6.9%
China	8.5%	9.4%	9.0%	-0.7%	2.3%	2.8%
India	7.0%	8.1%	8.3%	11.1%	10.3%	7.7%
Mexico	-6.9%	2.8%	3.1%	5.3%	4.0%	4.2%
Brazil	-0.9%	2.9%	3.5%	4.9%	4.8%	4.8%
Russia	-7.3%	3.0%	4.1%	11.8%	7.0%	9.0%

Forecast as of: January 13, 2010

¹Aggregated Using PPP Weights

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2010				2011		2010				2011	
	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q2	Q3	Q4	Q1	Q2
U.S.	0.30%	0.35%	0.55%	0.80%	1.50%	2.35%	3.80%	4.00%	4.20%	4.40%	4.50%	4.60%
Japan	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	1.30%	1.35%	1.45%	1.55%	1.60%	1.70%
Euroland	0.70%	0.80%	1.00%	1.50%	2.00%	2.75%	3.30%	3.50%	3.90%	4.25%	4.40%	4.45%
U.K.	0.60%	0.65%	0.90%	1.45%	2.20%	3.20%	3.80%	3.90%	4.20%	4.50%	4.60%	4.75%
Canada	0.50%	0.60%	1.00%	2.00%	3.00%	3.75%	3.50%	3.60%	4.00%	4.30%	4.40%	4.45%

Forecast as of: January 13, 2010

Source: Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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