

WEEKLY ECONOMIC & FINANCIAL COMMENTARY

August 22, 2008

U.S. Review

Growth Will Not Be Snuffed Out By The Summer Wind

Preseason football, the end of the Summer Olympics and the onset of the political conventions signal that fall is just around the corner. And somehow, miraculously, the economy continues to eke out at some modicum of growth. Second quarter real GDP growth will likely be revised up to around a 3 percent pace and growth during the current quarter should be 1.5 percent.

The second half of 2008 will be very challenging. Questions about the viability of Fannie Mae and Freddie Mac are keeping mortgage rates higher than they should be, putting additional strain on home sales. Slower job and income growth, declining home prices, and the end of tax rebates should produce at least a modest pullback in consumer spending; we expect outright declines in the next two quarters.

Business investment appears set to slow as well. Lending standards for all types of loans continue to tighten, forcing some businesses to make difficult decisions. Profits remain under pressure, although many firms have offset some of their higher costs with strong productivity gains.

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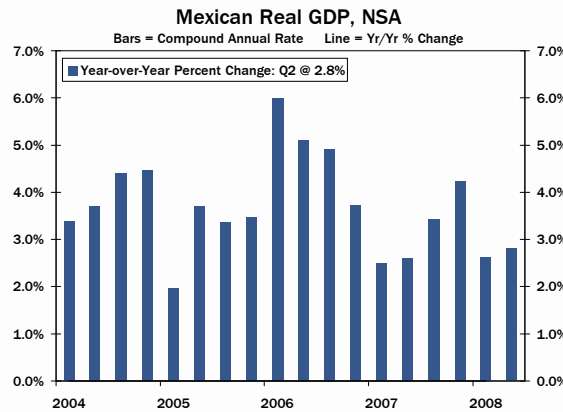
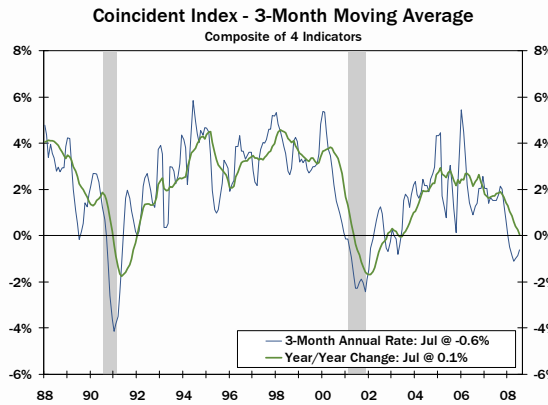
Global Review

Mexican Growth Remains Slow

The Mexican economy continues to expand, albeit at a relatively slow pace. Data released this week showed that real GDP rose 2.8 percent in the second quarter, up marginally from the 2.6 percent year-over-year growth rate registered in the first quarter (see graph at left). Indeed, Mexican GDP growth has generally followed a downward trend since early 2006, in line with the slowdown observed in the U.S. economy.

A breakdown of real GDP into its underlying demand components is not yet available, but monthly data offer some clues as to the culprits behind the slowdown. As shown in the top graph on page four, growth in Mexican industrial production has essentially stalled this year. No doubt the slowdown in the United States, to which Mexico sends 85 percent of its exports, is contributing to slower growth south of the border.

Please turn to page 4



Recent Special Commentary

Date	Title	Authors
August-19	"Older and More Diverse Nation by Midcentury"	Vitner & York
August-19	Commercial Real Estate Quarterly: Second Quarter	Vitner & Khan
August-15	Consumers Feeling A Little Blue This Year	Vitner & York
August-14	The Outlook for U.S. Export Growth Revisited	Bryson

U.S. Forecast

	Actual				Forecast				Actual			Forecast		
	2007 1Q	2007 2Q	2007 3Q	2007 4Q	2008 1Q	2008 2Q	2008 3Q	2008 4Q	2005	2006	2007	2008	2009	2010
Real Gross Domestic Product ¹	0.0	4.8	4.8	-0.2	0.9	1.9	2.2	1.2	2.9	2.8	2.0	1.8	1.8	2.1
Personal Consumption	3.9	2.0	2.0	1.0	0.9	1.5	-0.7	-0.7	3.0	3.0	2.8	0.9	0.7	2.2
Inflation Indicators ²														
"Core" PCE Deflator	2.3	2.1	2.0	2.2	2.2	2.2	2.2	1.9	2.1	2.3	2.2	2.1	1.8	1.9
Consumer Price Index	2.4	2.6	2.4	4.0	4.2	4.3	5.1	3.5	3.4	3.2	2.9	4.3	2.1	1.9
Industrial Production ¹	1.5	3.2	3.6	0.3	0.5	-3.1	0.2	2.0	3.3	2.2	1.7	0.4	2.0	3.3
Corporate Profits Before Taxes ²	-1.0	-0.5	-2.7	-2.0	-1.5	-8.0	-6.0	-10.5	17.6	15.2	-1.6	-6.5	4.9	9.2
Trade Weighted Dollar Index ³	80.5	78.7	74.4	73.3	70.3	71.0	72.5	73.6	86.0	81.5	73.3	73.6	82.4	90.0
Unemployment Rate	4.5	4.5	4.7	4.8	4.9	5.3	5.7	5.8	5.1	4.6	4.6	5.5	6.2	6.3
Housing Starts ⁴	1.45	1.46	1.30	1.15	1.05	1.02	0.91	0.90	2.07	1.81	1.34	0.97	1.00	1.30
Quarter-End Interest Rates														
Federal Funds Target Rate	5.25	5.25	4.75	4.25	2.25	2.00	2.00	2.00	4.25	5.25	4.25	2.00	2.00	3.00
10 Year Note	4.65	5.03	4.59	4.04	3.45	3.99	4.00	3.90	4.39	4.71	4.04	3.90	4.00	5.20

Data As of: August 6, 2008

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

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Slogging Through The Credit Crunch

The first tidbits from the Fed's annual retreat this weekend in Jackson Hole, Wyoming came out this morning. Ben Bernanke noted that "the financial storm that reached gale force some weeks before our last meeting here in Jackson Hole has not yet subsided, and its effects on the broader economy are becoming apparent in the form of softening economic activity and rising unemployment." While this sentence, which was in the first paragraph of his remarks, contained little new information, we believe it shows the Fed's primary concern today remains containing the damage from the credit crunch on the broader economy. Talk of a rate hike, which was prevalent a few weeks ago, has resurfaced, while the prospects for a rate cut are now being discounted.

This week's economic reports were generally consistent with our forecast for continued sluggish economic growth. The index of leading indicators fell by a relatively large 0.7 percent in July, but most of the drop was due to a huge decline in building permits which was tied to a change in building regulations in New York. This quirk, however, was not responsible for the entire drop. Rising unemployment claims and declines in the money supply and stock market also pulled the index lower. The only positives were the interest rate spread and consumer sentiment. Hours worked, supplier deliveries and manufacturers new orders were all either unchanged or essentially flat.

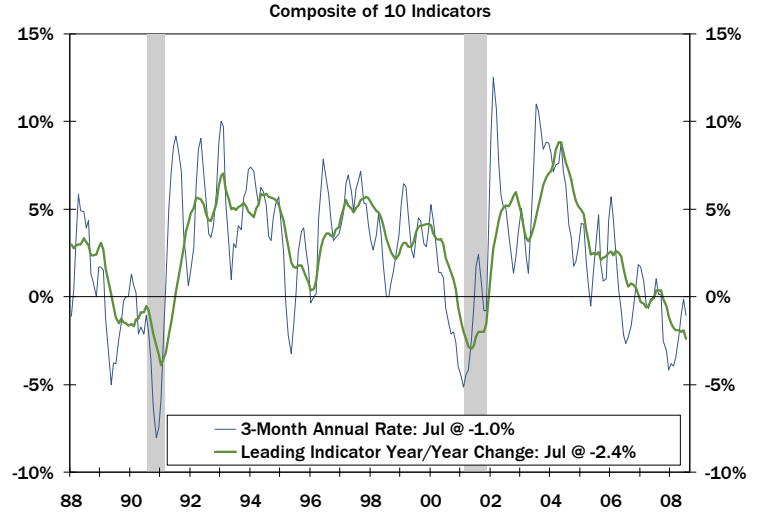
The index of coincident indicators rose 0.1 percent in July, with three of the four indicators increasing. The increase marks the first monthly gain this year. The index declined in February and May and was unchanged in all other months. The coincident index is made up of the four key economic indicators that the National Bureau of Economic Research has historically looked at to call turning points in the business cycle. The recent performance, which shows the index of coincident indicators declining 0.4 percent over the past seven months is more consistent with an economy stalling out rather than one falling into recession.

Other key economic reports included the Producer Price Index, Housing Starts, and Philadelphia Fed survey. None broke new ground. The PPI jumped 1.2 percent in July but that was the month that oil prices jumped to \$145 a barrel. Oil has come down more recently, however, and we will likely see some declines in the PPI in coming months. Housing starts fell in line with expectations and still appear to be headed lower. Home sales should bottom out in the next six to nine months. The Philadelphia Fed survey rose from -16.3 percent in July to -12.7 percent in August.

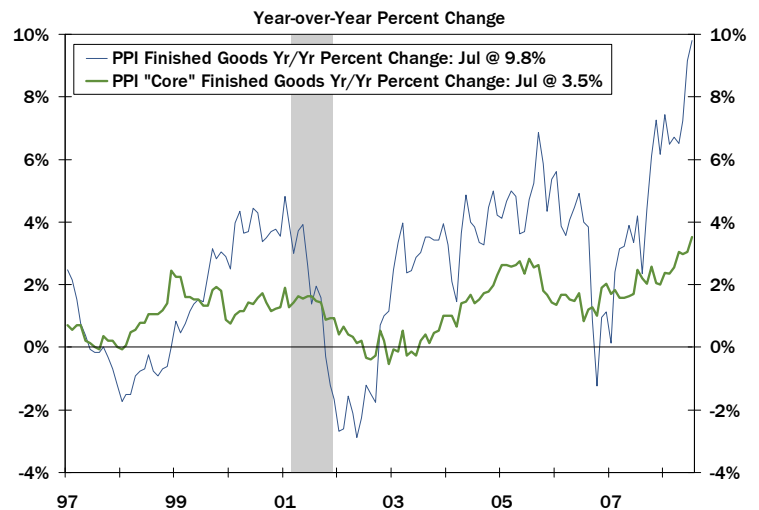
Selected Current Data

Gross Domestic Product - CAGR	Q2 - 2008	1.9%
GDP Year-over-Year	Q2 - 2008	1.8%
Personal Consumption	Q2 - 2008	1.5%
Business Fixed Investment	Q2 - 2008	2.3%
Consumer Price Index	July - 2008	5.6%
"Core" CPI	July - 2008	2.5%
"Core" PCE Deflator	June - 2008	2.3%
Industrial Production	July - 2008	-0.1%
Unemployment	July - 2008	5.7%
Federal Funds Target Rate	Aug - 22	2.00%

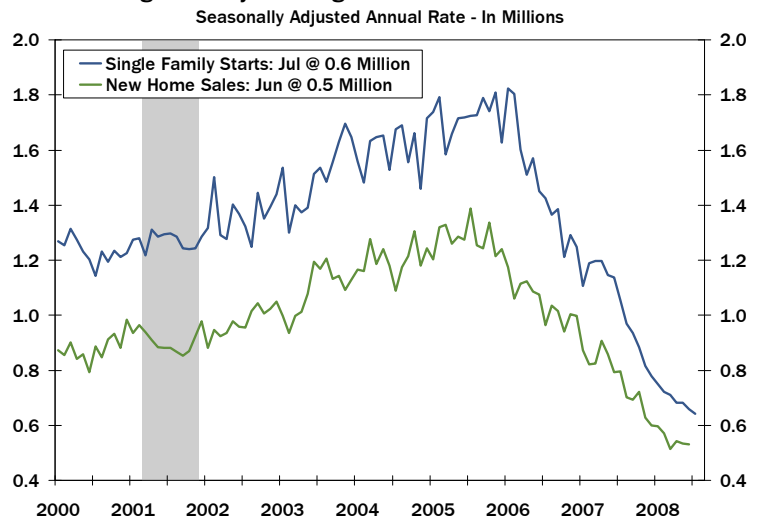
Leading Indicator Index - 3-Month Moving Average



Producer Price Index



Single Family Housing Starts and New Home Sales



Existing Home Sales • Monday

Reversing all of May's two percent increase, existing home sales fell 2.6 percent in June to an annualized rate of 4.86 million units. Elevated inventory levels remain problematic as evidenced by the supply of existing homes on the market rising to 11.1 months (single-family 11.0 months, condos 12.0 months).

The Pending Home Sales index has been strengthening as of late, albeit from depressed levels, and suggests there could be an upward surprise to the July existing home sales numbers. We believe, however, that another modest decline is probable. While it appears the descent of existing home sales could be stabilizing, tightening credit standards, higher mortgage rates and an increasing pace of foreclosures will continue to weigh on the housing market throughout 2009.

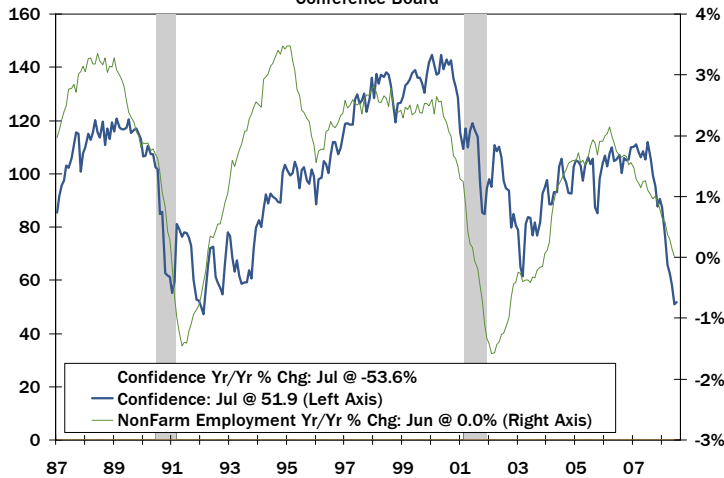
Previous: 4.86M

Wachovia: 4.75M

Consensus: 4.90M

Consumer Confidence Index

Conference Board


Real GDP • Thursday

According to the advanced estimates of the Bureau of Economic Analysis (BEA), real GDP grew at an annualized rate of 1.9 percent in the second quarter. While originally below consensus estimates, it appears growth will be revised significantly higher in the preliminary report. The BEA had assumed the trade deficit would widen in June, thereby subtracting from overall economic growth. Broad-based strength in exports, however, contributed to the unexpected narrowing in the June trade deficit to -\$56.8B. By itself, this would require the BEA to revise its estimate of second quarter growth by one full percentage point. Supporting the call for a faster rate of growth are subsequently released data from construction spending and wholesale inventories. On balance, we expect real GDP growth in the second quarter to rise towards a 2.9 percent annual rate. Growth in the third and fourth quarters should trend lower as the consumer spending outlook softens.

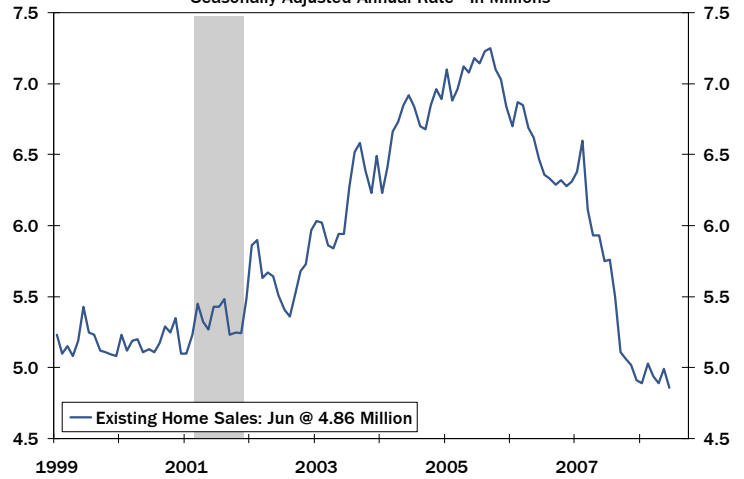
Previous: 1.9%

Wachovia: 2.9%

Consensus: 2.8%

Existing Home Resales

Seasonally Adjusted Annual Rate - In Millions


Consumer Confidence • Tuesday

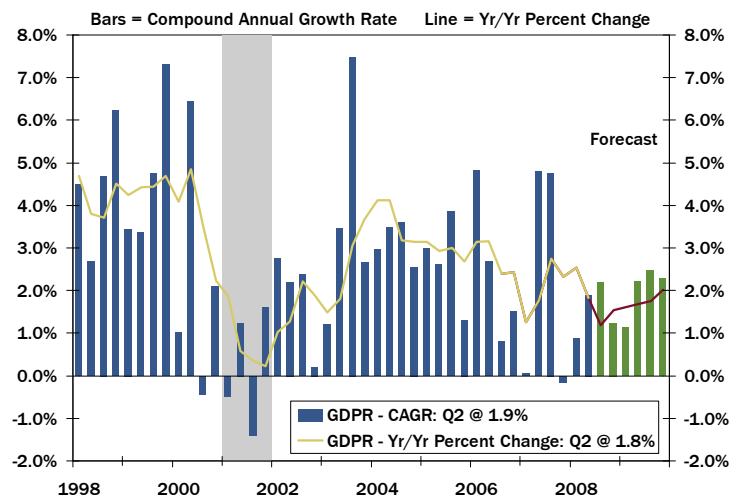
A deteriorating labor market, elevated energy prices, falling home prices and tight credit conditions continue to pressure consumers' psyche this summer. The tax rebates checks did provide some temporary relief to consumers but much of the benefit was offset by soaring gasoline costs which saw the average national price of retail gasoline reach \$4.17 a gallon by mid-July.

While we expect to see a small rebound this month due to moderating gasoline prices, consumer confidence, on balance, should remain around these depressed levels in the coming months. The climbing unemployment rate should result in slower consumer spending in the second half of the year.

Previous: 51.9

Wachovia: 54.0

Consensus: 53.0

Real GDP


Global Review

(Continued from Page 1)

Indeed, the volume of U.S. imports from Mexico in the first half of the year may be off as much as 10 percent relative to the same period in 2007.

CPI Inflation Remains Elevated

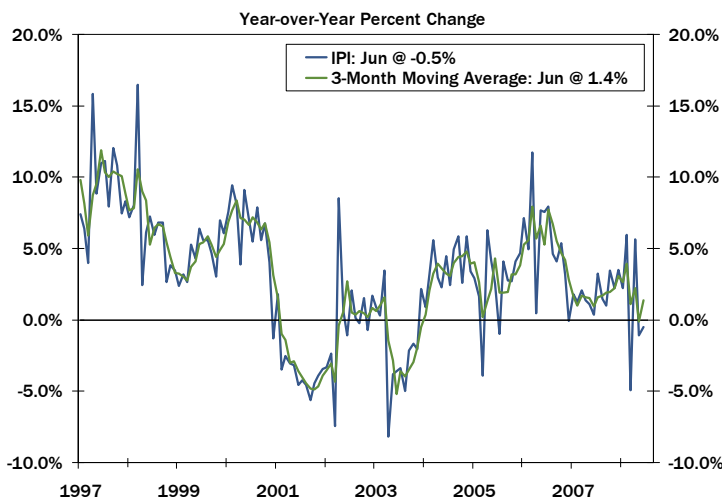
On the surface, consumer spending appears to be holding up rather well. The value of retail sales grew at a year-over-year pace of 4.3 percent in the first two months of the second quarter, little changed from the 4.5 percent pace registered in the first quarter. However, the rise in inflation over the past few months, which will be discussed in greater detail below, suggests that the pace of real consumer spending has slowed more than the headline figures on nominal retail sales suggests. The recent drop in consumer confidence to the lowest level since at least 2001, also suggests that the pace of consumer spending growth is probably weakening.

As shown in the middle chart, CPI inflation has risen this year. Although the current year-over-year rate of 5.4 percent is well below the double-digit rates that prevailed in 2000, it is well above the Bank of Mexico's target of 3 percent. If the rise in the overall rate of CPI inflation simply reflected sharp rises in food and energy prices earlier this year, the central bank could take comfort in recent declines in these prices. However, the core rate of inflation, which excludes food and energy prices, has risen to 5.1 percent. Therefore, it could take an extended period of sub-trend economic growth to bring CPI inflation back to target.

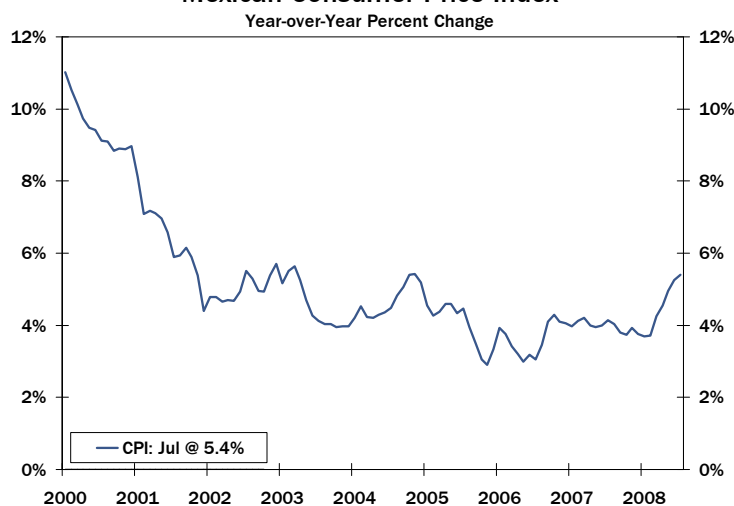
In that regard, the Bank of Mexico has been tightening policy, hiking its target for the overnight inter-bank interest rate by 75 basis points since mid-May. The increase in interest rates in Mexico relative to the United States contributed to the rise in the value of the Mexican peso versus the dollar to a six-year high earlier this month (see bottom chart).

The peso has given up some of its gains over the past two weeks as the greenback has rallied versus most currencies. Looking ahead, however, we look for the peso to strengthen anew, at least in the near term. Rates in Mexico should remain high, and the Fed likely won't be tightening policy anytime soon. Therefore, favorable interest rate differentials should continue to attract money south of the border, at least for the next few quarters.

Mexican Industrial Production Index



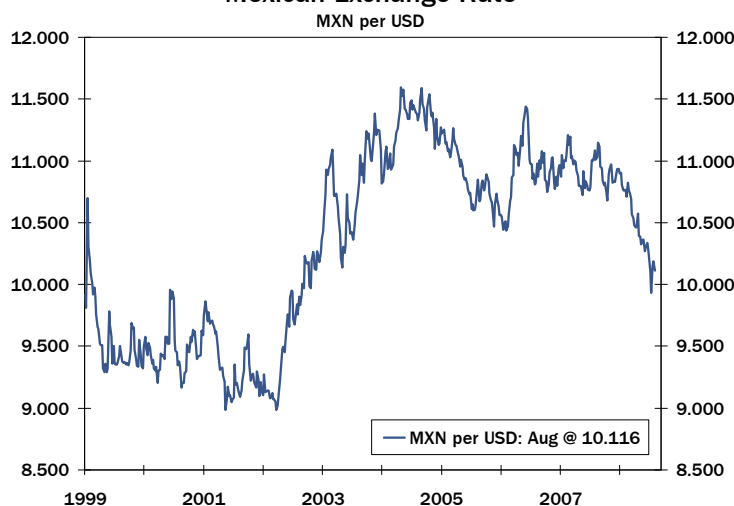
Mexican Consumer Price Index



Selected Global Data

Japan	GDP Year-over-Year	Q2 - 2008	1.0%
	CPI	June - 2008	2.0%
	Unemployment	June - 2008	4.1%
	BoJ Target Rate	Aug - 22	0.50%
Euro-Zone	GDP Year-over-Year	Q2 - 2008	1.5%
	CPI	July - 2008	4.0%
	Unemployment	June - 2008	7.3%
	ECB Target Rate	Aug - 22	4.25%
UK	GDP Year-over-Year	Q2 - 2008	1.4%
	CPI	July - 2008	4.4%
	Unemployment	July - 2008	2.7%
	BoE Target Rate	Aug - 21	5.00%
Canada	GDP Year-over-Year	May - 2008	0.6%
	CPI	July - 2008	3.4%
	Unemployment	July - 2008	6.1%
	BoC Target Rate	Aug - 22	3.00%

Mexican Exchange Rate



German Ifo Index • Tuesday

German real GDP contracted at an annualized rate of 2.0 percent in the second quarter, which reflected, at least in part, some statistical payback for the 5.2 percent growth rate registered in the first quarter. However, there is little doubt that the underlying pace of German growth is slowing. The Ifo index of business sentiment, which is fairly correlated with industrial production growth, has dropped sharply in recent months. The Ifo index for August, which will print on Tuesday, will give investors some insights into the current state of the German economy.

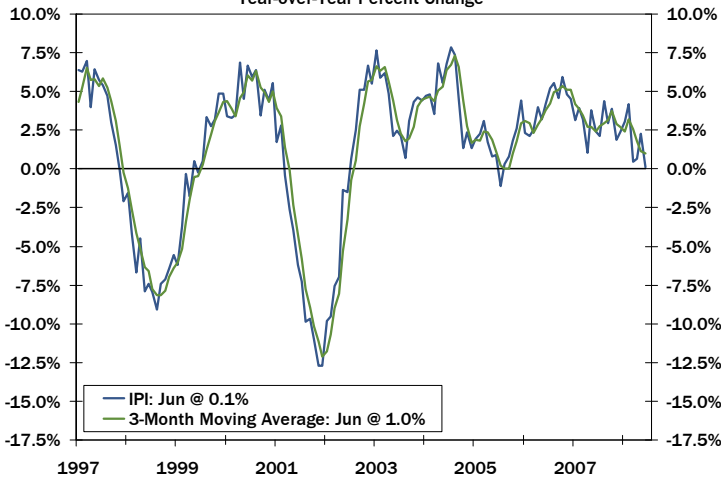
Despite signs of slower growth in the Euro-zone, the ECB has been reluctant to cut rates due to the sharp rise in CPI inflation this year. The “flash” estimate of CPI inflation in August will be released on Friday. The consensus forecast anticipates that inflation declined from 4.1 percent in July to 3.9 percent in August.

Previous: 97.5

Consensus: 97.2

Japanese Industrial Production Index

Year-over-Year Percent Change


Canadian Real GDP • Friday

Canadian real GDP fell at an annualized rate of 0.3 percent in the first quarter relative to the previous quarter. Much of the decline can be explained by the massive swing in inventories that sliced more than 5 percentage points off of the overall growth rate. While investors project a modest rebound in real GDP in the second quarter, the underlying pace of growth clearly has weakened.

Data released this week showed that the overall rate of CPI inflation did not rise as much as expected, and the core rate remained steady at only 1.5 percent. Although the Bank of Canada likely will maintain its policy rate at 3.00 percent when it meets on September 3, the combination of weak growth and benign inflation could open the door for further easing early next year.

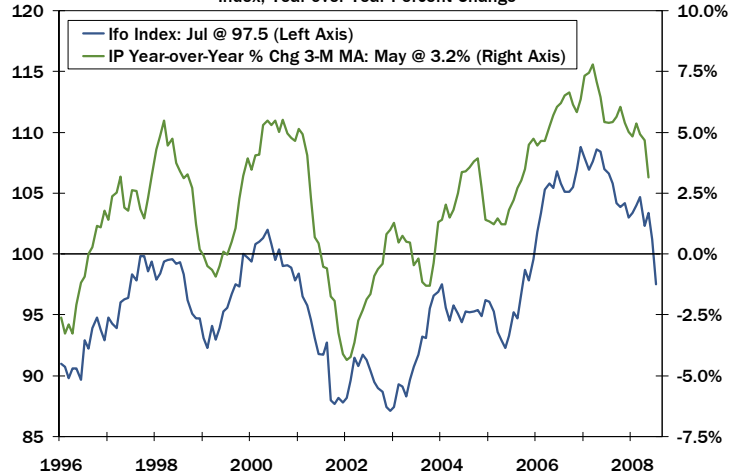
Previous: -0.3% (annualized rate)

Wachovia: 0.9%

Consensus: 0.7%

German Production Indicators

Index, Year-over-Year Percent Change


Japanese Industrial Production • Friday

The Japanese economy contracted at an annualized rate of 2.4 percent in the second quarter due in part to the 3.3 percent drop that occurred in industrial production during the quarter. If the consensus forecast is realized, which looks for a 0.6 percent decline in industrial production in July relative to the previous month, then real GDP in the third quarter probably got off to a weak start.

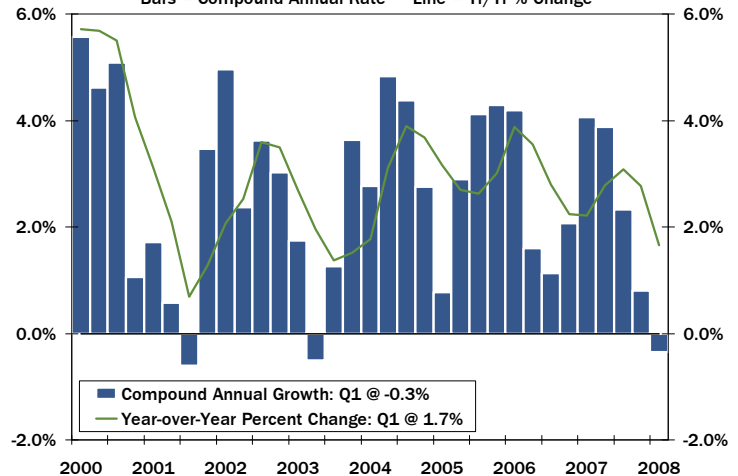
Other indicators slated for release next week (CPI inflation, the unemployment rate, housing starts, retail spending, and small business confidence) will give investors even more insight into the current state of the Japanese economy. In our view, the Japanese economy has slipped into a mild recession.

Previous: -2.2% (month-on-month change)

Consensus: -0.6%

Canadian Real GDP

Bars = Compound Annual Rate Line = Yr/Yr % Change



Interest Rate Watch
Interest Rate Inertia: No Easy Out for Credit Adjustment

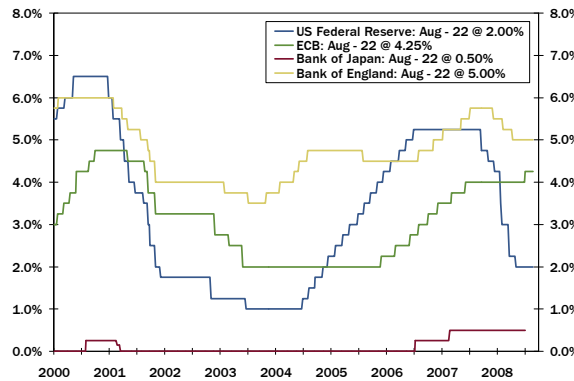
Sub-par economic growth combined with modest upward inflation pressures suggest the Fed is keeping the benchmark funds rate on hold. There is no easy out for creditors or debtors in our outlook.

Short-term rates are likely to remain steady as the Federal Reserve faces the dual imbalance of a slow growth economy along with above-target inflation. Meanwhile credit availability, as measured by the Fed's own Senior Loan Officer Survey, is being rapidly reduced. For the second half of this year we expect average real growth around 1.6 percent with weakness centered in the domestic economy - consumption and business investment. While inflation, as measured by the core PCE deflator, remains above the top end of the Federal Reserve's target range.

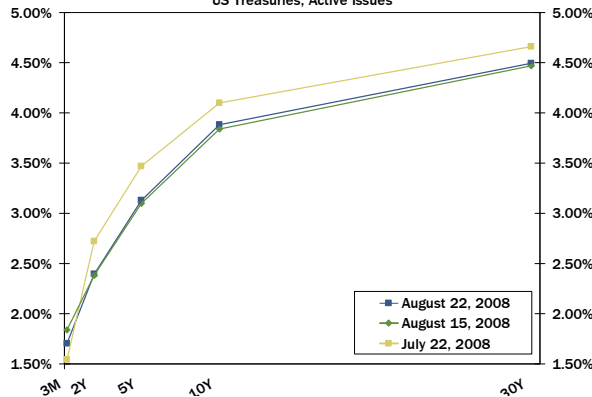
As for long rates we expect the ten-year rate in a tight 3.8 - 4.0 percent range. Yet there is significant uncertainty on both the dollar and federal deficit outlook that suggests that rates could rise above our outlook.

Credit: GSE Uncertainty Means Tighter Credit

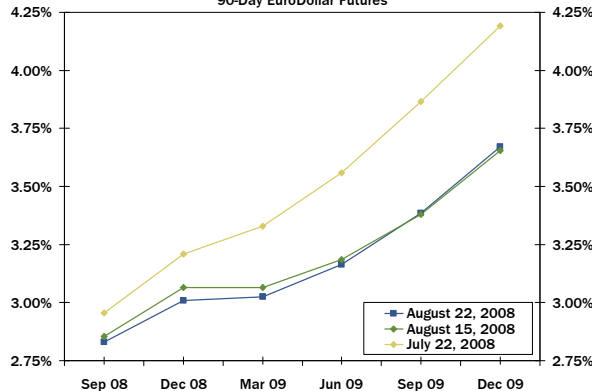
Financial concerns about the viability of the GSEs suggest that credit supply will be further constrained. Mortgage backed securities have suffered due to credit concerns on the GSEs. These concerns have ripple effects as many owners of GSE equity and debt attempt to assess their own balance sheet and price in the downside risk of valuations on the GSEs. Capital markets continue to search for a new risk/reward tradeoff. Unfortunately the recent widening of bank CDS and AAA CMBS spreads suggests credit is being further constrained.

Central Bank Policy Rates

Yield Curve

US Treasuries, Active Issues


Forward Rates

90-Day EuroDollar Futures


Topic of the Week
Challenging Times Ahead for Non-Residential Construction

Commercial construction was one of the economy's bright spots during the first half of 2008 and is expected to remain positive in the current quarter. However, most of the recent strength reflects projects committed to prior to the credit crunch. The pipeline of commercial projects is rapidly winding down and we expect commercial construction to turn down late this year or early 2009. The volume of commercial construction is expected to decline by roughly 25 percent over the next year.

Construction of apartments has been a notable strength for private non-residential construction. Demand is being fueled by the expectation that the housing slump and tighter lending standards for home mortgages would compel potential homeowners locked out of the housing market to rent.

Demand for lodging has held up surprisingly well considering the run-up in gasoline prices and cutbacks at major airlines. Private lodging construction is now up roughly 41 percent, but the pace of growth is slowing.

The greatest source of demand is currently coming from the energy sector, with new gas-fired electric plants, oil refinery expansions, ethanol, and bio-fuel plants leading the way. Education and healthcare also remain very strong and there is also a long pipeline of highway and road projects. With relatively little overbuilding, income properties should weather the current credit storm fairly well. More ambitious projects will certainly run into trouble, but outright declines in property values should be less problematic than we are seeing in the residential sector. Please read our [full report](#) for more color.

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Market Data ♦ Mid-Day Friday
U.S. Interest Rates

	Friday 8/22/2008	1 Week Ago	1 Year Ago
3-Month T-Bill	1.70	1.83	3.65
3-Month LIBOR	2.81	2.81	5.50
1-Year Treasury	1.96	2.13	3.91
2-Year Treasury	2.39	2.38	4.18
5-Year Treasury	3.13	3.10	4.37
10-Year Treasury	3.88	3.83	4.65
30-Year Treasury	4.49	4.46	4.96
Bond Buyer Index	4.64	4.67	4.81

Foreign Interest Rates

	Friday 8/22/2008	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	4.95	4.96	4.68
3-Month Sterling LIBOR	5.76	5.76	6.62
3-Month Canadian LIBOR	3.35	3.33	4.87
3-Month Yen LIBOR	0.87	0.88	1.01
2-Year German	4.13	4.00	4.03
2-Year U.K.	4.62	4.53	5.39
2-Year Canadian	2.93	2.76	4.17
2-Year Japanese	0.69	0.70	0.87
10-Year German	4.22	4.17	4.30
10-Year U.K.	4.61	4.58	5.10
10-Year Canadian	3.61	3.57	4.40
10-Year Japanese	1.45	1.47	1.58

Foreign Exchange Rates

	Friday 8/22/2008	1 Week Ago	1 Year Ago
Euro (\$/€)	1.480	1.469	1.354
British Pound (\$/£)	1.854	1.866	1.993
British Pound (£/€)	0.798	0.787	0.680
Japanese Yen (¥/\$)	109.870	110.535	115.338
Canadian Dollar (C\$/ \$)	1.046	1.059	1.062
Swiss Franc (CHF/\$)	1.097	1.098	1.206
Australian Dollar (US\$/A\$)	0.870	0.866	0.807
Mexican Peso (MXN/\$)	10.117	10.187	11.049
Chinese Yuan (CNY/\$)	6.834	6.873	7.604
Indian Rupee (INR/\$)	43.425	42.685	40.924
Brazilian Real (BRL/\$)	1.619	1.638	2.011
U.S. Dollar Index	76.708	77.180	81.249

Commodity Prices

	Friday 8/22/2008	1 Week Ago	1 Year Ago
W. Texas Crude (\$/Barrel)	117.98	113.77	69.26
Gold (\$/Ounce)	825.97	787.70	660.80
Hot-Rolled Steel (\$/S.Ton)	1125.00	1125.00	540.00
Copper (¢/Pound)	348.60	334.25	322.70
Soybeans (\$/Bushel)	13.48	12.72	7.71
Natural Gas (\$/MMBTU)	8.13	8.09	5.58
Nickel (\$/Metric Ton)	21,465	19,090	26,975
CRB Spot Inds.	477.63	470.57	469.86

Next Week's Economic Calendar

	Monday 25	Tuesday 26	Wednesday 27	Thursday 28	Friday 29
U.S. Data	Existing Home Sales June 4.86M July 4.75M (W)	Consumer Confidence July 51.9 August 54.0 (W) New Home Sales June 530K July 500K (W)	Durable Goods Orders June 0.8% July 0.2% (W) Durables Ex Trans. June 2.0% July -0.4% (W)	GDP (QoQ) 1Q 0.9% 2Q 2.9% (W)	Personal Income June 0.1% July 0.4% (W) Personal Spending June 0.6% July 0.4% (W)
Global Data		Germany Ifo - Business Climate Previous (Jul) 97.5		Germany Unemployment Rate Previous (Jul) 7.8%	Canada GDP Annualized Previous(1Q) -0.3% Japan Indus. Production Previous(Jun) -2.2%

Note: (W) = Wachovia Estimate (c) = Consensus Estimate

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