



ECONOMICS GROUP

WEEKLY ECONOMIC & FINANCIAL COMMENTARY

October 24, 2008

U.S. Review

Risk is Being Re-priced

This morning's carnage on Wall Street appears to be linked to forced liquidations by hedge funds that had taken on far too much risk for far too little return in what seems today like a long time ago. Alan Greenspan had warned us that past episodes where risk had been mispriced had not ended well. We are seeing that this morning in spades.

While the stock market is a forward looking indicator, we believe the market has priced in a far worse economic environment than we are likely to see. There is no doubt the next two to three years will be challenging, but they will not be devoid of growth. Recessions tend to clear out excess built up during the expansion. Over the past decade the greatest excesses were in housing and finance. Those are the two sectors seeing the greatest corrections and much of that appears to have already been done. By contrast, Main Street did not misprice risk like Wall Street. Business fixed investment and hiring were both muted during the past decade, which may mean the downside risk to the real economy is less than currently feared.

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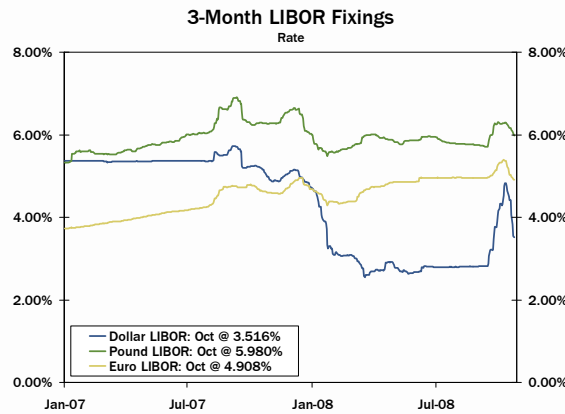
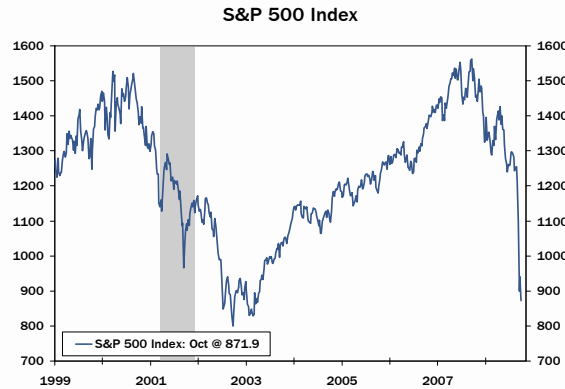
Global Review

Global Financial Crisis Takes a New Turn

Believe it or not there was actually a bit of good news this week as steps taken by governments around the world over the past week or so to ease the global credit crunch led to a decline in LIBOR rates (see graph at left). LIBOR rates are critical because they serve as benchmark lending rates for many businesses and consumers. Although LIBOR rates have declined, they still remain very elevated relative to central bank policy rates.

However, the good news on the LIBOR front was overshadowed by extreme volatility in other financial markets, indicating that times are hardly "normal." Volatility in financial markets this week appears to have been sparked by the growing realization among investors that a global recession is imminent. Indeed, data released on Friday showed that real GDP in the United Kingdom slumped

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Recent Special Commentary

Date	Title	Authors
October-20	Japan's "Lost Decade": Implications for the U.S. Economy	Bryson
October-09	Global Chartbook - October 2008	Bryson & Quinlan
October-08	Housing Chartbook - October 2008	Vitner & York
October-08	Everyone Seems To Have Gotten The Message	Vitner & Bryson

U.S. Forecast

	Actual 2008				Forecast 2009				Actual 2005-2007			Forecast 2008-2010		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2005	2006	2007	2008	2009	2010
Real Gross Domestic Product ¹	0.9	2.8	-0.7	-3.0	-2.3	1.4	1.8	1.7	2.9	2.8	2.0	1.3	-0.5	1.9
Personal Consumption	0.9	1.2	-3.1	-1.6	-0.6	1.4	1.9	2.1	3.0	3.0	2.8	0.5	-0.2	2.1
Inflation Indicators ²														
"Core" PCE Deflator	2.2	2.3	2.5	2.2	2.1	2.1	1.8	2.0	2.1	2.3	2.2	2.3	2.0	1.9
Consumer Price Index	4.2	4.3	5.3	3.4	2.5	1.7	0.8	2.0	3.4	3.2	2.9	4.3	1.7	2.4
Industrial Production ¹	0.4	-3.1	-2.4	-3.1	-1.9	0.3	1.6	2.4	3.3	2.2	1.7	-0.3	-1.2	2.5
Corporate Profits Before Taxes ²	-1.5	-8.3	-7.5	-12.0	-4.0	0.0	8.0	9.2	17.6	15.2	-1.6	-7.3	3.1	8.5
Trade Weighted Dollar Index ³	70.3	71.0	76.1	77.8	80.0	82.8	84.9	87.2	86.0	81.5	73.3	77.8	87.2	90.0
Unemployment Rate	4.9	5.3	6.0	6.4	6.8	7.1	7.4	7.7	5.1	4.6	4.6	5.7	7.3	8.0
Housing Starts ⁴	1.05	1.03	0.91	0.82	0.78	0.78	0.80	0.86	2.07	1.81	1.34	0.95	0.80	1.09
Quarter-End Interest Rates														
Federal Funds Target Rate	2.25	2.00	2.00	1.00	0.75	0.75	0.75	0.75	4.25	5.25	4.25	1.00	0.75	2.00
10 Year Note	3.45	3.99	3.85	3.70	3.80	3.90	3.90	4.00	4.39	4.71	4.04	3.70	4.00	4.20

Data As of: October 8, 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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There is No Joy in Mudville

The recession will likely be along the lines of the 1973/75 downturn. That recession was relatively long and deep. Real GDP declined by 3.1 percent from peak to trough and the downturn lasted for 18 months. By contrast, the past two recessions were relatively short and shallow, with real GDP declining at most 1.3 percent and the downturn lasting for nine months each.

Our outlook calls for three quarters of declines in real GDP but close to two years of declines in domestic demand. The weakest period for the economy is likely to be the fourth quarter of this year and the early part of 2009. The unemployment rate, however, which has already risen 1.4 percent since its cycle trough, will likely rise throughout the next year and peak at around 8.0 percent in early 2010.

Initial jobless claims continue to indicate weakness for the labor market in coming months. Claims rose to 478,000 on the week, but the Department of Labor did note that the residual effects of Hurricane Ike added 12,000 claims to this week's reading. Smoothing the weekly volatility in claims with a 4 or 8-week moving average shows a labor market in roughly the same condition as during the 2001 recession. We expect the labor market will continue to weaken over the coming months.

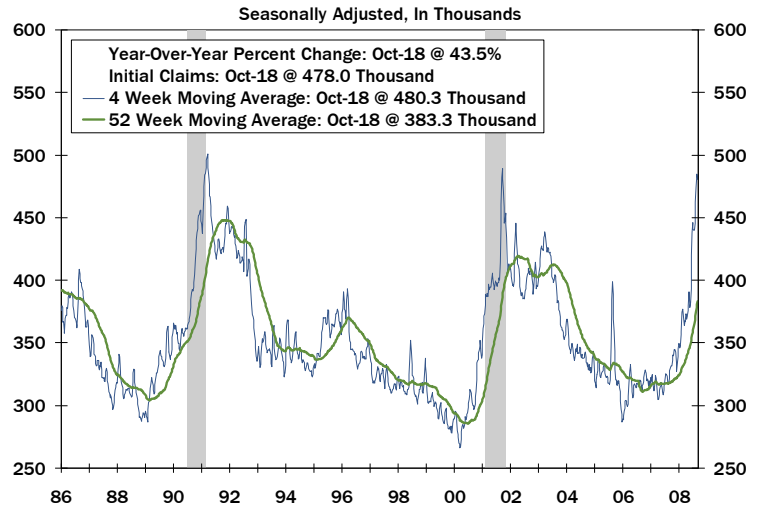
In this environment, consumer spending will be particularly weak. We estimate declines for multiple quarters, marking the first consecutive declines in consumption since 1990-91. The declines will likely be partially offset as they contribute to a dramatic improvement in the nation's trade deficit as consumers curtail purchases of imported products. The improving trade balance should continue to add to real GDP over the coming quarters, but the slowdown across the globe may provide downside risk to U.S. export activity.

The poor state of the housing market continues to hammer the consumer and the economy as a whole. However, sales of existing homes managed their biggest gain in years to a pace of 5.18M, breaking out of a tight range they held for the last year. It may not be time to celebrate though, the National Association of Realtors noted that 35 to 40 percent of sales were distressed or foreclosure related. In addition, 80 percent of those distressed sales were of primary residences. We had been hearing of some distressed activity in many of the former bubble markets and that seems to be spreading. However, with the pressure that distressed sales put on home values, the consumer will remain squeezed.

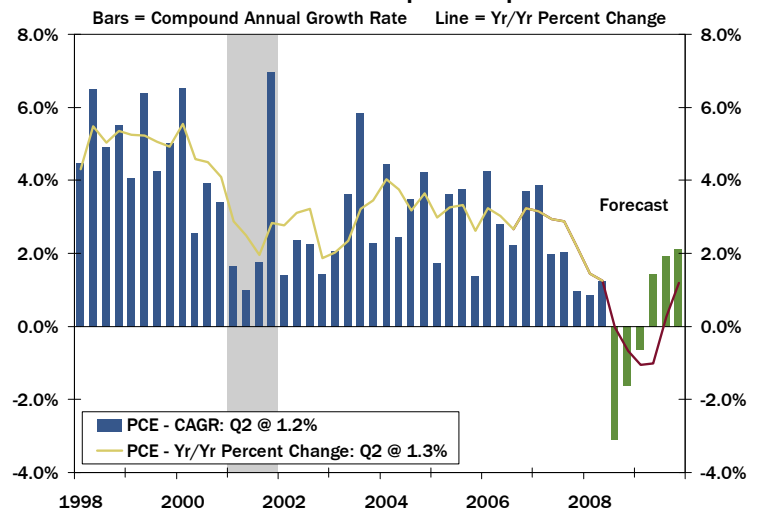
Selected Current Data

Gross Domestic Product - CAGR	Q2 - 2008	2.8%
GDP Year-over-Year	Q2 - 2008	2.1%
Personal Consumption	Q2 - 2008	1.2%
Business Fixed Investment	Q2 - 2008	2.5%
Consumer Price Index	September - 2008	4.9%
"Core" CPI	September - 2008	2.5%
"Core" PCE Deflator	August - 2008	2.6%
Industrial Production	September - 2008	-4.5%
Unemployment	September - 2008	6.1%
Federal Funds Target Rate	Oct - 24	1.50%

Initial Claims for Unemployment



Real Personal Consumption Expenditures



Existing Single-Family Home Resales



Durable Goods • Wednesday

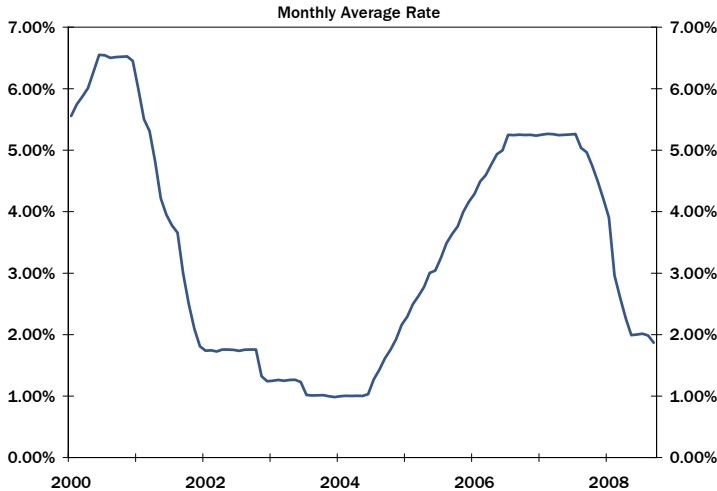
Durable goods orders fell 4.5 percent in August, the largest decline since January 2008. We expect durable goods orders to contract a second consecutive month continuing to be driven by slower economic growth and tight lending standards. With financing harder to come by, firms are reserving capital by putting off expansion plans and scaling back hiring. Additionally, aircraft and motor vehicle production continue to post declines.

Nondefense capital goods orders ex-aircraft should also decline suggesting business fixed investment is on pace to contract in the coming quarters. Weak business fixed investment and consumer spending will weigh heavily on economic growth. We do not anticipate any positive contribution to economic growth from business spending until 2010.

Previous: -4.5%

Wachovia: -2.5%

Consensus: -0.9%

Federal Funds Effective Rate

GDP • Thursday

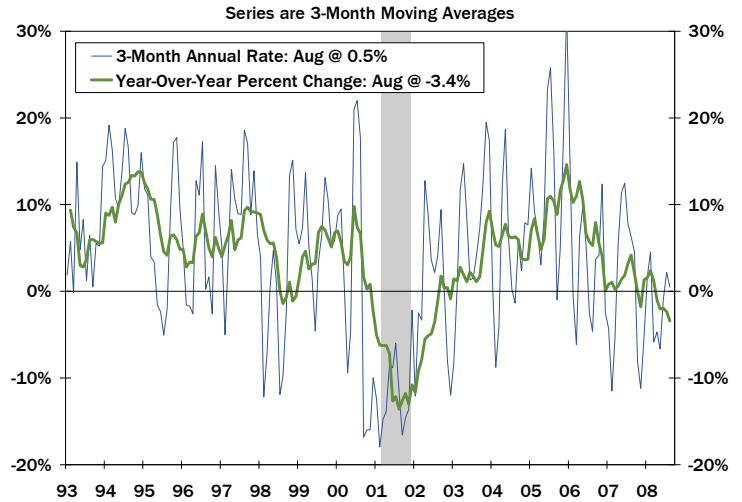
While recent economic data has taken a back seat to equity market volatility in news headlines, all signs point to the onset of a recession beginning in the third quarter. We project third quarter GDP contracted 0.7 percent and should continue to post declines in the coming quarters.

Much of the contraction will be due in large part to a decline in consumer spending. We now project real consumer spending contracted 3.1 percent in the third quarter. The housing downturn, weak labor market and moderating income growth should continue to put downward pressure on real consumer spending well into the first quarter of 2009. Exports provided an enormous boost for the economy over the past year, but are now expected to slow with global economic growth moderating.

Previous: 2.8%

Wachovia: -0.7%

Consensus: -0.5%

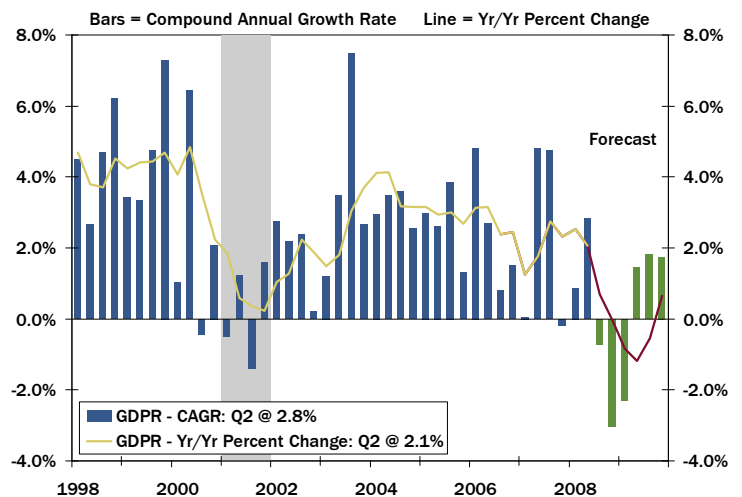
Durable Goods New Orders

FOMC Rate Decision • Wednesday

The Federal Reserve will continue to try to tame the credit markets and sluggish domestic economic growth by cutting its target for the Fed Funds rate by at least 25bps. The Fed joined with other central banks by cutting rates by 50 bps on October 8. Now that global growth is slowing sharply and inflation rates are receding, the Fed and other central banks have the green light to ease policy with a clear conscious.

Earlier this week, the Federal Reserve announced another funding facility to help ease strain in the short-term debt markets. The Federal Reserve Bank of New York will provide senior secured funding to a series of special purpose vehicles to finance the purchase of U.S. dollar-denominated certificates of deposit and commercial paper issued by highly rated financial institutions and having remaining maturities of 90 days or less.

Previous: 1.50%

Consensus: 1.00%

Real GDP


Global Review

(Continued from Page 1)

0.5 percent (not annualized) in the third quarter, the first contraction in the British economy since 1992. Growth in Japanese export volumes slowed sharply in the third quarter and, as shown in the top chart, the manufacturing PMI in the Euro-zone slumped to an all-time low in October. (The series begins in 1997.)

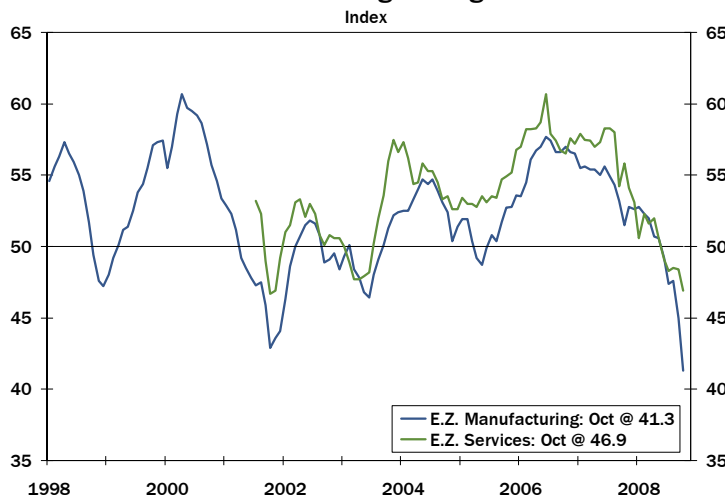
If volatility in equity markets seemed high, it was extraordinary in currency markets. The big gainer this week was the Japanese yen, which strengthened to a 13-year high against the dollar (see middle chart). The Japanese yen often strengthens during periods of extreme risk aversion because Japan incurs a sizeable current account surplus. In an environment in which global capital flows are shrinking rapidly, countries that incur current account deficits, which need to be financed by capital inflows, usually experience currency depreciation.

Poland, South Africa and Turkey (to name a few examples) saw their currencies get hammered this week. What do these countries have in common? If you said "large current account deficits" advance to "Go" and collect \$200. Moreover, most emerging market currencies depreciated sharply this week. As shown in the bottom chart, the Fed's "Other Important Trading Partners" index, which measures the value of the dollar versus the currencies of some important developing economies, spiked higher this week, bringing its total rise since its nadir in late July to nearly 15 percent.

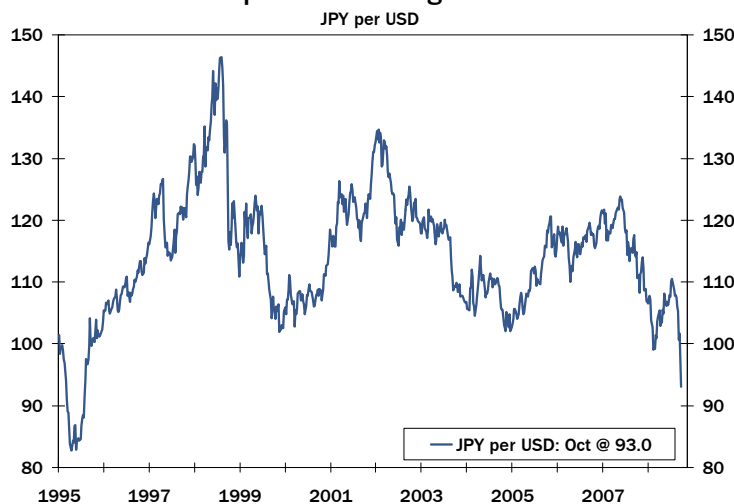
Although not every developing country incurs a current account deficit, emerging market currencies as a class were hammered because of concerns about global growth. Although many developing countries may not actually follow major economies into full-blown recessions, growth rates in the emerging world should slow sharply. The marked decline in emerging market stock indices over the past few weeks, not to mention significant drops in most major markets as well, is consistent with expectations of significantly slower economic growth.

Assuming that policymakers eventually succeed in stabilizing financial markets, most emerging market currencies could experience a near-term bounce. However, the currencies of most developing economies should remain weak until the outlook for the global economy begins to improve, which we do not expect for at least a few more quarters.

Euro-zone Purchasing Manager Indices



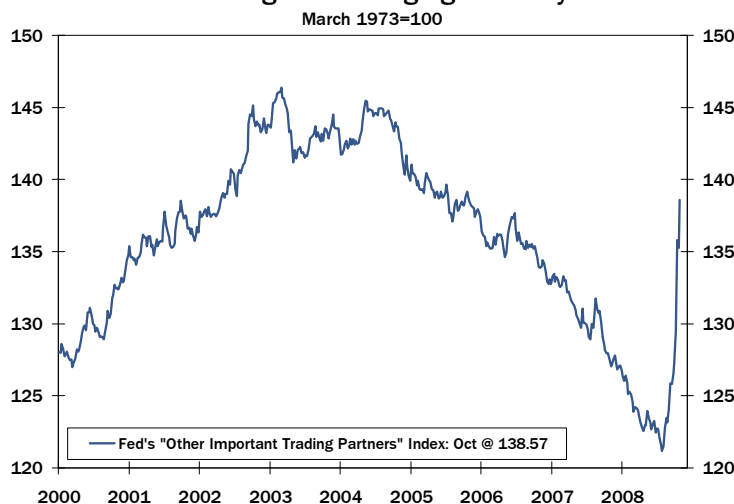
Japanese Exchange Rate



Selected Global Data

Japan	GDP Year-over-Year	Q2 - 2008	0.7%
	CPI	August - 2008	2.1%
	Unemployment	August - 2008	4.2%
	BoJ Target Rate	Oct - 24	0.50%
Euro-Zone	GDP Year-over-Year	Q2 - 2008	1.4%
	CPI	September - 2008	3.6%
	Unemployment	August - 2008	7.5%
	ECB Target Rate	Oct - 24	3.75%
UK	GDP Year-over-Year	Q3 - 2008	0.3%
	CPI	September - 2008	5.2%
	Unemployment	September - 2008	2.9%
	BoE Target Rate	Oct - 24	4.50%
Canada	GDP Year-over-Year	July - 2008	1.2%
	CPI	September - 2008	3.4%
	Unemployment	September - 2008	6.1%
	BoC Target Rate	Oct - 24	2.25%

US Trade Weighted Emerging Currency Index



German Ifo Index • Monday

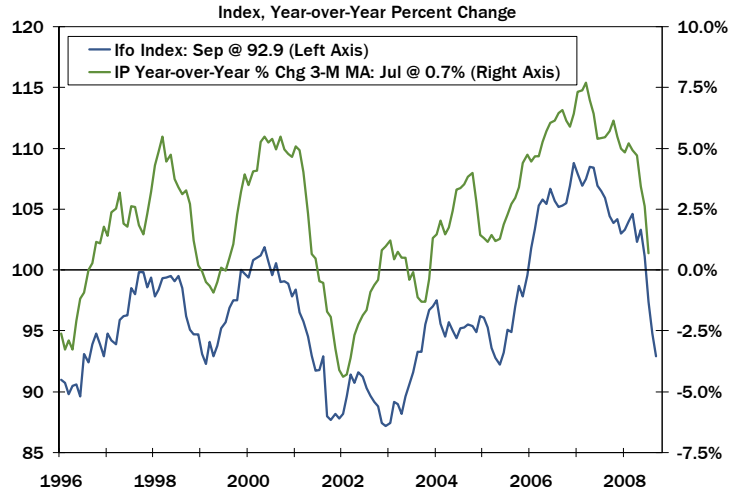
The Ifo index of German business sentiment, which is closely followed by investors because it is highly correlated with growth in German industrial production, has fallen off a cliff recently. If the consensus forecast for October is realized, it would be the lowest level for the Ifo index since 2003. Data on German retail sales and unemployment will print on Friday.

Not only is the widely watched Ifo index slated for release next week, but economic data from the broader Euro-zone are also on the docket. The business climate indicator prints on Thursday, and the “flash” estimate of CPI inflation in October is on the docket on Friday. In our view, the incipient recession in the Euro-zone and receding inflation will give the ECB scope to cut rates further in the months ahead.

Previous: 92.9

Consensus: 91.0

German Production Indicators



Japanese Industrial Production • Wednesday

Japanese Industrial Production Index



Japanese producers said that they expected a bounce-back in industrial production in September following the 3.5 percent drop in August, but their projections have proven to be optimistic recently. Even if IP bounces back a bit, the trend in production is clearly weakening. Indeed, the Japanese economy appears to be in recession at present.

There are a number of other data releases on the docket next week that will give investors insights into the current state of the Japanese economy. September data on the labor market, CPI inflation, and housing starts print on Friday, and the Bank of Japan also holds a policy meeting on Friday. Most investors expect that the BoJ will keep its policy rate unchanged at 0.50 percent.

Previous: -3.5% (month-on-month change)

Consensus: 0.4%

U.K. House Price Index

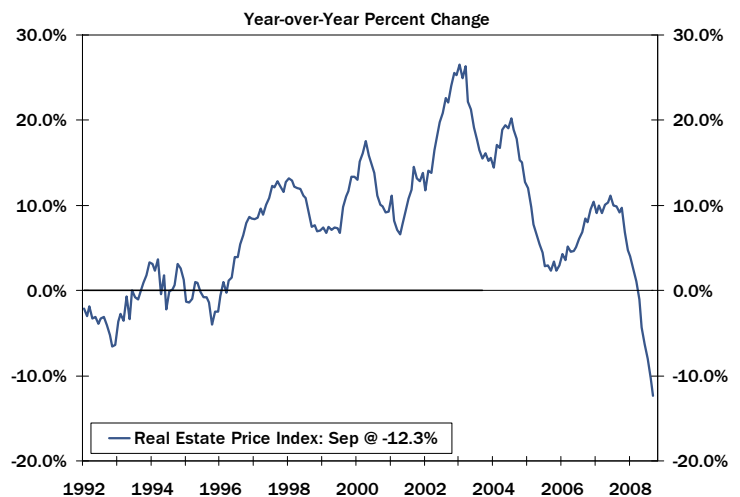
Data released today showed that the U.K. economy has entered recession as real GDP contracted 0.5 percent (not annualized) in the third quarter. Like the United States, house prices in the United Kingdom rose a significant amount over the past decade. However, U.K. house prices have now started to decline. Indeed, the widely followed Nationwide index of house prices was down more than 12 percent in September relative to the same month last year. Data for October, which will print next week, will probably show house prices slumping further.

Other data releases next week, including the money supply and credit, survey data on retail spending in October, and consumer confidence should give investors additional insights into the current state of the U.K. economy.

Previous: -12.4% (year-over-year change)

Consensus: -14.7%

U.K. Home Prices



Interest Rate Watch
Credit and Recession Concerns Dictate Another Fed Ease

Once more unto the breach! Another cut in the fed funds rate, this time by at least 25 basis points, is expected as the Fed faces recession and continued issues in the credit markets.

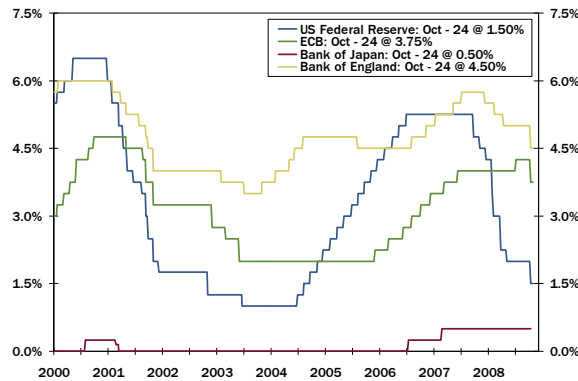
Our outlook is for the recession, which appears to have started in July, to persist through at least the first quarter of next year. This unfolding recession is characterized by significant weakness in both consumer spending and real investment, and it likely will be the deepest U.S. downturn since 1981-82. Looking further ahead we expect another Fed ease, possibly in December, and continued liberal liquidity facilities through the first half of next year.

Credit Revulsion

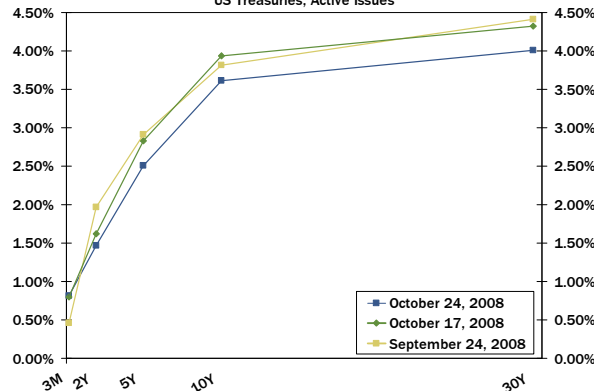
Financial markets have evidenced some very modest improvement in credit spreads but the search for that new equilibrium remains in progress. Markets continue to search for that new tradeoff between risk and reward.

For example, both the price and the availability of credit to the high grade and high yield bond markets have assumed a very different tone from earlier in this decade. Issuance of high grade and high yield debt remains extremely limited. Ten-year investment grade yields of 5.5 percent in 2005 are now in the 7.5 to 8.5 percent range. Average issuance of high grade bonds of \$170 billion plus since 1999 has given way to below \$20 billion in the third quarter of this year.

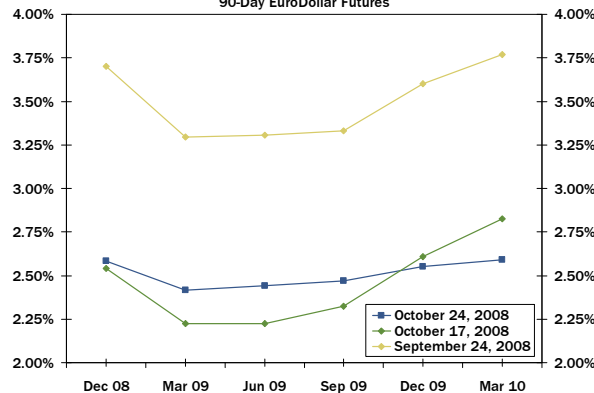
The market and the economy remain constrained by the paradox of lemons—make more lemonade. This process will take time and suggests continued Fed easing at the short end of the curve and credit aversion in the private market.

Central Bank Policy Rates

Yield Curve

US Treasuries, Active Issues


Forward Rates

90-Day EuroDollar Futures


Topic of the Week
Lost Decade, Implications for the U.S.

The Japanese economy stagnated for a decade or so following the collapse of its asset price bubbles in the early 1990s. Real GDP growth in Japan, which averaged nearly 4 percent per annum during the 1980s, dropped to an annual average rate of only 1 percent during the subsequent decade. Could the U.S. economy experience a “lost decade” in the wake of its own burst asset price bubbles?

Unlike policymakers in Japan, who were slow to support the Japanese financial system via monetary easing and direct assistance to financial institutions, U.S. policymakers have responded aggressively to the current financial crisis in the United States. The Treasury Department is about to embark upon a program to recapitalize financial institutions. The quick response of U.S. policymakers should reduce the risk of a downward spiral of bank lending and economic activity.

However, Japan’s experience during the 1990s shows that the U.S. economy could experience a few years of sub-par economic growth. Corporate deleveraging in Japan weighed on investment spending and restrained Japanese economic growth between 1990 and 2003. Although the U.S. economy may be spared from a Japan-like “lost decade”, it appears that a few “lost years” await. For more commentary and observation about similarities and implications between the United States today and Japan in the 1990s, read our full report on the topic [here](#).

The Week Ahead

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

	Friday 10/24/2008	1 Week Ago	1 Year Ago
3-Month T-Bill	0.81	0.79	3.85
3-Month LIBOR	3.52	4.42	5.07
1-Year Treasury	1.28	1.29	3.70
2-Year Treasury	1.45	1.61	3.74
5-Year Treasury	2.50	2.83	3.99
10-Year Treasury	3.61	3.93	4.34
30-Year Treasury	4.01	4.32	4.64
Bond Buyer Index	5.32	6.01	4.33

Foreign Exchange Rates

	Friday 10/24/2008	1 Week Ago	1 Year Ago
Euro (\$/€)	1.269	1.341	1.427
British Pound (\$/£)	1.583	1.728	2.050
British Pound (£/€)	0.802	0.776	0.696
Japanese Yen (¥/\$)	94.210	101.688	114.265
Canadian Dollar (C\$/\\$)	1.271	1.182	0.969
Swiss Franc (CHF/\\$)	1.161	1.136	1.172
Australian Dollar (US\$/A\\$)	0.624	0.689	0.903
Mexican Peso (MXN/\\$)	13.418	12.876	10.834
Chinese Yuan (CNY/\\$)	6.844	6.833	7.493
Indian Rupee (INR/\\$)	49.983	48.883	39.580
Brazilian Real (BRL/\\$)	2.301	2.119	1.808
U.S. Dollar Index	86.035	82.413	77.546

Foreign Interest Rates

	Friday 10/24/2008	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	4.91	5.02	4.62
3-Month Sterling LIBOR	5.98	6.16	6.28
3-Month Canadian LIBOR	3.11	3.84	4.93
3-Month Yen LIBOR	1.00	1.06	0.92
2-Year German	2.67	2.95	3.92
2-Year U.K.	3.08	3.63	5.01
2-Year Canadian	2.09	2.27	4.13
2-Year Japanese	0.72	0.79	0.79
10-Year German	3.76	4.01	4.15
10-Year U.K.	4.36	4.67	4.84
10-Year Canadian	3.60	3.73	4.29
10-Year Japanese	1.50	1.59	1.58

Commodity Prices

	Friday 10/24/2008	1 Week Ago	1 Year Ago
W. Texas Crude (\\$/Barrel)	64.87	71.85	87.10
Gold (\\$/Ounce)	738.30	783.35	763.95
Hot-Rolled Steel (\\$/S.Ton)	860.00	860.00	520.00
Copper (\\$/Pound)	170.00	218.10	345.10
Soybeans (\\$/Bushel)	8.55	8.27	9.32
Natural Gas (\\$/MMBTU)	6.29	6.79	6.97
Nickel (\\$/Metric Ton)	9,173	10,560	31,380
CRB Spot Inds.	373.74	395.29	493.35

Next Week's Economic Calendar

	Monday 27	Tuesday 28	Wednesday 29	Thursday 30	Friday 31
U.S. Data	New Home Sales August 460K September 460K (W)	Consumer Confidence September 59.8 October 48.5 (W)	Durable Goods Orders August -4.8% September -2.5% (W) FOMC Rate Decision Current 1.50% Expected 1.00% (c)	GDP (QoQ) 2Q 2.8% 3Q -0.7% (W)	Personal Income August 0.5% September 0.4% (W) Personal Spending August 0.0% September -0.2% (W) PCE Deflator (YoY) August 4.5% September 4.2% (W)
Global Data	Germany IFO-Business Climate Previous (Sep) 92.9	Japan Retail Trade (MoM) Previous (Aug) 0.7%	Japan Indus. Production (MoM) Previous (Aug) -3.5%	Germany Unemployment Rate (s.a) Previous (Sep) 7.6%	Japan Jobless Rate Previous (Aug) 4.2% Japan CPI (YoY) Previous (Aug) 2.1%

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

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