

WEEKLY ECONOMIC & FINANCIAL COMMENTARY

October 03, 2008

U.S. Review

Another Momentous Week

The incredible volatility in the financial markets has eclipsed virtually everything else, including the underlying economy, the presidential race and the start of Major League Baseball playoffs. For those that missed it last night, the Cubs are down two games to none. The Cubs troubles are the only thing this fall that comes close to resembling normalcy. The volatility in the financial markets, the congressional debate, and global financial instability are truly without precedent.

While the financial markets have garnered considerable attention the performance of the underlying economy has taken a definitive turn for the worse. This week's major indicators included a 6.4 point plunge in the ISM manufacturing survey, a 4.0 percent drop in factory orders, and a 159,000-job drop in nonfarm employment. In addition, car sales turned in one of their weakest performances in decades and sales traffic through dealer showrooms during the last ten days of October was reported the worst since records began being kept back in 1986. Together, this data suggest the economy is already in recession.

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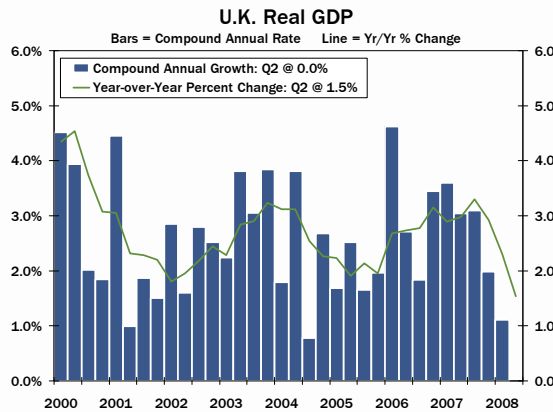
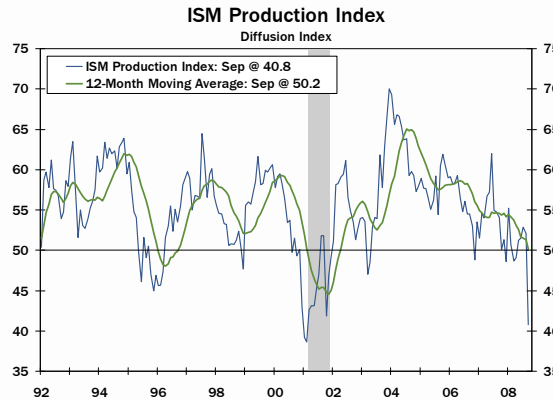
Global Review

Recession in the United Kingdom?

After economic growth in the United Kingdom slowed to a virtual standstill in the second quarter, a slate of other negative economic news this week offered further evidence that the British economy may be slipping into recession. In fact, the European Commission issued a report this week predicting that by the end of this year the United Kingdom, Germany and Spain would all fall into recession.

The manufacturing PMI for September cratered to a record low of 41, falling from an already-low reading of 45.3 in August; a troubling sign for the struggling manufacturing sector. The same report recorded the lowest readings for new orders, output and employment since the survey began in the early 1990s. All of which present significant challenges to growth. Meanwhile, the services PMI came in at 46.0, which was considerably weaker than expected.

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Recent Special Commentary

Date	Title	Authors
September-25	Recession Probability Remains Very High	Silvia
September-22	Story Continues: No Bright Light Marking End of Sub-Par Growth	Silvia
September-22	Implications of the Treasury's Plan for the Dollar	Bryson
September-18	Global Central Banks Work to Soothe Fears	Vitner

U.S. Forecast

	Actual				Forecast				Actual			Forecast		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2005	2006	2007	2008	2009	2010
Real Gross Domestic Product ¹	0.0	4.8	4.8	-0.2	0.9	3.3	0.8	0.8	2.9	2.8	2.0	1.8	1.8	2.2
Personal Consumption	3.9	2.0	2.0	1.0	0.9	1.7	-0.8	-0.3	3.0	3.0	2.8	1.0	0.9	2.1
Inflation Indicators ²														
"Core" PCE Deflator	2.3	2.1	2.0	2.2	2.2	2.2	2.3	2.0	2.1	2.3	2.2	2.2	1.9	1.9
Consumer Price Index	2.4	2.6	2.4	4.0	4.2	4.3	5.0	3.3	3.4	3.2	2.9	4.2	2.0	1.9
Industrial Production ³	1.5	3.2	3.6	0.3	0.4	-3.2	1.7	2.0	3.3	2.2	1.7	0.5	2.2	3.3
Corporate Profits Before Taxes ²	-1.0	-0.5	-2.7	-2.0	-1.5	-7.0	-7.5	-11.0	17.6	15.2	-1.6	-6.7	4.9	8.5
Trade Weighted Dollar Index ³	80.5	78.7	74.4	73.3	70.3	71.0	75.6	77.4	86.0	81.5	73.3	77.4	86.0	91.0
Unemployment Rate	4.5	4.5	4.7	4.8	4.9	5.3	6.0	6.2	5.1	4.6	4.6	5.6	6.7	7.4
Housing Starts ⁴	1.45	1.46	1.30	1.15	1.05	1.02	0.95	0.92	2.07	1.81	1.34	0.99	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	2.00
10 Year Note	4.65	5.03	4.59	4.04	3.45	3.99	3.70	3.80	4.39	4.71	4.04	3.80	4.10	4.30

Data As of: September 10, 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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The Underlying Economy Is Weak, Congress Needs To Act

As we have noted in previous commentaries, passage of the financial rescue package will not immediately reverse the troubles we are currently seeing in the economy, but they will prevent them from becoming even worse. In addition to the credit problems which are severely affecting motor vehicle sales and making it more difficult for dealers to finance their inventory, we are beginning to see serious cracks in other areas. The Los Angeles Times reported this morning that the State of California may need to seek financing from the federal government and several other states and municipalities are running into funding problems. Interest rates on variable rate municipal debt have skyrocketed and new bond deals for many states have been shelved.

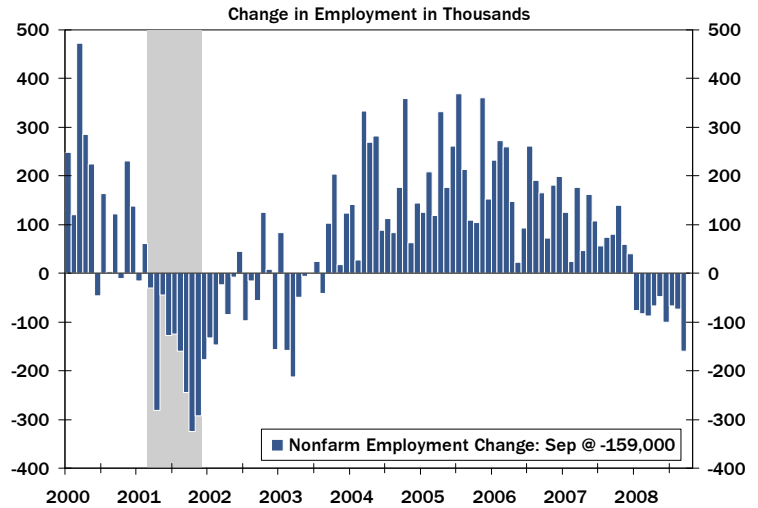
Many businesses are also experiencing financing difficulties. Even some of the healthiest firms in the country have had trouble raising money in the commercial paper market. Conditions began to improve marginally after the Senate overwhelmingly passed the rescue package. House passing finally occurred today. With a bill in hand, we expect credit conditions to improve in coming weeks.

Improvement in the credit markets is necessary in order for the economy to recover but we expect the economy to endure at least three quarters of declining real GDP, despite passage of the rescue package. September's employment numbers are emblematic of the challenges currently facing the economy. Nonfarm employment declined by 159,000 and the unemployment rate remained unchanged at 6.1 percent. Job losses were broad based during September, with large declines in construction, manufacturing and retailing. Auto dealers and department stores were two notable weak spots.

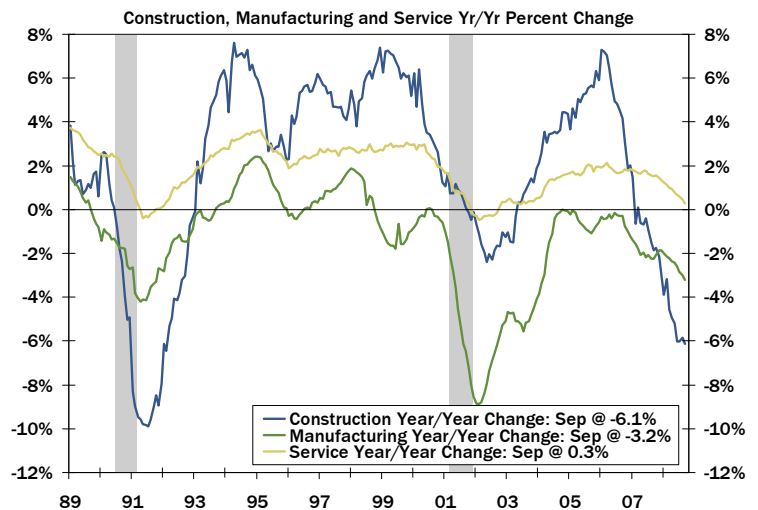
Retailing and hospitality are two areas vulnerable to credit crunch. Many stores are likely to have difficulty securing credit to stock up for the holiday season, which accounts for the bulk of their profits. If they do not have the goods to sell, they do not make any profits and many will likely shut their doors early next year. Restaurant chains are also vulnerable, with a number of franchisees reportedly having trouble attracting financing.

The ISM manufacturing report declined 6.4 points to 43.5, which is roughly in line with where it would be in a typical recession. New orders and order backlogs both declined sharply, indicating more weakness is in the pipeline. The non-manufacturing survey held up slightly better but both surveys occurred before the onslaught of the credit crunch and will likely weaken further in coming months.

Nonfarm Employment Change



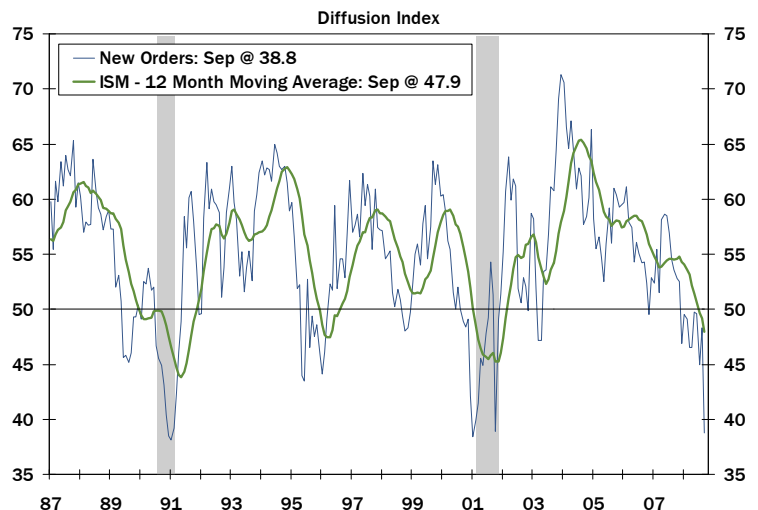
Job Growth



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	August - 2008	5.4%
"Core" CPI	August - 2008	2.5%
"Core" PCE Deflator	August - 2008	2.6%
Industrial Production	August - 2008	-1.5%
Unemployment	September - 2008	6.1%
Federal Funds Target Rate	Oct - 03	2.00%

ISM New Orders Index



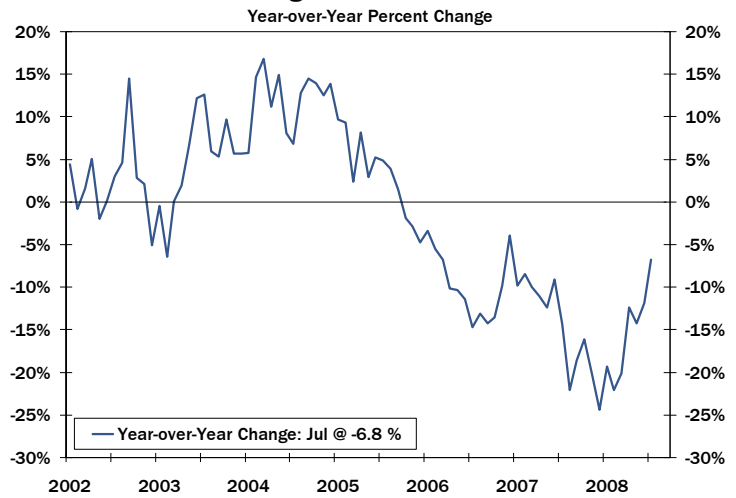
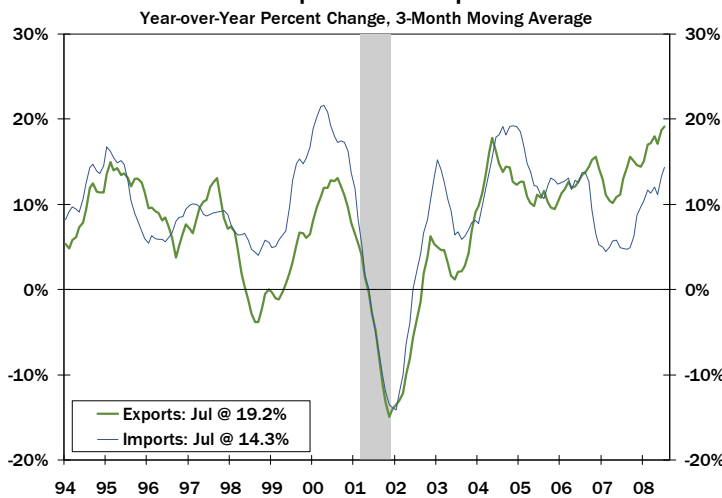
Pending Home Sales • Wednesday

The National Association of Realtors Pending Home Sales Index, a leading indicator of housing activity, contracted 3.2 percent month-on-month in July. On a year-over-year basis, pending home sales have been edging higher suggesting that the pace of deceleration in home sales has slowed and are probably close to bottoming.

Sales of both new and existing homes have more or less fluctuated around recent levels for the past six months and price declines appear to be moderating. Modest improvement in the pending home sales index would suggest sales will hold near current levels for the next few months. We still believe that existing home sales bottom around the end of the year.

Previous: -3.2%

Consensus: -1.0%

Pending Home Sales Index

U.S. Exports and Imports

International Trade Balance • Friday

The goods and services deficit widened by 5.7 percent in July to -\$62.20 billion as imports jumped 3.9 percent. Driving the solid import growth was an 18.6 percent jump in crude oil prices and a 1.7 percent increase in services. Exports rose 3.3 percent with a notable 12.7 percent monthly gain in automotives.

A modest widening of the deficit is expected in August. Regarding imports, we should see a significant pullback in petroleum prices as crude oil prices plunged from July to August. The Summer Olympics will come into play this month as royalty payments for the Olympic broadcast rights should sharply lift services. Weakness in capital goods shipments suggests we could see exports moderate in August. The outlook is beginning to dim for trade balance's contribution to GDP. Global growth is waning and will likely slow export growth going forward.

Previous: -\$62.2B

Wachovia: -\$59.1B

Consensus: -\$60.2B

Import Price Index • Friday

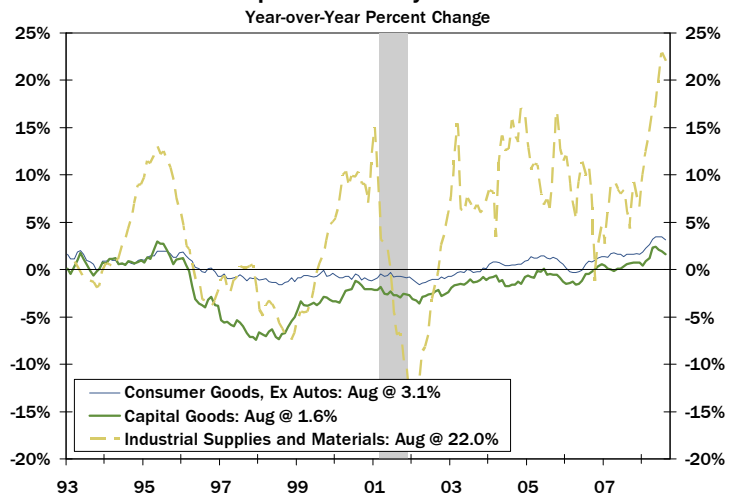
Declining a weaker than expected 3.7 percent in August, import prices were driven down by lower petroleum prices at a time when the value of the dollar was rising. August's decline was the largest monthly decrease since the series started in December 1988.

We expect import prices to decline again in September, but the drop should be less severe than was witnessed in August. Energy prices continued to decelerate while the dollar strengthened on net in August. While the U.S. dollar has strengthened recently it will take some time to make imported goods less expensive from these elevated levels.

Previous: -3.7%

Wachovia: -4.4%

Consensus: -2.5%

Import Prices By Sector


Global Review

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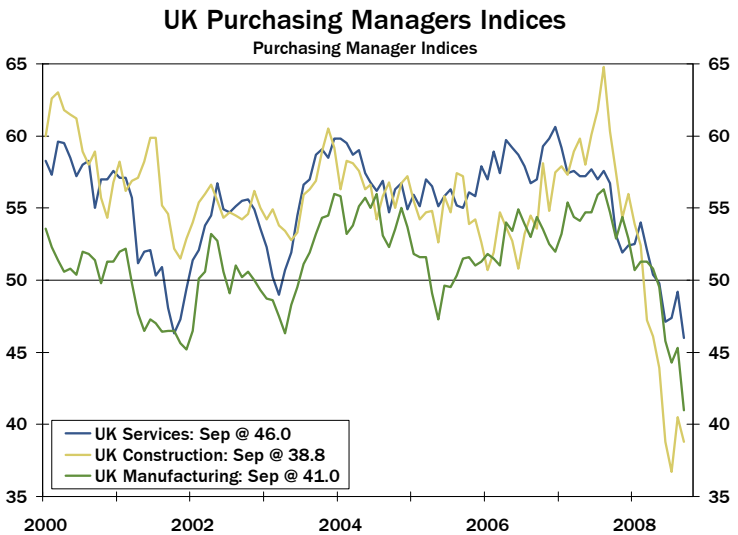
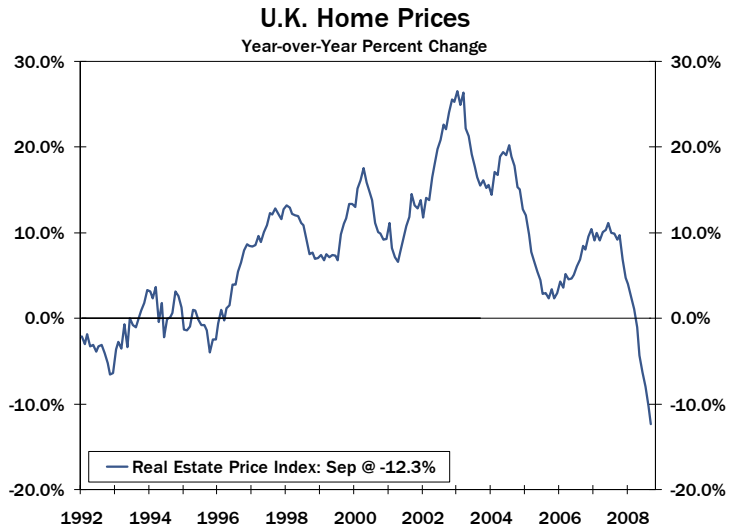
Economic Crisis is Increasing Pressure for Government Action

As it is in the United States, the U.K. housing market continues to struggle as higher unemployment and tighter lending standards weigh on home prices. Indeed, data this week confirmed the gloom many homeowners are feeling with nationwide house prices down 12.3 percent year over year, the largest annual decline since the last recession in 1991. There is little sign of hope for a near-term turnaround in housing. The construction PMI was lower in September reflecting dour sentiment on the part of U.K. homebuilders.

Given these weak numbers out of the United Kingdom, it is little surprise that sterling weakened further this week and is testing multi-year lows.

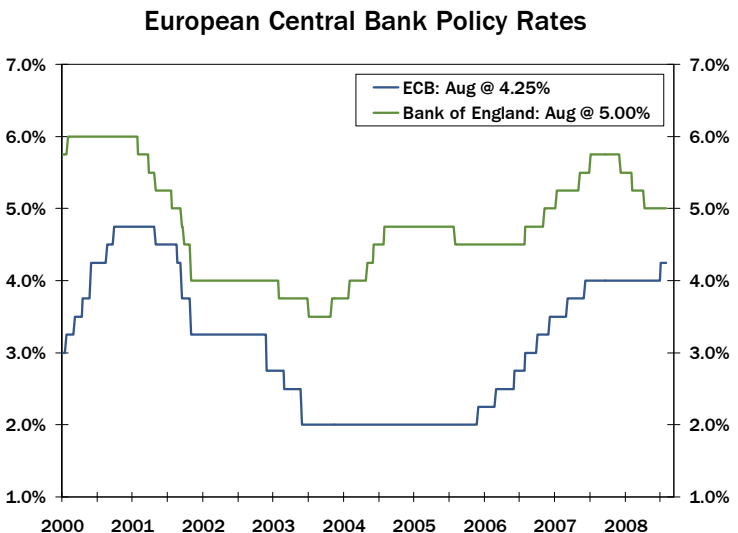
Against this backdrop of general weakness and nearly universal assessment that recession is right around the corner without some sort of action, we suspect there would be little resistance should Bank of England (BoE) Governor Mervin King and the monetary policy committee decide to ease rates, despite the fact that inflation is climbing toward 5 percent. In the minutes from its September meeting, the committee acknowledged that a case could be made for a reduction or an increase in the bank rate, but decided to stay on hold with the provision that "the Committee would continue to make its judgment each month on the basis of the changing evidence." One of the eight voting members voted in favor of a fifty basis point ease in September. It is quite possible when the committee meets again next week, other members may find the recent deterioration in the economy could alleviate their concerns about the risks posed by inflation. Indeed, we expect the BoE will ease at their meeting next week. While a 50 basis point rate cut isn't off the table, and 25 basis point cut seems more likely.

The crisis in financial markets is increasing pressure on Prime Minister Gordon Brown to extend the guarantees on British savers' bank deposits after Ireland announced measures to shore up the debts and savings accounts of its six largest lenders, and the U.S. Congress passed a bank rescue. The prime minister responded by floating the idea of increasing the level at which savers' deposits were guaranteed from £35,000 to £50,000 but said he wanted to wait for things to simmer down in the wild financial markets.



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 - 03	0.50%
Euro-Zone	GDP Year-over-Year	Q2 - 2008	1.4%
	CPI	August - 2008	3.8%
	Unemployment	August - 2008	7.5%
	ECB Target Rate	Oct - 03	4.25%
UK	GDP Year-over-Year	Q2 - 2008	1.5%
	CPI	August - 2008	4.7%
	Unemployment	August - 2008	2.8%
	BoE Target Rate	Oct - 03	5.00%
Canada	GDP Year-over-Year	July - 2008	1.2%
	CPI	August - 2008	3.5%
	Unemployment	August - 2008	6.1%
	BoC Target Rate	Oct - 03	3.00%



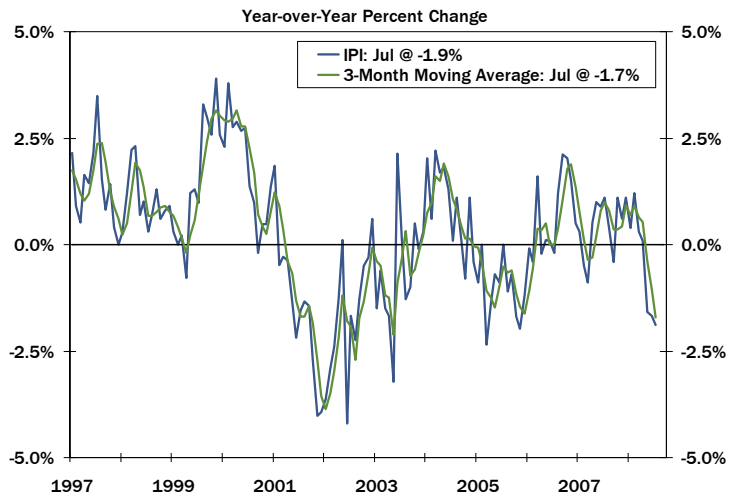
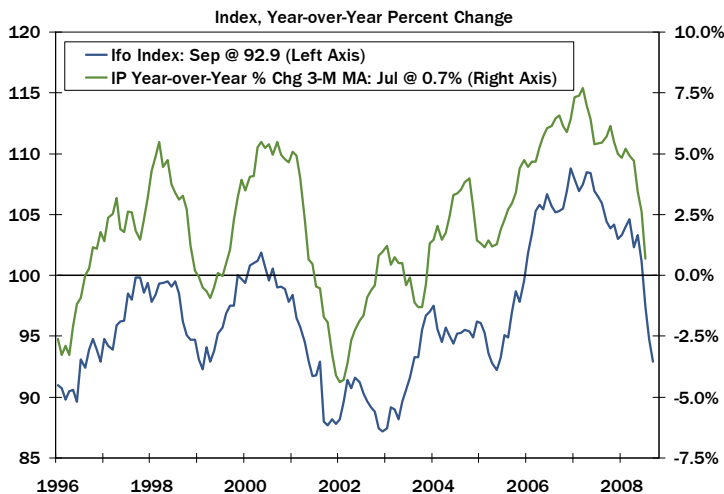
UK Industrial Production • Tuesday

As discussed in the global review, the U.K. economy appears to be sliding into recession. Manufacturing in the U.K. has been slowing at a faster pace than it is in the Euro-zone. Industrial Production hits the wire on Monday. After the manufacturing PMI dropped to its lowest level since 1992, we expect continued weakness out of the British factory sector.

Real GDP slowed to a virtual stand-still in the second quarter, and estimates for third quarter GDP growth will print on Monday. These estimates will help gauge whether or not economic growth has turned negative in the third quarter. Trade balance data for August released on Thursday will indicate the extent to which net exports will impact economic growth.

Previous: -0.4%

Consensus: -0.2%

U.K. Industrial Production Index

German Production Indicators

German Industrial Production • Tuesday

The German economy appears to be slowing quickly. Real GDP declined at an annualized rate of 2.0 percent in the second quarter, which partially reflects statistical payback for the very strong 5.2 percent rate registered in the first quarter. However, more recent indicators suggest that growth in the third quarter likely will be weak. The Ifo index of German business sentiment, which is highly correlated with growth in industrial production, has plunged to its lowest level since mid-2005. Industrial production in August likely will confirm other signs of slowing growth.

Data on German factory orders in August are expected to be released Tuesday, which will give some indication as to the outlook for industrial production in the months ahead.

Previous: -1.8%

Consensus: -0.3%

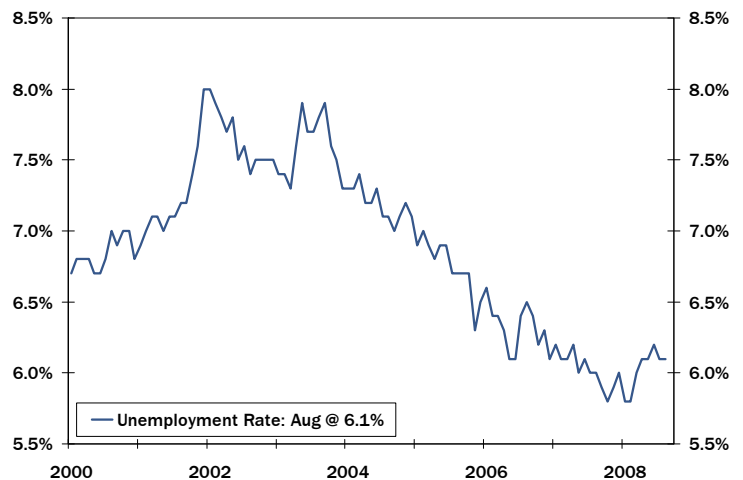
Canadian Unemployment • Friday

As recently as this summer, the Canadian labor market was showing signs of weakness. A drop of more than 55,000 jobs in July was the largest monthly contraction in the Canadian labor force since the last recession in 1991. So the gain of more than 15,000 jobs in August reversed two consecutive monthly contractions and signaled that the Canadian job market was not falling apart. We expect the unemployment rate in Canada will stay around 6 percent before eventually going higher as Canadian employers grapple to deal with slowing global growth.

Also due out next week in Canada is new information on the state of the struggling housing market. Building permits and housing starts will likely slow as Canadian homebuilders hold back on new projects in an environment of cooling demand and tightening lending standards.

Previous: 6.1%

Consensus: 6.2%

Canadian Unemployment Rate


Interest Rate Watch
Recession & Credit Restraint Frame Interest Rate Picture

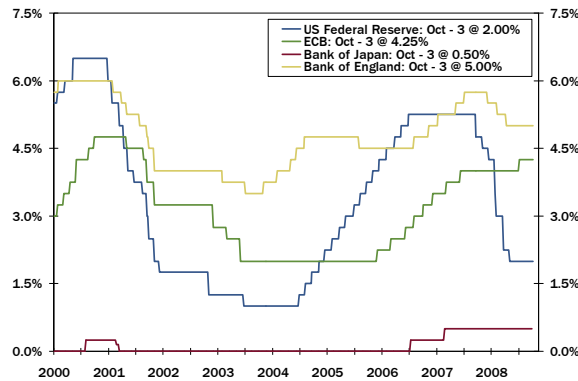
Recession combined with strong risk aversion suggest the Fed will keep the funds rate steady but that private market rates will remain relatively high reflecting credit fears. There is no easy out for creditors or the economy.

Short-term rates are likely to remain steady as the Federal Reserve faces the dual imbalance of negative growth along with expectations of lower inflation in the future. Meanwhile, credit availability, as measured by the Fed's own Senior Loan Officer Survey, is being rapidly reduced. LIBOR spreads remain very high and issuance of high grade and high yield debt is extremely limited. Yet again foreign lending to our capital markets remains very limited compared to prior years. Both the price and availability of credit remains limited compared to a year ago.

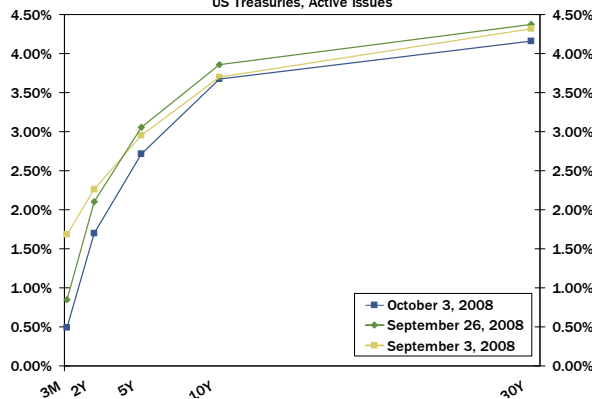
As for long rates, we expect the flight-to-safety will keep the ten-year Treasury rate in a tight 3.5 - 4.0 percent range. Yet there is significant uncertainty on both the dollar and federal deficit outlook that suggests that rates could rise above our outlook.

Risk Aversion Means Tighter Credit

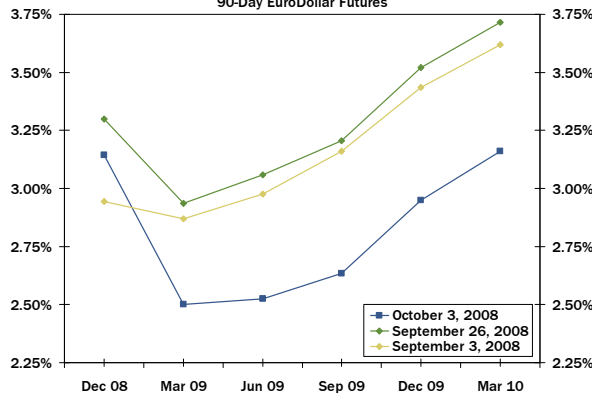
Financial concerns about the viability of numerous financial markets and pricing suggest that credit supply will be further constrained. Mortgage backed securities have suffered due to credit concerns. These concerns have ripple effects as many owners of equity and debt attempt to assess their own balance sheet and price in an era of downside risk of valuations. Capital markets continue to search for a new risk/reward tradeoff. The market and the economy remain constrained by the paradox of lemons. We continue to make lemonade.

Central Bank Policy Rates

Yield Curve

US Treasuries, Active Issues


Forward Rates

90-Day EuroDollar Futures


Topic of the Week
Taking Down the Credit Crunch

In the early 1990s, Japan's economy experienced a financial crisis after a bubble burst. Different band-aids were applied to the series of failures that resulted. The sum cost of all of the measures taken to resolve the crisis amounted to 86 trillion yen, about 17 percent of GDP. The prolonged period of stagnant growth and continual financial crisis became known as *the lost decade*. Similarly to Japan, bad assets have choked off the supply of credit in the current U.S. financial environment. Interbank lending rates (e.g. LIBOR) are abnormally high, especially compared to T-bill yields, manifested in the extreme highs of the TED spread. This flight to safety demonstrates extremely risk-averse behavior by banks. Banks do not want to lend to each other or to businesses because they fear defaults, just as the cost of credit default swaps (CDS), which insure lenders against defaults by borrowers, skyrockets. For banks, liquidity needs cannot be met and wholesale bank runs ensue, in which large depositors withdraw funds in order to fall beneath the amount insured by the FDIC. For corporations that rely on short-term financing, ever-diminishing commercial paper lending forces them to turn to banks. Weak bank balance sheets curtail their ability to provide loans at any rates. A disastrous sequence of economic events ensues.

The financial system must be recapitalized and credit markets unfrozen. Banks need to purge their bad assets and free up space on their balance sheets to begin lending anew. Huge sums of money are certainly required. Maybe the fast band-aid removal approach is best—it might sting now but it's better than the prolonged pain of a lost decade.

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

	Friday 10/3/2008	1 Week Ago	1 Year Ago
3-Month T-Bill	0.49	0.84	3.94
3-Month LIBOR	4.33	3.76	5.24
1-Year Treasury	1.22	1.76	3.88
2-Year Treasury	1.69	2.10	4.02
5-Year Treasury	2.71	3.05	4.25
10-Year Treasury	3.68	3.85	4.56
30-Year Treasury	4.16	4.37	4.80
Bond Buyer Index	5.36	5.23	4.42

Foreign Interest Rates

	Friday 10/3/2008	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	5.33	5.14	4.79
3-Month Sterling LIBOR	6.27	6.26	6.24
3-Month Canadian LIBOR	4.20	4.10	4.92
3-Month Yen LIBOR	1.03	0.94	1.02
2-Year German	3.28	3.66	4.02
2-Year U.K.	4.03	4.25	5.02
2-Year Canadian	2.55	2.83	4.14
2-Year Japanese	0.74	0.83	0.86
10-Year German	3.92	4.16	4.33
10-Year U.K.	4.41	4.55	4.97
10-Year Canadian	3.75	3.68	4.36
10-Year Japanese	1.46	1.47	1.69

Foreign Exchange Rates

	Friday 10/3/2008	1 Week Ago	1 Year Ago
Euro (\$/€)	1.386	1.462	1.409
British Pound (\$/£)	1.781	1.845	2.032
British Pound (£/€)	0.779	0.793	0.693
Japanese Yen (¥/\$)	105.375	106.010	116.750
Canadian Dollar (C\$/ \$)	1.074	1.034	0.998
Swiss Franc (CHF/\$)	1.125	1.090	1.181
Australian Dollar (US\$/A\$)	0.777	0.831	0.883
Mexican Peso (MXN/\$)	11.144	10.787	10.909
Chinese Yuan (CNY/\$)	6.847	6.843	7.506
Indian Rupee (INR/\$)	47.063	46.548	39.593
Brazilian Real (BRL/\$)	2.024	1.845	1.839
U.S. Dollar Index	80.245	76.953	78.573

Commodity Prices

	Friday 10/3/2008	1 Week Ago	1 Year Ago
W. Texas Crude (\$/Barrel)	93.71	106.89	79.94
Gold (\$/Ounce)	828.52	878.75	727.90
Hot-Rolled Steel (\$/S.Ton)	940.00	940.00	520.00
Copper (¢/Pound)	271.00	307.95	374.95
Soybeans (\$/Bushel)	9.42	11.16	8.94
Natural Gas (\$/MMBTU)	7.35	7.47	7.28
Nickel (\$/Metric Ton)	15,070	16,870	30,375
CRB Spot Inds.	436.69	447.97	493.60

Next Week's Economic Calendar

	Monday 6	Tuesday 7	Wednesday 8	Thursday 9	Friday 10
U.S. Data		Consumer Credit July \$4.6 Billion August \$5.8 Billion (C)		Wholesale Inventories July 1.4% August 0.4% (C)	Trade Balance July -\$62.2 Billion August -\$59.1 Billion (W) Import Price Index (MoM) August -3.7% September -4.4% (W)
Global Data	UK Indus. Production (MoM) Previous (Jul) -0.4% UK NIESR GDP Estimate Previous (Aug) -0.2%	Germany Factory Orders (MoM) Previous (Jul) -1.7%	Germany Indus. Production (MoM) Previous (Jul) -1.8%		Canada Unemployment Rate Previous (Aug) 6.1%

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

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