

# WEEKLY ECONOMIC & FINANCIAL COMMENTARY

October 17, 2008

## U.S. Review

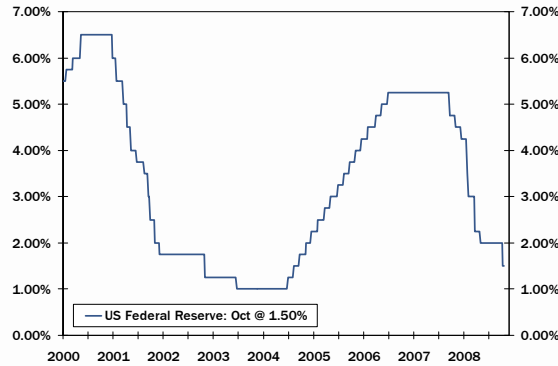
### Wild Week, No Easy Fix

Momentous events have become commonplace during the past few weeks, with huge multi-hundred point swings in the Dow Jones Industrial Average becoming the new norm. The high volatility reflects the extreme uncertainty felt by investors and businesses. The whole host of actions taken by Treasury and the Federal Reserve were designed to bring some certainty back into the market. But sometimes taking such bold action has the unintended consequence of contributing to the very fears those actions were intended to calm.

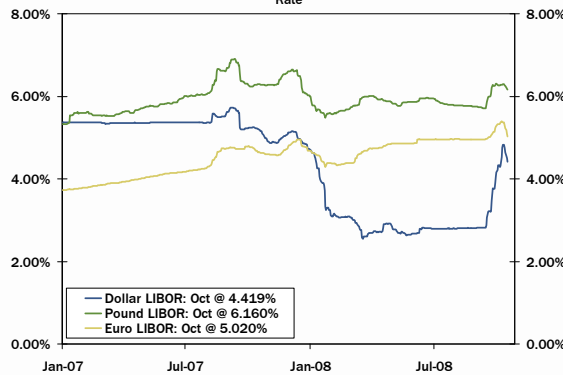
Our view on the recent actions by the Treasury and Fed is that there are no easy solutions to the problems currently plaguing the financial markets and economy. Housing and consumer spending were overdone during the past decade and it will take time to clear the excesses. The leveraging up of financial assets tied to housing and the consumer was also extremely overdone and will take time and considerable financial resources to work toward a resolution. We feel the policies put in place today will help provide some downside protection for the economy and

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U.S. Federal Reserve Target Rate



3-Month LIBOR Fixings Rate



## Global Review

### Money Markets Thaw a Bit

Following last week's coordinated rate cuts by major central banks, policymakers took additional actions this week to thaw credit markets. Treasury Secretary Paulson announced that he would use part of the \$700 billion TARP funds to buy preferred shares in U.S. financial institutions. The news that the Treasury Department would start to directly recapitalize the U.S. banking system propelled the Dow Jones Industrial Average to its largest point gain on record. Many foreign banks, especially those in Europe, have been starved recently for U.S. dollar liquidity. Therefore, the Federal Reserve, which had already increased its swap lines with European central banks, announced that it will extend unlimited swap lines to the ECB, the Bank of England and the Swiss National Bank that will be in place until April 2009. Last week, many governments in western

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## Recent Special Commentary

Date	Title	Authors
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
September-25	Recession Probability Remains Very High	Silvia

## 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 <sup>1</sup>	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 <sup>2</sup>														
"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 <sup>1</sup>	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 <sup>2</sup>	-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 <sup>3</sup>	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 <sup>4</sup>	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

<sup>1</sup> Compound Annual Growth Rate Quarter-over-Quarter

<sup>2</sup> Year-over-Year Percentage Change

<sup>3</sup> Federal Reserve Major Currency Index, 1973=100 - Quarter End

<sup>4</sup> Millions of Units

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U.S. Review

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**Will the Treasury & Federal Reserve Actions Work?**

ultimately help markets correct. A recession, however, cannot be avoided and has probably already begun.

The critical question circulating around Wall Street and Washington is: "Will the actions taken to date help spur new lending?" That question is difficult to answer. Even with the banks flush with cash there is still far less tolerance for risk, particularly in parts of the country where housing prices are falling rapidly. One chief area of concern has been the commercial paper market, which serves as the source of funds for consumer financing for automobiles and other consumer durables. While the Fed has become a participant in the commercial paper market, we still believe terms will be far more difficult this year, which means holiday retail sales will be constrained by a lack of credit.

The investment of funds directly in large banks will also likely pack less punch than is hoped for. While pumping \$250 billion directly into preferred shares is a much quicker way of relieving the banking sector and will serve to boost confidence in the banking system, the greater perception of risk in the economy today means lenders are less risk tolerant. In other words, banks will pay more attention to the 5 Cs. Remember those? (Conditions, Credit, Collateral, Capacity to Repay, and Character) Tighter lending requirements mean credit will likely remain constrained for quite some time.

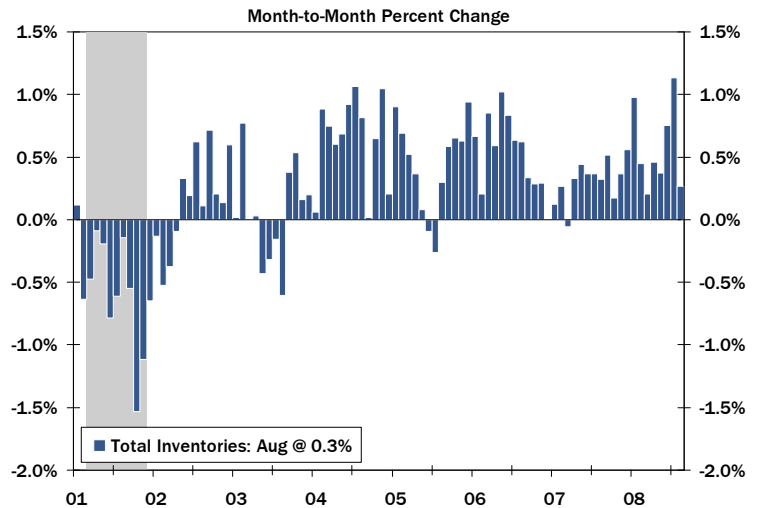
Tight lending policies among banks have downstream effects throughout the economy. Business inventories continued to build in August, as sales slowed at the fastest rate in two years. Earlier this year inventories at retailers and wholesalers seemed to be making improvement while inventories at factories climbed. But as credit-deprived consumers continue to spend less, the picture only gets worse for retail inventories, and eventually wholesalers as well. That darkening picture came into focus as retail sales fell 1.2 percent in September – the fastest pace of decline in three years. Industrial production fell 2.8 percent in September – the largest drop in 34 years - driven by weakness in manufacturing outside the automotive sector.

Over-extended consumers are well-aware they can no longer rely on rising home values and a ready line of credit to support their spending. There was further evidence of that this week as housing starts continued to move lower; pushed by the sharpest decline in single-family activity since late 2006. With the credit crunch continuing to pressure an already strained market, we do not look for near-term improvement.

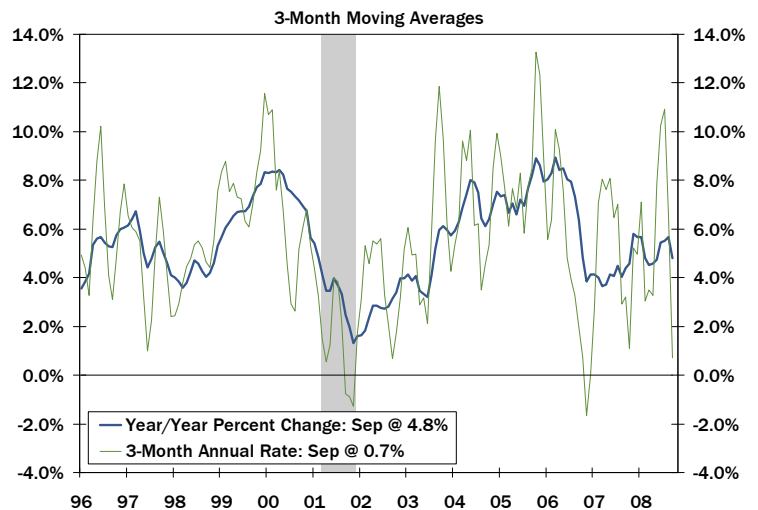
**Selected Current Data**

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 - 17	1.50%

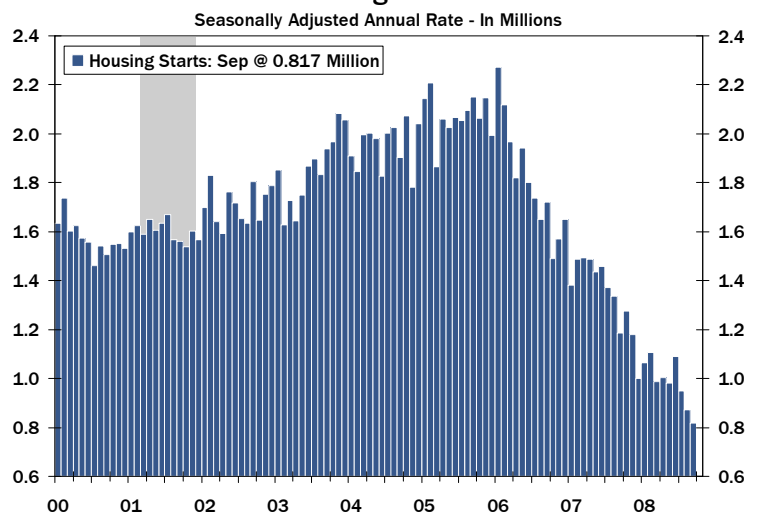
**Total Business Inventories**



**Retail Sales Ex-Motor Vehicles**



**Housing Starts**



**Leading Economic Indicator • Monday**

The Leading Economic Indicators index (LEI) declined sharply, down 0.5 percent, in August as seven of the ten subcomponents contracted.

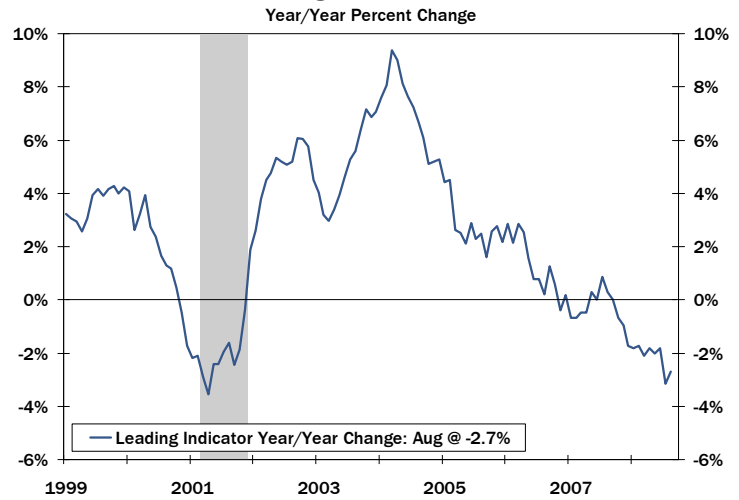
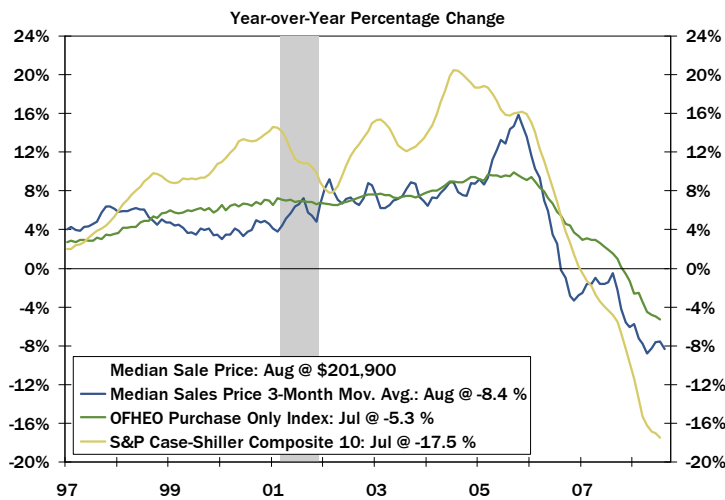
Following its largest two month consecutive decline in eighteen years, we are likely to see a modest rebound in the LEI in September. Positive contributions are expected from the money supply, consumer confidence, supplier deliveries and the yield curve. Negative contributions should largely come from initial jobless claims, stock prices and the manufacturing workweek.

Clearly the year-over-year measure of LEI is suggesting the economy will experience further weakness in the quarters to come. This view corresponds to our updated economic forecast where we see real GDP contracting over the next three quarters.

**Previous: -0.5%**

**Wachovia: 0.2%**

**Consensus: -0.2%**

**Leading Indicator Index**

**OFHEO Home Prices • Thursday**
**Home Prices**


Price data for the second quarter came in generally better than expected, and while the slide continues, the pace of price declines has leveled off (or even improved in some cases). While it may be more than a year before prices stop falling nationwide, and perhaps longer in some markets, the pace of declines may lessen from here. This should not be taken as a reduction in our pessimism on prices. Declines could still easily top 40 percent from peak-to-trough in many of the “bubble markets” and may decline between 20 and 30 percent nationally, depending on the price index considered. A few markets are showing tentative signs of stability.

**Previous: -0.6%**

**Consensus: -0.4%**

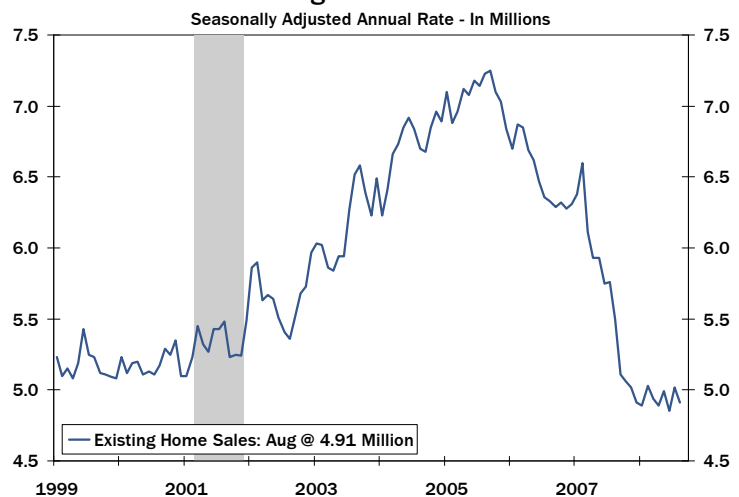
**Existing Home Sales • Friday**

Existing home sales have shown tentative signs of bottoming, with some support from even the hardest-hit markets. Foreclosure sales appear to be giving sales a boost, particularly in California and Florida. Foreclosed properties likely account for a large portion of the recent increase, which, given the recent weak employment in those states, may be giving a false sense of comfort about sales. High inventories will pressure home prices well into 2009 and possibly further. Pending home sales have been trending better over the last few months, but they may be overstating the improvement in activity, as many would-be buyers cannot obtain financing.

**Previous: 4.91M**

**Wachovia: 4.75M**

**Consensus: 4.98M**

**Existing Home Resales**


**Global Review**

*(Continued from Page 1)*

Europe announced steps to fully insure bank deposits, and governments in some Asian nations adopted similar measures this week.

Attempts to thaw frozen credit markets appear to have had some success, although credit markets are by no means back to "normal." The 1-week U.S. dollar LIBOR rate fell more than 150 basis points this week, but it still remains about 80 basis points above the rate that prevailed before the Lehman bankruptcy in mid-September. Moreover, the 1-week LIBOR rate, which is normally a few basis points higher than the fed funds rate, is currently more than 150 basis points above the 1.50 percent target for the Fed's policy rate. Further back the yield curve, 3-month LIBOR rates declined a bit but they still remain very elevated (see graph on front page). In our view, money markets must normalize before one can say with some confidence that the global financial crisis is drawing to a close. LIBOR rates are slowly moving in the right direction, but money markets have clearly not returned to normal yet.

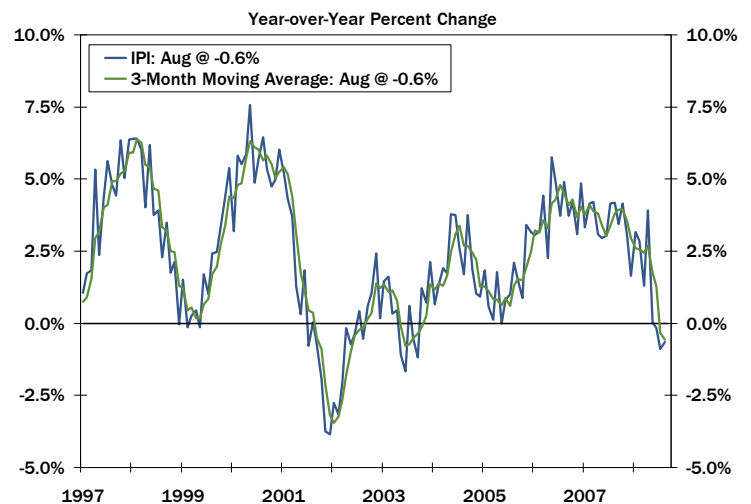
Meanwhile, real economic activity in many countries continues to weaken, and further contraction seems likely, especially if credit markets remain dysfunctional. The number of British workers claiming unemployment insurance for the first time continued to rise in August, pushing the unemployment rate to an eight-year high (see top chart). As we discuss on page 5, third quarter real GDP data in the United Kingdom, which will be released next week, is expected to show the first decline since 1992. Unfortunately, further contraction in the quarters ahead seems likely. In the Euro-zone, industrial production in August rose 1.1 percent, more than offsetting the 0.2 percent decline registered during the previous month. However, the middle chart shows that the trend is clearly down, and recent purchasing managers' indices point to further weakness in the months ahead.

If there is a silver lining to slower global growth, it is that oil prices have plunged more than 50 percent since their mid-July highs. The tumble in oil prices is causing CPI inflation in many countries to recede, which will give scope to most central banks to ease policy further. In order for lower policy rates to help the real economy, however, LIBOR rates, which serve as benchmarks for many borrowing rates, must decline further.

**U.K. Unemployment Rate**



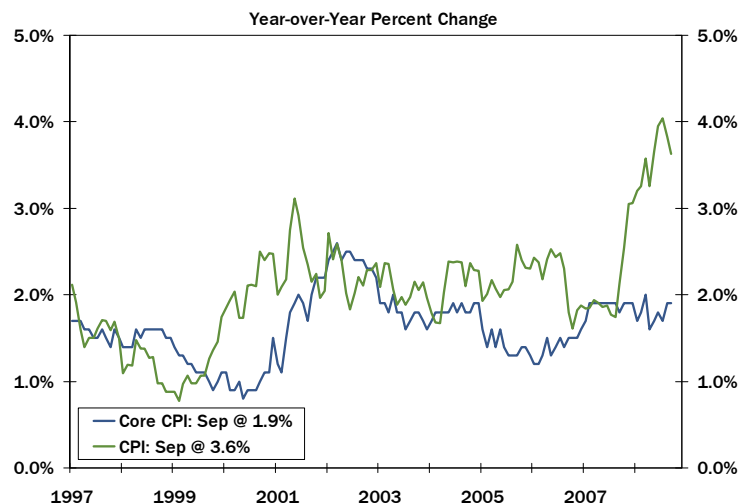
**Euro-zone Industrial Production Index**



**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 - 17	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	Nov - 06	3.75%
UK	GDP Year-over-Year	Q2 - 2008	1.5%
	CPI	September - 2008	5.2%
	Unemployment	September - 2008	2.9%
	BoE Target Rate	Oct - 17	4.50%
Canada	GDP Year-over-Year	July - 2008	1.2%
	CPI	August - 2008	3.5%
	Unemployment	September - 2008	6.1%
	BoC Target Rate	Oct - 17	2.50%

**Euro-zone Consumer Price Inflation**



**Bank of Canada Policy Meeting • Tuesday**

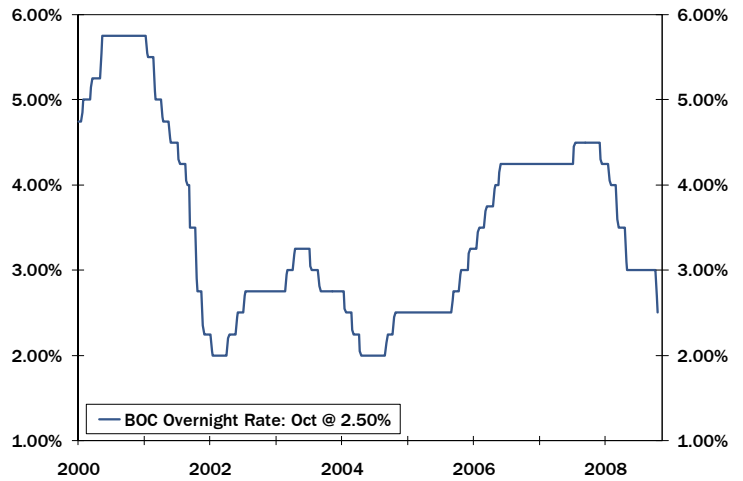
The Bank of Canada joined other major central banks on October 8 when it cut its policy rate by 50 basis points. The Bank holds a regularly scheduled meeting on Tuesday, and analysts are divided over the outcome of the meeting. While we expect the Bank of Canada will ease policy further in the months ahead, we are not convinced it will happen so soon after last week's coordinated action. That said, we would not be completely surprised if the Bank opts to cut rates again next week.

In our view, declining inflation and weak economic growth will give the Bank of Canada scope to ease monetary policy further. In that regard, August data on retail spending will print on Wednesday, and September data on CPI inflation are slated for release on Friday.

**Current BoC Policy Rate: 2.50%**

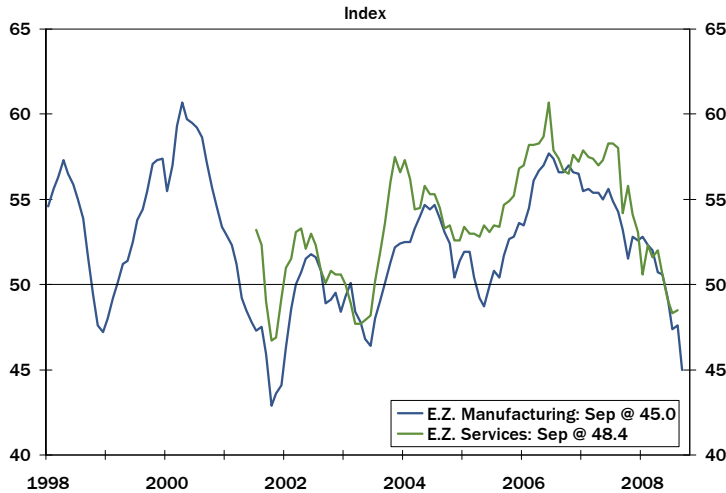
**Consensus: 2.13%**

**Bank of Canada Overnight Lending Rate**



**Euro-zone PMI's • Friday**

**Euro-zone Purchasing Manager Indices**



Over the past few months, the manufacturing and service sector PMIs in the Euro-zone have dropped sharply, and the consensus forecasts anticipate further declines in October. Indeed, if the consensus forecasts are realized, both indices would fall to their lowest levels since 2001.

The Euro-zone economy appears to be in recession at present, and we look for a few more quarters of negative growth. Last week, the European Central Bank reversed course when it joined other major central banks by cutting its policy rate by 50 basis points. In our view, the incipient recession and receding inflation will give the ECB scope to cut rates further in the months ahead.

**Previous Mfg PMI: 45.0**

**Consensus Mfg PMI: 44.0**

**Previous Services PMI: 48.4**

**Consensus Services PMI: 46.7**

**U.K. Third Quarter GDP • Friday**

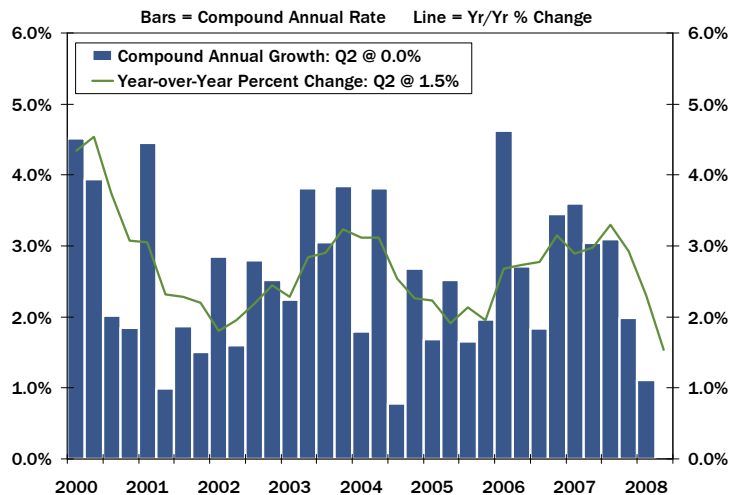
Real GDP in the United Kingdom was flat in the second quarter, and monthly indicators suggest that GDP contracted at an annualized rate of roughly 1 percent in the third quarter. If the official GDP data on Friday confirm the monthly data, it will be the first decline in British real GDP since the second quarter of 1992. Unfortunately, we see further contraction in the British economy over the next few quarters.

Consumer spending has held up remarkably well so far this year, but the market consensus forecast anticipates that the volume of retail sales fell 0.6 percent in September following the stronger-than-expected rise of 1.2 percent in the previous month. Looking ahead, we expect consumer spending will weaken further as unemployment climbs higher.

**Previous: 0.0% (sequential rate, not annualized)**

**Consensus: -0.2%**

**U.K. Real GDP**

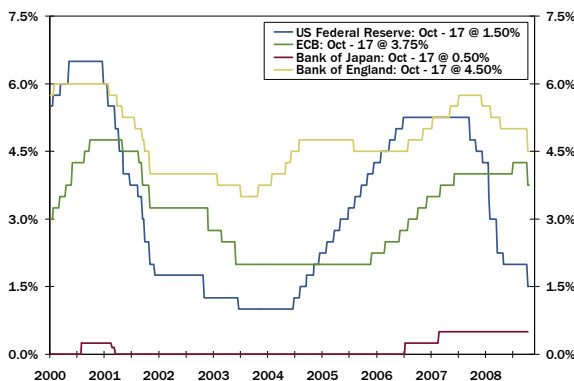
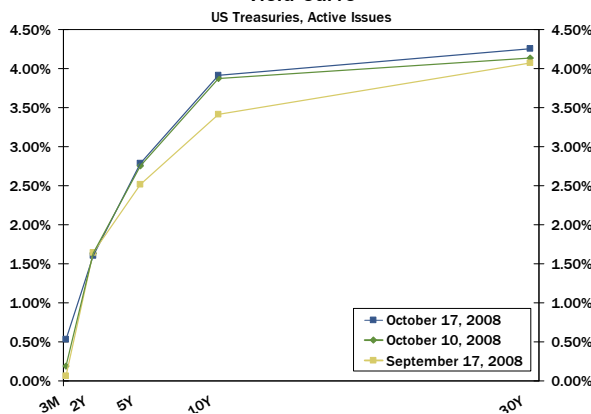
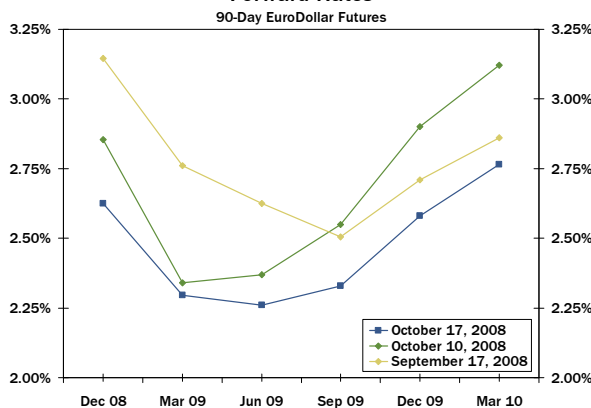


**Interest Rate Watch**
**Recession Drives Fed Policy and Credit Restraint**

This week we saw declines in retail sales, industrial production and the Philadelphia Fed index which drive expectations for a prolonged recession. Our expectation is that the recession will last through the first quarter of 2009. Therefore we expect the Federal Reserve to lower interest rates again this quarter and to maintain their liquidity facilities through the first quarter of next year.

Unfortunately, recessions also suggest credit aversion. Therefore, we expect that credit spreads over the funds rate will remain wider than the 2003-2006 period. The market continues to search for that new tradeoff between risk and reward. There is no easy out for creditors or the economy. Credit, as measured by the Fed's own Senior Loan Officer Survey, will continue to be in short supply. Both the price and the availability of credit are likely to assume a very different tone than earlier in this decade. Issuance of high grade and high yield debt will remain extremely limited.

A new twist will be the tension among foreign investors towards the U.S. capital markets given the uncertainties associated with large Federal deficits and a new political leadership. How committed will this leadership be to a strong currency, limited inflation and restraint on federal deficits? In the short run 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 if the policy outlook takes on a less friendly tone to capital market concerns. The market and the economy remain constrained by the paradox of lemons – make more lemonade.

**Central Bank Policy Rates**

**Yield Curve**

**Forward Rates**

**Topic of the Week**
**Global Recession Appears Likely**

Global real GDP growth averaged nearly five percent per annum between 2004 and 2007, the strongest four-year period of growth in decades. However, real GDP growth rates have slowed in most countries this year, and we look for further deceleration in 2009. Indeed, we project that global GDP will grow only two percent in 2009, the slowest year for global growth since 1993. If credit markets remain frozen for a prolonged period of time, global growth next year could be even slower than our official projection. Indeed, it is very difficult to forecast with any reasonable degree of certainty during the middle of a global financial crisis. Underlying all of our projections is our assumption that policymakers will take the necessary steps to prevent the global financial system from completely imploding.

We project that every G-7 economy will contract somewhat over the next few quarters. Growth in the developing world should slow further next year as well. However, economic fundamentals in many developing countries are generally much stronger today than in the past, making those countries more resilient to downturns in the developed world. That said, most developing countries will probably experience the slowest year of growth since 2002.

Although the U.S. economy continued to expand in the first half of the year, it now appears that the U.S. has slipped into recession as credit markets have essentially shut down. It also appears that the U.K. has slipped into recession, and we look for U.K. economic activity to contract for a few more quarters. Japanese growth turned negative recently, and the Euro-zone economy will probably contract modestly over the next few quarters.

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

	Friday 10/17/2008	1 Week Ago	1 Year Ago
3-Month T-Bill	0.53	0.52	3.99
3-Month LIBOR	4.50	4.75	5.21
1-Year Treasury	1.29	1.16	4.03
2-Year Treasury	1.60	1.53	3.97
5-Year Treasury	2.84	2.63	4.34
10-Year Treasury	3.96	3.64	4.65
30-Year Treasury	4.26	4.05	4.90
Bond Buyer Index	6.01	5.47	4.39

**Foreign Interest Rates**

	Friday 10/17/2008	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	5.02	5.37	4.65
3-Month Sterling LIBOR	6.16	6.29	6.30
3-Month Canadian LIBOR	3.84	3.80	4.97
3-Month Yen LIBOR	1.06	1.08	0.98
2-Year German	2.89	3.04	4.16
2-Year U.K.	3.57	3.53	5.22
2-Year Canadian	2.25	2.13	4.28
2-Year Japanese	0.79	0.80	0.86
10-Year German	3.96	4.00	4.39
10-Year U.K.	4.62	4.47	5.03
10-Year Canadian	3.69	3.63	4.43
10-Year Japanese	1.59	1.47	1.66

**Foreign Exchange Rates**

	Friday 10/17/2008	1 Week Ago	1 Year Ago
Euro (\$/€)	1.349	1.360	1.417
British Pound (\$/£)	1.731	1.710	2.033
British Pound (£/€)	0.778	0.787	0.696
Japanese Yen (¥/\$)	101.679	99.820	116.920
Canadian Dollar (C\$/ \$)	1.176	1.150	0.979
Swiss Franc (CHF/\$)	1.131	1.139	1.180
Australian Dollar (US\$/A\$)	0.691	0.643	0.891
Mexican Peso (MXN/\$)	12.833	13.093	10.819
Chinese Yuan (CNY/\$)	6.833	6.836	7.516
Indian Rupee (INR/\$)	48.883	48.470	39.563
Brazilian Real (BRL/\$)	2.132	2.313	1.822
U.S. Dollar Index	82.427	82.997	78.120

**Commodity Prices**

	Friday 10/17/2008	1 Week Ago	1 Year Ago
W. Texas Crude (\$/Barrel)	72.19	86.59	87.61
Gold (\$/Ounce)	788.52	849.85	754.82
Hot-Rolled Steel (\$/S.Ton)	915.00	940.00	520.00
Copper (¢/Pound)	211.30	215.65	358.45
Soybeans (\$/Bushel)	8.27	9.07	9.26
Natural Gas (\$/MMBTU)	6.76	6.54	7.46
Nickel (\$/Metric Ton)	10,560	13,200	31,450
CRB Spot Inds.	403.33	418.89	492.80

**Next Week's Economic Calendar**

	Monday 20	Tuesday 21	Wednesday 22	Thursday 23	Friday 24
<b>U.S. Data</b>	<b>Leading Indicators</b> August -0.5% September 0.2% (W)			<b>Initial Jobless Claims</b> October 11 461K Oct. 18th 465K (c)	<b>Existing Home Sales</b> August 4.91M September 4.75M (W)
<b>Global Data</b>		<b>Canada</b> <b>Bank of Canada Rate</b> Previous 2.50%	<b>Canada</b> <b>Retail Sales (MoM)</b> Previous (Jul) 0.1%	<b>UK</b> <b>Retail Sales (MoM)</b> Previous (Aug) 1.2%	<b>UK</b> <b>GDP (QoQ)</b> Previous (2Q) 0.0% <b>Euro Zone</b> <b>PMI Manufacturing</b> Previous (Sep) 45.0

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

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