

### WEEKLY ECONOMIC & FINANCIAL COMMENTARY

November 14, 2008

#### U.S. Review

##### Fourth Quarter Off to Weak Start

This week had a relatively light schedule of economic reports but nearly every report confirmed more weakness in the underlying economy. The highlight (should that be lowlight?) of the week was the release of retail sales data that showed a 2.8 percent drop in overall retail sales in October (see graph at right). Although the sharp drop in gasoline prices in October contributed to the falling value of retail sales, it was not the entire story. Spending on autos and parts tumbled 5.5 percent, and most other categories of retail spending posted losses as well. Our forecast calls for real consumer spending to plunge more than three percent in the fourth quarter, which would follow the 3.1 percent decline in the third quarter, and the retail sales data for October give us little hope that the actual outturn will be stronger than we project.

Most major retailers have reduced their expectations for the holiday shopping season. Our own forecast calls for a slight decline in holiday sales, ranging somewhere between -0.5 percent and -2.0 percent (year-over-year changes) Hiring will be down this holiday season and

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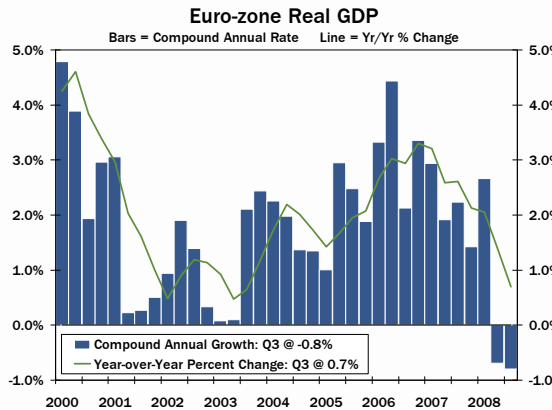
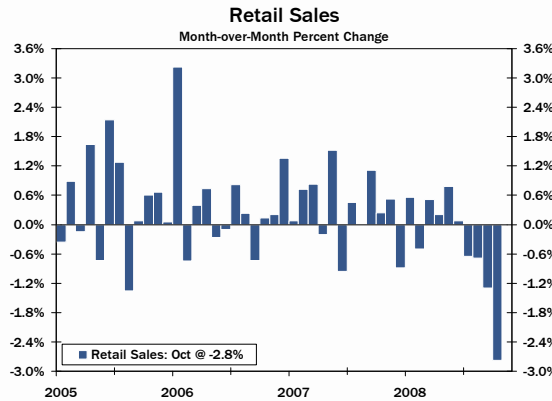
#### Global Review

##### It's Official: Euro-zone Recession

Data released this week showed that real GDP in the Euro-zone declined 0.2 percent in the third quarter relative to the previous quarter, which translates into an annualized rate of decline of approximately 0.8 percent (see graph at left). If the unofficial definition of recession is two consecutive quarters of negative real GDP growth, then it seems apparent that the Euro-zone has slipped into recession.

Some individual countries in the Euro-zone released their individual GDP data this week. Among the largest individual economies the lone bright spot was France, where real GDP edged up at an annualized rate of 0.6 percent. Although investment spending posted its second consecutive quarterly decline, consumer spending continues to hold up reasonably well, growing at an annualized rate of 1.6 percent in

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#### Recent Special Commentary

Date	Title	Authors
November-14	Trends, Cycles and Dangers of Historical Extrapolation	Silvia & Iqbal
November-13	Global Chartbook - November 2008	Bryson & Quinlan
November-05	The Grinch May Roil Holiday Sales This Year	Vitner & York
October-20	Japan's "Lost Decade": Implications for the U.S. Economy	Bryson

#### 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 <sup>1</sup>	0.9	2.8	-0.3	-3.6	-2.5	0.0	1.0	1.6	2.9	2.8	2.0	1.3	-1.0	1.4
Personal Consumption	0.9	1.2	-3.1	-3.3	-1.3	0.7	1.2	1.3	3.0	3.0	2.8	0.4	-0.9	1.5
Inflation Indicators <sup>2</sup>														
"Core" PCE Deflator	2.2	2.3	2.5	2.2	2.0	1.9	1.7	1.9	2.1	2.3	2.2	2.3	1.9	2.0
Consumer Price Index	4.2	4.3	5.3	3.4	2.4	1.7	0.7	2.0	3.4	3.2	2.9	4.3	1.7	2.4
Industrial Production <sup>1</sup>	0.4	-3.1	-6.0	-6.7	-5.0	-2.7	-1.4	0.3	3.3	2.2	1.7	-1.0	-4.1	1.0
Corporate Profits Before Taxes <sup>2</sup>	-1.5	-8.3	-12.5	-17.5	-25.0	-20.0	-16.0	-10.0	17.6	15.2	-1.6	-10.0	-18.1	6.3
Trade Weighted Dollar Index <sup>3</sup>	70.3	71.0	76.1	81.8	85.6	88.7	91.6	94.3	86.0	81.5	73.3	81.8	94.3	96.5
Unemployment Rate	4.9	5.3	6.0	6.5	7.2	7.7	8.0	8.3	5.1	4.6	4.6	5.7	7.8	8.8
Housing Starts <sup>4</sup>	1.05	1.03	0.88	0.76	0.66	0.65	0.68	0.73	2.07	1.81	1.34	0.93	0.68	0.98
Quarter-End Interest Rates														
Federal Funds Target Rate	2.25	2.00	2.00	0.75	0.50	0.50	0.50	0.50	4.25	5.25	4.25	0.75	0.50	1.00
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	4.50

Data As of: November 12, 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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discounts will likely be far more aggressive than in years past. Speaking of hiring (or lack thereof), weekly first-time unemployment claims surged by 32,000 to 516,000 in early November (see top chart). The four-week moving average, which is our preferred way of looking at this volatile series, rose to 491,000, which is its highest level since the tail end of the 1990/91 recession. Actual layoff announcements have increased in recent weeks and we expect weekly first-time unemployment claims and the unemployment rate to rise significantly further. Indeed, we project that the unemployment rate, which currently stands at 6.5 percent, will approach eight percent by the middle of next year. With consumers worried about their jobs, the outlook for consumer spending is obviously not very bright.

Overall U.S. GDP growth has been supported over the past few quarters by strong export growth. Unfortunately, the latest trade figures that were released this week contained some disappointing news. As shown in the middle chart, the trade gap narrowed by \$2.6 billion to \$56.5 billion in September. However, the modest improvement in the trade deficit actually masks some disturbing trends in both imports and exports. Total imports of goods and services plunged \$12.5 billion in September, the largest monthly decline on record. Although the collapse in oil prices caused the value of petroleum imports to tumble \$6.9 billion, non-petroleum imports were off \$5.2 billion, reflecting the underlying weakness in the U.S. economy.

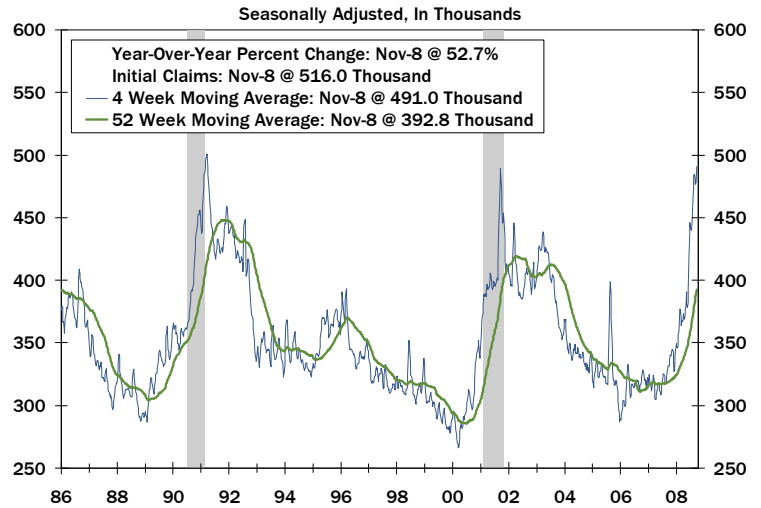
Perhaps more disturbingly, exports nosedived \$9.8 billion in September, also a record. Although the decline may have been exaggerated by the Boeing strike, which reduced output at the nation's largest exporter, the losses in exports were broad-based. It appears that weak growth in the rest of the world is starting to show up at the U.S.'s doorstep in the form of slowing export growth. Indeed, as we discuss in the international section of this report, the Euro-zone, to which the United States ships about 20 percent of its exports, has slipped into recession. With most major foreign economies either in recession or about to enter one, U.S. export growth is sure to slow further.

In sum, it appears that the fourth quarter has gotten off to a very weak start. As noted previously, we project that real personal consumption expenditures will tumble more than 3 percent in the fourth quarter. Businesses are cutting back on capex plans, and inventories likely will be cut further. If, as we expect, real GDP falls at an annualized rate of 3.6 percent in the fourth quarter, it will be the sharpest quarterly contraction since the first quarter of 1982.

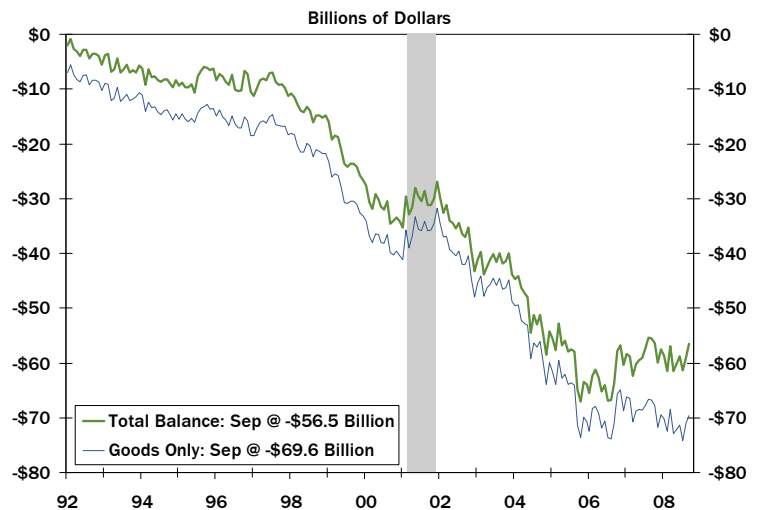
**Selected Current Data**

Gross Domestic Product - CAGR	Q3 - 2008	-0.3%
GDP Year-over-Year	Q3 - 2008	0.8%
Personal Consumption	Q3 - 2008	-3.1%
Business Fixed Investment	Q3 - 2008	-1.0%
Consumer Price Index	September - 2008	4.9%
"Core" CPI	September - 2008	2.5%
"Core" PCE Deflator	September - 2008	2.4%
Industrial Production	September - 2008	-4.5%
Unemployment	October - 2008	6.5%
Federal Funds Target Rate	Nov - 14	1.00%

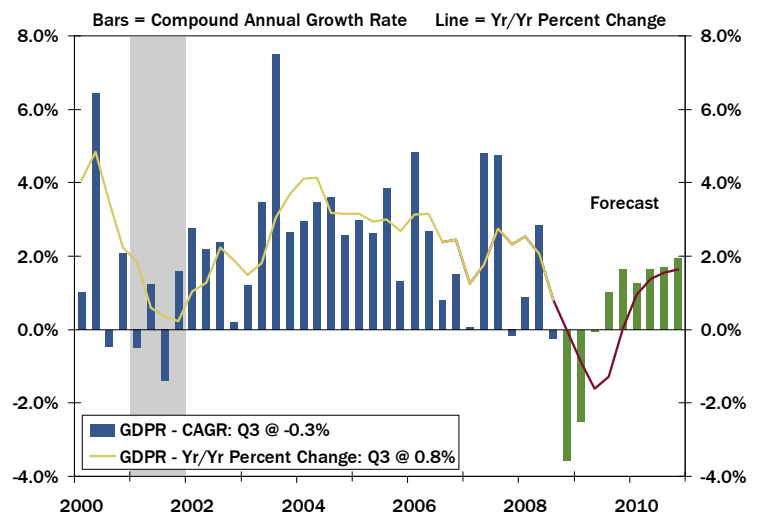
**Initial Claims for Unemployment**



**Trade Balance In Goods And Services**



**Real GDP**



**Industrial Production • Monday**

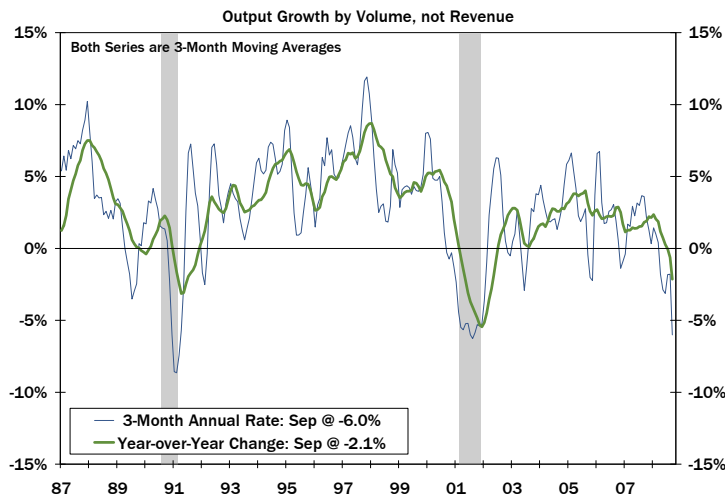
Industrial production fell 2.8 percent in September driven by weakness in manufacturing ex-autos, mining and the impact of Hurricane Ike. Over the last three months, industrial production has trended down to levels consistent with previous recessions.

We expect industrial production to continue to post declines and look for a contraction of 0.8 percent in October. Declines in ISM Manufacturing, Chicago PMI and manufacturing employment continue to show weakness in the manufacturing sector and suggest a drop in manufacturing activity. In particular, motor vehicle production should decline, reflecting weak demand. The outlook for industrial production is worrisome as slower export activity due to a stronger U.S. dollar and slower global growth may limit improvement in the second half of 2008 and early 2009.

**Previous: -2.8%**

**Wachovia: -0.8%**

**Consensus: 0.2%**

**Total Industrial Production Growth**

**Consumer Price Index • Wednesday**

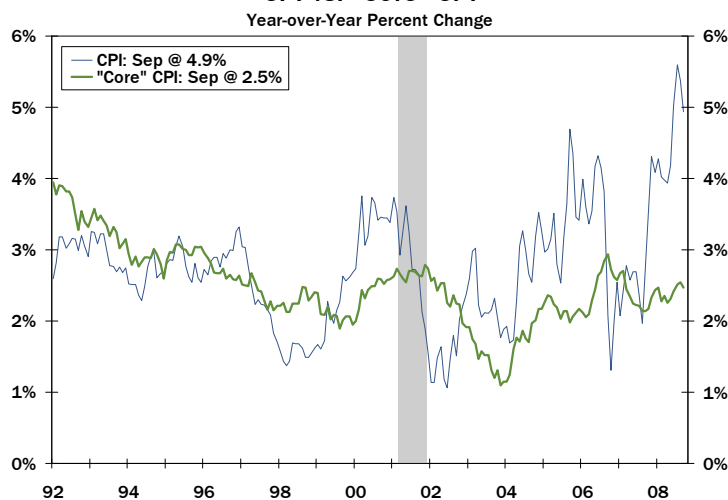
Consumer prices were flat in September, but we expect headline CPI to decline 0.5 percent in October. The outlook for consumer price inflation appears to be easing, especially with the recent sharp decline in gasoline prices. On average, prices at the pump were down roughly 20 percent in October compared to September and wholesale gasoline prices suggest further declines. We expect core prices went up 0.1 percent in month of October. Despite rapid increases in food and energy, core CPI has remained well behaved.

The rate of inflation will likely peak in the third quarter and slow moderately by the end of the year.

**Previous: 0.0%**

**Wachovia: -0.5%**

**Consensus: -0.8%**

**CPI vs. "Core" CPI**

**Housing Starts • Wednesday**

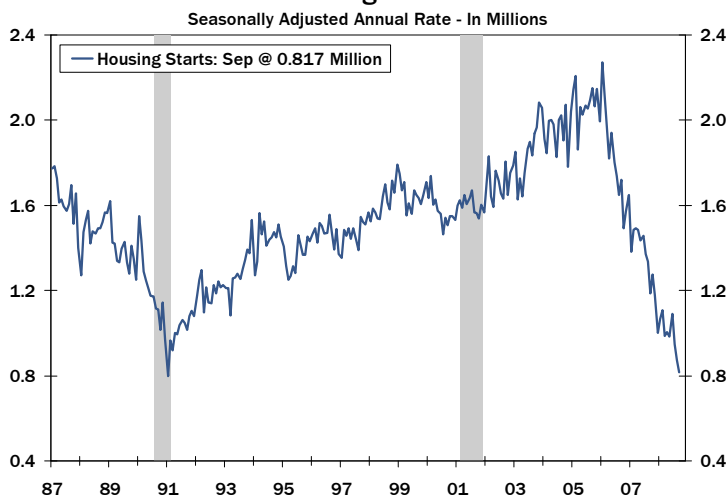
Housing starts continued to move lower in September pushed by a 12 percent decline in single-family activity—the sharpest decline since late 2006. Building permits also continued to move lower, off 8.3 percent.

With the credit crunch continuing to pressure an already strained market, we expect housing starts to fall further in October to an annualized pace of 770K. While there are signs that residential construction is stabilizing, housing is unlikely to make a positive contribution to growth for several quarters as inventory levels of unsold and unoccupied homes remains elevated. The single-family market remains extremely weak and we expect this weakness to persist well into next year.

**Previous: 817K**

**Wachovia: 770K**

**Consensus: 780K**

**Housing Starts**


**Global Review**

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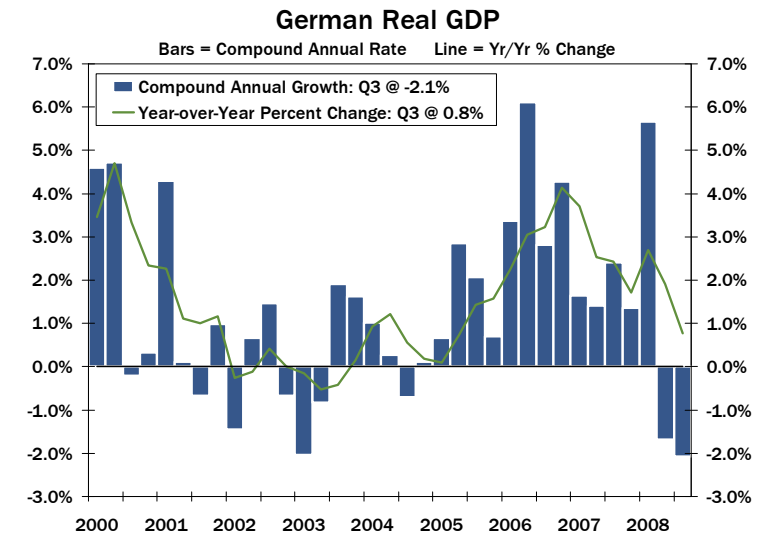
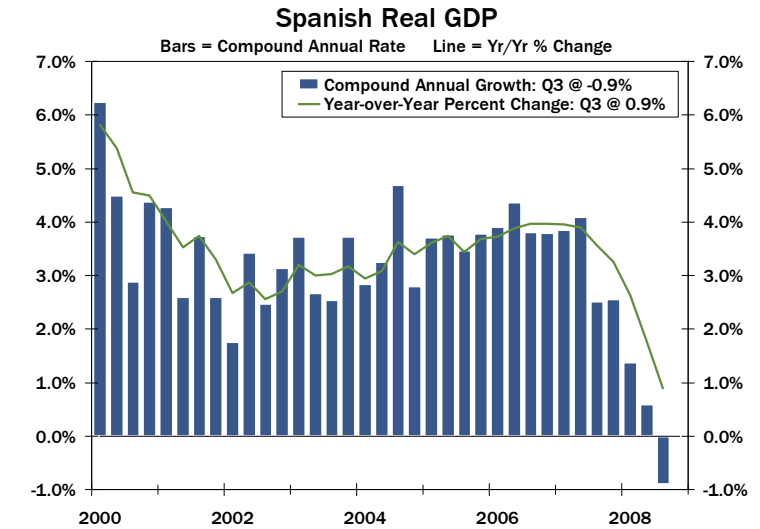
the third quarter. However, the 7.1 percent rise in exports does not seem sustainable given weak growth in the rest of the world.

Indeed, most other Euro-zone economies, to which France sends about 60 percent of its exports, underperformed the French economy in the third quarter. Real GDP in the Netherlands was flat, and Spanish GDP fell at an annualized rate of 0.9 percent, the first contraction in the Spanish economy since at least 1995 (see top chart). In Italy, output fell at an annualized rate of 2.0 percent in the third quarter, which follows the 1.8 percent contraction in real GDP in the previous quarter.

The German economy turned out to be much weaker than previously thought. As shown in the middle chart, real GDP tumbled at an annualized rate of 2.1 percent in the third quarter, the sharpest decline since the first quarter of 1996. Although a breakdown of real GDP into its underlying demand components is not yet available, German statistical authorities said a big swing in net exports, induced by strong growth in gross imports and a sharp fall in gross exports, was partly responsible for the weakness in overall real GDP. The statistical authorities also said consumer spending rose during the quarter, which is somewhat surprising given the 1.6 percent annualized decline in real retail sales that occurred. Apparently, consumer spending on services held up fairly well in the third quarter.

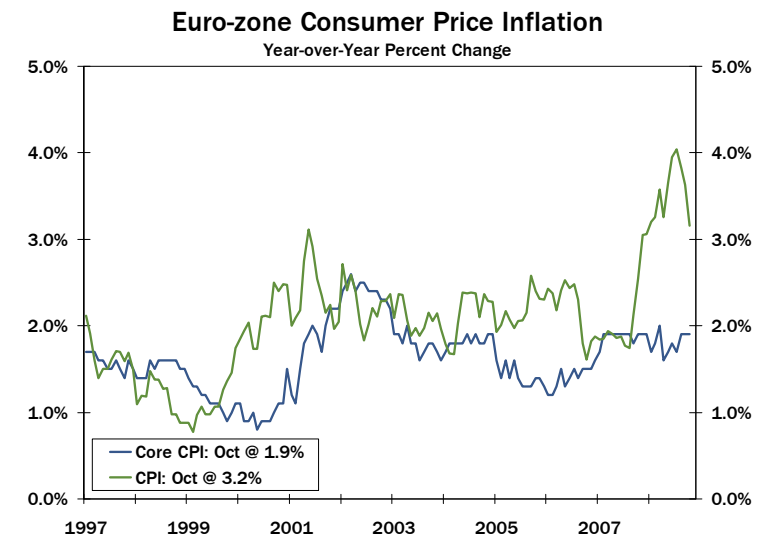
A few months ago, the ECB thought that the most serious issue it faced was inflation. Indeed, the year-over-year rate of CPI inflation rose to 4.0 percent in both June and July, well above the two percent rate ECB policymakers consider to be consistent with price stability (see bottom chart). However, the ground has shifted underneath the ECB's feet over the past few months. With the Euro-zone in recession and energy prices down sharply, inflation should be the least of the ECB's worries at present.

The ECB joined other major central banks by cutting rates by 50 basis points on October 8, and reduced its policy rate by another 50 basis points last week. In our view, the ECB will take its policy rate down 150 basis points more by early next year as the recession deepens. As we discuss in our recent *Monthly Economic Outlook*, further ECB easing should cause the euro to trend lower versus the dollar in 2009.



**Selected Global Data**

Japan	GDP Year-over-Year	Q2 - 2008	0.7%
	CPI	September - 2008	2.1%
	Unemployment	September - 2008	4.0%
	BoJ Target Rate	Nov - 07	0.30%
Euro-Zone	GDP Year-over-Year	Q2 - 2008	1.4%
	CPI	September - 2008	3.6%
	Unemployment	September - 2008	7.5%
	ECB Target Rate	Nov - 07	3.25%
UK	GDP Year-over-Year	Q3 - 2008	0.3%
	CPI	September - 2008	5.2%
	Unemployment	September - 2008	2.9%
	BoE Target Rate	Nov - 06	3.00%
Canada	GDP Year-over-Year	August - 2008	0.6%
	CPI	September - 2008	3.4%
	Unemployment	October - 2008	6.2%
	BoC Target Rate	Nov - 07	2.25%



**Japanese Real GDP • Monday**

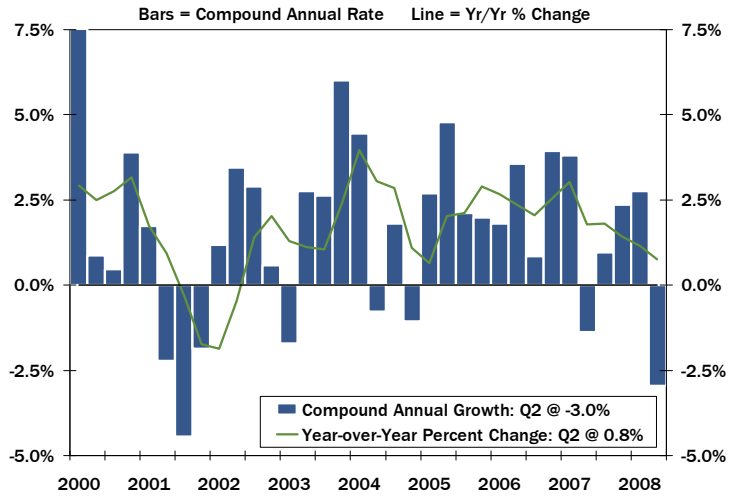
Real GDP in Japan declined at an annualized rate of 3.0 percent in the second quarter, the fastest rate of contraction since 2001. The consensus forecast anticipates that growth was roughly flat in the third quarter, but Japanese GDP is a bit of a black box so a range of outcomes is possible. In general, however, Japanese economic growth has clearly slowed over the last year, and it is hard to imagine Japan avoiding a downturn if many other major economies are in recession.

A few data releases next week will help investors determine the state of the Japanese economy in the current quarter. Data on department store sales print on Tuesday, and the merchandise trade balance in October will be announced on Thursday.

**Previous: -3.0% (annualized rate)**

**Consensus: 0.1%**

**Japanese Real GDP**



**U.K. Retail Sales • Thursday**

Real GDP in the United Kingdom tumbled at an annualized rate of 2.0 percent in the third quarter, the first quarter of negative growth since 1992. Unfortunately, a few more quarters of contraction seem likely. A widely watched manufacturing survey will print on Wednesday and data on retail spending in October, which is on the docket on Thursday, will give investors some insights into how the fourth quarter started.

Data on CPI inflation, which rose to a 16-year high of 5.2 percent in September, will print on Tuesday. However, the Bank of England recently forecasted that inflation will drop like a stone in the months ahead due to the collapse in energy prices and the incipient recession. Speaking of the Bank of England, the minutes of the November 6 policy meeting, at which the MPC slashed rates by 150 basis points, will be released on Wednesday. The minutes may give some clues about the stance of monetary policy going forward.

**Previous: -0.4% (month-on-month)**

**Consensus: -0.8%**

**United Kingdom Retail Sales**



**Euro-zone PMIs • Friday**

As discussed in the main body of this report, data released this week showed that real GDP in the Euro-zone declined 0.2 percent (not annualized) in the third quarter. This contraction in overall GDP had already been signaled by the sharp decline in the manufacturing and service sector PMIs in recent months. The "flash" estimates of both indices will be released on Friday. If both indices decline further in November as the consensus forecasts anticipate, then it seems likely the recession is deepening in the current quarter.

The French economy expanded in the third quarter due in part to modest growth in consumption expenditures. Data on retail sales in October, which are slated for release on Friday, will offer some insights into the current state of consumer spending.

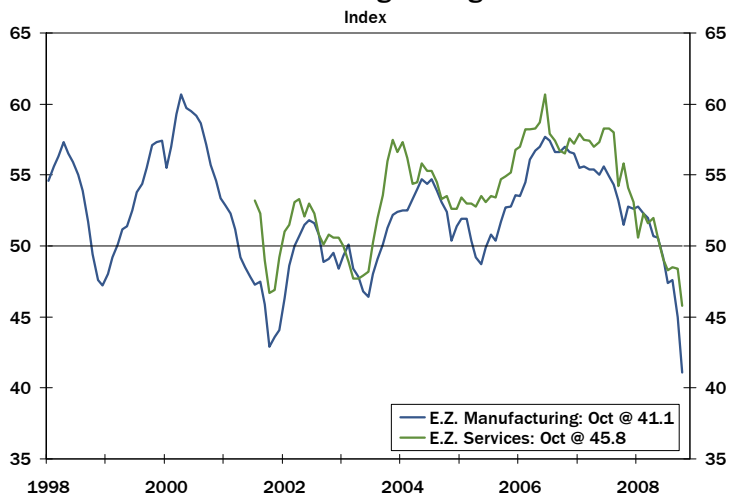
**Previous Manufacturing PMI: 41.1**

**Consensus: 40.5**

**Previous Service PMI: 45.8**

**Consensus: 45.2**

**Euro-zone Purchasing Manager Indices**



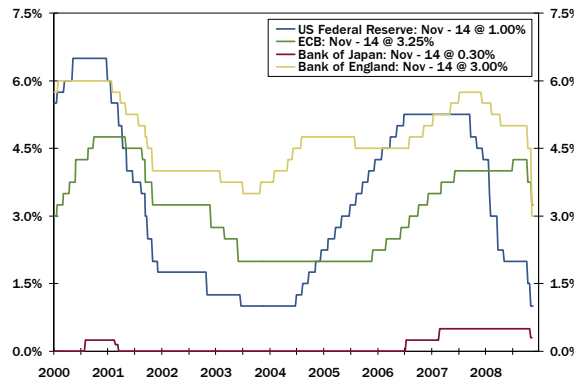
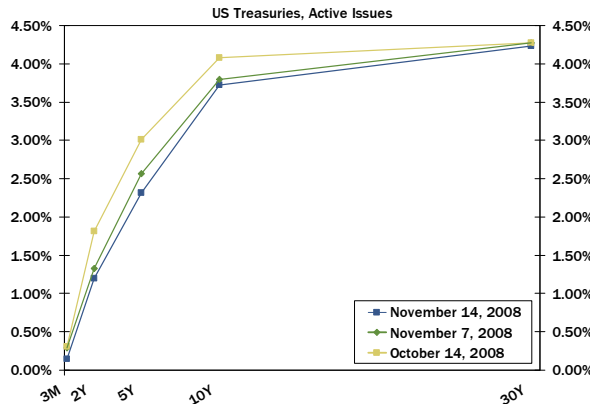
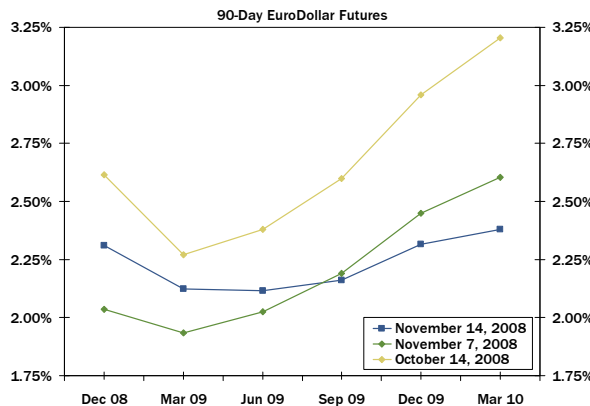
**Interest Rate Watch**
**Rates and Credit in a Recession**

We expect persistently weak economic growth for this quarter and the first half of 2009. From this fundamental driver comes a view that inflation will not be a major issue in 2009. However Treasury deficits and corporate profits will raise investor concerns. In addition, we expect that weak economic growth will keep the Federal Reserve on hold and the funds rate below one percent for all of next year. Inflation concerns are just not a barrier to the Fed's program of liquidity/credit supply to financial intermediaries.

With these fundamentals in place, what can we expect from interest rates? For Treasuries we expect continued low short rates with the two-year Treasury remaining between 1.6 and 2.0 percent for the next year. Historically, the two-year Treasury has served as a good benchmark for pricing private instruments but also as a proxy for expected future Fed funds rate moves. For us, we expect that the two-year will be consistent with no Fed moves but some upward pressure on rates as Treasury debt financing becomes a concern. We expect a steady rise in rates for 5, 10 & 30 year benchmark Treasuries as deficit financing concerns will weigh on investor demand.

**Credit: Trust in Short Supply**

We expect that the recent improvement at the short end of the yield curve for private markets, such as LIBOR, will remain in place and improve along with further Fed easing. Credit availability is coming back into the market, at least for inter-bank lending, the worst of the credit problem may have passed—at least at the short-end of the curve. However, the credit channel from banks to borrowers will not improve as rapidly.

**Central Bank Policy Rates**

**Yield Curve**

**Forward Rates**

**Topic of the Week**
**A Healthy Dose Of Reality**

President Bush delivered a speech Thursday defending the virtues of capitalism. The notion that capitalism has to be defended is absurd to us. The capitalist, free-market system has increased the standard of living for more people than any other economic system ever devised or put in place. American-style capitalism, which has taken the brunt of criticism recently, has built the largest and most successful economy in world history. Countries which have adopted the U.S. system or moved toward it; including Japan, Korea, India and much of Eastern Europe, have rapidly achieved the greatest prosperity their nations have ever seen. Capitalism is not without its faults but its positives outweigh its negatives by a greater margin than any other system. Leaders from the G-20 countries will gather in Washington this weekend to discuss ways to increase transparency and reduce volatility in global markets and economies. There is no one silver bullet to solve the financial crisis or single way to rejuvenate global economic growth. The imbalances that have built up in the global economy, including the huge U.S. trade deficit and lack of strong domestic demand in many countries overseas, will need to be undone. Global economic growth will stagnate as these adjustments take place. Decisions made by the G-20 and policies adopted by member nations may soften the blow of this downturn but any sustained recovery in the U.S. and global economies will be driven by market forces not governments. The health and sustainability of the eventual recovery will be influenced by how far countries move away from the free-market system. The closer they stay to it, the stronger and more enduring any successive recovery is likely to be.

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

	Friday 11/14/2008	1 Week Ago	1 Year Ago
3-Month T-Bill	0.14	0.28	3.39
3-Month LIBOR	2.24	2.29	4.88
1-Year Treasury	0.76	0.95	3.55
2-Year Treasury	1.19	1.32	3.50
5-Year Treasury	2.31	2.56	3.82
10-Year Treasury	3.73	3.79	4.25
30-Year Treasury	4.23	4.27	4.60
Bond Buyer Index	5.14	5.24	4.53

**Foreign Interest Rates**

	Friday 11/14/2008	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	4.22	4.47	4.57
3-Month Sterling LIBOR	4.18	4.50	6.30
3-Month Canadian LIBOR	3.05	3.10	4.92
3-Month Yen LIBOR	0.89	0.89	0.89
2-Year German	2.22	2.41	3.90
2-Year U.K.	2.17	2.49	4.70
2-Year Canadian	1.91	1.91	3.94
2-Year Japanese	0.56	0.58	0.78
10-Year German	3.68	3.68	4.15
10-Year U.K.	4.07	4.19	4.74
10-Year Canadian	3.62	3.74	4.21
10-Year Japanese	1.50	1.52	1.53

**Foreign Exchange Rates**

	Friday 11/14/2008	1 Week Ago	1 Year Ago
Euro (\$/€)	1.271	1.272	1.465
British Pound (\$/£)	1.486	1.564	2.053
British Pound (£/€)	0.856	0.813	0.714
Japanese Yen (¥/\$)	97.090	98.235	111.320
Canadian Dollar (C\$/\\$)	1.221	1.189	0.967
Swiss Franc (CHF/\\$)	1.191	1.179	1.124
Australian Dollar (US\$/A\\$)	0.663	0.674	0.895
Mexican Peso (MXN/\\$)	12.999	12.816	10.902
Chinese Yuan (CNY/\\$)	6.824	6.831	7.427
Indian Rupee (INR/\\$)	48.980	47.800	39.305
Brazilian Real (BRL/\\$)	2.272	2.147	1.742
U.S. Dollar Index	86.840	85.907	75.814

**Commodity Prices**

	Friday 11/14/2008	1 Week Ago	1 Year Ago
W. Texas Crude (\\$/Barrel)	56.49	61.04	94.09
Gold (\\$/Ounce)	746.00	736.65	811.95
Hot-Rolled Steel (\\$/S.Ton)	770.00	790.00	520.00
Copper (\\$/Pound)	171.85	169.25	330.15
Soybeans (\\$/Bushel)	8.58	8.68	10.16
Natural Gas (\\$/MMBTU)	6.12	6.76	7.84
Nickel (\\$/Metric Ton)	11,317	11,237	33,100
CRB Spot Inds.	350.39	363.29	489.19

**Next Week's Economic Calendar**

	Monday 17	Tuesday 18	Wednesday 19	Thursday 20	Friday 21
<b>U.S. Data</b>	<b>Industrial Production</b> September -2.8% October -0.8% (W) <b>Capacity Utilization</b> September 76.4% October 75.8% (W)	<b>PPI</b> September -0.4% October -1.3% (W) <b>Core PPI</b> September 0.4% October 0.1% (W)	<b>CPI</b> September 0.0% October -0.5% (W) <b>Core CPI</b> September 0.1% October 0.1% (W) <b>Housing Starts</b> September 817K October 770K (W)	<b>Leading Indicators</b> September 0.3% October -0.4% (W)	
<b>Global Data</b>	<b>Japan</b> <b>GDP Annualized</b> Previous (2Q) -3.0%	<b>UK</b> <b>CPI (YoY)</b> Previous (Sep) 5.2%		<b>UK</b> <b>Retail Sales (MoM)</b> Previous (Sep) -0.4%	<b>Euro-Zone</b> <b>PMI Manufacturing</b> Previous (Oct) 41.1 <b>Canada</b> <b>CPI (YoY)</b> Previous (Sep) 3.4%

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

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