

# WEEKLY ECONOMIC & FINANCIAL COMMENTARY

February 27, 2009

## U.S. Review

### The Bottom Falls Out

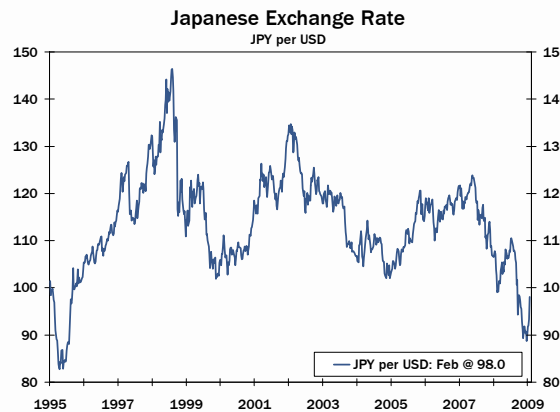
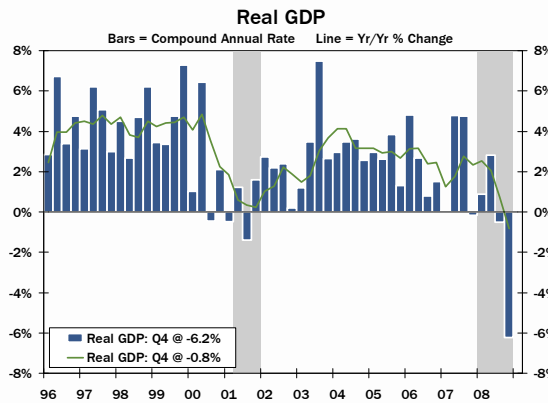
Fourth quarter real GDP declined much more than previously reported, with the new preliminary figures showing output tumbling at a 6.2 percent annual rate. The advance estimate, released last month, had put the decline at a less severe 3.8 percent rate.

The 6.2 percent decline in fourth quarter real GDP marks the largest quarterly drop since the first quarter of 1982, which occurred in the midst of the long and deep 1981-82 recession. That downturn was, up until now, the longest and deepest since World War II.

The large downward adjustment to fourth quarter growth was due to larger declines in consumer spending, export, and business fixed investment. Inventories also declined by nearly \$20 billion during the quarter, which means that final sales fell at an even larger 6.4 percent annual rate.

Nominal GDP, which is essentially revenue growth for the entire economy, fell at a 5.8 percent pace in the fourth quarter, which is the sharpest drop since 1958. Falling revenues at businesses and governments are one big reason why employment has fallen so hard.

*Please turn to page 2*



## Global Review

### No More Yen for Yen?

After winning the honor of the world's strongest currency in 2008, the Japanese yen has recently lost its footing. Indeed, the greenback fell more than 20 percent versus the Japanese currency over the course of 2008, and most other major currencies dropped even further. As shown in the chart at left, however, the dollar strengthened about eight percent versus the yen during February and most other major currencies posted gains as well. What's suddenly wrong with the yen?

The short answer is that the Japanese economy has fallen off a cliff, pulling the currency with it. Real GDP in Japan plunged at a jaw-dropping annualized rate of 12.7 percent in the fourth quarter. (See our report on Japanese GDP, posted [here](#) our website, for more details.) Unfortunately, data released this week showed that the carnage continued in January.

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## Recent Special Commentary

Date	Title	Authors
February-23	This Is Not the End of America	Vitner
February-23	Housing & Finance: Still Searching for a New Equilibrium	Silvia
February-12	Global Chartbook - February 2009	Bryson & Quinlan
February-12	Housing Chartbook - February 2009	Vitner & York

## U.S. Forecast

	Actual 2008				Forecast 2009				Actual 2005-2008				Forecast 2009-2010	
	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	-0.5	-3.8	-6.7	-1.9	-0.4	0.6	2.9	2.8	2.0	1.3	-2.7	1.1
Personal Consumption	0.9	1.2	-3.8	-3.5	-2.9	-0.4	0.1	1.1	3.0	3.0	2.8	0.3	-1.8	1.0
Inflation Indicators <sup>2</sup>														
"Core" PCE Deflator	2.2	2.3	2.3	1.8	1.4	1.2	0.9	1.2	2.1	2.3	2.2	2.2	1.2	1.6
Consumer Price Index	4.2	4.3	5.3	1.5	-0.3	-1.3	-2.6	0.1	3.4	3.2	2.9	3.8	-1.1	1.7
Industrial Production <sup>1</sup>	0.4	-3.4	-8.9	-11.5	-14.5	-7.2	-2.5	0.4	3.3	2.2	1.7	-1.7	-8.9	0.6
Corporate Profits Before Taxes <sup>2</sup>	-1.5	-8.3	-9.2	-17.5	-25.0	-24.0	-20.0	-14.0	17.6	15.2	-1.6	-9.1	-21.0	5.2
Trade Weighted Dollar Index <sup>3</sup>	70.3	71.0	76.1	79.4	85.6	89.3	91.3	90.9	86.0	81.5	73.3	79.4	90.9	78.7
Unemployment Rate	4.9	5.4	6.1	6.9	7.7	8.3	8.9	9.3	5.1	4.6	4.6	5.8	8.6	9.6
Housing Starts <sup>4</sup>	1.05	1.03	0.88	0.66	0.47	0.51	0.57	0.61	2.07	1.81	1.34	0.90	0.54	0.77
Quarter-End Interest Rates														
Federal Funds Target Rate	2.25	2.00	2.00	0.25	0.25	0.25	0.25	0.25	4.25	5.25	4.25	0.25	0.25	0.50
10 Year Note	3.45	3.99	3.85	2.25	3.00	3.10	3.10	3.10	4.39	4.71	4.04	2.25	3.10	3.50

Data As of: February 11, 2009

<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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First Quarter Growth Will be Weak as Well

While we do not expect final domestic demand to be as weak as it was in the fourth quarter, it remains disturbingly weak. Our most recent estimate for first quarter real GDP called for a decline at a 6.7 percent annual rate. This was before the fourth quarter numbers were revised sharply lower. We update our forecast the week after the employment numbers are reported and our next forecast will be published on March 11. Right now, it looks as though first quarter real GDP will be just about as weak as the fourth quarter was. The composition will be much different, however, with inventories falling much more rapidly and consumer spending probably not plunging as much as it has in recent quarters.

Most of the early 2009 data is disappointing to say the least. Home sales have still not found a bottom, even though they hit new lows for this cycle and, in the case of new homes, the modern era. Sales of new homes plunged 10.2 percent in January and sales for December were revised lower and now show a 14.7 percent drop.

The winter months are the low season for home sales, so these sales numbers carry a little less weight than they would if they occurred in April or May. That said, consumers appear to be in no mood to make major purchases in any way, reflecting the growing desire to shore up their balance sheets and rebuild savings. Sales of existing homes fell 5.3 percent in January to a 4.49 million unit pace, the lowest pace in this cycle. New incentives for first-time homebuyers included in the Economic Stimulus Package may provide a slight boost to home sales later this year but sales will not turn up in a major way until employment conditions improve.

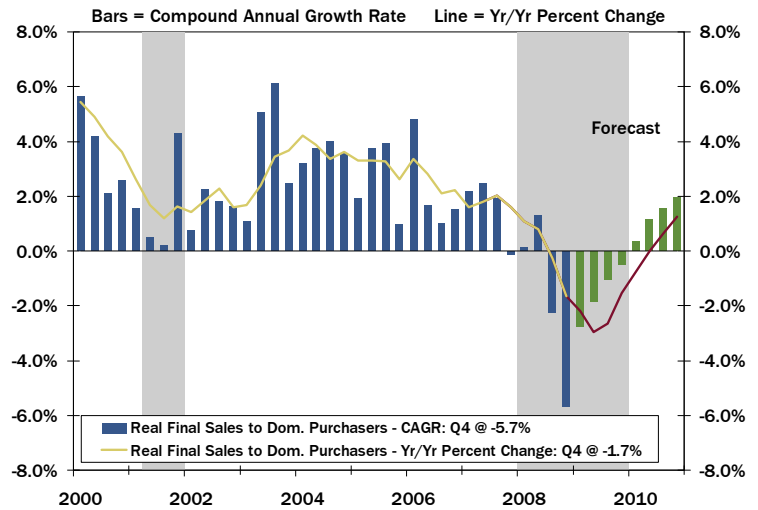
There were also a number of regional manufacturing surveys released this week and all pointed to continued weakness in the factory sector. The Chicago Purchasing Managers' survey rose 0.9 points in February to 34.2. Despite the increase, this key business barometer remains exceptionally low. Moreover, the employment series plummeted 9.6 points in February to 25.2, which is the second lowest reading ever. On the positive side, production rose five points in February but that came off of an extremely low January figure. New orders were essentially unchanged at 30.6. Virtually every key component remains well below the key 50 breakeven level, except supplier deliveries. Clearly the factory sector is nowhere near turning the corner just yet.

The labor markets also do not appear to have bottomed out. First time claims for unemployment insurance surged in mid-February, suggesting that we will see another outsized decline in nonfarm payrolls and further increase in the unemployment rate.

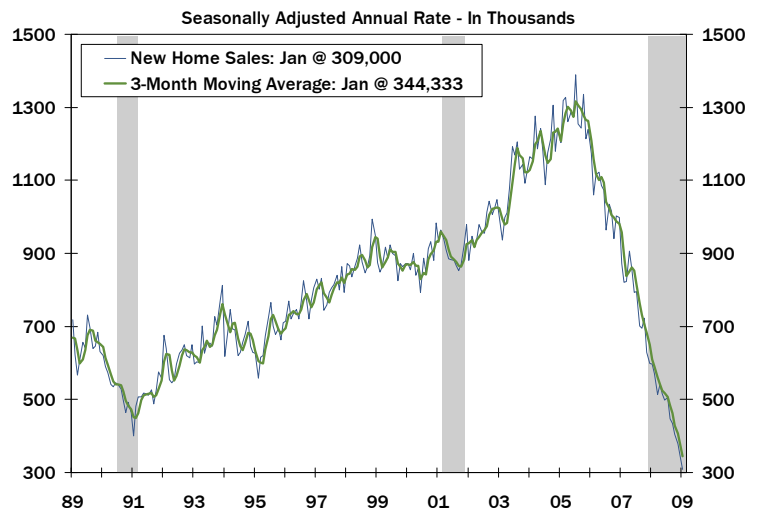
Selected Current Data

Gross Domestic Product - CAGR	Q4 - 2008	-6.2%
GDP Year-over-Year	Q4 - 2008	-0.8%
Personal Consumption	Q4 - 2008	-4.3%
Business Fixed Investment	Q4 - 2008	-21.1%
Consumer Price Index	January - 2009	0.0%
"Core" CPI	January - 2009	1.7%
"Core" PCE Deflator	December - 2008	1.7%
Industrial Production	January - 2009	-10.0%
Unemployment	January - 2009	7.6%
Federal Funds Target Rate	Feb - 27	0.25%

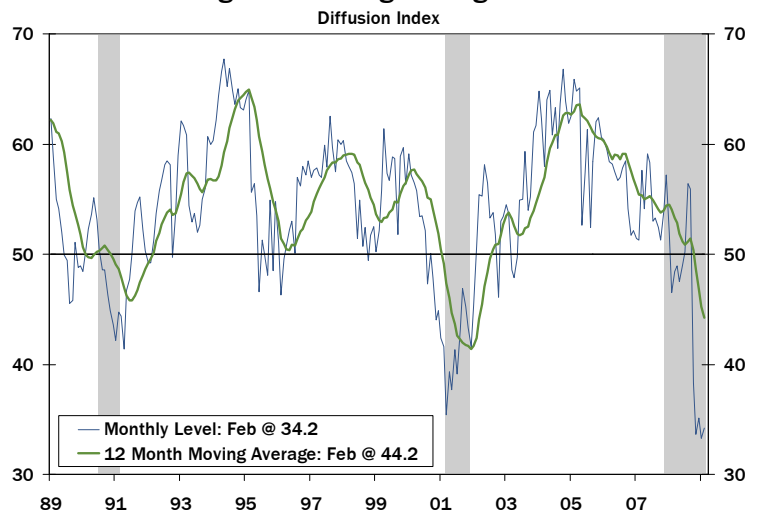
Real Final Sales to Domestic Purchasers



New Home Sales



Chicago Purchasing Managers' Index



**Personal Income • Monday**

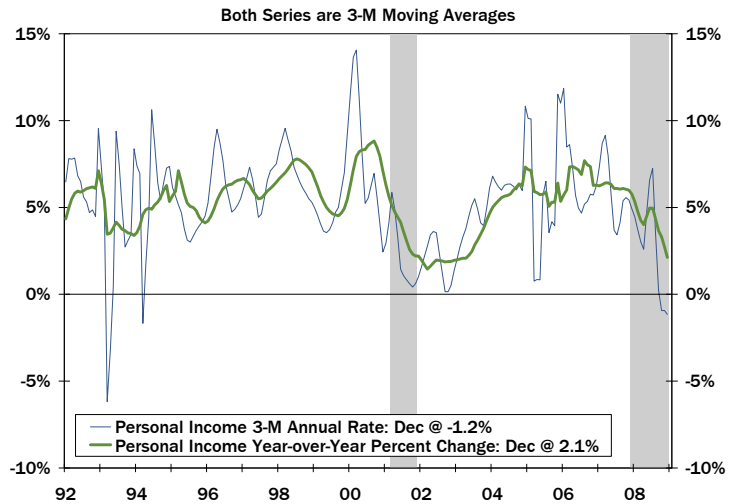
Personal income declined 0.2 percent in December and tumbled at a 1.2 percent annual rate during the fourth quarter. A substantial drag on personal income during the quarter came from declines in wages and salaries as well as sharp reductions in proprietors' income and investment earnings. Personal consumption expenditures fell 1.0 percent in December, although falling prices exaggerated that decline somewhat.

Personal income and spending should get a slight boost in January due to a bounce back from declines in recent months and seasonal adjustments. We expect personal income and spending will rise 0.1 and 0.5 percent, respectively. The saving rate should give back some of its previous gains, but the long run trend is still up as consumers pull back on making purchases in the face of weak economic growth, job uncertainty and less access to credit.

**Previous: -0.2%**

**Wachovia: 0.1%**

**Consensus: -0.3%**

**Personal Income**

**ISM Manufacturing Index • Monday**

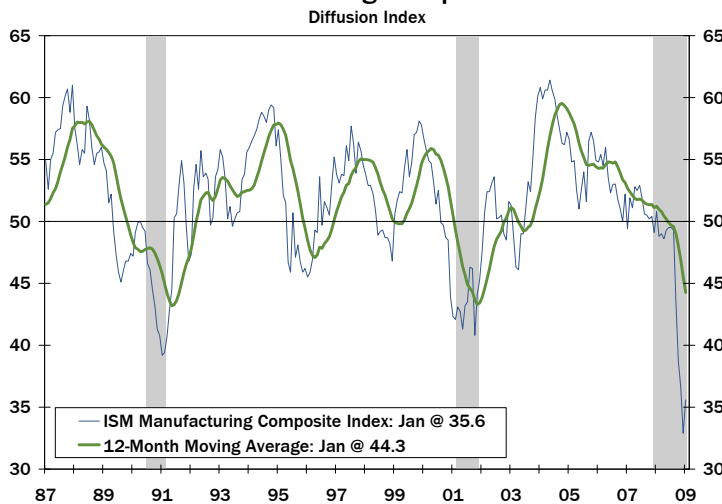
The ISM manufacturing index moved up to 35.6, off of a multi-decade low set in December. Key sub-indices including production and new orders both moved higher. Employment held at 29.9 and manufacturing contracted sharply.

We expect ISM to have a slight up tick in February, but remain squarely in recession territory. The long run trend, however, is down and the index remains at levels last seen since the early 1980s. New orders and order backlogs should continue to decline, indicating more weakness in the pipeline. Employment should also remain sluggish. The regional purchasing manager reports (Empire, Philadelphia, Dallas and Richmond) remain weak, suggesting a decline in the headline number.

**Previous: 35.6**

**Wachovia: 35.9**

**Consensus: 34.0**

**ISM Manufacturing Composite Index**

**Employment • Friday**

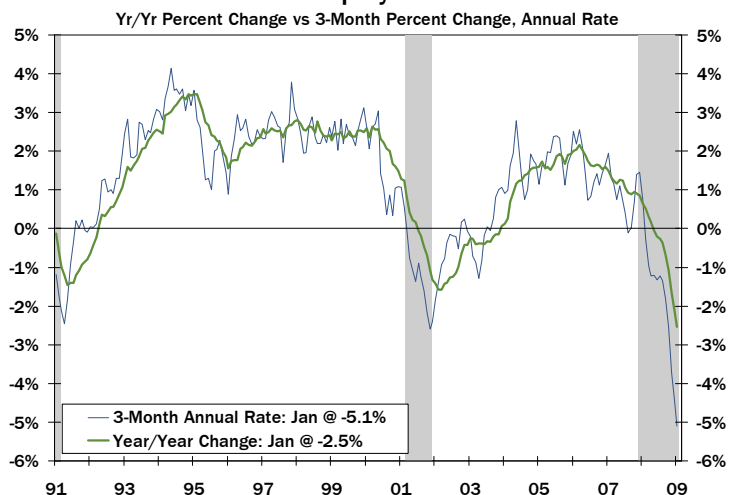
Employment losses have deepened considerably in recent months and revisions to previously published data suggest that total job losses for this recession will now top 6.5 million. The heaviest losses by far have occurred during the past five months, a period during which nominal GDP has been negative. With total revenue declining at its worst pace since the late 1950s, many businesses and governments are in survival mode and have no choice but to cut jobs.

Initial jobless claims remain solidly in recession territory with the four week moving average surging to 639,000, the highest on record. Continuing claims also remain at historical levels. We expect job losses to reach a new all-time high in February with the unemployment rate reaching 7.9 percent. With consumers worried about their jobs, the outlook for consumer spending is obviously not very bright.

**Previous: -598K**

**Wachovia: -685K**

**Consensus: -618K**

**Nonfarm Employment Growth**


**Global Review**

*(Continued from Page 1)*

As shown in the top chart, industrial production in January was down nearly 30 percent (year-over-year), which is partially a reflection of the unbelievable 39 percent decline in export volumes that has transpired over the past year. Japan is a major supplier of capital goods equipment to the rest of the world, especially to other Asian countries, and the sharp falloff in global trade has taken a toll on Japanese exports. In addition, the previous strength of the yen has no doubt contributed to the sharp decline in Japanese exports.

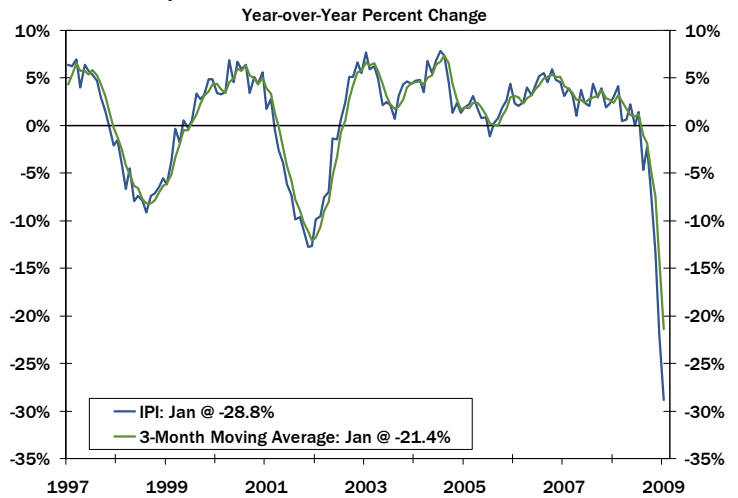
With exports collapsing, the Japanese trade balance, which had been in the black since 1980, has turned into a deficit over the past few months (see middle chart). Although the overall current account balance, which includes more items than the merchandise trade balance, is still in the black, the surplus in December fell to a 13-year low. At the rate that exports are plummeting, it seems like only a matter of time before Japan registers a current account deficit.

It is the chronic current account surplus that helps to explain the strength of the yen last year. When investors become risk averse, as they have done to an extreme over the past year, capital tends to flow from the borrowing nations (i.e., countries with current account deficits) to lending nations (i.e., those with current account surpluses). However, Japan is rapidly falling out of the latter category. Moreover, the deep recession - some would say depression - that is underway in Japan has caused returns on Japanese assets to become very unattractive. Foreign investors have turned into net sellers of Japanese stocks and bonds while Japanese portfolio investment abroad has picked up. The combination of a rapidly shrinking current account surplus and a pick-up in net capital outflows has led to yen depreciation recently.

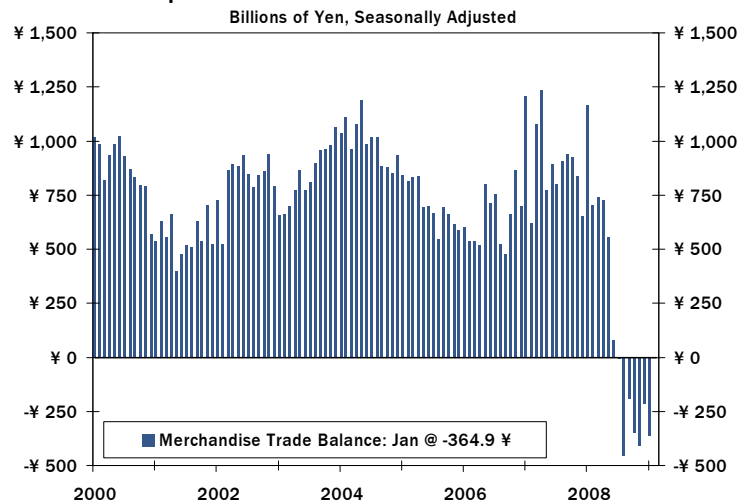
**Yen Will Probably Continue to Trend Lower**

The Japanese yen has lost a fair bit of ground in a relatively short period of time, so some retraction is bound to occur sooner or later. However, we look for the yen to weaken further on a trend basis in the quarters ahead. Japan will probably remain in a deep recession throughout most of the year, which will cause the economy to experience a mild case of deflation again (see bottom chart). Consequently, the Bank of Japan will keep rates as low as possible for as long as possible. Rock-bottom returns in Japan should contribute to further yen depreciation.

**Japanese Industrial Production Index**



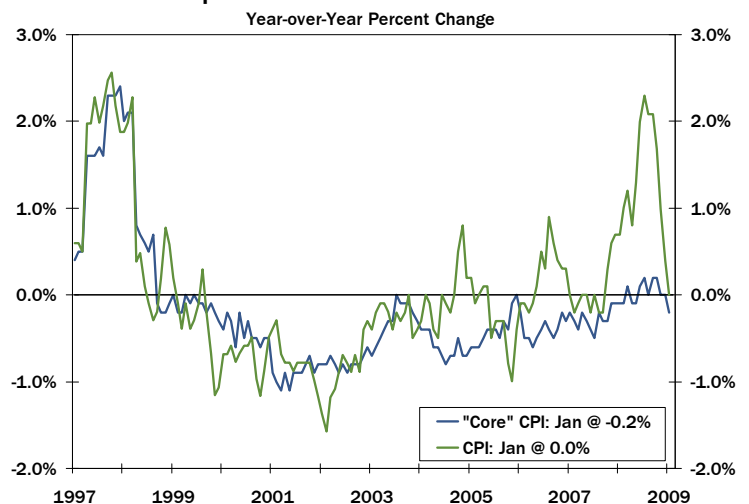
**Japanese Merchandise Trade Balance**



**Selected Global Data**

Japan	GDP Year-over-Year	Q4 - 2008	-4.6%
	CPI	January - 2009	0.0%
	Unemployment	January - 2009	4.1%
	BoJ Target Rate	Feb - 27	0.10%
Euro-Zone	GDP Year-over-Year	Q4 - 2008	-1.2%
	CPI	January - 2009	1.1%
	Unemployment	January - 2009	8.2%
	ECB Target Rate	Feb - 27	2.00%
UK	GDP Year-over-Year	Q4 - 2008	-1.9%
	CPI	January - 2009	3.0%
	Unemployment	January - 2009	3.8%
	BoE Target Rate	Feb - 27	1.00%
Canada	GDP Year-over-Year	November - 2008	-0.8%
	CPI	January - 2009	1.1%
	Unemployment	January - 2009	7.2%
	BoC Target Rate	Feb - 27	1.00%

**Japanese Consumer Price Index**



**Canadian Real GDP • Monday**

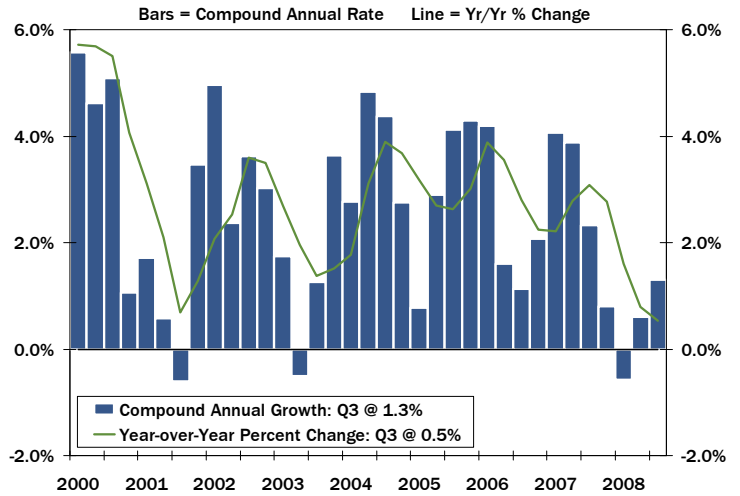
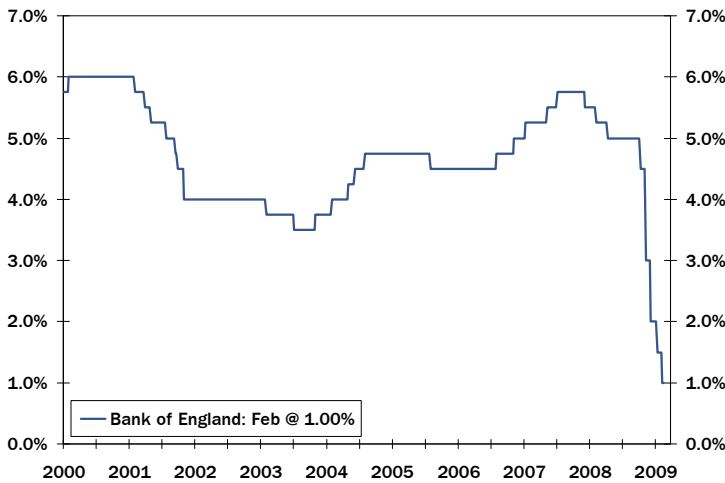
Canadian monthly real GDP has contracted for two consecutive months in October and November. Even though the Canadian economy grew at an annualized rate of 1.3 percent in the third quarter, we suspect economic growth likely contracted at about a three percent annual rate in the fourth quarter. Given the worsening outlook for the global economy, it does not seem reasonable that Canadian exports will be adding substantively to growth, at least in the near future.

On Tuesday, the Bank of Canada (BoC) is widely expected to announce a cut in its overnight lending rate. In the BoC's January policy report, the central bank acknowledged its outlook for growth prospects deteriorated "significantly." The BoC has been responsive to the financial crisis by participating in the coordinated rate cuts in October with subsequent rate reductions in December and October. We look for a 50 basis point cut from the BoC on Tuesday.

**Previous: 1.3%**

**Wachovia: -3.6%**

**Consensus: -3.5%**

**Canadian Real GDP**

**Bank of England Policy Rate**

**Bank of England Policy Rate • Thursday**

The Bank of England holds its monthly policy meeting on Thursday, and we are in line with the consensus expectation looking for a 50 bps rate cut. Whether the Monetary Policy Committee (MPC) takes the policy rate below 0.50 percent in the months ahead is open to question. Once the MPC is done cutting the policy rate, however, it will turn to unconventional policy measures (e.g., extending credit directly) to support the rapidly contracting economy.

Speaking of the economy, the MPC will have some February data to consider when it makes its policy decision. The manufacturing PMI will print on Monday and the comparable index for the service sector is slated for release on Wednesday. The consensus forecast anticipates that both indices slid further into recession territory in February.

**Previous: 1.00%**

**Wachovia: 0.50%**

**Consensus: 0.50%**

**ECB Policy Rate • Thursday**

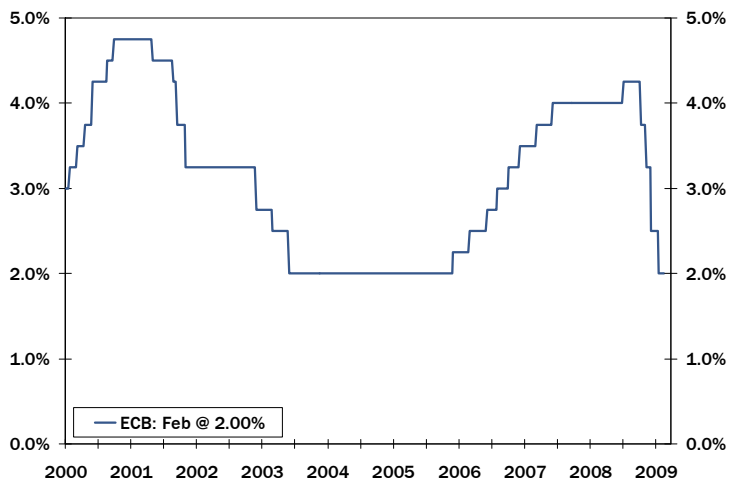
The European Central Bank holds its monthly policy meeting on Thursday. After remaining on hold at 2.00 percent in February we expect the ECB to cut its policy rate by 50 bps, which is also the consensus view. Anecdotal evidence, including purchasing managers' indices and business confidence surveys, suggests that the Euro-zone economy slid deeper into recession in February. In addition, the overall rate of CPI inflation fell to a 10-year low of only 1.1 percent in January, which should allow the inflation-phobic ECB to breathe a bit easier.

The final estimates of the February PMIs will be released earlier in the week, and a breakdown of real GDP, which fell at an annualized rate of 5.8 percent in the fourth quarter, into its underlying demand components will print on Thursday.

**Previous: 2.00%**

**Wachovia: 1.50%**

**Consensus: 1.50%**

**European Central Bank Policy Rate**


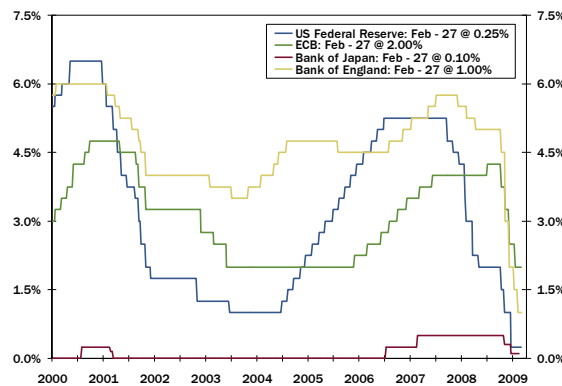
**Interest Rate Watch**
**No Easy Way Out**

Today's GDP release reinforces our view that there is no easy out this year. In a traditional business cycle, Federal Reserve policy easing on the scale of the last year would have elicited more of a response in economic activity than what we have seen in this cycle. The culprit, we would argue, has been the dramatic deterioration in both the availability and pricing of credit. On availability, we have seen from the Senior Loan Officer Survey a rapid rise in the net percentage of banks that have tightened credit for both business and consumer credits.

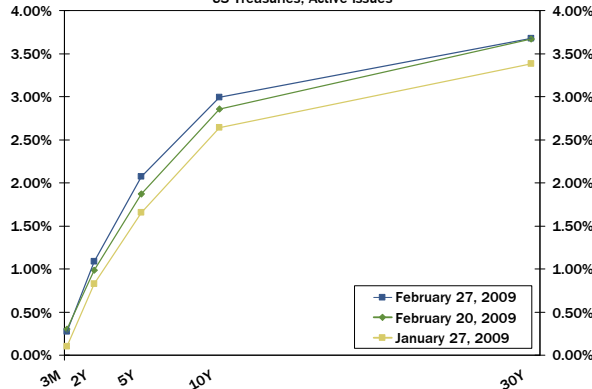
At the short end of the interest rate curve, Fed easing has led to a decline in the TED spread and other short-term liquidity spreads. In fact, in each market where the Fed has been very active, we have witnessed an improvement in liquidity along with a decline in risk premium. However, wherever the Fed is not engaged, such as corporate bonds or CMBS, spreads have not come in significantly.

Looking ahead, increased federal deficit financing poses a threat to long-term interest rates and financial stability, though not primarily from inflation fears. Instead, the increased supply of Treasury securities and a loss of confidence in U.S. economic policy could destabilize both the dollar and longer-term Treasury rates. The impact of rising Treasury bond supply over time is likely to offset the liquidity supply impact of Fed easing in the short-run.

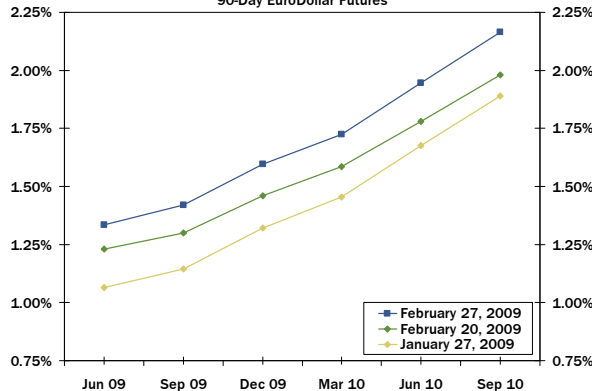
An unwinding of the "flight" capital, propelled by financial turmoil of the past eighteen months, could complicate the outlook in this cycle. Treasury yields could rise from unusually low levels sooner than they did during the two previous weak economic recoveries.

**Central Bank Policy Rates**

**Yield Curve**

US Treasuries, Active Issues


**Forward Rates**

90-Day EuroDollar Futures


**Topic of the Week**
**This is Not the End of America**

Understanding the current economic environment requires a look back at recent U.S. economic history. Some of the problems we face today were created over the past few years, while others have been gestating for decades. Economic policy over the past quarter century or so has been more geared toward solving those short-term cyclical imbalances.

Unfortunately, these actions have merely resulted in rolling many of those longer-run imbalances into the next business cycle. Each successive expansion since the mid-1970s has resulted in higher levels of leverage throughout our economy, particularly at the household level. The most recent expansion and subsequent downturn suggest we have reached the limits of how far increased leverage can paper over our long-run structural imbalances.

While we must correct the cyclical imbalances first, prosperity will not return to our nation on a sustainable basis until we address our long-term imbalances. The largest long-run imbalance is the great productivity slowdown that began with the early 1970s oil shock.

The oil shock and productivity slowdown added to the inflation problems of the late 1970s and early 1980s and sluggish real income growth that accompanied it. Sluggish income growth led to a drop in the saving rate and the leveraging of household balance sheets. We did enjoy a brief respite in productivity growth during the later part of the 1990s, but it is far from certain whether those gains are sustainable, and those gains did not flow through to workers and living standards.

You can access our full report online [here](#).

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

	Friday 2/27/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.26	0.27	1.96
3-Month LIBOR	1.26	1.25	3.09
1-Year Treasury	0.79	0.66	1.89
2-Year Treasury	1.05	0.94	1.99
5-Year Treasury	2.07	1.83	2.89
10-Year Treasury	3.01	2.79	3.85
30-Year Treasury	3.71	3.57	4.65
Bond Buyer Index	4.87	4.89	5.11

**Foreign Interest Rates**

	Friday 2/27/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	1.83	1.88	4.39
3-Month Sterling LIBOR	2.05	2.07	5.70
3-Month Canadian LIBOR	1.35	1.48	3.85
3-Month Yen LIBOR	0.64	0.63	0.90
2-Year German	1.29	1.31	3.36
2-Year U.K.	1.44	1.48	4.31
2-Year Canadian	1.18	1.23	3.06
2-Year Japanese	0.41	0.39	0.63
10-Year German	3.08	3.01	4.09
10-Year U.K.	3.59	3.42	4.70
10-Year Canadian	3.14	2.87	3.82
10-Year Japanese	1.28	1.28	1.48

**Foreign Exchange Rates**

	Friday 2/27/2009	1 Week Ago	1 Year Ago
Euro (\$/€)	1.268	1.283	1.512
British Pound (\$/£)	1.426	1.443	1.982
British Pound (£/€)	0.889	0.889	0.763
Japanese Yen (¥/\$)	98.027	93.348	106.490
Canadian Dollar (C\$/ \$)	1.266	1.252	0.980
Swiss Franc (CHF/\$)	1.167	1.156	1.063
Australian Dollar (US\$/A\$)	0.642	0.645	0.942
Mexican Peso (MXN/\$)	15.039	14.777	10.699
Chinese Yuan (CNY/\$)	6.840	6.837	7.142
Indian Rupee (INR/\$)	51.161	49.770	39.785
Brazilian Real (BRL/\$)	2.378	2.384	1.670
U.S. Dollar Index	88.219	86.488	74.213

**Commodity Prices**

	Friday 2/27/2009	1 Week Ago	1 Year Ago
W. Texas Crude (\$/Barrel)	43.43	38.94	99.64
Gold (\$/Ounce)	953.35	992.90	957.84
Hot-Rolled Steel (\$/S.Ton)	475.00	475.00	700.00
Copper (¢/Pound)	150.20	141.40	384.00
Soybeans (\$/Bushel)	8.64	8.80	14.22
Natural Gas (\$/MMBTU)	3.96	4.01	8.93
Nickel (\$/Metric Ton)	9,980	9,821	27,729
CRB Spot Inds.	335.61	337.87	503.47

**Next Week's Economic Calendar**

	Monday 2	Tuesday 3	Wednesday 4	Thursday 5	Friday 6
<b>U.S. Data</b>	<b>ISM Manufacturing</b> January 35.6 February 35.9 (W) <b>Personal Income</b> December -0.2% January 0.1% (W) <b>Personal Spending</b> December -1.0% January 0.5% (W)	<b>Total Vehicle Sales</b> January 9.6M February 9.9M (W)	<b>ISM Non-Manufacturing</b> January 42.9 February 41.9 (W)	<b>Nonfarm Productivity</b> 3Q 1.5% 4Q 2.5% (W) <b>Unit Labor Cost</b> 3Q 2.6% 4Q 0.7% (W) <b>Factory Orders</b> December -3.9% January -4.2% (W)	<b>Nonfarm Payrolls</b> January -598K February -685K (W) <b>Unemployment Rate</b> January 7.6% February 7.9% (W)
<b>Global Data</b>	<b>Canada</b> <b>GDP</b> Previous (3Q) 1.3% <b>UK</b> <b>PMI Manufacturing</b> Previous (Jan) 35.8	<b>Canada</b> <b>Bank of Canada Rate</b> Previous 1.00%	<b>UK</b> <b>PMI Services</b> Previous (Jan) 42.5	<b>UK</b> <b>BOE Announces Rates</b> Previous 1.00% <b>Euro-zone</b> <b>ECB Announces Rates</b> Previous 2.00%	

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

## Wachovia Economics Group

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