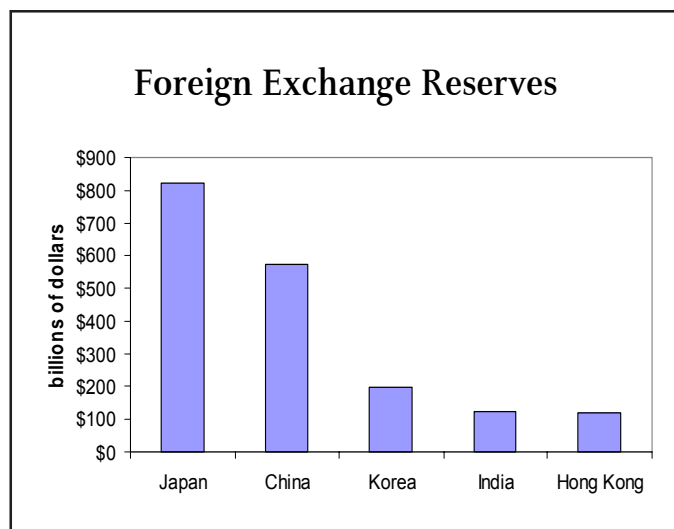
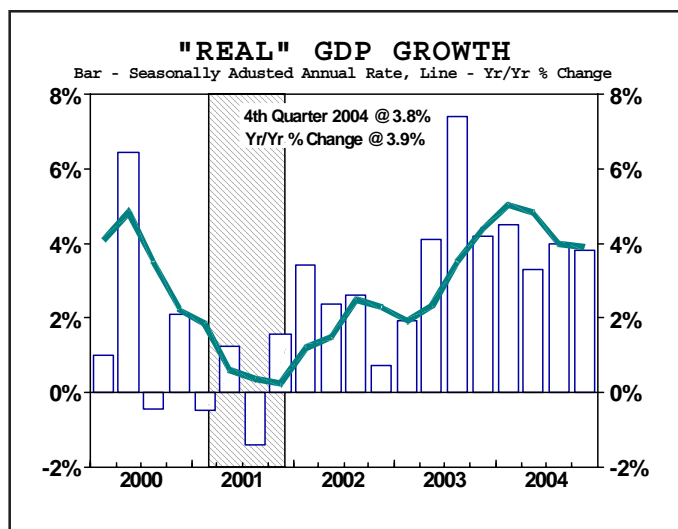


Weekly Economic and Financial Commentary

February 25, 2005

Executive Summary

- The economy ended 2004 on a much stronger note than was initially reported. Real GDP grew at a 3.8% annual rate, which is 0.7 percentage points higher than first reported. The larger gain is due to significantly stronger growth in business investment and stronger exports. With the revision, GDP increased 4.4% in 2004.
- The dollar took a hit this week when the media mistakenly reported that the Korean central bank would begin to diversify its foreign exchange reserves. Foreigners presently own nearly 20% of all U.S. securities, so U.S. financial markets could be significantly affected by wholesale selling of U.S. assets. However, we find few reasons why foreigners, either central banks or private investors, would want to do that.



This Week's Data

U.S.

- Consumer Confidence, Feb @ 104.0 vs Jan @ 105.1
- Consumer Price Index, Jan @ 0.1% vs Dec @ 0.0%
- Core Consumer Price Index, Jan @ 0.2% vs Dec @ 0.2%
- Durable Goods Orders, Jan @ - 0.9% vs Dec @ 1.4%
- Help Wanted Advertising, Jan @ 41 vs Dec @ 38
- Real GDP, Q4 Prelim 3.8% @ vs Q4 Adv @ 3.1%
- Existing Home Sales, Jan @ 5.94M vs Dec @ 5.97M

International

- Japanese CPI (YoY), Jan @ - 0.1% vs Dec @ 0.2%
- German GDP (not annualized), Q4 @ - 0.2% vs Q3 @ 0.0%
- German IFO Survey, Feb @ 95.5 vs Jan @ 96.4
- French Consumer Spending, Jan @ 1.5% vs Jan @ -0.4%
- French Business Confidence Indicator, Feb @ 104.0 vs Jan @ 105.0
- French Unemp. Rate, Jan @ 10.0% vs Dec @ 9.9%
- Italian Business Confid., Feb @ 86.8 vs Jan @ 88.7
- Canadian Retail Sales, Dec @ - 1.4% vs Nov @ -0.1%
- Canadian CPI (YoY), Jan @ 2.0% vs Dec @ 2.1%
- Chinese CPI (YoY), Jan 2.9% vs Dec 2.4%

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Slow And Steady Wins The Race

Alan Greenspan introduced a new term into the economic lexicon at his annual testimony before congress when he noted that the persistence of low long-term interest rates at a time when the Fed was raising short-term rates presented a bit of a conundrum for the Fed. Alan Greenspan chooses his words carefully and the choice of the word conundrum was certainly intentional. My old Webster's dictionary defines a conundrum as a riddle who's answer is a pun or a puzzling problem.

If the Fed's intention was to call attention to the question of how much longer long-term rates will remain this low, then they are achieving some success. The market's reaction and coverage in the financial press is near the same pitch that it was when Alan Greenspan first brought up irrational exuberance back in December 1996. But while there is clearly more attention being paid to the persistence of remarkably low long-term interest rates, there have so far been few good answers as to why.

There is no one single, good explanation as to why long-term interest rates have remained so low for so long, particularly now that the economy is growing so solidly. We noted last week that the Fed itself has been part of the problem, in that they have made monetary policy too transparent by spelling out their intentions to the financial markets so clearly. Recall that back when the financial markets were worried about deflation, the Fed made it abundantly clear that monetary policy could remain accommodative for a "considerable period of time." Later, when the Fed began to raise interest rates, they made it clear that they would only do so at a "measured pace."

Now, the Fed appears to want to interject a degree of volatility into the mix and will probably drop any mention of the "measured pace" in their next policy statement. One of the problems facing the Fed is that they will, in all likelihood, not have to raise interest rates by a quarter percentage point at each of their remaining eight meetings this year. If they did, that would put the federal funds rate at 4.50% at year end.

Our own forecast has the funds rate ending the year at 3.75%, implying that the Fed leaves interest rates unchanged at three meetings. If they were to do that, would that mean that the Fed would then be removing accommodation at something less than a measured pace? Now that's a conundrum.

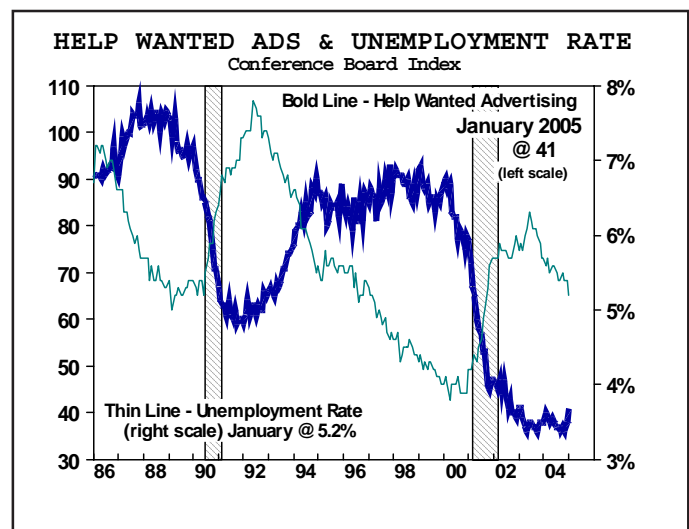
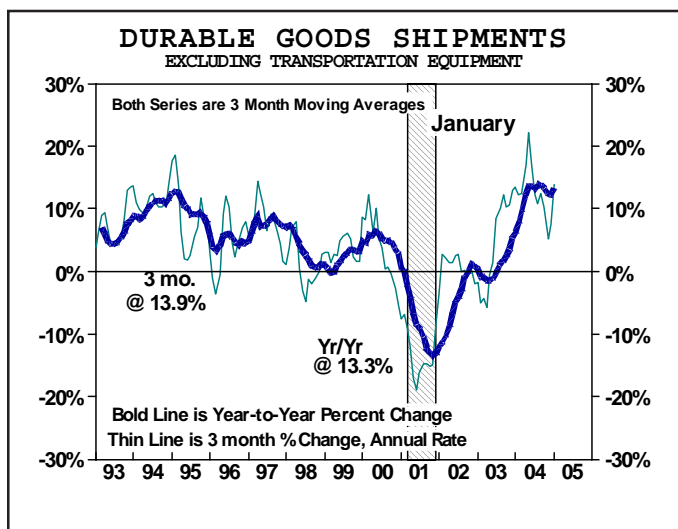
Reverse Soft-Landing

The Fed's transparency and well-timed, measured rate hikes appear to be working exceptionally well. The Fed appears to be on the verge of achieving a reverse soft-landing. The economy is regaining momentum, employment conditions are improving, and money growth is slowing, which should keep inflation in check for quite some time.

This week's batch of economic statistics confirm that the economy remains on solid footing. Real GDP growth was revised up solidly during the fourth quarter, and now shows growth at a 3.8% annual rate. Moreover, inflation remained in check during the quarter, with the GDP deflator rising at a 2.1% annual rate, and the Fed's preferred measure of inflation, the core PCE deflator, climbing at just a 1.6% annual rate.

Growth during the current quarter also looks to be stronger than earlier thought. This week's durable goods report showed solid gains in capital spending. Orders for nondefense capital goods, excluding aircraft, rose 2.9%, and shipments, which tend to correlate well with equipment and software spending, rose 3.7%. Even with some falloff in February and March, that gain should put business fixed investment up at around a 9.0% pace in the first quarter.

There was also more encouraging news on the employment front. First-time jobless claims rose by 9,000 in the latest week, but the latest four-week moving average fell to 308,750, which is the lowest level since November 2000. Help wanted advertising also increased in January and the latest Consumer Confidence report showed that the number of households reporting that jobs are hard to get fell for the third month in a row. Our own forecast calls for a net gain of 161,000 jobs in February, with the risks stacked solidly to the upside.



International Developments

Nervousness About Foreign Central Bank Reserve Management

The foreign exchange market was thrown into a bit of a tizzy this week by a news report claiming that Korea's central bank was planning to diversify some its foreign exchange reserves. The news was noteworthy because the Bank of Korea (BoK) holds about \$200 billion in foreign exchange reserves, the third largest stockpile in the world (see graph on front page). The report raised suspicion that more central banks would sell some of their dollar reserves for other currencies. With global reserves totalling about \$3.5 trillion, wholesale reshuffling of reserves could put significant downward pressure on the dollar. The BoK subsequently said that it does not plan to sell dollar reserves, but rather that going forward it would accumulate less dollars and more of other major currencies. However, the damage had already been done to the greenback.

Whenever foreign central banks are mentioned, the issue of foreign holdings of U.S. securities (especially Treasury securities) soon follows because many people are concerned about the amount of U.S. securities that foreigners hold. The chart below shows that foreign holdings of U.S. Treasury securities have trended up from about 25% of the total outstanding in 1996 to nearly 45% presently. Of the \$1.9 trillion worth of Treasury securities that are held outside the country, foreign central banks own nearly \$1.2 trillion.

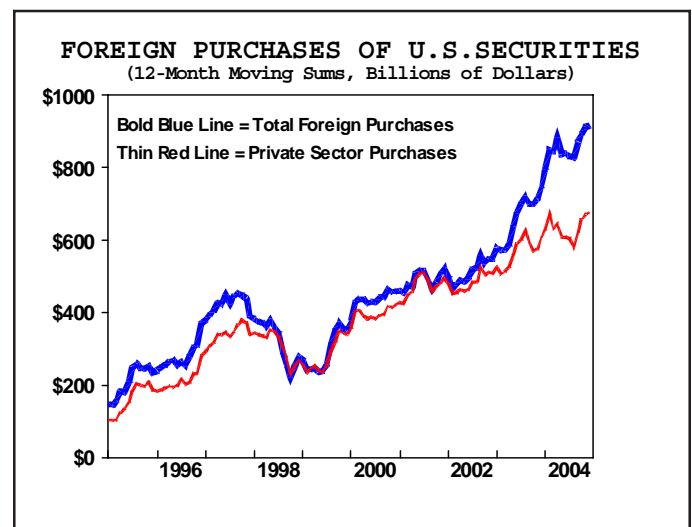
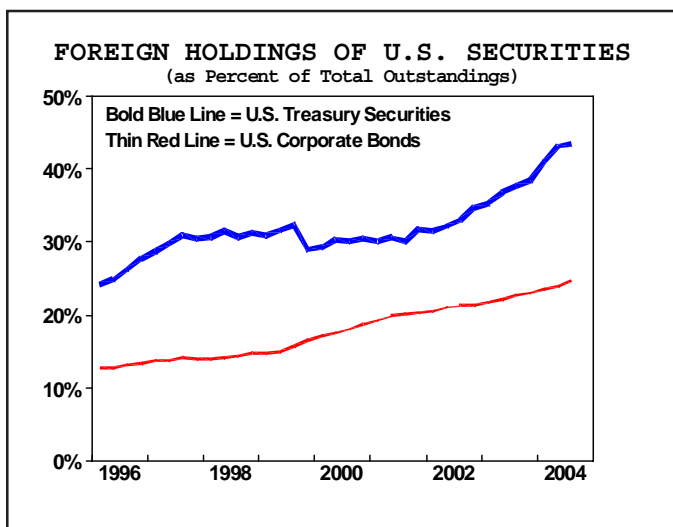
In addition, foreigners own about 25% of all corporate bonds outstanding, and about 10% each of U.S. stocks and agency securities. (The latter includes issues of government-sponsored enterprises (GSE), such as Fannie Mae and Freddie Mac, and GSE-backed mortgage pool securities.) In total, foreign holdings of U.S. Treasury securities, agency securities, corporate bonds, and equities come to about \$6 trillion presently, about 18% of the total amount of these securities outstanding. The fear is that

mass liquidation of these securities by foreigners could cause long-term interest rates to shoot higher and the dollar to crash.

Mass Liquidation Does Not Seem Likely, However

There is no doubt that mass liquidation of U.S. assets by foreigners could cause a financial crisis in the United States. However, these doomsday scenarios usually assume that foreigners will start to dump their U.S. assets. But why would they do that? It is hard to conjure up a reasonable scenario under which foreign central banks would begin to dump their dollar reserves. Like the BoK, they may decide to accumulate less dollars going forward, but wholesale liquidation of dollar assets by foreign central banks does not seem likely. After all, few foreign governments have an interest in precipitating a U.S. financial crisis that very likely would spill over to their own financial systems and economies. In the event of a dollar crash and/or a spike in U.S. long-term interest rates it seems more likely that major foreign central banks would take action to stabilize markets through massive purchases of dollars *via* foreign exchange market intervention.

What about the foreign private sector, which, unlike foreign governments, is more interested in profit and loss than in macroeconomic stability? After all, the private sector accounts for roughly 75% of foreign holdings of U.S. securities. While foreign investors, acting *en masse*, could bring about a U.S. financial crisis, there is still the question of motive. Perhaps foreign investors would bolt for the exits if something happened (e.g., a crippling terrorist attack) that called into question the creditworthiness of U.S. borrowers. However, short of that, we come up empty when we try to think of reasons for why foreign investors would engage in wholesale selling of their U.S. assets. Indeed, as the chart below shows, purchases of U.S. securities by the foreign private sector recently have risen to an all-time high. Foreign investors are hardly bolting for the exits.



Interest Rate Watch**Inflation, and Greenspan, and Oil - Oh My!**

Bond markets have had a lot of information to digest over the last two weeks. At the beginning of last week, the 10 year Treasury yield was just over 4 percent. Lions and tigers and bears have gotten the best of the Treasury market, however, as yields have jumped more than 20 basis points since then.

The climb started when Chairman Greenspan spent two days presenting his semiannual Monetary Policy Report to Congress in the middle of last week. During his testimony, the Chairman referred to the "conundrum" of stubbornly low long term Treasury rates, and hinted that perhaps the FOMC would remove the "measured pace" phrase in meeting statements. The 10-Year Treasury bond yield rose nearly ten basis points over the two-day period.

The day after Greenspan's testimony was finished, the release of January producer prices sparked inflation fears. Core prices rose 0.8 percent, quadruple consensus expectations, and pushed year-over-year core prices up 2.7 percent. Core producer prices rising at their quickest pace since 1995 spooked a sell-off in Treasuries that equated to another 10 basis point rise in yield.

Finally, concerns surrounding Korean diversification of currency reserves and oil prices that bounced back above \$50 per barrel were balanced with consumer inflation that came in right on expectations and a disappointing headline durable goods orders number this week. Ten-year Treasuries bounced around between a low of 4.21 percent and a high of 4.30 percent through the news releases. A strong upward revision to fourth quarter GDP and a slight increase in the price deflator caused some large, but temporary moves in yield today, with the T-bond settling back to 4.27 percent, about where it kicked off the week.

Topic of the Week**Oil back over \$50**

The price of oil continued the surge it has experienced over the past couple of weeks. Our forecast for the price of oil to be at \$46 per barrel for 2005, which we published in December, was one of the more bullish forecasts out there. At the time, we felt that OPEC would try to hold sweet crude prices in a sweet-spot range between \$40-\$50 per barrel, thus effectively providing a floor to crude prices. OPEC has adopted a more hands-on method of oil supply regulation. With the run-up over the past few weeks, we would like to take this opportunity to offer some reasons as to why the price of crude zoomed through \$50 and continues to bubble up.

The price of oil, like the price of all goods, is driven by the two key market factors of supply and demand. Domestic supplies of crude and gasoline are not fundamentally supportive of a run-up in prices. Shoulder month fundamentals dictate that petroleum prices should fall back some in the next week or two, as physical domestic demand for petroleum products like heating oil and gasoline wanes. This decline may not occur, however, because despite the impending decline in domestic demand, supply disruption concerns could continue to exert upward pressure on prices.

Right now, global supplies of crude oil are tight. On Tuesday, a Saudi minister stated that the Saudis would not allow global oil inventories to build. This statement re-enforced the already rampant global concern over crude supplies, and the price of oil jumped above \$50 for the first time since the fall. The tightness of the crude market - which was reinforced in December by an OPEC cut in production—is driving prices higher. With the current global tensions between Iran and the G7 over nuclear weapons, and the impending OPEC meeting to be held in Isfahan, Iran on March 16th, it is possible that the price of crude could rise higher. OPEC remains the wild-card restricting the elasticity of supply, and if it wants to drive the price higher, it can. Price risks are clearly to the upside.

Next Week's Highlights

- Next week provides lots of economic data for market analysts to digest. Personal Income & Spending and New Home Sales start the week off on Monday, followed by the ISM manufacturing index and motor vehicle sales on Tuesday. Reports on productivity and the ISM service sector index are reported Thursday, followed by the all-important nonfarm employment report, Michigan Consumer Sentiment and Factory Orders report on Friday.
- International data next week includes international PMIs and retail, factory order, and employment data out of Germany. The ECB will also meet next week, but is unlikely to change rates.

SUBSCRIPTION INFORMATION

Wachovia's *Weekly Economic & Financial Commentary* is distributed to subscribers each Friday afternoon by e-mail. The *Weekly Economic & Financial Commentary* is also available via the Internet at <http://www.wachovia.com/economics>.

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Market Data
U.S. Interest Rates

	Friday Feb. 25	1 Week Ago	1 Year Ago
3-Month T-Bill	2.71	2.59	0.96
3-Month LIBOR	2.91	2.85	1.12
1-Year Treasury	3.14	3.06	1.22
2-Year Treasury	3.54	3.44	1.60
5-Year Treasury	3.92	3.87	2.97
10-Year Treasury	4.28	4.27	4.01
30-Year Treasury	4.65	4.65	4.89
Bond Buyer Index	4.42	4.35	4.50

Commodity Prices

	Friday Feb. 25	1 Week Ago	1 Year Ago
W. Texas Crude/Barrel	5.06	47.54	36.03
Gold (\$)/Ounce	434.10	427.41	396.05
St. Steel Scrap (\$)/Ton	1575	1575	1617
Copper (\$)/Pound	158.61	158.02	141.66
Soybeans (\$)/Bushel	5.67	5.40	9.37
Natural Gas (\$)/BTU	6.31	6.03	5.08
CRB Spot Inds.	327.70	325.01	310.54

Foreign Interest Rates

	Friday Feb. 25	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	2.13	2.13	2.07
3-Month Yen LIBOR	0.05	0.05	0.05
3-Month Canadian LIBOR	2.62	2.63	2.29
3-Month Sterling LIBOR	4.95	4.89	4.20
10-Year German	3.71	3.66	4.08
10-Year Japanese	1.44	1.43	1.21
10-Year U.K.	4.76	4.69	4.79
10-Year Canadian	4.28	4.24	4.41

Foreign Exchange Rates

	Friday Feb. 25	1 Week Ago	1 Year Ago
Euro (\$/€)	1.32	1.31	1.25
Yen (¥/\$)	105.19	105.65	108.99
Pound (\$/£)	1.92	1.89	1.87
Canadian Dollar (C\$/D\$)	1.24	1.23	1.33
Mexican Peso (MXN/\$)	11.09	11.08	11.06
Australian Dollar (US\$/A\$)	0.79	0.79	0.77
U.S. Dollar Index	82.90	83.48	87.25

Economic Calendar (Consensus Estimates)

Monday	Tuesday	Wednesday	Thursday	Friday
February 28	March 1	2	3	4
Personal Income Dec 3.7% Jan	Light Vehicle Sales (SAAR) Jan 16.2M Feb 16.7 M (W)		ECB Rates Feb 2.00% Mar 2.00% (W)	NonFarm Payrolls Jan 146K Feb 161K (W)
Personal Spending Dec 0.8% Jan	ISM Manufacturing Jan 56.4 Feb		Nonfarm Productivity Q4 (Adv) 0.8% Q4 (Final)	Factory Orders Dec 0.3% Jan
New Home Sales Dec 1098 Jan	German Unemp. Rate Jan Feb		ISM Non-Mfg Index Jan 59.2 Feb	Consumer Sentiment Feb (Prelim) 94.2 Feb (Final)
7	8	9	10	11
Consumer Credit Dec \$3.1B Jan		German Industrial Prod. Dec 0.9% Jan	Wholesale Inventories Dec 0.4% Jan	International Trade Bal. Dec -\$56.4B Jan
		U.K. Industrial Production Dec 0.5% Jan	U.S. Monthly Budget Feb' 04 -\$96.7B Feb '05	

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