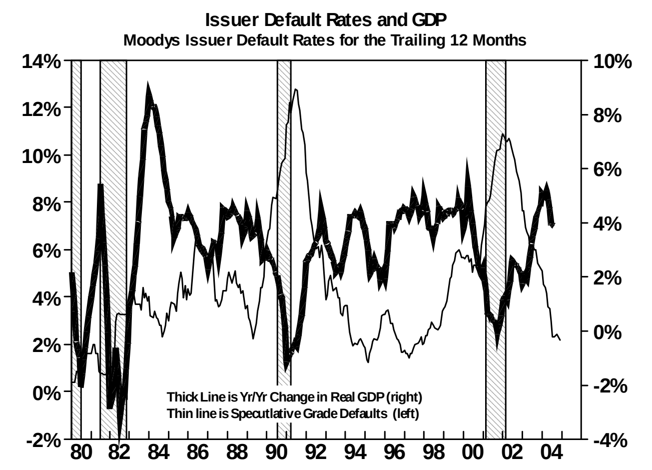
Economics Group

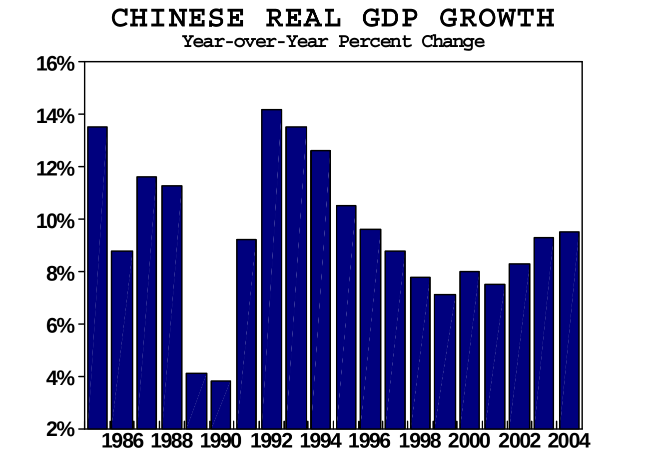
Weekly Economic and Financial Commentary

January 28, 2005

Executive Summary

- **How Long Can the Sweet Spot Last?** Speculative grade defaults remain near historic lows, as to spreads, despite the last few weeks of widening. Solid economic growth expectations support a low level of defaults, even with the Fed on an upward path.
- International highlights this week included a deluge of data out of Japan, the strongest Chinese annual GDP since 1996 (lower right graph), a mixed German Ifo, solid U.K. GDP figures and an impending OPEC meeting. Growth is in the cards accross the board, even if it's likely to be a bit slower in some countries this year. OPEC, however, is likely to hold oil production quotas unchanged, which will hold global crude supplies constricted.





This Week's Data

U.S.

- Existing Home Sales: Dec 6.69M vs Nov 6.92M
- Durable Goods Orders: Dec 0.6% vs Nov 1.8%
- Help Wanted Index: Dec 38 vs Nov 36
- GDP Annualized: 4QA 3.1% vs 3Q 4.0%
- Personal Consumption: 4QA 4.6% vs 3Q 5.1%
- GDP Price Deflator: 4QA 2.0% vs 3Q 1.4%
- Employment Cost Index: 4Q 0.7% vs 3Q 0.9%

International

- Japanese Unemployment: Dec 4.4% vs Nov 4.5%
- Japanese CPI YoY: Dec 0.2% vs nov 0.8%
- Japanese Indust Prod MoM: Dec -1.2% vs Nov 1.7%
- Japanese Retail MoM, sa: Dec -0.5% vs Nov -0.8%
- Japanese Vehicle Prod: Dec -3.3% vs Nov 7.1%
- Chinese GDP: 4Q 9.5% vs 3Q 9.1%
- German Ifo (Current Assess): Jan 96.4 vs Dec 96.2
- German Ifo (Expectations): Jan 97.6 vs Dec 96.5
- U.K. GDP YoY: 4QA 2.8% vs 3Q 3.1%
- U.K. GDP MoM: 4QA 0.7% vs 3Q 0.5%

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Behind this Week's Numbers

Consumers Remain Optimistic About Current Economic Environment

The Conference Board's Consumer Confidence index rose slightly in January to 103.4 from 102.7 in December to mark the second consecutive monthly increase. The gain in confidence this month was exclusively due to the 5.2 percent gain in the present situation index. The expectations index fell slightly, however, down to 98.4 from 100.7. One possible explanation for lower future expectations could have been the upcoming tax season and the lower tax returns consumers expect to receive this spring. The percent of respondents who expect income to rise in the next six months fell to 18.0 percent from 21.0 percent in December, a depth not seen since July 2004. Across measurements, consumers feel optimistic about the current economic environment. The key to getting more consumers feeling positive about the economy is improving job prospects. A solid January nonfarm employment figure next Friday would go a long way in making consumers believe good times are still ahead.

Accelerated Depreciation Likely Contributed to December Durable Goods Results

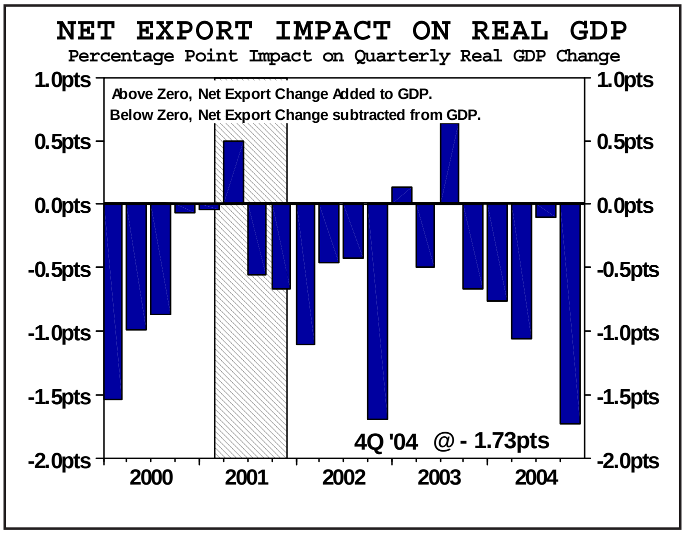
Durable goods orders came in about as expected in December at + 0.6 percent. A 32.3 percent and 16.7 percent decline in orders of defense aircraft and civilian aircraft, respectively, held down any larger increase in total orders. Non-defense capital goods orders ex-aircraft rose 1.8 percent and shipments of these capital goods orders increased 2.2 percent. These "core" orders were driven higher by solid gains in machinery and computers and likely reflects the temporary boost provided by the expiration of the bonus depreciation allowances ending December 31, 2004. While we would not be surprised to see a dip in capital goods orders in January and February following the end of the tax break, the ISM New Orders index continues to suggest solid growth in the durable goods manufacturing sector.

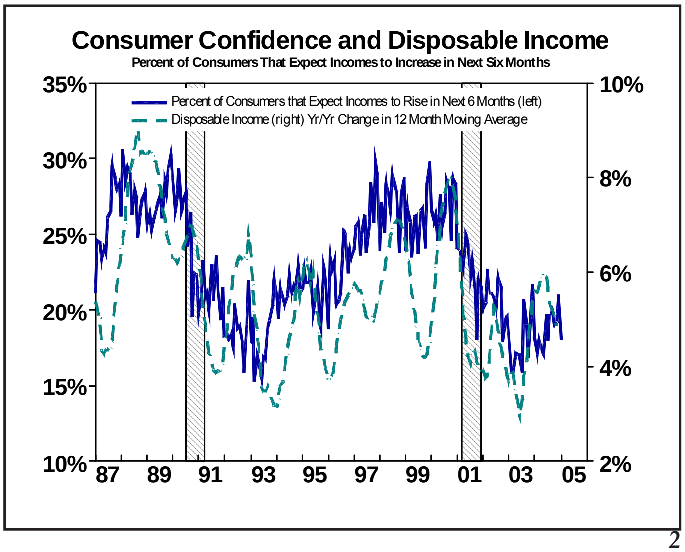
Trade Balance a Drag on Growth

After a four percent gain in the third quarter, real GDP returned to average growth in the fourth quarter, posting a 3.1 percent increase. Most categories of economic growth recorded solid gains for the quarter, but the record trade deficit proved to be a formidable drag. Net exports subtracted 1.73 points from real growth in the fourth quarter, due to a very strong increase in imports of 9.1 percent and a disappointing decline in exports of 3.9 percent. Personal consumption, business purchases of investment and software, inventories, and government spending all contributed gains in growth during Q4. Consumer purchases were up 4.6 percent, boosted by more purchases of nondurable goods and services than the third quarter, but fewer purchases of durable items. Even with rising energy prices, consumer purchases increased 3.8 percent for the year in total, slightly higher than the 3.5 percent average annual growth of the last twenty years. We anticipate another steady year for personal consumption expenditures in 2005, as a better employment situation and rising incomes keep consumers shopping.

Benefits Continue to Outpace Wages & Salaries

Employment costs rose marginally in Q4, up just 0.7 percent after a 0.9 percent gain in Q3. On a year-over-year basis, costs are 3.7 percent higher, slightly lower than the long-term average increase of 4.1 percent. The big story here is benefit costs, however, which continue to outpace wages and salaries. Benefit costs rose 6.9 percent over the last year, accounting for more than sixty percent of the increase in total compensation costs for civilian workers in Q4. In contrast, wages and salaries for civilian workers grew a meager 0.4 percent in Q4 after a 0.7 percent Q3 increase. The quarterly gain was the slowest since 1999, and, on a yearly basis, is the slowest increase in the history of the series.





"Disappointingly" Strong Growth of the Week: China
This week, one of the biggest pieces of news for international markets was Chinese growth. Apparently, China's attempt to slow growth at the end of 2004 was anything but effective. Despite government policies to put the brakes on, including an interest rate hike, growth showed no sign of abating in the fourth quarter, and rose to 9.5 percent at an annualized rate. Furthermore, Chinese annual growth in 2004 was 9.5 percent -- the highest level since 1996 (front page). In the buildup to the 2008 Beijing Olympics, Chinese growth is expected to continue. This should continue to engender further tightness in commodity markets.

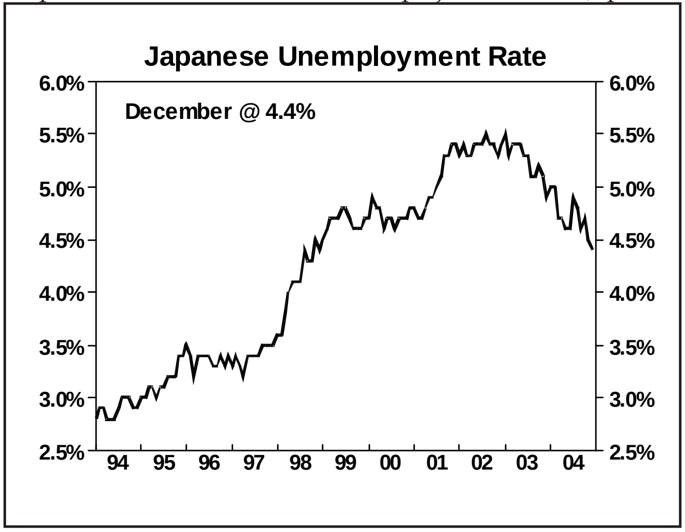
Mixed Data Highlight of the Week: German Ifo
This week, the German IFO indices of business confidence were released. These indices are relatively strongly correlated with German economic growth. The current assessment portion of the index weakened somewhat from 96.0 to 95.3. The future expectations index, however, saw an upward revision in December from 96.4 to 96.5, and rose in January to an even higher 97.6. Despite this relatively positive data concerning Germany's future economic growth, the near term signs of weakness continue to pervade the marketplace.

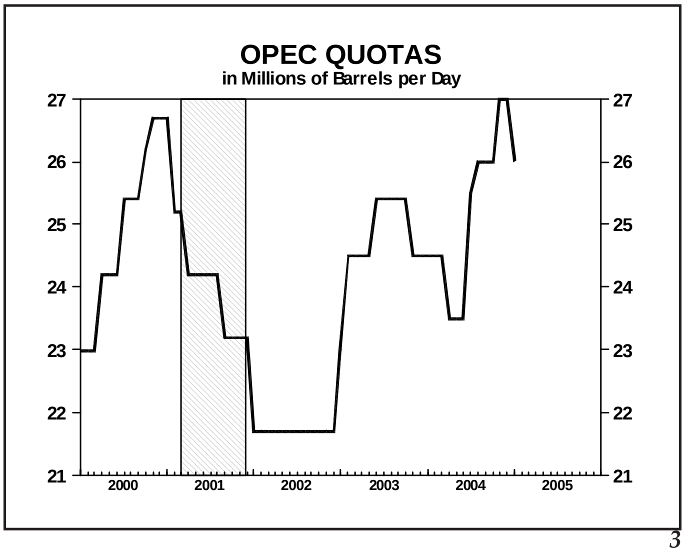
Data Deluge Country of the Week: Japan
A variety of Japanese economic data were released this week. Japanese employment, inflation, and industrial production data all hit the screens yesterday evening. A big data day by any measure, the signals were somewhat mixed. The Japanese jobless rate fell in December to 4.4 percent from 4.5 percent in November (bottom left graph). National CPI fell on a month-over-month seasonally adjusted basis by 0.4 percent, and national year-over-year CPI remained at a rather innocuous 0.2 percent. On the downside, Japanese industrial production in December, and fell 1.2 percent month-over-month.

This deluge of Japanese data came on the heels of retail sales that showed marked declines: -0.5 percent fall month-over-month in December, and –0.7 percent year-over-year. Vehicle production was also down –3.3 percent year-over-year in December, which was a sharp drop from the +7.1 percent rate of production in November. We project that the Japanese economy will continue to expand in 2005, albeit at a slower rate of growth than last year.

Exceeded Expectation of the Week: U.K. GDP
The first release of the United Kingdom's fourth quarter GDP came out on Wednesday. Consensus estimates were calling for quarter-over-quarter growth of 0.5 percent and year-over-year growth of 2.6 percent. The actual figures were stronger, with quarter-over-quarter growth at 0.7 percent and year-over-year at 2.8 percent. Although the year-over-year growth fell in the fourth quarter from 3.1 percent in the third quarter, it was above expectations and is further evidence that the major economies of the world may be stronger than currently viewed. Well, except for Germany, which in the near term may be as weak as it appears.

Four Crude Letters of the Week
This week we continued to see oil rise toward $50 per barrel. A certain four letter factor has been driving oil prices. Maybe the four letters are I-R-A-Q. On January 30, there will be national elections. The magnitude of anticipated terrorist interventions is in the hundreds. This sort of thing has a knack for driving up the supply disruption premium. Of course, maybe the other four letter factor driving oil to these levels is S-N-O-W. With a nationwide cold-snap only now snapping back, and blizzards abounding in the Northeast, it is no wonder the price of heating oil has risen. About 80 percent of heating oil is consumed in Northeast regions. A final four letter factor driving oil markets right now is O-P-E-C. With global growth in full effect, the IEA continues to chide OPEC for cutting production in December at such a critical time (bottom right graph). On Sunday, OPEC meets in Vienna to decide if more cuts (yikes!) are necessary. They will likely keep production at current levels, which according to Petrologistics are about 800,000 barrels per day less than they were in December. OPEC has seen their profits fall as the dollar has depreciated, and it has come to the realization that Americans are willing to pay $40-$50 per barrel of oil. For now, we see further evidence buttressing our oil forecast of $46 per barrel for the year, as OPEC tries to help markets find the sweet-spot price of sweet crude between $40 and $50 per barrel. It appears as if OPEC, Iraq, and snow are the near term trifecta threatening to drive the price of crude higher.





Interest Rate Watch

Monetary Policy: Targets, Indicators and Instruments

Last week we focused on the Fed's target of a neutral fed funds rate and how we might judge a neutral rate by key economic indicators. These indicators include home sales, factory orders and the dollar.

What about market indicators such as quality spreads, commodity prices and the yield curve which are so critical to financial market performance? These financial market indictors are useful but suffer from the impact of other factors that limit our ability to separate the influence of monetary policy and other independent factors.

Financial Indicators: A Question of Independence

Quality spreads typically widen as the economy slows. Therefore, a less-neutral monetary policy might be associated with a wider quality spread than an accommodative policy. However, events (accounting revelations for example) independent of monetary policy often shock the market and lead to a widening of spreads. This pattern of event risks is quite common over the business cycle and the subsequent widening of spreads would be a misleading indicator of the impact of policy.

In a similar way the fluctuations in commodity prices may reflect the influences of weather or global politics independent of the influence of monetary policy. If policy is suppose to be less accommodative and yet commodity prices rise then the story may be more of a supply shock than an issue of inflation expectations.

Finally, a flatter yield curve has traditionally been viewed as a proxy for policy restraint and yet the yield curve reflects the decisions of many investors especially the presence of foreign central banks. These banks will often buy Treasury debt independent of market indications of neutral policy.

Topic of the Week

The American Jobs Creation Act of 2004, which was signed into law by President Bush last October, allows U.S. companies to repatriate the profits of their foreign subsidiaries at very attractive tax rates in 2005. Johnson & Johnson announced last week that it would bring home $11 billion, and other large companies followed suit this week. How much money could be repatriated? Could it have a significant effect on dollar exchange rates?

Regarding the former question, most reliable estimates place the amount of eligible funds somewhere between $400 billion and $700 billion. However, the amount that companies actually will bring back is much less certain, as some companies may simply decide to keep the funds overseas in order to fund capital spending in foreign countries. Nobody really knows for sure how much.

There is even more uncertainty with respect to exhange rates. Repatriation would have an effect on exchange rates only if foreign currencies need to be sold for dollars. However, some analysts speculate that a sizeable portion of the foreign profits are already in dollars, implying no exchange rate effect on this portion. One reasonable estimate places the amount of foreign profits that need to be converted to dollars as between $100 billion and $200 billion over the course of 2005. That sounds like alot of money. However, the Bank of Japan's intervention purchases of dollars, which totalled $170 billion in the first three months of 2004, only managed to keep the dollar-yen exchange rate stable.

Our best guess is that repatriation will have little net effect on dollar exchange rates this year. However, we readily admit that repatriation represents a significant risk to our view that the greenback will trend modestly lower over the course of 2005. If stronger-than-expected economic growth in the U.S. manages to change the dollar's downward trend, repatriation could give it another shot in the arm.

Next Week's Highlights

- **Domestic highlights** next week include the FOMC rate decision on Wednesday, followed by Nonfarm Payroll on Friday. There is a slew of data smattered in between.
- **Internationally,** the OPEC meeting this Sunday will probably be the most important international event of the week. The group was initially supposed to discuss further production cuts. Now there are calls for production increases. The group, however, is likely to leave things as they are.

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 Jan. 28	1 Week Ago	1 Year Ago
3-Month T-Bill	2.46	2.35	0.93
3-Month LIBOR	2.74	2.70	1.12
1-Year Treasury	2.94	2.85	1.28
2-Year Treasury	3.24	3.14	1.82
5-Year Treasury	3.68	3.64	3.21
10-Year Treasury	4.14	4.14	4.19
30-Year Treasury	4.62	4.64	5.03
Bond Buyer Index	4.37	4.40	4.57

Foreign Interest Rates

	Friday Jan. 28	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	2.14	2.14	2.08
3-Month Yen LIBOR	0.05	0.05	0.05
3-Month Canadian LIBOR	2.61	2.62	2.44
3-Month Sterling LIBOR	4.87	4.87	4.11
10-Year German	3.55	3.57	4.15
10-Year Japanese	1.32	1.36	1.32
10-Year U.K.	4.60	4.60	4.83
10-Year Canadian	4.20	4.22	4.62

Commodity Prices

	Friday Jan. 28	1 Week Ago	1 Year Ago
W. Texas Crude/Barrel	48.05	48.33	33.62
Gold ($)/Ounce	424.80	427.25	410.35
St. Steel Scrap ($)/Ton	1520	1520	1495
Copper ($)/Pound	154.66	152.11	117.25
Soybeans ($)/Bushel	5.22	5.29	8.30
Natural Gas ($)/BTU	6.48	6.25	5.86
CRB Spot Inds.	321.84	321.59	310.29

Foreign Exchange Rates

	Friday Jan. 28	1 Week Ago	1 Year Ago
Euro ($/€)	1.30	1.30	1.25
Yen (¥/$)	103.58	102.69	106.23
Pound ($/£)	1.88	1.88	1.82
Canadian Dollar (C$/$)	1.24	1.22	1.33
Mexican Peso (MXN/$)	11.27	11.24	11.00
Australian Dollar (US$/A$)	0.77	0.77	0.77
U.S. Dollar Index	83.71	83.26	86.97

Economic Calendar (Wachovia Estimates)

Monday	Tuesday	Wednesday	Thursday	Friday
31	February 1	2	3	4
New Home Sales Nov 1125K Dec 1110K (W) **Personal Income** Nov 0.3% Dec **Personal Spending** Nov 0.2% Dec	**Construction Spending** Nov -0.4% Dec **ISM Manufacturing** Dec 58.6 Jan **Total Vehicle Sales** Dec 18.4M Jan 16.6M (W)	**FOMC Rate Decision** Dec 2.25% Feb 2.50% (W)	**NonFarm Productivity** 3Q 1.8% 4Q **Factory Orders** Nov 1.2% Dec **ISM Non-Manufacturing** Dec 63.1 Jan	**Unemployment Rate** Dec 5.4% Jan **NonFarm Payroll** Dec 157K Jan 155K (W)
7	8	9	10	11
Consumer Credit Nov -$8.7B Dec		**Wholesale Inventories** Nov 1.1% Dec **U.K. Industrial Prod** Nov 0.2% Dec	**Trade Balance** Nov -$60.3B Dec -$63.1B **Monthly Budget Statement** Dec -$1.4B Jan **BOE Rates** Jan 4.75% Feb 4.75% (W)	