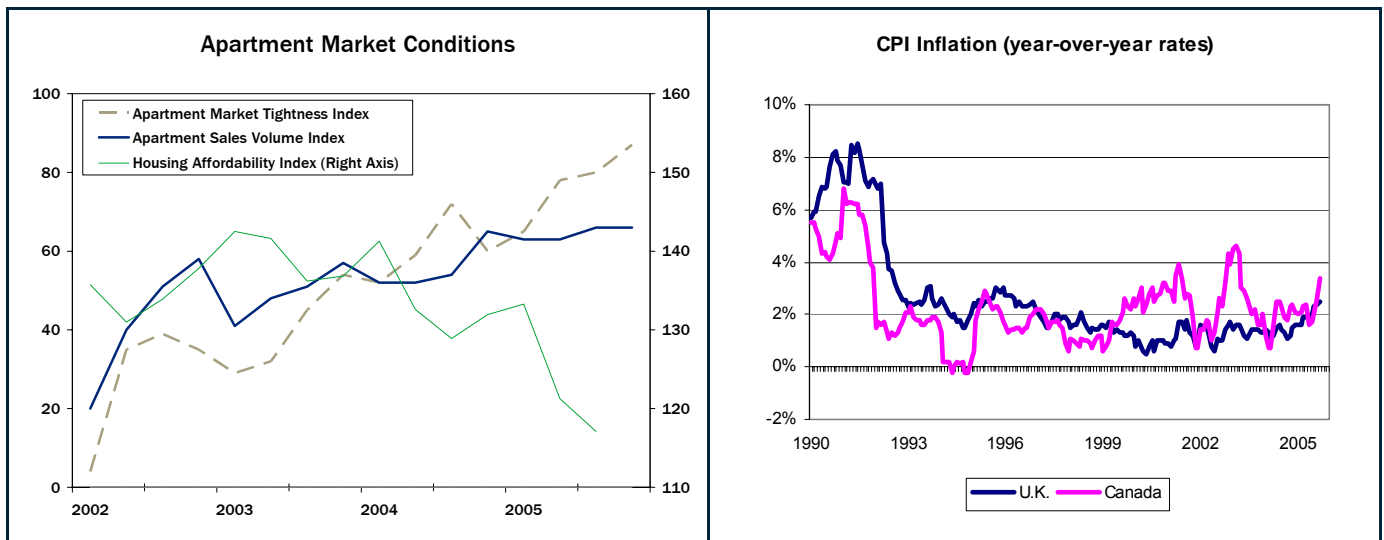


Weekly Economic and Financial Commentary

October 28, 2005

Executive Summary

- **Apartment Tightness Increases as Housing Affordability Declines.** Nice to see that sometimes the theory works out just fine. Over the last two years housing affordability has declined. In response we have witnessed a rise in the Apartment Market Tightness index published by the National Multi Housing Council. Employment and income gains in the economic expansion have led to increased occupancy of both single and multi-family housing.
- Ben Bernanke, who has been tapped to succeed Alan Greenspan as Fed Chairman, is on record as favoring an explicit inflation target for the Fed. Some major foreign countries that have mandated inflation targets for their central banks have experienced a significant decline in long-term interest rates that has improved the economic performance of those countries. However, we do not believe an explicit inflation target for the Fed is imminent, because it is not apparent how much further long-term interest rates in the U.S. could decline if one were in place.



This Week's Data

US

- Real GDP Annualized: 3QA 3.8% vs 2Q 3.3%
- Real Personal Consumption: 3QA 3.9% vs 2Q 3.4%
- Employment Cost Index: 3Q 0.8% vs 2Q 0.7%
- U. of Michigan Confidence: Oct(F) 74.2 vs Oct(P)75.4
- Existing Home Sales: Sept 7.28M vs Aug 7.28M
- Consumer Confidence: Oct 85.0 vs Sept 87.5
- Durable Goods Orders: Sept -2.1% vs Aug 3.8%
- Durables ex-trans: Sept -1.0% vs Aug 5.1%
- New Home Sales: Sept 1222K vs Aug 1197K

International

- Euro-zone CPI Estimate (YoY): Oct 2.5% vs Sept 2.6%
- French Unemployment: Sept 9.8% vs Aug 9.9%
- German IFO (Business Climate): Oct 98.7 vs Sept 96.0
- German CPI (YoY): Oct 2.4% vs Sept 2.5%
- French Producer Prices (YoY): Sept 3.4% vs Aug 2.8%
- French Business Conf Indicator: Oct 102 vs Sept 100
- Italian Business Confidence: Oct 89.5 vs Sept 89.3
- Japanese CPI (YoY): Sept -0.3% vs Aug -0.3%
- Japanese Retail Trade (MoM): Sept -0.8% vs Aug 1.5%
- Japanese Jobless Rate: Sept 4.2% vs Aug 4.3%
- Japanese Industrial Prod (MoM): Sept 0.2% vs Aug 1.1%
- Canadian CPI (YoY): Sept 3.4% vs Aug 2.6%
- Canadian CPI Core (YoY): Sept 1.7% vs Aug 1.7%
- Canadian Indust Prices (MoM): Sept 0.4% vs Aug 0.4%



Shifting Undercurrents on a Quiet Lake

On the surface the pattern of consecutive trend-plus growth quarters of gross domestic product (GDP) has given decision-makers a false sense of stability. Reality is a bit scarier. While aggregate growth continues there is a clear move away from consumer leadership towards federal spending, construction and more modest gains in business investment. Moreover, the fundamentals of inflation, interest rates and profits are becoming more negative. The easy money has been made. The hard part is beginning to appear.

Economic Growth: Sources of Leadership Change

Over the past three years, consumer spending has provided the leadership to domestic demand. Investment tax cuts have helped to spur business investment. Housing has boomed.

Yet, we can now see that the fundamentals behind these three demand drivers have deteriorated. Rising inflation and higher interest rates are slowing consumer spending. Inflation has reduced real personal income. Higher interest rates have reduced the incentive to borrow and thereby have increased the financing cost for consumer durable spending. In our outlook, real disposable income grows at just 1.5 percent in 2006 and consumer durable spending weakens.

Meanwhile the fundamentals behind business investment spending have also changed. Corporate growth is slowing and interest rates are up. Tax cuts for investment have expired. The net is that equipment & software spending is expected to slow from ten percent this year to seven

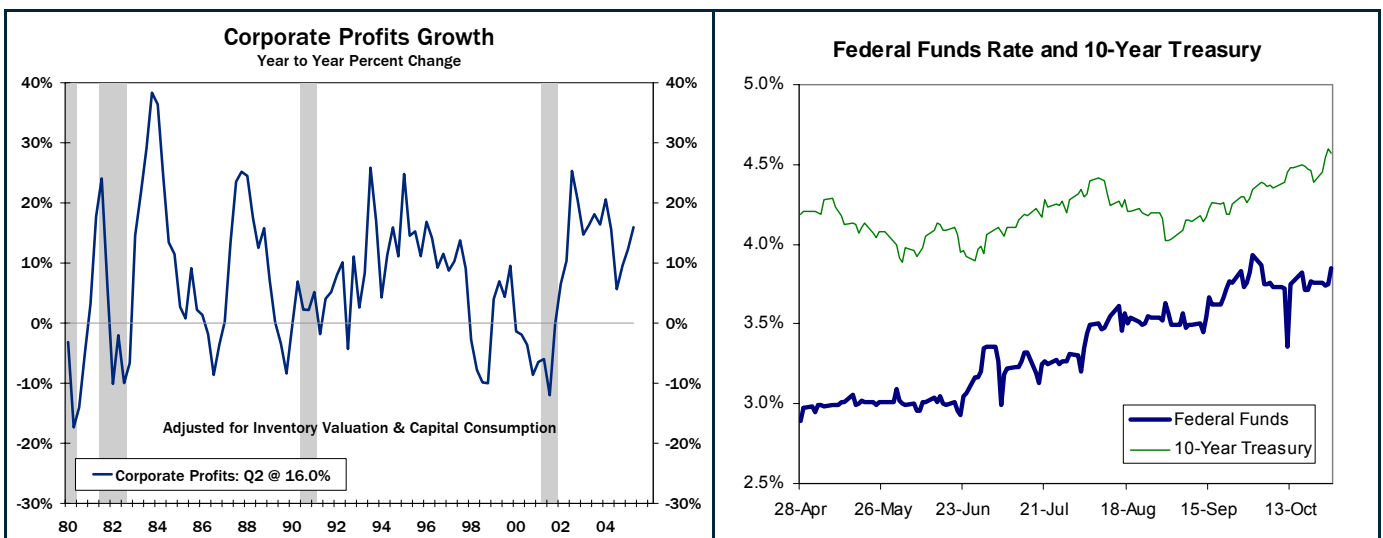
percent next year. Finally, residential construction is expected to be flat as rising rates make home improvement spending expensive. With leadership now more dependent on federal spending and business investment in structures we are clearly entering into the mid-phase of the economic cycle.

Financial Backdrop Takes a Dip

Despite the lack of respect, financial market developments are central to the prosperity of the real economy and these developments are less friendly to growth than we have seen in the past. Already we have witnessed a peaking in the growth of corporate profits (graph lower left) as compensation costs have risen and productivity growth has slowed. The net has been a rise in unit labor costs and a decline in profit margins. In addition, there has been a distinct upswing in the cost of capital at both the short and long end of the curve. Rising interest rates (graph lower right) have already started to price out the marginal buyers as seen by the slowdown in both residential and business equipment spending.

On Net, the Undercurrents Have Already Moved

On net, the fundamentals supporting economic growth have already shifted away from stimulus and toward restraint. While the top of the lake appears smooth and growth rates of GDP appear relatively steady, the underlying economic and financial fundamentals are suggesting slower growth and a step down in the expected rates of return on financial assets.





Ben Bernanke, President Bush's choice to succeed Alan Greenspan as Chairman of the Federal Reserve, is on record as favoring an explicit inflation target for the U.S. Although we do not believe that adoption of an explicit inflation target for the U.S. is imminent, we thought it may be insightful to discuss the inflation targeting experience of some major foreign central banks.

The first major central bank to give an explicit inflation mandate by its government was the Reserve Bank of New Zealand in 1989. Since then, governments in Australia, Canada, Sweden, and the United Kingdom have also turned their central banks into explicit inflation targeters. In each instance, the central bank is required to hit an explicit inflation rate or a target range, usually in the "medium term". In that regard, neither the Fed nor the ECB are inflation targeters in the strict sense of the word, because neither central bank has an explicit inflation target. Rather, each central bank pursues the less precise concept of "price stability."

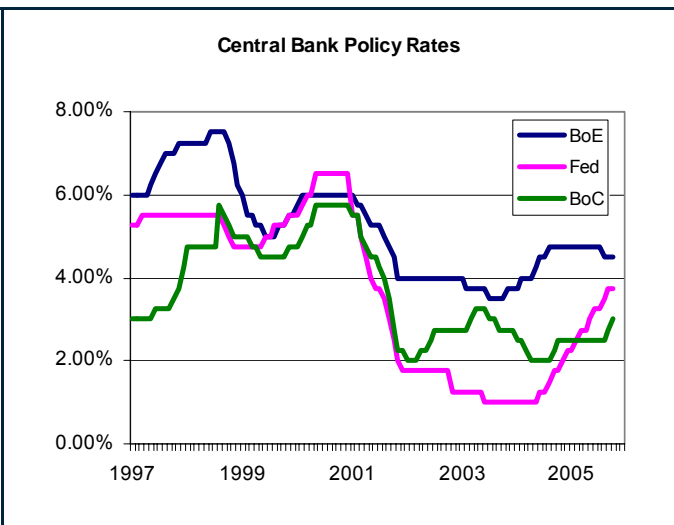
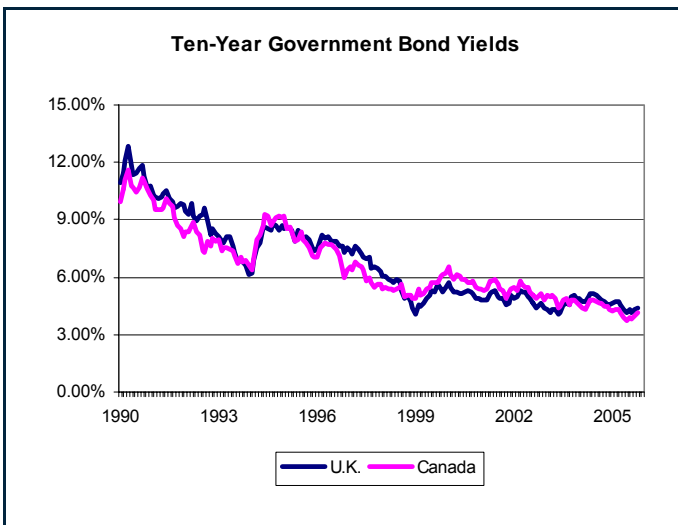
Some foreign governments decided to give their respective central bank an explicit inflation target due to the high rates of inflation that prevailed 10 to 15 years ago. As the graph on the front page makes clear, central banks in the U.K. and Canada have been very successful in bringing their inflation rates down. A major benefit that these countries have reaped from the anchoring of inflationary expectations is the significant decline in long-term interest rates (see chart below). Consequently, the cost of capital for many businesses has fallen, which has helped to improve the economic performance of these countries.

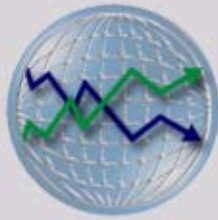
Many investors seem to believe that inflation-targeting central banks tend to be more "hawkish". Maybe in the current environment, in which inflationary concerns

predominate, inflation-targeting central banks are unusually hawkish. However, a commitment to an inflation target implies that the central bank needs to be willing to ease policy when it looks like inflation will undershoot the target. Indeed, when deflation fears gripped markets two years ago, it was Bernanke who seemed more "dovish" than most of his Fed colleagues.

Therefore, it may be more correct to characterize inflation-targeting central banks as more proactive. The graph below shows that the Bank of England (BoE) has changed its policy rate 32 times since it became an inflation targeter in 1997. Despite an economic environment that has been more volatile in the U.S. than in the U.K. (i.e., the buildup and subsequent collapse of the tech bubble, 9/11, and the need to return rates to a more normal level), the Fed has also changed policy 32 times. (One may have expected the Fed to have changed policy more often than the BoE). Thus, the BoE has arguably been more proactive than the Fed over the past eight years. Indeed, the BoE recently cut rates despite the rise in CPI inflation to a 9-year high. Why? The BoE believes that the recent slowdown in the economy could lead CPI inflation to undershoot the target in another year or so.

Is an explicit inflation target in store for the Fed? As noted above, we don't think it is imminent. First, the rest of the FOMC would need to approve the change, but a number of members are on record as opposing an explicit inflation target for the Fed. Moreover, an act of Congress may be needed to change the Fed's mandate. With long-term interest rates remaining near decades' lows, it is not apparent how much benefit the U.S. economy would reap from adopting an explicit inflation target. The old American maxim that "if it ain't broke, don't fix it" may apply in this situation.





Interest Rate Watch

Short Rates Moving Up: Fed funds at 4.5% In January

Trend-plus economic growth and rising inflation suggests the Fed will continue to raise the Fed funds rate to 4.50 percent by the time Chairman Greenspan leaves in January. Today's real GDP release reinforces this outlook.

However, going into next year the tenor of the economic cycle is expected to evidence slower real growth but modestly rising inflation. Since the Federal Reserve operates under a dual mandate of conducting policy to achieve the best possible outcomes for both inflation and employment the challenge for policy is that these goals conflict. Growth is slower and yet inflation higher. Which goal comes first? While the Fed is very interested in the inflation targeting, the extent to which the Fed can pursue that goal will be limited in the context of slower real growth and employment gains.

And Bonds?

Where will the bond market find the balance between growth and inflation? As growth slows will bonds rally? As inflation continues to rise will bonds sell off? If the Fed simply pursues an inflation target without regard to the state of employment then bonds may well rally as they did at the end of 1994. Investors would see growth slowing and discount an end to Fed increases and broader economic weakness as happened in 1995. Therefore we could see the much feared inverted yield curve in mid-2006. Much depends on how aggressive the Fed sets an inflation target. How are you going to set this inflation target? Since 1982 the average CPI change has been 3.2 percent and its variability pretty high. So what is the target? Stay tuned.

Topic of the Week

The Port of Wilmington and the Mississippi River

In speaking with the North Carolina State Ports Authority this week, we learned that the Port of Wilmington has been receiving corn from the Mississippi River region. In fact, the port has already received 35,000 tons and anticipates as much as 100,000 tons.

Why would the Port of Wilmington be receiving such a large amount of corn from the Midwest? In the aftermath of Hurricane Katrina and Hurricane Rita, there continues to be a backlog of barges in the Mississippi river as ports in the region continue to run at lower capacity. The ports are struggling to find enough labor to support capacity that is being brought back online. These barges and inventories backed up on the Mississippi River are loaded with perishable agricultural commodities. The thousands of tons of corn coming to Wilmington were once meant for human consumption but were left too long on the Mississippi. The corn has been downgraded and is now being shipped to Wilmington and, presumably, other ports around the country for livestock feed.

We have no data as to how many tons of corn and other perishable commodities are being downgraded or going to waste because of the backlog on the Mississippi River, but the effect could be dramatic for commodity prices and farmers in the region.

Next Week's Highlights

- **Domestically**, nonfarm payrolls are expected to post a gain, the Fed is expected to hike its policy rate 25 bps, factory orders are likely to be weak and a potentially dismal auto sales figure will be the highlights next week. Watch the weather move the natural gas market.
- **Internationally**, recent data suggest that growth in the Eurozone may be picking up a tad. Investors will look at the manufacturing and service sector PMI indices in the Eurozone to see if that momentum continued in October. Comparable indices will also be released in the U.K.

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U.S. Interest Rates

	Friday 10/28/2005	1 Week Ago	1 Year Ago
3-Month T-Bill	3.90	3.85	1.90
3-Month LIBOR	4.25	4.20	2.03
1-Year Treasury	4.32	4.11	2.22
2-Year Treasury	4.37	4.20	2.57
5-Year Treasury	4.44	4.25	3.31
10-Year Treasury	4.56	4.38	4.05
30-Year Treasury	4.77	4.60	4.82
Bond Buyer Index	4.56	4.47	4.43

Foreign Interest Rates

	Friday 10/28/2005	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	2.26	2.19	2.15
3-Month Yen LIBOR	0.06	0.06	0.05
3-Month Canadian LIBOR	3.20	3.17	2.70
3-Month Sterling LIBOR	4.60	4.59	4.90
10-Year German	3.42	3.23	3.89
10-Year U.K.	4.36	4.37	4.75
10-Year Canadian	4.15	4.03	4.49
10-Year Japanese	1.52	1.52	1.49

Commodity Prices

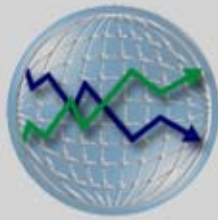
	Friday 10/28/2005	1 Week Ago	1 Year Ago
W. Texas Crude (\$/Barrel)	61.00	60.63	50.92
Gold (\$/Ounce)	470.35	466.89	424.35
Hot-Rolled Steel (\$/Short Ton)	515.00	515.00	660.00
Copper (\$/Pound)	185.60	192.80	125.75
Soybeans (\$/Bushel)	5.44	5.58	5.18
Natural Gas (\$/MMBTU)	13.07	12.87	8.68
CRB Spot Inds.	331.40	333.15	312.80

Foreign Exchange Rates

	Friday 10/28/2005	1 Week Ago	1 Year Ago
Euro (\$/€)	1.21	1.20	1.27
Yen (¥/\$)	115.57	115.91	106.30
Pound (\$/£)	1.78	1.77	1.83
Canadian Dollar (C\$/D)	1.18	1.19	1.22
Mexican Peso (MXN/\$)	10.83	10.87	11.53
Australian Dollar (US\$/A\$)	0.75	0.75	0.75
Chinese Yuan (CNY/\$)	8.08	8.09	8.28
U.S. Dollar Index	89.35	90.31	85.28

Economic Calendar (Wachovia Estimates)

Monday	Tuesday	Wednesday	Thursday	Friday
31	1	2	3	4
Personal Income Aug -0.1% Sept	ISM Manufacturing Sept 59.4 Oct 57.5 (W)	German Unemp Rate Sept 11.7% Aug	NonFarm Prod 2Q 1.8% 3QP	NonFarm Payroll Aug -27K Sept +90K (W)
Personal Spending Aug -0.5% Sept	Total Vehicle Sales Sept 16.4 Oct		ISM Non-Manuf Sept 53.3 Oct	Unemployment Rate Sept 5.1% Oct 5.1% (W)
Canadian GDP July 0.2% Aug	FOMC Rate Decision Sept 3.75% Oct 4.00% (W)		Factory Orders Aug 2.5% Sept -1.5% (W)	
7	8	9	10	11
Consumer Credit Aug \$4.9B Sept		Wholesale Inventories Aug 0.5% Sept	Trade Balance Aug -\$59.0B Sept	Veteran's Day Holiday
German Ind Prod Aug -1.6% Sept			Import Price Index Sept 2.3% Oct	Markets Closed
UK Ind Prod Aug -0.9% Sept			Japanese Mach. Order Aug 8.2% Sept	



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