



## Monthly Economic Outlook

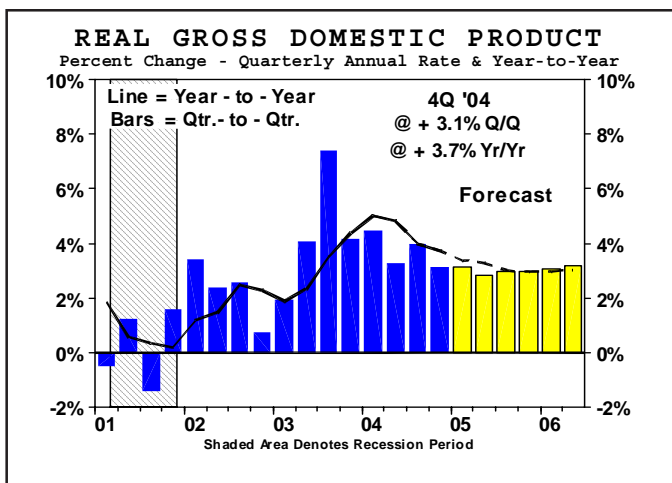
February 14, 2005

### U.S. Overview

After posting 4.4% GDP growth in 2004, the U.S. economy now appears to be settling down to something closer to its long run sustainable growth rate. Real GDP is expected to rise 3.3% in 2005, with slightly less growth in consumer spending and business investment being partially offset with greater increases in business inventories and less deterioration in the nation's trade deficit. In this environment, the Fed will likely continue to gently nudge short-term interest rates higher. We currently expect the federal funds rate to reach 3.75% by year end. With growth moderating and inflation still low by recent historical standards, the yield curve with flatten even further.

Near term projections for the U.S. economy have been slightly increased, reflecting some slight improvement in the nation's trade deficit in November and December as well as stronger data on consumer spending, factory orders, and initial unemployment claims. Fourth quarter GDP growth is expected to be revised up by at least 0.2 percentage points due to a smaller trade deficit than was reported in the advance GDP report. Construction outlays also appear to have been stronger than initially projected.

Growth prospects for the first quarter have also been boosted, with most of the increase coming from stronger consumer spending. In addition, there appears to be less of a payback from the ending of bonus depreciation this past year. Most notably, demand for heavy trucks remains very strong.

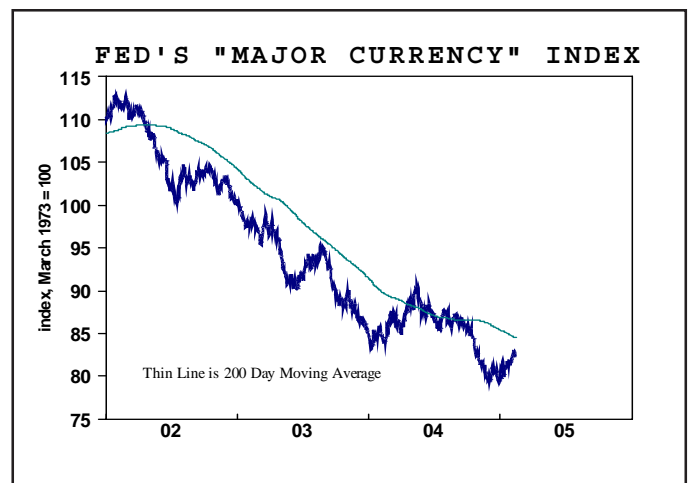


### International Overview

The dollar has strengthened on balance so far this year, which is not all that surprising given its rapid decline at the end of last year. However, we are inclined to view this appreciation as a corrective rally within a continuing downward trend. The problem with the dollar is not capital inflows, because foreign purchases of U.S. securities stand at an all-time high. Rather, the current account deficit continues to widen, and a significant decline does not appear to be in the cards yet.

If a turnaround in the value of the current account deficit were imminent, the trade balance as measured in volume terms would be stabilizing. However, the "real" trade balance continues to deteriorate, suggesting that the nominal current account deficit will widen further over the months ahead. Indeed, the experience of the late 1980's, the last time that a significant correction in the U.S. current account imbalance occurred, shows that the nominal current account deficit continues to widen for a year or so after the "real" trade deficit begins to decline.

Given the ongoing expansion in the U.S. and our projection of rising rates of return on dollar assets, we do not expect that capital inflows will weaken sharply. However, we also are not hopeful that capital inflows will accelerate to the point that they will more than offset the downward pressure on the dollar emanating from the current account deficit. Therefore, we project that the dollar will continue to trend lower, albeit at a gradual pace, over the course of the next year or so.



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**A More Mature Goldilocks**

Any disappointment about the smaller than expected rise in nonfarm payrolls during January seems to have been more than offset by the prospect that the Fed may show even more restraint in boosting interest rates this year. Nonfarm payrolls rose by 146,000 in January and have risen by an average of 150,000 jobs per month over the past eight months. During this period, the civilian unemployment rate has fallen 0.4 percentage points.

So has the economy found a growth rate that will produce lower unemployment and maintain relatively low rates of inflation? The financial markets certainly seem to think so. Stocks and bonds both rallied after the employment figures were released, and the yield on the 10-year Treasury briefly dropped below 4% following some encouraging comments from Federal Reserve Bank of Atlanta president Jack Guynn. His comments were widely interpreted to mean that the Fed is getting close to the point where it will hold off on any additional rate hikes.

We have a slightly different view. While we agree that at some point this year the Fed will clearly need to change the wording in their policy statement, we still feel the Fed has plenty of work to do. The federal funds rate is still way below the level that would be considered neutral and we expect at least five more quarter-point rate hikes this year.

Sooner or later, however, the Fed will need to change the wording in its policy statement, so that they drop any reference to a measured pace of rate hikes. That statement, while providing a great deal of transparency to the financial markets, is actually proving to be counterproductive to the Fed's objective of removing some of the extra stimulus they put in place following the September 11 attacks. The problem is that the Fed is being too transparent. Bond investors can keep the carry trade on, or take their time unwinding it, if they are assured that the Fed will only raise the federal funds rates a quarter of a percentage point at each meeting.

**1990s Reprise**

Long-term interest rates are also falling on expectations that

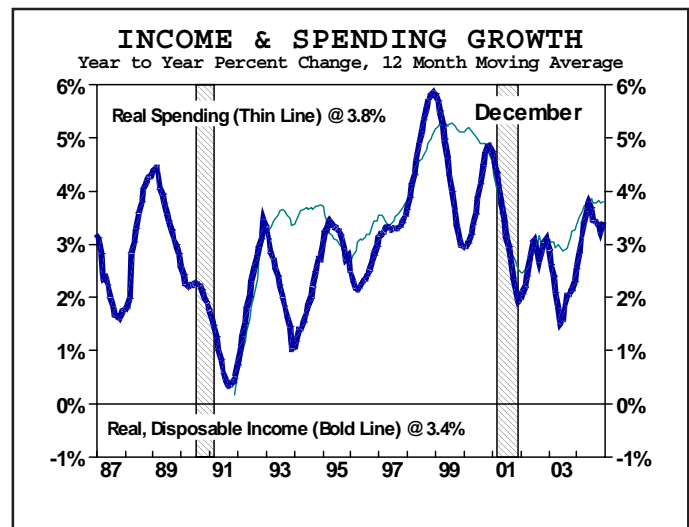
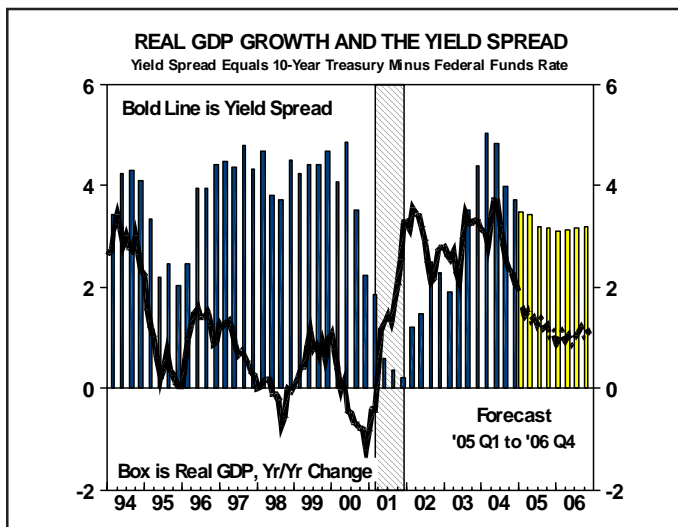
the economy will slow. This is the same thing that happened back in the mid 1990s. Back then, the yield on the 10-year Treasury briefly fell below the federal funds rate. That flattening of the yield curve coincided with a fairly dramatic slowdown in overall growth, with real GDP growth decelerating from a 4.1% pace in 1994 to a 0.9% pace during the first half of 1995. For all of 1995, growth was a respectable 2.5%. Moreover, growth ramped back up the following year, with GDP climbing at a 4.4% pace.

While there are some similarities between the economy today and the economy of the mid 1990s, there are also many differences. Investors and traders would do well to remember that 2004 did not see a repeat of 1994, even though the markets were worried about that very thing occurring periodically throughout last year. Along those lines, we doubt that 2005 will see a repeat of 1995. The yield curve will become flatter, but we do not think it will flatten as much as it did a decade ago. To believe otherwise, you would have to believe that the Fed learned nothing from the mistakes they made back then.

The basic mistake that the Fed made in the mid 1990s was that they tightened too much and far too quickly in response to a surge in core intermediate goods prices. Those higher prices did not end up being passed on to consumers, however, due largely to increased global competition. The Fed has gone out of its way not to repeat this mistake today, particularly since global competition is so much greater now.

So where does that leave us? We expect the Federal Reserve to continue to push interest rates higher, even as GDP growth slows to a 3% to 3 1/2% annual rate. Long-term interest rates will eventually edge higher, as it becomes apparent that this pace of growth, while slower, will still lead to a tighter labor market and higher inflation.

Real GDP growth in the 3% plus range should be sufficient enough to produce decent employment and income gains. Consumer spending will slow from its recent pace but still rise a respectable 3.0% in 2005. Business investment spending is also expected to moderate this year, while inventories and net exports are both expected to add to overall growth this year.



**(Percentage Changes)**

QUARTER:	Actual 4Q	Forecast				2005				2006				Annual (d)			
		1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	2003	2004	2005	2006	
<b>REAL GROSS DOMESTIC PRODUCT(e)</b>	3.1	3.3	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.2	3.2	3.2	3.0	4.4	3.3	3.1
PERSONAL CONSUMPTION	4.6	2.7	3.1	3.0	2.8	2.7	2.6	2.6	2.6	2.6	2.6	2.6	2.6	3.3	3.8	3.4	2.7
BUSINESS INVESTMENT	10.3	5.5	4.9	6.3	7.1	7.8	8.3	8.4	8.4	8.3	8.3	8.4	8.4	3.3	10.3	7.8	7.5
EQUIPMENT & SOFTWARE	14.9	4.0	5.1	6.6	7.4	8.1	8.6	8.6	8.6	8.6	8.6	8.6	8.6	6.4	13.4	8.9	7.8
STRUCTURES	-4.1	1.5	4.0	5.0	6.0	6.5	7.0	7.5	7.5	7.0	7.0	7.5	7.5	-5.6	1.0	1.6	6.4
RESIDENTIAL CONSTRUCTION	0.3	-0.8	0.7	-1.2	-1.2	-0.8	-0.5	0.0	0.0	-0.8	-0.5	0.0	0.0	8.8	9.5	0.9	-0.6
GOVERNMENT PURCHASES	0.9	2.0	2.4	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.8	2.0	1.8	2.3
<b>NET EXPORTS (\$ BILLIONS)</b>	-632	-630	-629	-629	-630	-629	-628	-627	-627	-629	-628	-627	-627	-518	-586	-630	-628
% Pt. Contribution to GDP	-1.8	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.5	-0.7	-1.0	0.0
<b>INVENTORY CHANGE (\$ BILLIONS)</b>	46	56	50	48	47	43	41	40	40	43	41	40	40	-1	45	50	41
% Pt. Contribution to GDP	0.4	0.4	-0.2	-0.1	0.0	-0.1	-0.1	0.0	0.0	-0.1	-0.1	0.0	0.0	-0.1	0.4	0.4	0.0
<b>NOMINAL GDP</b>	5.2	6.0	5.6	5.7	5.8	5.8	6.0	6.0	6.0	5.8	6.0	6.0	6.0	4.9	6.6	5.7	5.8
<b>REAL FINAL SALES</b>	2.7	3.0	2.6	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	3.1	4.0	3.3	3.2
"CORE" GDP (a)	5.1	2.9	3.2	3.2	3.1	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.6	4.9	3.8	3.2
<b>CONSUMER PRICE INDEX (b)</b>	3.4	3.2	2.7	2.6	2.6	2.7	2.8	2.8	2.8	2.7	2.8	2.8	2.8	2.3	2.7	2.8	2.8
"CORE" CONSUMER PRICE INDEX (b)	2.1	2.2	2.3	2.3	2.4	2.4	2.5	2.5	2.5	2.4	2.5	2.5	2.5	1.4	1.8	2.3	2.5
<b>EMPLOYMENT COST INDEX (b)</b>	3.7	3.8	3.7	3.6	3.7	3.7	3.6	3.5	3.5	3.7	3.6	3.5	3.5	3.9	3.8	3.7	3.6
<b>REAL DISPOSABLE INCOME</b>	4.1	3.0	3.4	3.2	3.0	3.0	2.9	2.8	2.8	3.0	2.9	2.8	2.8	2.3	3.4	3.9	3.0
<b>UNEMPLOYMENT RATE (%)</b>	5.4	5.3	5.2	5.2	5.1	5.1	5.1	5.0	5.0	5.1	5.1	5.0	5.0	6.0	5.5	5.2	5.1
<b>HOUSING STARTS (MILLIONS)</b>	1.96	1.88	1.85	1.82	1.79	1.78	1.77	1.76	1.76	1.78	1.77	1.76	1.76	1.85	1.95	1.84	1.77
<b>TOTAL VEHICLE SALES (MILLIONS)</b>	17.2	16.9	16.8	16.8	16.9	17.0	17.1	17.1	17.1	17.0	17.1	17.1	17.1	16.8	16.8	16.9	17.1
<b>INDUSTRIAL PRODUCTION (b)</b>	4.2	4.6	4.6	4.5	4.4	4.2	4.0	3.8	3.8	4.2	4.0	3.8	3.8	0.0	4.1	4.5	4.8
<b>CORPORATE PROFITS NIPA B/T (b)</b>	8.1	11.0	10.0	9.5	9.0	8.8	8.6	8.7	8.7	8.8	8.6	8.7	8.7	16.8	14.5	10.4	5.1
<b>Quarter End - INTEREST RATES (%) (c)</b>																	
FEDERAL FUNDS (Target)	2.25	2.75	3.00	3.50	3.75	4.00	4.50	4.75	4.75	4.00	4.50	4.75	4.75	1.06	1.56	3.25	4.50
3 MONTH LIBOR	2.49	2.85	3.15	3.65	3.85	4.15	4.60	4.85	4.85	4.15	4.60	4.85	4.85	1.12	1.75	3.38	4.61
PRIME RATE	5.25	5.75	6.00	6.50	6.75	7.00	7.50	7.75	7.75	7.00	7.50	7.75	7.75	4.06	4.50	6.25	7.50
3 MONTH T-BILL (BEY)	2.18	2.80	3.10	3.60	3.85	4.10	4.60	4.80	4.80	4.10	4.60	4.80	4.80	0.98	1.53	3.34	4.58
2 YEAR T-NOTE	3.08	3.40	3.70	4.20	4.50	4.75	5.00	5.25	5.25	4.75	5.00	5.25	5.25	1.54	2.50	3.95	5.09
5 YEAR T-NOTE	3.63	3.80	4.10	4.50	4.75	4.90	5.30	5.50	5.50	4.90	5.30	5.50	5.50	2.82	3.40	4.31	5.33
10 YEAR T-NOTE	4.24	4.20	4.30	4.60	4.80	5.00	5.50	5.70	5.70	5.00	5.50	5.70	5.70	3.89	4.21	4.54	5.61
30 YEAR T-BOND	4.85	4.60	4.70	4.80	4.90	5.10	5.60	5.80	5.80	5.10	5.60	5.80	5.80	5.02	4.94	4.80	5.65

(a) Core GDP equals consumption, business fixed investment and residential investment.

(b) Percent changes from same quarter year ago.

(c) End Of Quarter Estimate

(d) 4-Qtr Moving Average, Percent Change

(e) Qtr/Qtr Percent Change, Annual Rate

As shown on the front page, the dollar has rallied thus far in 2005, which should not be all that surprising. After all, the greenback got pounded at the tail end of last year, and some retracement was bound to occur sooner or later. However, we are more inclined to view the dollar's recent appreciation as more of a corrective rally than as the beginning of a change in trend, simply because the fundamentals do not appear to have changed.

Doomsayers fret that foreign investors are nearing the point where they will start dumping their dollar assets *en masse*, leading to a full-blown dollar crisis. However, recent data indicate that there is nothing wrong with foreign purchases of U.S. assets. As shown below, net foreign purchases of U.S. securities currently stand at an all-time high. True, some of the increase reflects an unprecedented amount of foreign central bank purchases of U.S. Treasury securities last year in the wake of massive foreign exchange market intervention that was needed to prop up the dollar. However, purchases of U.S. securities by the foreign private sector have strengthened markedly over the past few months, and they also stand near an all-time high.

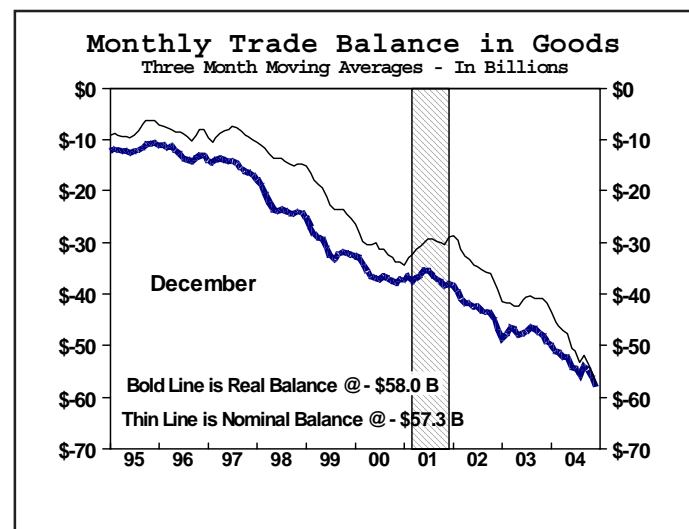
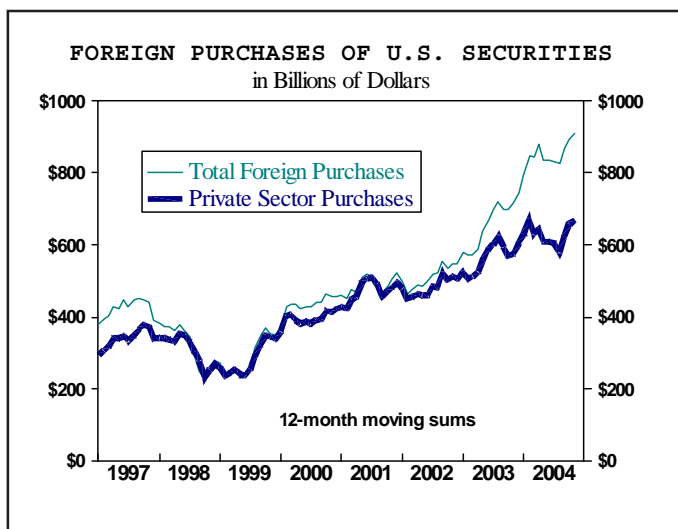
Rather, the problem is the current account deficit, which continues to grow wider and wider. If stabilization in the current account deficit *via* previous dollar depreciation were imminent, it would appear first in the trade deficit expressed in volume terms. That is, dollar depreciation helps to slow growth in import volumes and contributes to acceleration in export volumes through its effects on price competitiveness. However, the deficit in value terms continues to widen, at least for a while, because dollar depreciation inflates the dollar cost of imports. (In economic jargon this is known as the J-curve.)

History offers some interesting insights. The dollar began to depreciate in early 1985, yet it was not until late 1986 that the real trade deficit stabilized and started to narrow. However, it was not until late 1987 that the trade deficit expressed in value terms stabilized, and it was not until

a year later that it began to narrow significantly. As we explained in our report last month, slower growth in the U.S. in the late 1980's also contributed to the decline in the current account deficit at that time. The chart below shows that the real trade deficit shows no signs yet of stabilizing, let alone narrowing, making a significant decline in the nominal trade deficit seem remote.

The upshot is that the current account deficit should continue to widen over the course of the next year or so. Although foreign capital inflows are not likely to decline, we also are not very optimistic that they will accelerate to the point that they cause the dollar to appreciate on a trend basis. We readily admit that stronger-than-expected growth in the United States would raise U.S. rates of return, which would tend to be dollar supportive, everything else equal. However, everything else is not equal. Stronger growth in the U.S. would do little to bring about a correction in the current account deficit. Indeed, it probably would widen even further. Stronger foreign growth would help to reduce the U.S. current account deficit *via* stronger exports. However, stronger foreign growth would also raise rates of return in those countries, increasing the attractiveness of foreign assets, which would not be dollar supportive.

The point is that 2005 is not 1995 when the dollar last bottomed. As U.S. growth strengthened in the second half of the 1990's, rates of return rose and foreign capital started to pour into the country in quantities that easily financed the current account deficit, which totalled only 1-1/2% of GDP at the beginning of the period. Today, the deficit-to-GDP ratio is 5%, and it undoubtedly is headed higher. There is no natural law dictating that the dollar must necessarily depreciate just because the 5% of GDP threshold has been breached. However, we think that the most likely scenario going forward is that net capital inflows fall short of the current account deficit, which causes the dollar's downward trend to resume in line with our forecast on page 5.



February 14, 2005

Country	GDP		CPI		3-Month LIBOR								10-Year Bond						
	Growth		Inflation		(end of quarter)								(end of quarter)						
	2004	2005	2004	2005	2006	05-Q1	05-Q2	05-Q3	05-Q4	06-Q1	06-Q2	06-Q3	05-Q1	05-Q2	05-Q3	05-Q4	06-Q1	06-Q2	06-Q3
U.S.	4.4	3.2	3.1	2.8	2.8	2.85	3.15	3.65	3.85	4.15	4.60	4.85	4.20	4.30	4.60	4.80	5.00	5.50	5.70
Japan	2.9	1.6	2.4	0.0	0.4	0.05	0.05	0.05	0.05	0.05	0.20	0.40	1.50	1.60	1.70	1.80	2.00	2.20	2.40
Euroland	1.7	1.8	2.5	2.1	1.9	2.15	2.20	2.40	2.70	2.90	3.20	3.40	3.70*	3.90*	4.10*	4.25*	4.40*	4.45*	4.50*
U.K.	3.1	2.7	2.4	1.3	1.8	5.00	5.10	5.00	4.70	4.40	4.40	4.40	4.70	4.80	4.70	4.60	4.55	4.60	4.70
Canada	2.7	2.9	2.9	1.8	2.3	2.70	2.90	3.20	3.50	3.70	4.00	4.00	4.30	4.50	4.70	4.80	4.90	5.00	4.90

Currency	2005-Q1	2005-Q2	2005-Q3	2005-Q4	2006-Q1	2006-Q2	2006-Q3	2006-Q4
Euro (\$/€)	1.30	1.34	1.36	1.38	1.40	1.42	1.44	1.45
U.K. (\$/£)	1.86	1.90	1.92	1.93	1.94	1.95	1.96	1.97
U.K. (£/€)	0.70	0.71	0.71	0.72	0.72	0.73	0.73	0.74
Switzerland (CHF/\$)	1.19	1.16	1.15	1.14	1.13	1.12	1.11	1.10
Sweden (SEK/\$)	7.00	6.70	6.55	6.40	6.30	6.15	6.05	6.00
Norway (NOK/\$)	6.40	6.10	6.00	5.85	5.75	5.65	5.50	5.45
Poland (PLN/\$)	3.25	3.10	3.00	2.95	2.85	2.80	2.70	2.65
Japan (¥/\$)	105	102	100	98	96	94	92	90
Australia (US\$/A\$)	0.79	0.77	0.75	0.74	0.73	0.72	0.71	0.70
Singapore (S\$/US\$)	1.66	1.64	1.62	1.60	1.58	1.57	1.56	1.55
Korea (KRW/\$)	1040	1030	1020	1015	1010	1005	1000	1000
Canada (C\$/US\$)	1.26	1.22	1.20	1.18	1.16	1.14	1.13	1.12
Mexico (MXN/\$)	11.20	11.00	10.90	10.80	10.70	10.60	10.55	10.50
Brazil (BRL/\$)	2.70	2.60	2.50	2.40	2.35	2.30	2.25	2.20

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