WACHOVIA

Monthly Economic Outlook

January 13, 2006

U.S. Overview

Opportunities and Risks in the Mid-Cycle of the Economic Expansion

Mid-cycle economies are characterized by slower growth as well as a change in the composition of growth. Economic growth, as measured by Gross Domestic Product, is expected to slow from 3.7 percent in 2005 to 3.4 percent next year. For business decision-makers the change in the composition of economic growth will be equally significant. Consumer spending and residential investment will slow. Growth in business investment in equipment remains steady while non-residential investment (both private and municipal) and federal government spending will take the lead.

Changes in growth also suggest an alteration in the financial profile of the economy. Inflation takes on an upward bias. Interest rates also tend to rise. Profit growth decelerates. The altered financial profile brings a change to the cost of credit for household and corporate sectors.

Increases in the cost of credit are likely to slow the pace of consumer spending on durable goods and housing. In turn this suggests slower growth for industrial production for autos and appliances as well as major inputs to the housing sector. Slower profit growth will likely move many companies to seek outside financial support for increased spending on equipment and structures. Therefore, we are likely to see greater short and long-term financing in the open market.

For decision-makers, the pattern of economic growth will be more challenging in the year ahead. No longer will we see so many sectors perform so well together. Instead, sector differences will become more distinct and the need for vigilance on the data more relevant.

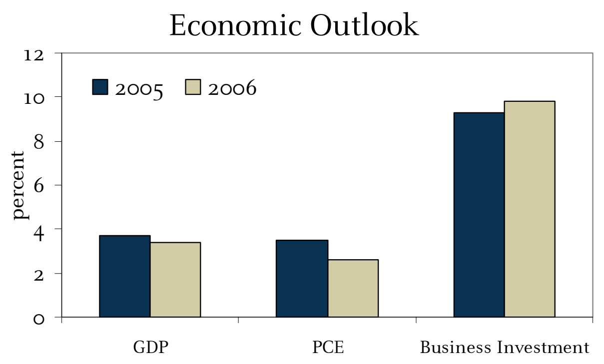
International Overview

The dollar has weakened somewhat versus most major currencies thus far in the New Year due to indications that the Fed may be nearing the end of its tightening cycle. We look for the greenback to weaken further over the course of the year due to the interplay of the current account deficit and the capital inflows that finance that deficit.

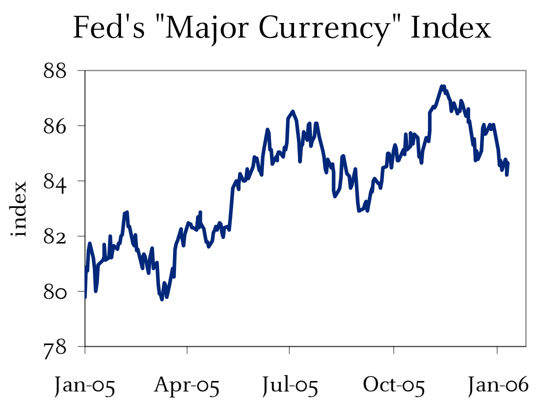
Regarding the former, we expect that the deficit will rise even further, at least over the next quarter or two. As interest rate differentials between the U.S. and some major foreign economies narrow this year, dollar assets will lose some of their luster for foreign investors. Therefore, we do not expect that net capital inflows will keep pace with the widening current account deficit, which will exert modest downward pressure on the greenback.

China made news this week when it announced that it would seek more efficient ways to invest its foreign currency reserves. The announcement raised some concerns that a portfolio shift by China could lead to downward pressure on the dollar as well as higher long-term interest rates in the U.S. Indeed, China currently holds nearly $800 billion in foreign currency reserves and about $250 billion in U.S. Treasury securities.

However, we are not losing any sleep about the potential for a U.S. financial crisis caused by China's reallocation of its foreign reserve assets. Every move that Chinese policymakers take is viewed through the prism of social stability. Instability in U.S. financial markets could cause slower U.S. economic growth that would lead to a slowdown in Chinese export growth. The resulting rise in unemployment could lead to social instability. China has about as much interest in a U.S. financial crisis as the U.S. does (*i.e.*, none). Therefore, any portfolio reallocation by China likely will occur gradually.



Source: BEA, Wachovia Economics



Mid-Cycle Slowdown: Size and Composition Matters

Economic slowdown does not mean recession, yet the slowdown represents a different set of opportunities and challenges to decision-makers. Aggregate demand slows while supply-side cost pressures assert themselves. Decision-makers will have to navigate this weaker demand/rising cost mix by monitoring key signals of the state of the economy.

Three signals suggest the move into the mid-phase of the business cycle. First, the Institute for Supply Management (ISM) index has moderated to the mid 50s from the 60 plus level. Second, the service sector ISM survey also came in a touch below prior levels. Third, capital goods orders have moderated compared to prior months and the Mortgage Bankers association purchase application index has also moderated.

Sector Rotation

Two sectors, consumer and residential investment, are expected to lead the slowdown. Slower job growth is already evident and inflation persists at a slightly higher level. These factors will slow the growth of real disposable personal income. In addition, home equity extraction by households is expected to slow significantly and this will reduce spending to a pace more consistent with the growth of income. Meanwhile, residential investment is expected to decline in the year ahead. Higher interest rates, slower income growth and tighter credit standards will all interact to slow housing starts in the year ahead.

On the positive side, we expect business investment to remain strong as structures spending kicks in and equipment spending remains on a secular upswing. Government purchases, particularly on the state & local government level, pick up at this phase of the cycle. Investment in structures picks up in typical mid-cycle fashion. Business confidence and cash flow has improved enough to support large, physical investments. At the same time, vacancy rates for office and retail space have declined and therefore firms believe that the need is there for capital expansion. Equipment and software spending continues on its secular growth path driven by the imperative of global competitiveness. State and local policy makers are now seeing the inflow of tax revenues and are likely to step up the pace of spending.

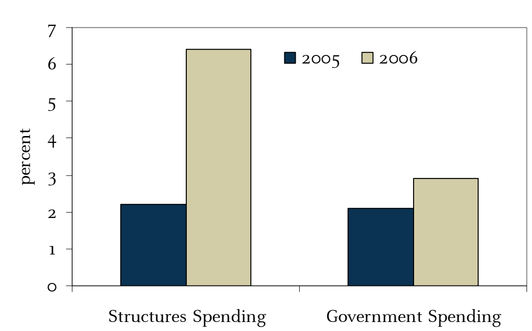
Financial Evolution

As the real economy matures, the favorable financial fundamentals of recovery deteriorate in the mid-cycle expansion. Productivity and unit labor costs begin to change, and as a result, so does the outlook for inflation and profits. As the economy moves into mid-cycle, productivity slows down, and, with labor compensation gradually rising, unit labor costs begin to rise. These higher unit labor costs, combined with slower top line sales growth, will result in slower profit growth.

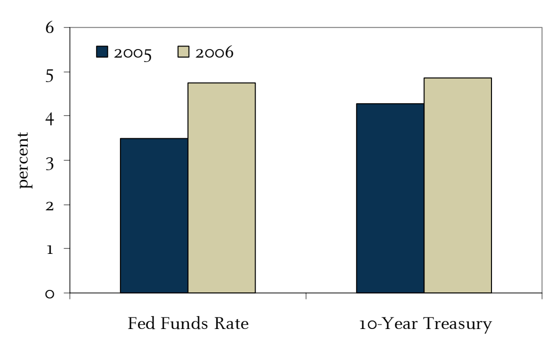
Rising unit labor costs and subsequent inflation also feed back into the outlook for monetary policy and short-term interest rates. We expect the Fed to continue to nudge short-term interest rates higher. We are currently forecasting the federal funds target rate at 4.75 percent by mid-2006. We also project the 10-year Treasury yield rising to 5.00% by year end (graph lower right). Our inflation and interest rate outlook does not produce an inversion in the yield curve. We do not see the case for a more significant period of restraint by the Fed to raise short rates nor do we see a downdraft in economic expectations to significantly lower interest rates in the future.

Risks? The Three Horseman of the Apocalypse

What risks would lead to the end of the economic cycle as we know it? First, there is the delicate balance between capital inflows and the current account deficit. A significant decline in the willingness of foreign private or central bank investors suggests risks to the inflation, interest rate and dollar outlook. Second, the Fed could pursue a more rigorous approach to inflation targeting and thereby raise the funds rate higher than we expect. Finally, the credit markets may have greater difficulty navigating the waters of the flat yield curve.



Source: BEA, Wachovia Economics



Source: Federal Reserve, Bloomberg, Wachovia Economics

(Percentage Changes)

	Actual 2005	Forecast 2005	2006				2007				Annual (d)			
QUARTER:	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2004	2005	2006	2007
REAL GROSS DOMESTIC PRODUCT(e)	4.1	3.9	3.4	2.9	3.0	3.2	3.2	3.2	3.2	3.2	4.2	3.7	3.4	3.2
PERSONAL CONSUMPTION	4.1	0.5	3.1	2.8	2.8	3.0	2.8	2.8	3.0	3.0	3.9	3.5	2.6	2.9
BUSINESS INVESTMENT	11.3	9.4	10.2	9.9	9.2	8.9	8.7	8.7	7.9	7.9	9.4	9.3	9.8	8.7
EQUIPMENT & SOFTWARE	10.6	10.2	10.7	10.2	9.7	9.5	9.4	9.4	8.6	8.5	11.9	11.2	10.3	9.3
STRUCTURES	2.2	6.0	8.0	8.5	7.0	6.5	6.0	5.5	5.0	5.0	2.2	2.2	6.4	6.1
RESIDENTIAL CONSTRUCTION	7.3	2.7	2.5	-4.5	-3.8	-3.3	-2.8	-2.3	-1.9	-1.4	10.3	7.1	1.1	-2.8
GOVERNMENT PURCHASES	2.9	4.8	2.5	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.2	2.1	2.9	2.4
NET EXPORTS ($ BILLIONS)	-618	-637	-649	-660	-669	-677	-685	-691	-698	-704	-601	-629	-663	-694
% Pt. Contribution to GDP	-0.1	-0.7	-0.4	-0.4	-0.3	-0.3	-0.3	-0.2	0.0	0.0	-0.8	-0.9	-0.6	-0.6
INVENTORY CHANGE ($ BILLIONS)	-13	42	38	36	36	38	41	47	48	49	52	21	37	46
% Pt. Contribution to GDP	-0.4	2.0	-0.1	-0.1	0.0	0.1	0.1	0.2	0.0	0.0	0.3	0.0	-0.1	0.2
NOMINAL GDP	7.6	7.4	6.7	6.1	6.1	6.2	6.1	6.1	6.4	6.4	7.0	6.6	6.6	6.1
REAL FINAL SALES	7.5	10.5	3.2	3.0	2.8	2.8	2.7	2.7	2.6	2.5	3.9	4.0	3.3	3.1
"CORE" GDP (a)	4.8	2.2	4.0	3.3	3.3	3.4	3.3	3.3	5.8	5.8	4.9	4.4	3.5	3.4
CONSUMER PRICE INDEX (b)	3.3	2.8	3.1	3.0	2.9	2.8	2.7	2.7	2.7	2.7	2.7	3.1	2.9	2.7
"CORE" CONSUMER PRICE INDEX (b)	2.1	2.1	2.3	2.4	2.4	2.4	2.4	2.4	2.5	2.5	1.8	2.2	2.4	2.5
WEST TEXAS INTERMED. OIL ($/BBL) (f)	53.2	59.0	58.0	57.0	60.0	60.5	60.0	59.0	61.0	58.0	41.5	50.9	58.9	59.9
EMPLOYMENT COST INDEX (b)	3.4	3.1	2.8	2.7	2.7	2.6	2.7	2.8	2.8	2.9	3.9	3.2	2.7	2.8
REAL DISPOSABLE INCOME	-2.0	3.5	2.9	2.8	2.9	3.1	3.0	3.0	3.0	3.0	3.4	1.2	2.9	3.0
UNEMPLOYMENT RATE (%)	5.0	5.0	5.0	5.0	4.9	4.8	4.8	4.7	4.6	4.5	5.5	5.1	5.0	4.7
HOUSING STARTS (MILLIONS)	2.10	1.98	1.95	1.93	1.91	1.90	1.88	1.87	1.85	1.83	1.95	2.05	1.92	1.86
TOTAL VEHICLE SALES (MILLIONS)	18.0	16.4	17.3	17.3	17.3	17.3	17.3	17.4	17.4	17.5	16.8	17.0	17.3	13.0
INDUSTRIAL PRODUCTION (b)	8.7	2.8	2.6	2.7	2.8	2.8	2.8	2.9	2.9	2.9	4.1	3.1	2.7	2.9
CORPORATE PROFITS NIPA B/T (b)	15.7	10.0	8.1	7.6	7.4	7.5	7.5	7.7	7.8	8.0	12.6	13.5	8.1	7.7
Quarter End - INTEREST RATES (%) (c)														
FEDERAL FUNDS (Target)	3.75	4.25	4.75	4.75	4.75	4.75	5.00	5.25	5.25	5.25	1.56	3.50	4.75	5.19
3 MONTH LIBOR	4.00	4.52	4.85	4.85	4.90	4.90	5.05	5.30	5.40	5.40	1.75	3.78	4.88	5.29
PRIME RATE	6.75	7.25	7.75	7.75	7.75	7.75	8.00	8.25	8.25	8.25	4.50	6.50	7.75	8.19
3 MONTH T-BILL (BEY)	3.51	4.08	4.70	4.75	4.80	4.90	5.00	5.30	5.35	5.40	1.53	3.37	4.79	5.26
2 YEAR T-NOTE	4.11	4.41	4.75	4.80	4.85	4.95	5.10	5.35	5.40	5.50	2.50	3.98	4.84	5.34
5 YEAR T-NOTE	4.13	4.35	4.75	4.80	4.85	4.95	5.10	5.40	5.50	5.60	3.40	4.09	4.84	5.40
10 YEAR T-NOTE	4.30	4.39	4.75	4.80	4.90	5.00	5.15	5.40	5.50	5.70	4.21	4.28	4.86	5.44
30 YEAR T-BOND	4.56	4.52	4.85	4.85	5.00	5.10	5.25	5.45	5.60	5.80	4.94	4.55	4.95	5.53

(a) Core GDP equals consumption, business fixed investment and residential investme
(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
(f) Prices are Reflective of Quarterly Average of the Near Contract Price

1/13/2006

Dollar Has Started New Year on Back Foot

After rising about 8% on balance between January 2005 and November 2005, the weighted-average value of the dollar has started the New Year on its back foot (see graph on front page). Indeed, the greenback has been weakening since early December, especially versus Asian currencies, and this slide accelerated in the first few trading days of the year. The catalyst for the dollar's weakness in 2006 appears to be indications that the Federal Reserve may be nearing the end of its tightening cycle. As shown in the forecast on the next page, we look for further dollar weakness over the course of 2006.

The problem remains the interplay of the U.S. current account deficit and the capital inflows into the U.S. that finance the deficit. As shown below, the U.S. current account deficit totaled $780 billion in the four quarters through 2005-Q3, and monthly trade data through November suggest that the deficit swelled further in the fourth quarter. However, the graph also indicates that private capital inflows (*i.e.,* foreign direct investment and inflows of portfolio capital) have managed to keep pace with the gaping current account deficit. In addition, purchases of U.S. securities by foreign central banks (mostly U.S. Treasury securities and agency securities) also have remained positive, albeit not as numerous as in 2004. The bottom line is that the U.S. experienced little difficulty financing its current account deficit last year.

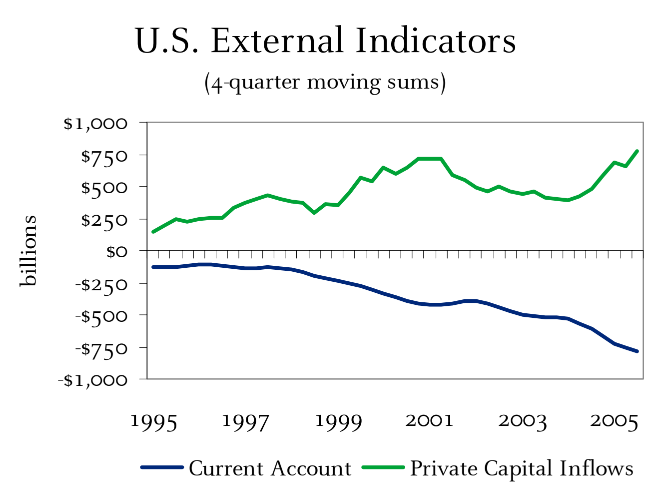
We think that the underlying fundamentals will change this year, if they have not begun to do so already. The current account deficit will grow even larger over the next few quarters, because imports currently are growing faster than exports. (Exports need to grow roughly twice as fast as imports simply to stabilize the deficit.) Therefore, capital inflows will need to rise even further to keep the dollar stable.

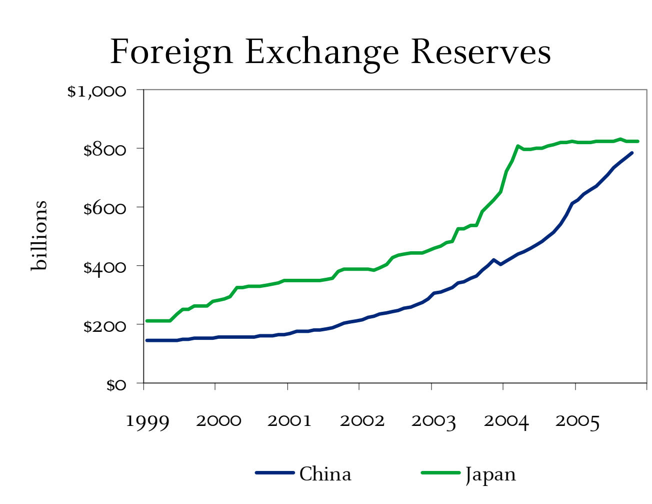
However, we question whether foreign capital inflows will continue to rise once the Fed's tightening cycle comes to a halt, which we expect will occur in March. Moreover, as our forecast on the next page shows, we expect that some major foreign central banks, including the ECB, the Bank of Canada, and the Bank of Japan, will hike rates this year.

China's Foreign Currency Reserves: Hype is Not Warranted

On a related note, China announced this week that it would begin to search for ways to utilize its foreign exchange reserves more efficiently. The announcement raised some concerns that China will reduce the amount of dollars that it holds in its foreign exchange reserves as well as the amount of U.S. Treasury securities that the country owns. In theory, a reserve shift by China could have a big effect on dollar exchange rates and U.S. long-term interest rates. As shown below, China's holdings of foreign exchange reserves total nearly $800 billion, and it will soon surpass Japan as the largest holder of foreign exchange reserves. Roughly $250 billion of the country's foreign exchange reserves are held in the form of U.S. Treasury securities.

However, we have not lost any sleep worrying about China dumping its dollar reserves, because essentially everything in China is viewed through the prism of social stability. A major reserve shift by China, especially if it involved significant selling of U.S. Treasury securities, could cause long-term U.S. interest rates to move higher. U.S. economic growth could then slow, which would weigh on Chinese export growth, leading to a rise in Chinese unemployment. In our view, Chinese authorities simply do not want to go there. Therefore, we believe that any rebalancing of China's foreign reserve portfolio will happen very gradually with little effect on U.S. financial markets.





January 13, 2006

	GDP Growth			CPI Inflation			3-Month LIBOR (end of quarter)							10-Year Bond (end of quarter)						
Country	2005	2006	2007	2005	2006	2007	06-Q1	06-Q2	06-Q3	06-Q4	07-Q1	07-Q2	07-Q3	06-Q1	06-Q2	06-Q3	06-Q4	07-Q1	07-Q2	07-Q3
U.S.	3.7	3.4	3.2	3.1	2.9	2.7	4.85	4.85	4.90	4.90	5.05	5.30	5.40	4.75	4.80	4.90	5.00	5.15	5.40	5.50
Japan	2.5	2.3	2.1	-0.3	0.3	0.7	0.05	0.05	0.20	0.40	0.50	0.70	0.90	1.60	1.80	2.00	2.10	2.20	2.30	2.40
Euroland	1.5	2.3	2.1	2.2	1.7	1.8	2.70	2.90	3.20	3.40	3.65	3.65	3.65	3.50	3.80	4.00	4.20	4.20	4.15	4.10
U.K.	1.7	2.1	2.3	2.1	2.0	2.1	4.60	4.40	4.40	4.40	4.40	4.40	4.40	4.10	4.00	4.00	4.10	4.15	4.20	4.25
Canada	2.9	3.4	3.1	2.2	2.0	2.0	3.70	4.20	4.40	4.60	4.60	4.60	4.60	4.20	4.50	4.65	4.80	4.80	4.75	4.70

Currency	2006-Q1	2006-Q2	2006-Q3	2006-Q4	2007-Q1	2007-Q2	2007-Q3	2007-Q4
Euro ($/€)	**1.22**	**1.26**	**1.30**	**1.32**	**1.33**	**1.34**	**1.35**	**1.35**
U.K. ($/£)	**1.76**	**1.79**	**1.83**	**1.85**	**1.87**	**1.88**	**1.89**	**1.89**
U.K. (£/€)	0.69	0.70	0.71	0.71	0.71	0.71	0.71	0.71
Switzerland (CHF/$)	**1.28**	**1.25**	**1.22**	**1.20**	**1.19**	**1.18**	**1.18**	**1.18**
Sweden (SEK/$)	**7.75**	**7.45**	**7.20**	**7.05**	**7.00**	**6.95**	**6.90**	**6.90**
Norway (NOK/$)	**6.40**	**6.15**	**5.95**	**5.80**	**5.70**	**5.65**	**5.55**	**5.55**
Poland (PLN/$)	**3.15**	**3.10**	**3.05**	**3.00**	**2.97**	**2.95**	**2.92**	**2.90**
Japan (¥/$)	**115**	**110**	**105**	**100**	**96**	**92**	**90**	**90**
Australia (US$/A$)	**0.75**	**0.74**	**0.73**	**0.72**	**0.71**	**0.70**	**0.69**	**0.68**
Singapore (S$/US$)	**1.65**	**1.62**	**1.58**	**1.56**	**1.54**	**1.52**	**1.50**	**1.50**
Korea (KRW/$)	**1000**	**980**	**960**	**940**	**930**	**920**	**910**	**900**
China (CNY/$)	**8.04**	**8.00**	**7.90**	**7.80**	**7.70**	**7.60**	**7.50**	**7.40**
Canada (C$/US$)	**1.17**	**1.16**	**1.15**	**1.14**	**1.13**	**1.12**	**1.11**	**1.10**
Mexico (MXN/$)	**10.40**	**10.70**	**10.50**	**10.40**	**10.20**	**10.10**	**10.00**	**10.00**
Brazil (BRL/$)	**2.25**	**2.30**	**2.40**	**2.50**	**2.60**	**2.70**	**2.80**	**2.80**

Wachovia Corp.
Economics Group

John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wachovia.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wachovia.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wachovia.com
Gina Martin, CFA	Financial Economist	(704) 383-6805	gina.martin@wachovia.com
Sam Bullard	Economist	(704) 383-7372	sam.bullard@wachovia.com
Jason Schenker	Economist	(704) 383-3695	jason.schenker@wachovia.com
Phillip Neuhart	Economic Analyst	(704) 715-8457	phillip.neuhart@wachovia.com

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