



U.S. Overview

Heightened inflation expectations and concerns that the Federal Reserve will push short-term interest rates higher than previously thought are cutting into expectations for U.S. and global economic growth. The underlying strength of the U.S. economy has also been called into question, as past income growth has been revised lower and anecdotal reports from the housing sector point to more weakness than the recent sales and construction statistics would indicate. We have slightly reduced our forecast and now expect GDP growth to slow to a pace somewhat below the economy's long-run potential. We still see the risks of recession as quite minimal and look for GDP growth to average a respectable 2.7% over the next two years.

Short-term interest rates are expected to rise only modestly from current levels. We expect the Federal Reserve to raise the federal funds rate just one more time, with a hike in late June now seeming most likely. Such a move, however, is not yet a forgone conclusion, as weakness in global stock markets, particularly in emerging economies, shows that higher interest rates are already beginning to bite.

Rising interest rates are also taking a bite out of the housing market. While sales and starts appear to be holding up reasonably well, builders are clearly more concerned. One facet of the housing market that is not shown in the official data is the rising number of cancellations of previous sales contracts. Housing speculators have apparently lost their nerve and are now canceling contracts and unloading properties. Often this means that national builders must compete with their own lower priced product.

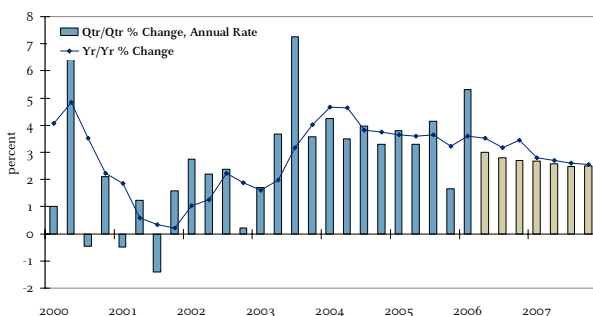
International Overview

After hiking rates by 400 basis points over the past two years, the end of the Fed's tightening cycle may be coming into view. However, central banks in many major foreign economies, which have lagged the Fed in terms of tightening, likely will hike rates over the remainder of the year (and, in some cases, into next year.) Signs of stronger growth and a higher-than-desired inflation rate have led the European Central Bank (ECB) to hike rates by 75 basis points since December. In our view, the ECB has 75 more basis points to go, a bit more than most investors currently expect.

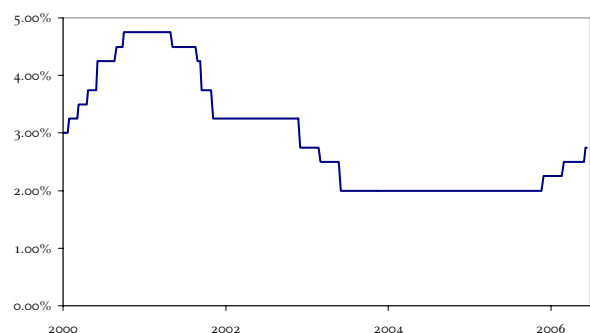
The Japanese economy also appears to have turned the corner, and inflation has recently turned positive. The Bank of Japan (BoJ) is starting to drain the excess reserves that it has pumped into the banking system over the past few years, the first step in normalizing monetary policy. The BoJ has maintained its major policy rate at essentially zero percent since September 2001, but it will soon begin to hike rates. Indeed, we look for the BoJ to lift its main policy rate by 125 basis points by the end of next year.

The U.S. current account deficit presently totals \$800 billion, which means that net capital inflows must exceed \$3 billion every business day simply to keep the dollar stable. If, as we expect, interest rate differentials narrow going forward, U.S. assets will lose some of their relative attractiveness. Although we do not look for a sharp decline in net capital inflows, which, if it materialized, would cause the greenback to fall significantly, we do expect that foreign purchases of U.S. assets will wane somewhat. Therefore, we continue to project that the dollar will trend lower versus most foreign currencies over the next year or two.

Real GDP



ECB Policy Rate



Same Theme But With Slightly Less Momentum

Our forecast for a gradual moderation in economic growth remains unchanged, but we do see some additional near-term downside risks. We have long warned that the transition from an economy driven by housing and consumer spending to one driven by business fixed investment might be a bit rocky. So far, it has **not** been. Home sales and new construction have been surprisingly resilient, while business fixed investment started off the year in strong form. Beneath the surface, however, economic conditions do not appear to be nearly as sanguine, with builders reporting that business conditions have clearly weakened, while orders for non-defense capital goods are up only modestly.

The transition at the Fed has also been a bit rocky. Some waves were expected, as the financial markets become accustomed to the new Fed chairman. We believe that Ben Bernanke and the Fed leadership is generally hawkish. Unfortunately, that is not the message Bernanke initially sent to the financial markets. As a result, the rhetoric has heated up from nearly all Fed speakers, which is causing the financial markets to rethink just how high short-term interest rates will rise before the Fed pauses. We have left our forecast unchanged, with the Fed pausing at 5.25 percent, although we moved the timing of the next rate hike up to June instead of August. Moreover, we do not yet see a June move as a sure thing, as global equity markets are signaling that higher interest rates are already making an impact.

Inflation Expectations Have Risen

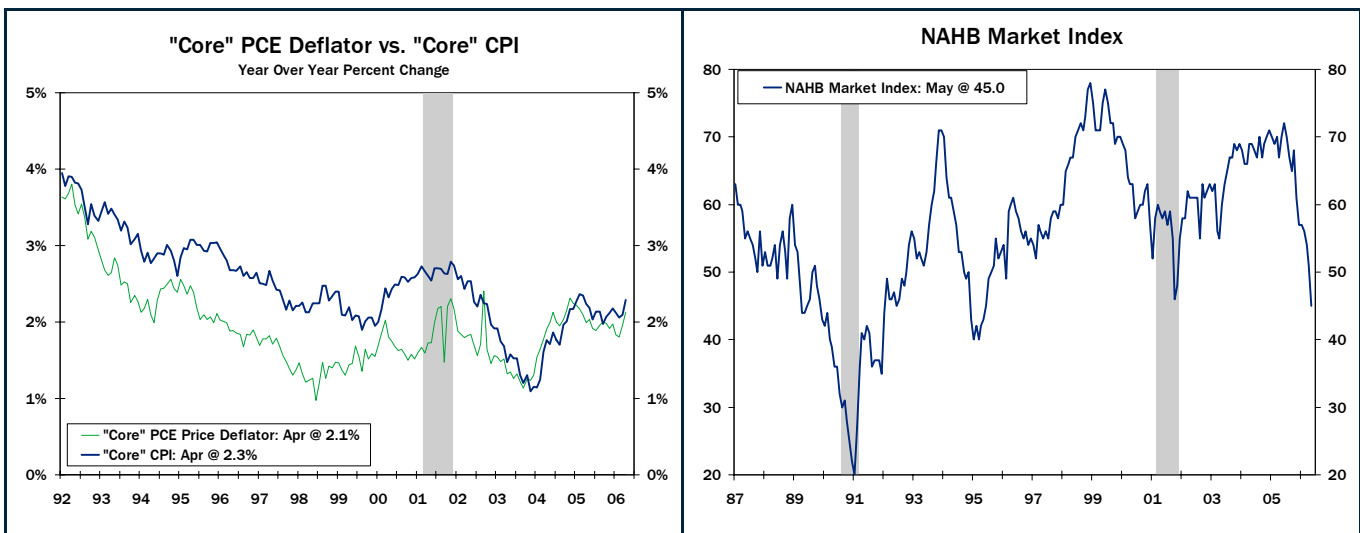
Worse than expected inflation numbers during March and April have sent the global financial markets into a mad rage. Stock markets in emerging countries, such as India and South Korea, have taken some of the biggest hits, but equity markets in developed nations have also sold off sharply. The principal worry is not that inflation will suddenly surge but rather that the Federal Reserve and

other central banks will stomp on the brakes too harshly and raise interest rates too much. To us, this fear appears to be overdone.

We warned following Bernanke's JEC testimony back in late April that the Fed appeared to be too complacent about near-term inflation prospects. Rising rental rates for apartments and the carry over to implied housing costs are likely to put pressure on the core CPI through at least the rest of this year, regardless of what the Fed does. A larger portion of rising energy costs are also likely to bleed over into core prices this year, as energy prices have now been high enough for a long enough period of time for some pass through to occur. Finally, wage and benefit costs are accelerating, while productivity growth is cooling off. All of these factors point to increases in the core rate of inflation this year that are above the Fed's stated comfort zone of around 2 percent.

That said, the longer-term inflation outlook is not so frightening. Energy prices and prices for many industrial commodities have moderated a bit recently. We expect the overall CPI to rise slightly less this year than it did in 2005. Core inflation also looks like it is set to cool off a bit. The year-to-year change in the core CPI and core Personal Consumption Expenditure price deflator will likely peak around 2.5 percent late this summer or early fall and then slip back toward the Fed's 2 percent comfort range.

With inflation set to cool off in a few months, the Fed should tread lightly. Housing is probably slowing more than the data suggests. The NAHB housing market index recently fell to 45, marking its lowest level in eleven years. The decline reflects a growing tide of contract defaults, as well as an increase in the number of homes for sale by speculators looking to cut their losses. We expect home sales and new construction to soften considerably during the second half of this year, and look for construction of single-family homes to weaken further in 2007.



(Percentage Changes)

QUARTER:	Actual	Forecast 2006				2007				2008	Annual (d)			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2004	2005	2006	2007	
REAL GROSS DOMESTIC PRODUCT(e)	5.3	3.0	2.8	2.7	2.7	2.7	2.5	2.5	2.6	4.2	3.5	3.4	2.7	
PERSONAL CONSUMPTION	5.2	2.7	2.7	2.6	2.7	2.7	2.6	2.6	2.7	3.9	3.5	3.2	2.6	
BUSINESS INVESTMENT	13.1	13.0	9.1	8.7	8.3	8.3	7.5	7.4	7.0	9.4	8.6	9.8	8.5	
EQUIPMENT & SOFTWARE	13.8	10.7	9.9	9.4	9.0	9.0	8.2	8.0	7.7	11.9	10.9	10.2	9.0	
STRUCTURES	11.3	6.0	5.8	5.5	5.0	4.5	4.5	4.5	4.0	2.2	2.0	6.0	5.1	
RESIDENTIAL CONSTRUCTION	3.0	-2.1	-7.0	-8.5	-9.0	-9.5	-9.0	-8.5	-8.0	10.3	7.1	0.9	-8.3	
GOVERNMENT PURCHASES	4.3	1.1	2.0	2.2	2.2	2.3	2.2	2.2	2.2	2.2	1.8	2.0	2.1	
NET EXPORTS (\$ BILLIONS)	-670	-675	-680	-686	-692	-699	-705	-711	-717	-601	-633	-678	-702	
% Pt. Contribution to GDP	-0.5	-0.2	-0.2	-0.2	-0.2	-0.2	0.0	0.0	0.0	-0.8	-0.9	-0.7	-0.6	
INVENTORY CHANGE (\$ BILLIONS)	32	26	28	31	34	36	35	33	35	52	20	29	35	
% Pt. Contribution to GDP	-0.2	-0.2	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.3	-0.3	0.1	0.0	
NOMINAL GDP	8.8	6.4	5.8	5.6	5.5	5.5	5.8	5.8	6.0	7.0	6.4	6.8	5.5	
REAL FINAL SALES	5.5	3.4	2.7	2.6	2.6	2.6	2.5	2.6	2.6	3.9	3.8	3.4	2.6	
"CORE" GDP (a)	6.1	3.7	2.9	2.7	2.7	2.6	2.6	2.7	2.7	4.9	4.4	3.9	2.8	
CONSUMER PRICE INDEX (b)	3.7	3.3	3.1	2.9	2.8	2.7	2.6	2.5	2.5	2.7	3.4	3.2	2.6	
"CORE" CONSUMER PRICE INDEX (b)	2.1	2.3	2.5	2.5	2.5	2.5	2.5	2.4	2.4	1.8	2.2	2.3	2.5	
WEST TEXAS INTERMED. OIL (\$/BBL) (f)	63.4	70.5	67.5	62.3	58.0	61.0	60.0	59.0	59.0	41.5	56.6	65.9	59.5	
EMPLOYMENT COST INDEX (b)	2.9	3.0	3.1	3.2	3.3	3.2	3.2	3.3	3.3	3.9	3.2	3.1	3.3	
REAL DISPOSABLE INCOME	2.1	2.1	2.3	2.5	2.6	2.7	2.8	3.0	3.1	3.4	1.4	2.3	2.8	
UNEMPLOYMENT RATE (%)	4.7	4.7	4.6	4.6	4.6	4.6	4.7	4.7	4.7	5.5	5.1	4.7	4.7	
HOUSING STARTS (MILLIONS)	2.13	1.93	1.88	1.86	1.82	1.79	1.76	1.74	1.73	1.95	2.07	1.95	1.78	
TOTAL VEHICLE SALES (MILLIONS)	16.9	16.6	16.9	16.7	16.7	16.6	16.8	16.7	16.6	16.8	17.0	16.9	16.8	
INDUSTRIAL PRODUCTION (b)	3.2	3.5	3.3	3.2	3.1	3.0	3.0	3.1	3.2	4.1	3.2	3.3	3.1	
CORPORATE PROFITS NIPA B/T (b)	8.6	8.0	7.9	8.3	8.5	6.7	6.8	8.0	8.5	12.6	13.5	8.2	7.5	
<u>Quarter End - INTEREST RATES (%) (c)</u>														
FEDERAL FUNDS (Target)	4.75	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	1.56	3.50	5.13	5.25	
3 MONTH LIBOR	4.99	5.25	5.25	5.30	5.35	5.35	5.35	5.35	5.35	1.75	3.78	5.20	5.35	
PRIME RATE	7.75	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25	4.50	6.50	8.13	8.25	
3 MONTH T-BILL (BEY)	4.81	5.05	5.20	5.25	5.30	5.30	5.35	5.35	5.35	1.53	3.37	5.08	5.33	
2 YEAR T-NOTE	4.82	5.10	5.25	5.30	5.35	5.35	5.40	5.45	5.45	2.50	3.98	5.12	5.39	
5 YEAR T-NOTE	4.82	5.10	5.25	5.30	5.35	5.45	5.45	5.50	5.50	3.40	4.09	5.12	5.44	
10 YEAR T-NOTE	4.86	5.15	5.25	5.30	5.35	5.40	5.50	5.50	5.60	4.21	4.28	5.14	5.44	
30 YEAR T-BOND	4.90	5.20	5.30	5.40	5.45	5.50	5.60	5.60	5.70	4.94	4.55	5.20	5.54	

(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

(f) Prices are Reflective of Quarterly Average of the Near Contract Price

6/13/2006

It has been our contention for some time that narrowing interest rate differentials between the United States and the rest of the world would reduce the relative attractiveness of U.S. assets, thereby making it increasingly difficult for the United States to finance its gaping current account deficit. Recent signs of slowing growth in the United States have many investors believing that the end of the Fed's tightening cycle is near at hand. In contrast, some major foreign central banks likely will lift rates over the remainder of 2006 and into next year.

Let's start with the Eurozone. As shown on the front page, the European Central Bank (ECB) hiked rates by 25 basis points on June 8, bringing its total amount of tightening since December to 75 basis points. Moreover, the Eurozone yield curve is priced for about 50 basis points of further tightening by the middle of next year. Our forecast, which is shown on the next page, is a bit more aggressive and projects 75 basis points of tightening by early 2007.

Real GDP in the Eurozone rose at a sequential annualized rate of 2.4% in the first quarter, and recent monthly indicators suggest that growth has remained solid in the second quarter. In addition, the CPI inflation rate currently stands at 2.4%, above the rate that the ECB would consider to be "price stability." Although the "core" inflation rate remains below 2%, we believe that signs of solid growth will induce the ECB to raise rates a bit more than most investors currently expect.

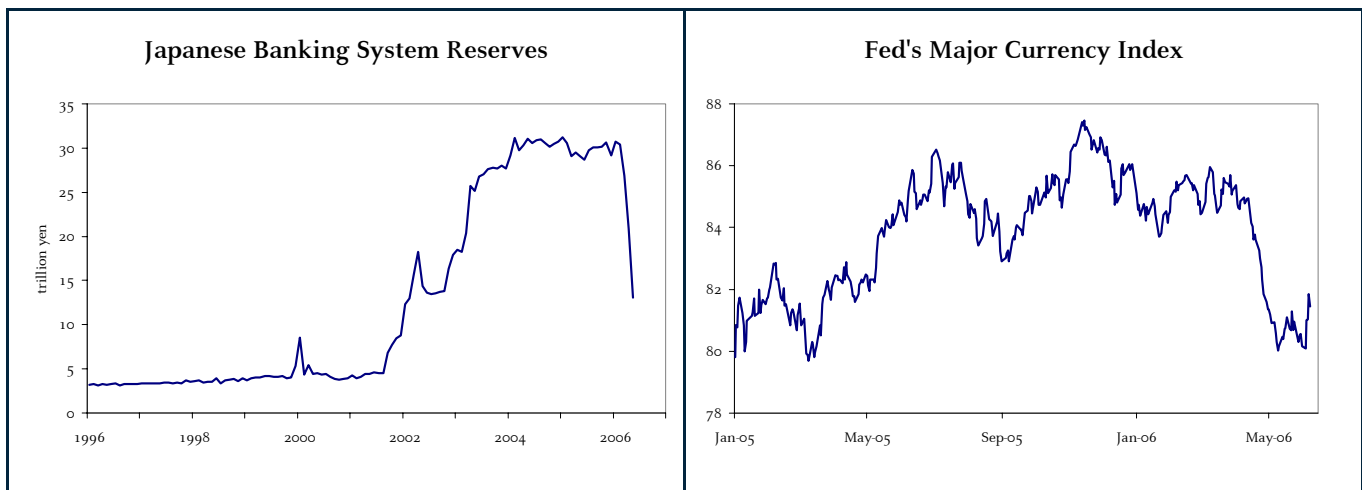
The Bank of Japan (BoJ) continues to keep its main policy rate at essentially zero percent, where it has remained since September 2001. However, the BoJ's Monetary Policy Board decided in March to take the first step toward higher short-term interest rates by ending its quantitative easing policy that pumped the Japanese banking system full of excess liquidity. As shown below, the BoJ will soon finish draining excess reserves from the banking system. When banking system reserves return to more normal

levels, conditions will be in place for an eventual hike in the BoJ's main policy rate.

Why is the BoJ tightening? The Japanese economy grew 2.6% in 2005, the most rapid rate of real GDP growth in five years. Moreover, the CPI inflation rate has turned modestly positive. Simply put, zero percent short-term interest rates are no longer appropriate in Japan. The Japanese economy could eventually face a serious inflation problem if the BoJ were to maintain an extremely accommodative monetary policy. We project that the BoJ will lift the overnight interbank rate (its main policy rate) by 125 basis points by the end of next year.

Other major central banks probably will tighten further. The Bank of England has maintained its policy rate at 4.5% for nearly a year, but signs of stronger consumer spending make it increasingly likely that the Bank will tighten policy again. After hiking rates by 175 basis points since September, the Bank of Canada looks like it will remain on hold for the next few months. However, the Bank could raise rates again later this year if growth remains solid, which would raise prospects of higher CPI inflation in the future.

As shown below, the dollar has depreciated versus most major currencies over the past two months as investors have started to anticipate the end of the Fed's tightening cycle. As our forecast on the next page makes clear, we believe that the greenback will trend even lower over the next year or two. More than \$3 billion of net capital inflows need to enter the United States every business day to finance the \$800 billion U.S. current account deficit. However, as interest rate differentials narrow in the quarters ahead, U.S. assets will lose some of their relative attractiveness. Although we do not anticipate a sharp decline in net capital inflows, which would cause the dollar to fall significantly, we look for the greenback to decline in an orderly fashion as foreign purchases of U.S. assets wane.



June 13, 2006

Country	GDP Growth			CPI Inflation			3-Month LIBOR (end of quarter)							10-Year Bond (end of quarter)						
	2005	2006	2007	2005	2006	2007	06-Q2	06-Q3	06-Q4	07-Q1	07-Q2	07-Q3	07-Q4	06-Q2	06-Q3	06-Q4	07-Q1	07-Q2	07-Q3	07-Q4
U.S.	3.5	3.4	2.7	3.4	3.2	2.6	5.25	5.25	5.30	5.35	5.35	5.35	5.35	5.15	5.25	5.30	5.35	5.40	5.50	5.50
Japan	2.6	3.0	2.2	-0.3	0.6	0.8	0.30	0.40	0.60	0.90	1.10	1.10	1.30	2.00	2.10	2.20	2.30	2.40	2.50	2.60
Euroland	1.4	2.2	2.0	2.2	2.4	2.0	3.00	3.40	3.70	3.85	3.85	3.85	3.85	4.00	4.30	4.50	4.60	4.60	4.55	4.50
U.K.	1.8	2.2	1.9	2.0	2.0	1.7	4.70	4.90	4.90	4.90	4.90	4.90	4.90	4.60	4.70	4.80	4.90	4.90	4.85	4.80
Canada	2.9	3.4	3.1	2.2	2.5	2.3	4.30	4.40	4.60	4.60	4.60	4.60	4.60	4.50	4.70	5.00	5.00	4.95	4.90	4.85

Currency	2006-Q2	2006-Q3	2006-Q4	2007-Q1	2007-Q2	2007-Q3	2007-Q4	2008-Q1
Euro (\$/€)	1.26	1.30	1.32	1.34	1.35	1.36	1.37	1.37
U.K. (\$/£)	1.85	1.88	1.90	1.91	1.91	1.92	1.92	1.93
U.K. (£/€)	0.68	0.69	0.69	0.70	0.71	0.71	0.71	0.71
Switzerland (CHF/\$)	1.24	1.20	1.19	1.18	1.17	1.16	1.15	1.15
Sweden (SEK/\$)	7.30	7.10	7.00	6.85	6.75	6.70	6.65	6.60
Norway (NOK/\$)	6.20	5.90	5.75	5.60	5.50	5.40	5.30	5.20
Poland (PLN/\$)	3.05	2.95	2.85	2.75	2.70	2.65	2.60	2.60
Japan (¥/\$)	114	110	105	100	96	94	92	90
Australia (US\$/A\$)	0.74	0.76	0.77	0.78	0.79	0.80	0.81	0.82
Singapore (S\$/US\$)	1.60	1.58	1.55	1.52	1.50	1.48	1.46	1.45
Korea (KRW/\$)	960	940	920	900	890	880	870	860
China (CNY/\$)	8.00	7.90	7.80	7.70	7.60	7.50	7.40	7.30
Canada (C\$/US\$)	1.12	1.10	1.09	1.08	1.07	1.06	1.05	1.04
Mexico (MXN/\$)	11.40	11.20	11.00	10.90	10.70	10.60	10.50	10.50
Brazil (BRL/\$)	2.25	2.30	2.35	2.40	2.45	2.50	2.55	2.60

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