



Monthly Economic Outlook

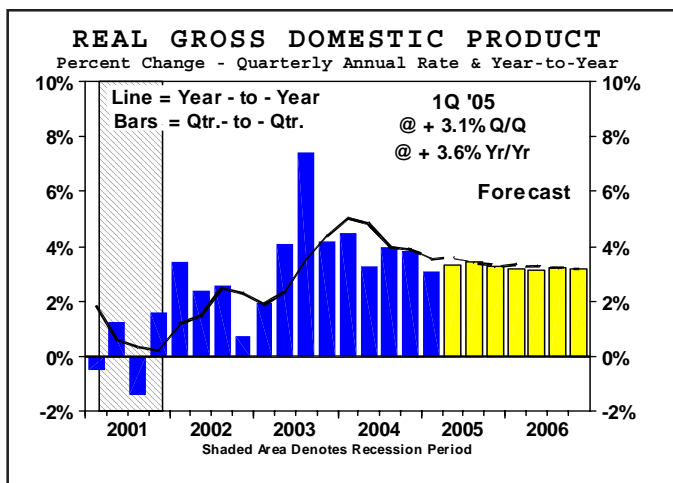
May 13, 2005

U.S. Overview

Near-term forecasts have bounced around quite a bit over the past month. A torrent of softer economic reports for the month of March, along with a much lower than expected first quarter GDP report, combined to raise concerns that the one-two punch from the Fed's eight quarter-point rate hikes and higher oil prices had staggered the recovery. Consensus forecasts for the second half of the year were slashed and doubts grew about whether or not the Fed would hike rates much further. Our economic growth forecast was slightly reduced but we retained the year-end federal funds rate at 4.00 percent.

What a difference a month makes. Faithful readers will remember that we were fairly cautious when the weaker March data was reported, noting then that we felt faulty seasonal adjustments brought about by an early Easter accounted for much of weakness. Now that April data are coming in, we can see that this was indeed the case. Moreover, several of the government's assumptions in the Advance first quarter GDP report should prove to be too conservative. We now expect first quarter GDP growth to be revised up to around a 3.5% annual rate, from the currently reported 3.1 percent.

While near-term prospects are generally better than has been reported, we still feel that the earlier run-up in oil prices and interest rates will take a toll on the economy. Consumer spending will rise less rapidly, businesses will remain cautious, and there are more risks evident in the credit markets. That said, we see growth continuing at close to the economy's long-run potential pace of around 3.3 percent.

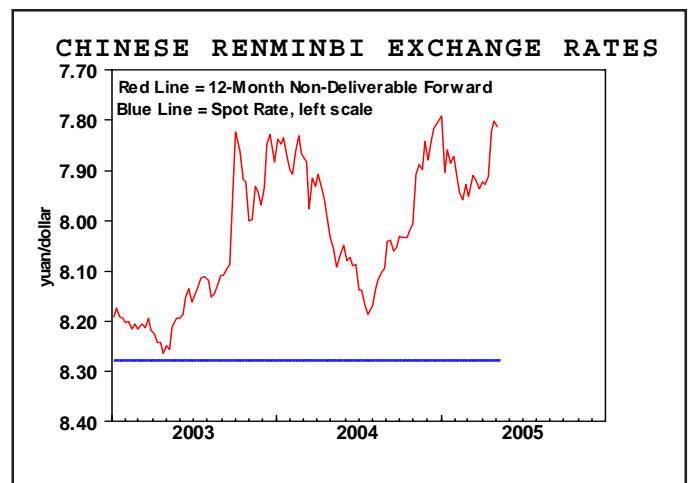


International Overview

Expectations of renminbi revaluation are on the rise again, due in part to recent comments by western officials that are meant to pressure the Chinese to allow some flexibility in their exchange rate. While we fully believe that the renminbi will be more flexible in the future, we do not think such a move is necessarily imminent. Our expectation is that the Chinese will allow some flexibility in the renminbi exchange rate later this year or early next year.

We also believe that flexibility will take the form of a managed exchange rate regime that will keep any renminbi appreciation rather modest. Outright flotation has the potential for significant appreciation of the currency, which could cause Chinese economic growth to slow *via* marked deceleration in exports. In our view, Chinese officials do not want to take that risk due to the potential for social instability, which they fear more than anything else.

If the renminbi exchange rate were made more flexible, the Chinese central bank would not be obligated to buy as many dollars as presently. This probably would not have a significant effect on U.S. bond yields, because Chinese purchases of Treasury securities are not as large as commonly thought. However, other Asian governments likely would allow their currencies to strengthen further against the dollar, which potentially could have a bigger effect on U.S. bond yields. To repeat, however, we do not expect sharp appreciation of the renminbi, so the overall effect on U.S. financial markets should be rather modest.



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Was It The Big Bad Wolf Or The Easter Bunny?

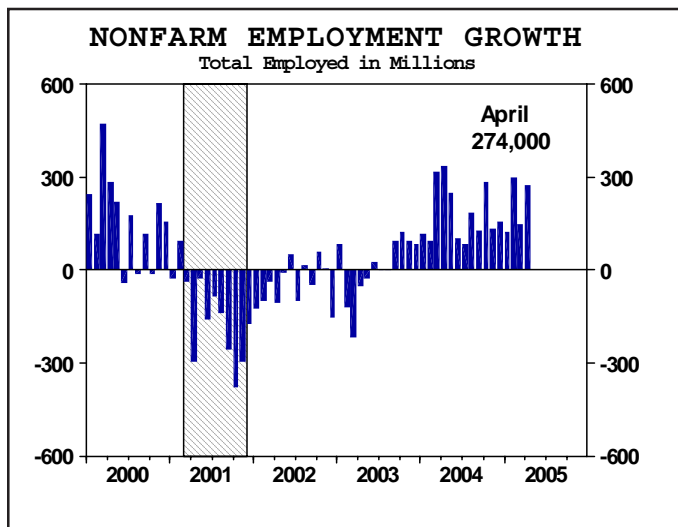
Of all the things to worry about, from threats of terrorism to the jolt of rising interest rates, the impact of an early Easter appears to have slipped by a large number of economists. While the impact has been noted recently, most folks were quick to dismiss such concerns back in April, when a spate of weaker than expected reports for the month of March raised concerns that the recovery was running out of steam. Following April's much stronger than expected reports on employment conditions and retail sales, we now know that the economy is in far better shape than was widely believed just one month ago.

Can one month's data really make that much difference?

Usually no, but this past month's data not only showed that employment and retail sales were much stronger and broader than expected in April, but also significantly increased estimates of growth during prior months. Moreover, recent reports on international trade and inventories show the trade deficit was significantly smaller than in the advance first quarter GDP report and that there was less of an inventory overhang. In fact, our estimate of an upward revision to first quarter GDP to around a 3.5% pace may prove too conservative and with less inventories, production will likely hold up better this spring and summer.

There is more good news. Oil prices have recently fallen back below \$50 a barrel and gasoline prices have fallen for four straight weeks. The drop in gasoline prices should bring some unexpectedly good news to the inflation figures. Gasoline prices normally rise in the spring, and the recent modest decreases will produce outsized declines in the seasonally adjusted figures, possibly producing outright declines in the overall CPI and PPI during May.

There are still some problems out there. Consumer confidence has fallen in recent months, possibly reflecting the recent weakness in the stock market, the earlier spike in oil prices and the ongoing problems at GM and Ford. The link between the confidence figures and spending, however, is fairly weak, particularly in the very near term.



We expect real GDP to average 3.3% through the remainder of this year, which is slightly higher than we projected one month ago. Consumer spending is still expected to moderate but growth has been raised a few tenths of a percentage point, reflecting the stronger job numbers reported for the past four months and the upward adjustment to income we expect to see in coming months.

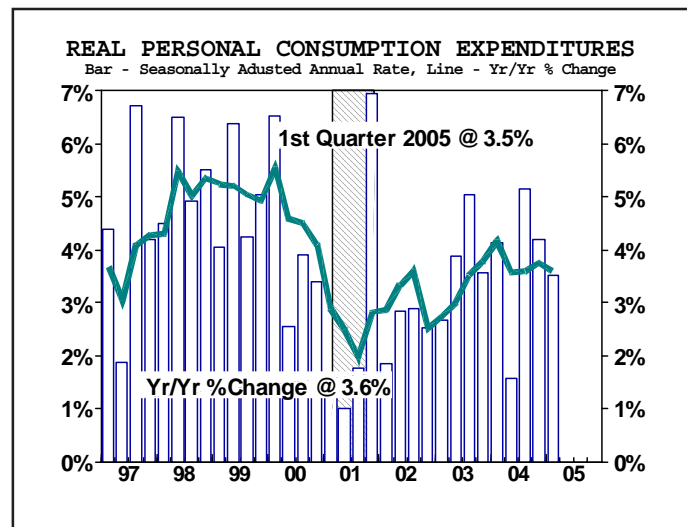
Business investment is also expected to strengthen. We believe that the abysmal March factory orders data was another early-Easter distortion. There has been a tendency for orders to strengthen in the first month of a quarter, which means the April numbers could be extremely robust. Moreover, Boeing has received a slew of orders for its next generation airliners, which by our count totals 297 airliners in the past three weeks. Most of these orders have come from overseas, indicating that the weaker dollar is having a positive impact on exports.

Residential construction has remained red hot, and recent declines in mortgage rates suggest demand for new and existing homes will remain strong throughout the key spring selling season. Commercial building, which posted a modest decline in the first quarter, is also poised for a recovery ahead.

Outlook for Interest Rates

Recent rumors of liquidity problems at some hedge funds following the S&P downgrade of GM and Ford debt ratings have raised a few red flags. There are concerns the problems at these hedge funds could spillover into the broader financial sector. If that were to occur, the Fed might be inclined to hold off raising short-term interest rates and might even have to reverse course and cut interest rates for a short period of time. Right now, we feel the odds of such an outcome are very slight. The Fed has plenty of time to analyze the situation, since their next meeting is not until the tail end of June.

Long-term interest rates have moved broadly lower in recent days, as have commodity prices. There is little doubt the world's largest economy is cooling off. Our contention remains, however, that growth will remain fairly robust and that inflation and interest rates will continue to creep higher. We are holding to our forecast of a year-end federal funds rate of 4.00% and look for the long bond to end the year at 4.70%.



(Percentage Changes)

| QUARTER: | Actual | Forecast | | | | 2006 | | | | 2007 | | Annual (d) | |
|--------------------------------------|--------|----------|------|------|------|------|------|------|------|------|------|------------|------|
| | 1Q | 2Q | 3Q | 4Q | 1Q | 2Q | 3Q | 4Q | 1Q | 2004 | 2005 | 2006 | |
| REAL GROSS DOMESTIC PRODUCT(e) | 3.1 | 3.3 | 3.4 | 3.3 | 3.2 | 3.2 | 3.2 | 3.2 | 3.2 | 3.3 | 4.4 | 3.5 | 3.3 |
| PERSONAL CONSUMPTION | 3.5 | 3.1 | 2.9 | 2.8 | 2.8 | 2.8 | 2.8 | 2.7 | 2.7 | 2.7 | 3.8 | 3.5 | 2.8 |
| BUSINESS INVESTMENT | 4.6 | 13.0 | 9.7 | 9.3 | 9.0 | 9.2 | 9.4 | 9.4 | 9.1 | 9.1 | 10.6 | 10.4 | 9.5 |
| EQUIPMENT & SOFTWARE | 6.9 | 11.7 | 11.0 | 10.5 | 10.0 | 10.1 | 10.2 | 10.1 | 9.7 | 9.7 | 13.6 | 12.3 | 10.4 |
| STRUCTURES | -2.6 | 6.0 | 4.0 | 4.0 | 4.5 | 5.0 | 5.5 | 6.0 | 6.0 | 6.0 | 1.4 | 1.9 | 4.8 |
| RESIDENTIAL CONSTRUCTION | 5.7 | 7.0 | 1.0 | 0.5 | 0.0 | -0.5 | -0.5 | -0.5 | -0.5 | -0.5 | 9.7 | 4.7 | 0.5 |
| GOVERNMENT PURCHASES | 0.6 | 1.7 | 2.2 | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 | 19.0 | 1.9 | 1.3 | 2.3 | 2.3 |
| NET EXPORTS (\$ BILLIONS) | -663 | -667 | -671 | -677 | -683 | -691 | -698 | -705 | -712 | -584 | -669 | -694 | -694 |
| % Pt. Contribution to GDP | -1.5 | -0.1 | -0.2 | -0.2 | -0.2 | -0.3 | -0.3 | -0.2 | 0.0 | -0.6 | -1.3 | 0.0 | 0.0 |
| INVENTORY CHANGE (\$ BILLIONS) | 80 | 50 | 49 | 49 | 48 | 47 | 47 | 45 | 47 | 46 | 57 | 47 | 47 |
| % Pt. Contribution to GDP | 1.2 | -1.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | -0.1 | 0.0 | 0.4 | 0.5 | 0.0 | 0.0 |
| NOMINAL GDP | 6.4 | 6.1 | 6.0 | 6.0 | 5.9 | 5.9 | 6.0 | 6.1 | 7.3 | 6.6 | 6.1 | 6.0 | 6.0 |
| REAL FINAL SALES | 0.5 | 2.6 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.3 | 4.0 | 3.4 | 3.4 | 3.4 |
| "CORE" GDP (a) | 3.8 | 4.7 | 3.7 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | 6.0 | 4.9 | 4.5 | 3.6 | 3.6 |
| CONSUMER PRICE INDEX (b) | 3.0 | 2.5 | 2.5 | 2.4 | 2.5 | 2.6 | 2.7 | 2.8 | 2.8 | 2.7 | 2.6 | 2.7 | 2.7 |
| "CORE" CONSUMER PRICE INDEX (b) | 2.3 | 2.3 | 2.3 | 2.2 | 2.1 | 2.2 | 2.2 | 2.3 | 2.4 | 1.8 | 2.3 | 2.2 | 2.2 |
| EMPLOYMENT COST INDEX (b) | 3.4 | 3.3 | 3.4 | 3.5 | 3.6 | 3.5 | 3.5 | 3.6 | 3.6 | 3.9 | 3.4 | 3.6 | 3.6 |
| REAL DISPOSABLE INCOME | 3.6 | 3.1 | 2.9 | 2.7 | 2.9 | 2.8 | 2.9 | 2.9 | 2.9 | 3.5 | 3.1 | 2.9 | 2.9 |
| UNEMPLOYMENT RATE (%) | 5.3 | 5.2 | 5.1 | 5.1 | 5.0 | 5.0 | 4.9 | 4.9 | 4.8 | 5.5 | 5.2 | 5.0 | 5.0 |
| HOUSING STARTS (MILLIONS) | 2.09 | 1.95 | 1.90 | 1.88 | 1.85 | 1.80 | 1.78 | 1.77 | 1.76 | 1.95 | 1.95 | 1.80 | 1.80 |
| TOTAL VEHICLE SALES (MILLIONS) | 16.4 | 17.2 | 17.2 | 16.9 | 17.0 | 17.1 | 17.1 | 17.1 | 17.2 | 16.8 | 16.9 | 17.1 | 17.1 |
| INDUSTRIAL PRODUCTION (b) | 3.8 | 3.4 | 3.5 | 3.7 | 3.9 | 4.1 | 3.9 | 3.7 | 3.7 | 4.1 | 3.6 | 4.7 | 4.7 |
| CORPORATE PROFITS NIPA B/T (b) | 11.0 | 10.0 | 9.5 | 9.0 | 8.8 | 8.6 | 8.7 | 8.7 | 8.7 | 14.5 | 8.6 | 8.1 | 8.1 |
| Quarter End - INTEREST RATES (%) (c) | | | | | | | | | | | | | |
| FEDERAL FUNDS (Target) | 2.75 | 3.25 | 3.75 | 4.00 | 4.25 | 4.50 | 4.75 | 4.75 | 5.00 | 1.56 | 3.44 | 4.56 | 4.56 |
| 3 MONTH LIBOR | 2.95 | 3.15 | 3.85 | 4.15 | 4.35 | 4.60 | 4.85 | 4.85 | 5.13 | 1.75 | 3.53 | 4.66 | 4.66 |
| PRIME RATE | 5.75 | 6.25 | 6.75 | 7.00 | 7.25 | 7.50 | 7.75 | 7.75 | 8.00 | 4.50 | 6.44 | 7.56 | 7.56 |
| 3 MONTH T-BILL (BEY) | 2.74 | 3.35 | 3.85 | 4.10 | 4.35 | 4.60 | 4.80 | 4.80 | 5.00 | 1.53 | 3.51 | 4.64 | 4.64 |
| 2 YEAR T-NOTE | 3.73 | 3.80 | 4.00 | 4.25 | 4.50 | 4.75 | 5.00 | 5.20 | 5.40 | 2.50 | 3.95 | 4.86 | 4.86 |
| 5 YEAR T-NOTE | 4.17 | 4.00 | 4.20 | 4.40 | 4.70 | 4.90 | 5.20 | 5.40 | 5.60 | 3.40 | 4.19 | 5.05 | 5.05 |
| 10 YEAR T-NOTE | 4.50 | 4.30 | 4.50 | 4.70 | 4.90 | 5.10 | 5.40 | 5.60 | 5.80 | 4.21 | 4.50 | 5.25 | 5.25 |
| 30 YEAR T-BOND | 4.85 | 4.65 | 4.85 | 5.00 | 5.30 | 5.50 | 5.80 | 6.00 | 6.20 | 4.94 | 4.84 | 5.65 | 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

The financial press has been full of stories over the past few weeks about the possible revaluation of the Chinese renminbi. These expectations have been fanned by recent comments by western officials that are meant to pressure China to allow more flexibility into its exchange rate. Indeed, prices of “non-deliverable” forward contracts show that investors expect that the renminbi will be about 5% stronger against the dollar a year from now (see graph on front page). We have written extensively about prospects of renminbi revaluation, but we feel that our views are worth repeating here given the importance of the topic.

We fully expect that the renminbi exchange rate will be more flexible in the future than it is today. (China essentially pegs its exchange rate at 8.28 yuan per dollar.) The only question is the timing. While we have no reason to believe that a move to flexibility is imminent, we would not be completely surprised either if it occurred sooner rather than later. Our guess, however, is that China will move to some form of flexibility later this year or early next year. Chinese authorities are slowly liberalizing the country’s financial markets, and reform of the exchange rate regime should be viewed in that longer-run context. China is slowly allowing market forces to determine the setting of long-term interest rates, and it will open up its banking system to foreign competition at the end of 2006 as per its WTO agreement.

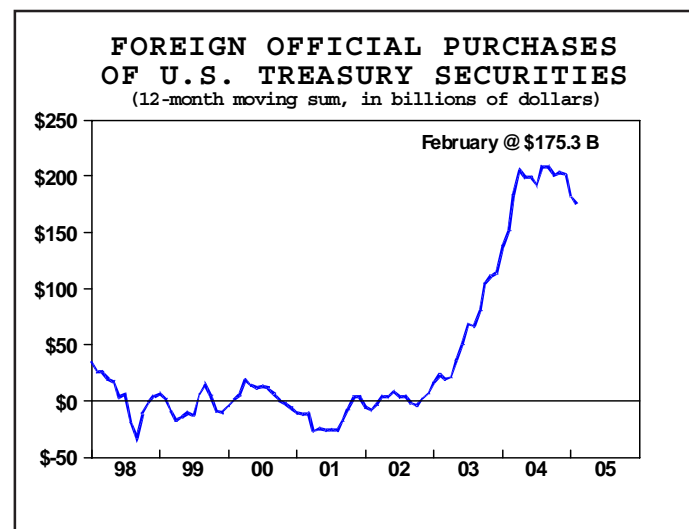
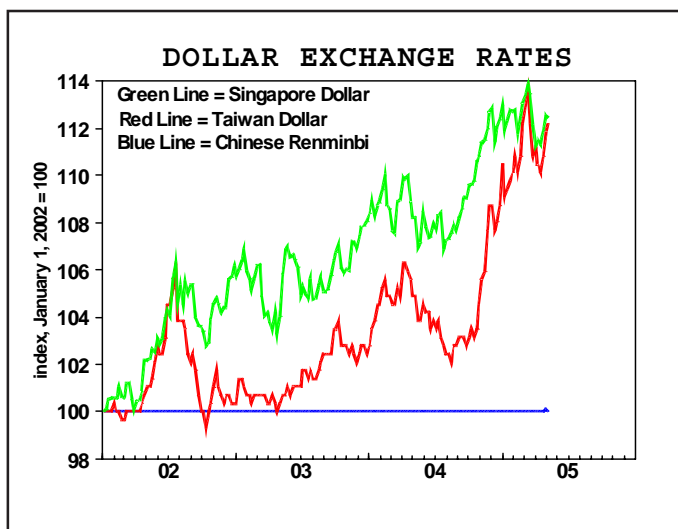
Moreover, we believe that any move in the renminbi likely will be rather modest, and we expect that flexibility will take the form of a managed exchange rate. That is, we expect that Chinese authorities will eventually allow the renminbi to trade freely within some band, and that they would be willing to allow the currency to strengthen 5% to 10% versus the dollar over the course of a year. However, we believe that unfettered flexibility (à la the dollar/euro exchange rate) is still some years off.

In our view, the Chinese government will not allow the renminbi to float freely in the near term because it could

deal a destabilizing blow to the Chinese economy. Nobody knows how much the renminbi would strengthen versus the dollar if it floated freely. However, if the currency were to strengthen, say, 30% to 40% Chinese export growth could slow significantly, which likely would cause a marked deceleration in the Chinese economy. Slower growth would lead to rising unemployment, which could lead to social instability, something that Chinese officials fear more than anything else. Therefore, we expect that the Chinese government will eventually allow some flexibility into the exchange rate, but that they will keep any appreciation rather modest.

What effects would managed flexibility of the renminbi have on other financial markets? The common perception is that the Chinese central bank buys significant amounts of U.S. Treasury securities, making investors fret that currency flexibility could cause a sharp decline in bond prices. (The Chinese central bank would accumulate fewer dollars and, hence, it would need to buy fewer Treasury securities.) However, as we argue above, we expect that currency flexibility, when it occurs, will be very modest, making any dropoff in Chinese buying of Treasury securities rather small. Moreover, Chinese purchases of Treasury securities totalled only \$33 billion in the twelve months to February, less than 10% of total Treasury issuance last year.

However, renminbi appreciation would make other Asian governments more willing to allow their currencies to strengthen further against the dollar (see chart below). Total purchases of Treasury securities by the foreign “official” sector ballooned up to \$200 billion last year, and most of these purchases likely were undertaken by Asian central banks (see chart below). If Asian central banks in aggregate were to buy significantly less Treasury securities, bond yields could back up sharply. To repeat, however, we do not expect sharp appreciation of the renminbi nor other Asian currencies. Therefore, any effects from renminbi appreciation on bond yields in the U.S. should be rather modest.



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| Country | GDP | | CPI | | 3-Month LIBOR | | | | | | 10-Year Bond | | | | | | | | | |
|----------|--------|------|-----------|------|------------------|---------|---------|---------|---------|---------|------------------|---------|---------|---------|---------|---------|---------|---------|---------|-------|
| | Growth | | Inflation | | (end of quarter) | | | | | | (end of quarter) | | | | | | | | | |
| | 2004 | 2005 | 2004 | 2005 | 2006 | 2005-Q2 | 2005-Q3 | 2005-Q4 | 2006-Q1 | 2006-Q2 | 2006-Q3 | 2006-Q4 | 2005-Q2 | 2005-Q3 | 2005-Q4 | 2006-Q1 | 2006-Q2 | 2006-Q3 | 2006-Q4 | |
| U.S. | 4.4 | 3.5 | 2.7 | 2.6 | 2.7 | 3.15 | 3.85 | 4.15 | 4.35 | 4.60 | 4.85 | 4.85 | 4.30 | 4.50 | 4.70 | 4.90 | 5.10 | 5.10 | 5.40 | 5.60 |
| Japan | 2.6 | 1.2 | 0.0 | 0.2 | 0.3 | 0.05 | 0.05 | 0.05 | 0.05 | 0.20 | 0.40 | 0.65 | 1.40 | 1.50 | 1.70 | 1.90 | 2.10 | 2.10 | 2.30 | 2.40 |
| Euroland | 1.8 | 1.3 | 2.1 | 1.9 | 1.6 | 2.15 | 2.15 | 2.15 | 2.40 | 2.70 | 2.90 | 3.15 | 3.50* | 3.60* | 3.90* | 4.10* | 4.30* | 4.40* | 4.40* | 4.50* |
| U.K. | 3.1 | 2.7 | 1.3 | 1.8 | 1.5 | 4.90 | 4.90 | 4.70 | 4.40 | 4.40 | 4.40 | 4.40 | 4.70 | 4.60 | 4.50 | 4.40 | 4.40 | 4.40 | 4.50 | 4.70 |
| Canada | 2.8 | 2.7 | 1.8 | 2.0 | 2.2 | 2.70 | 2.90 | 3.20 | 3.50 | 3.70 | 4.00 | 4.20 | 4.40 | 4.70 | 4.80 | 4.90 | 5.00 | 5.00 | 5.10 | 5.00 |

| Currency | 2005-Q2 | 2005-Q3 | 2005-Q4 | 2006-Q1 | 2006-Q2 | 2006-Q3 | 2006-Q4 | 2007-Q1 |
|----------------------|---------|---------|---------|---------|---------|---------|---------|---------|
| Euro (\$/€) | 1.26 | 1.28 | 1.32 | 1.34 | 1.36 | 1.38 | 1.39 | 1.40 |
| U.K. (\$/£) | 1.84 | 1.86 | 1.90 | 1.92 | 1.94 | 1.95 | 1.96 | 1.96 |
| U.K. (£/€) | 0.68 | 0.69 | 0.69 | 0.70 | 0.70 | 0.71 | 0.71 | 0.71 |
| Switzerland (CHF/\$) | 1.24 | 1.22 | 1.20 | 1.18 | 1.16 | 1.15 | 1.14 | 1.13 |
| Sweden (SEK/\$) | 7.40 | 7.20 | 7.00 | 6.85 | 6.70 | 6.60 | 6.55 | 6.50 |
| Norway (NOK/\$) | 6.50 | 6.35 | 6.15 | 6.00 | 5.90 | 5.80 | 5.70 | 5.60 |
| Poland (PLN/\$) | 3.50 | 3.40 | 3.25 | 3.20 | 3.15 | 3.10 | 3.05 | 3.00 |
| Japan (¥/\$) | 108 | 104 | 100 | 98 | 96 | 94 | 92 | 90 |
| Australia (US\$/A\$) | 0.76 | 0.75 | 0.74 | 0.73 | 0.72 | 0.71 | 0.70 | 0.70 |
| Singapore (S\$/US\$) | 1.65 | 1.63 | 1.60 | 1.58 | 1.56 | 1.54 | 1.52 | 1.50 |
| Korea (KRW/\$) | 1000 | 990 | 980 | 970 | 960 | 955 | 950 | 950 |
| Canada (C\$/US\$) | 1.26 | 1.24 | 1.22 | 1.20 | 1.18 | 1.17 | 1.16 | 1.15 |
| Mexico (MXN/\$) | 11.10 | 10.90 | 10.70 | 10.60 | 10.60 | 10.55 | 10.50 | 10.50 |
| Brazil (BRL/\$) | 2.55 | 2.50 | 2.45 | 2.40 | 2.35 | 2.30 | 2.25 | 2.25 |

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