



Monthly Economic Outlook

May 12, 2006

U.S. Overview

After a solid first quarter, economic activity appears to be moderating and the Federal Reserve hopes to be in position to at least temporarily halt their string of sixteen consecutive quarter-point interest rate hikes at their next FOMC meeting in late June. Our forecast sees real GDP growth returning to its trend rate of 3 percent and staying there for the next several quarters – a perfect landing that brings the economy back to a goldilocks environment. There are several risks along the way, however, including soaring gasoline prices, a slowing housing market, ongoing geopolitical pressures in the Middle East, and a contentious mid-term political campaign here at home.

Growth and Fed Policy

So far, businesses, consumers and policymakers have been able to navigate this environment quite well. Home sales have slowed, but not collapsed, and consumer spending has held up well, even as gasoline prices have spiked. Businesses also seem to be holding their own, with productivity growth and profits turning in strong performances during the first quarter.

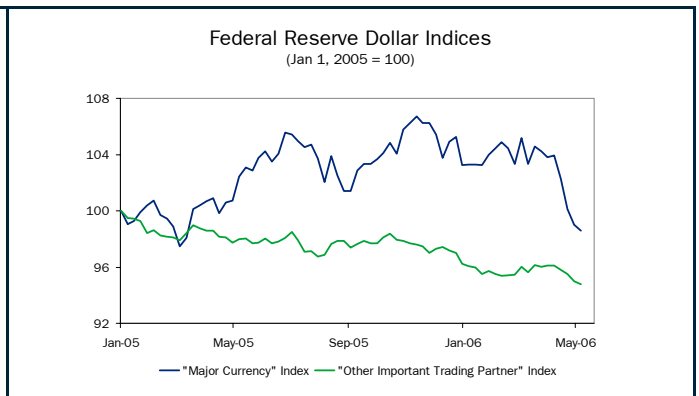
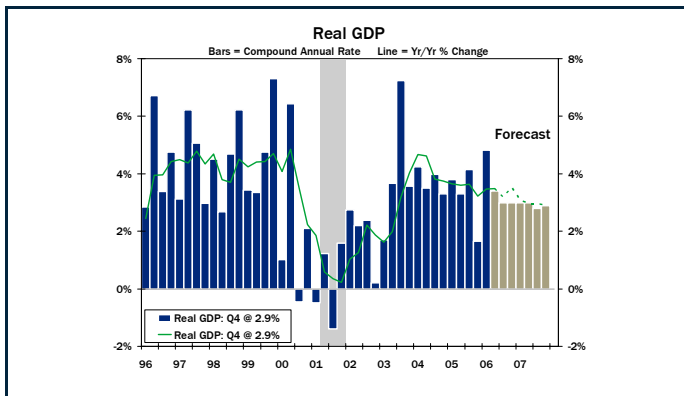
The second half of the year will be more challenging, as the recent slowdown in home sales will begin to be reflected in construction and employment. Consumer spending could also be ripe for a slowdown, faltering under the weight of higher gasoline prices, rising interest rates, and only modest wage and salary gains. With housing and consumer spending providing less punch, the economy will lean more heavily on the business sector. We expect equipment and structure spending to be solid. Inventory gains are also expected to boost industrial production. Trend growth plus modest inflation pressures will move the Fed to raise rates one more time in the second half of the year.

International Overview

The dollar has taken it on the chin over the course of the past month. The dollar's decline versus most major currencies reflects shifting perceptions about monetary policy going forward. The FOMC has recently suggested that its tightening cycle may be coming to an end. In contrast, many foreign central banks likely will tighten policy over the course of the year. The ECB, which already has tightened by 50 basis points, has more rate hikes up its sleeve, and even the Bank of Japan, which has kept its main policy rate at zero percent for nearly five years, should begin to hike rates this year.

The greenback has also depreciated against most emerging currencies. Whereas the United States is posting a gaping current account deficit, many developing countries are presently incurring current account surpluses. The difference in the current account positions naturally puts downward pressure on the dollar vis-à-vis many emerging currencies. In addition, the recent G-7 communiqué that called for "greater exchange rate flexibility ... for necessary adjustments to occur" signaled that central bank governors and finance ministers of the world's most developed economies would not object to further dollar depreciation.

Looking forward, we expect that the dollar will trend lower versus most currencies over the course of the year. The United States relies on capital inflows from the rest of the world to finance its current account deficit. However, as interest rate differentials narrow further, U.S. assets will lose their attractiveness, at least at the margin, to foreign investors. A topping out, if not modest decline, in net capital inflows in conjunction with the current account deficit, which likely will widen further over the next few quarters, should exert further downward pressure on the dollar.



Economic Trend Growth the Outlook

Most business cycles follow a fairly familiar pattern. The first half of the cycle is driven by strong gains in consumer spending and residential investment, which tend to feed off the fiscal and monetary stimulus put in place during the recession and early part of the recovery. As the economy recovers, the Fed tends to gradually remove the stimulus it had put in place, and the leadership of economic growth gradually shifts from consumer spending and housing to business fixed investment. The current business cycle appears to be following this path.

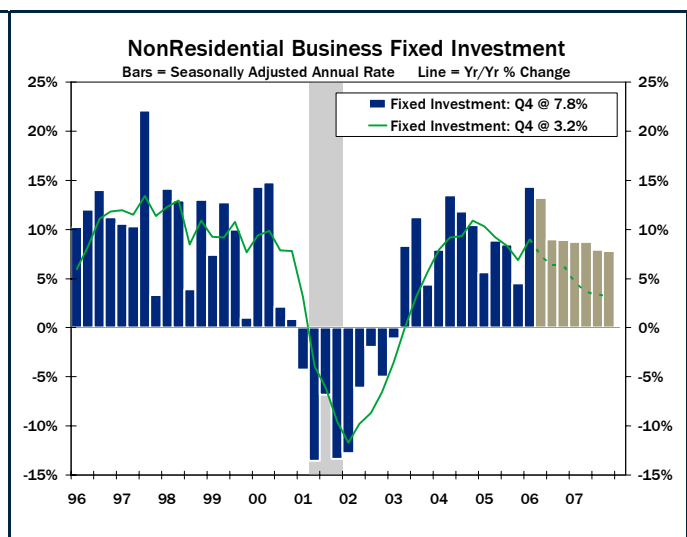
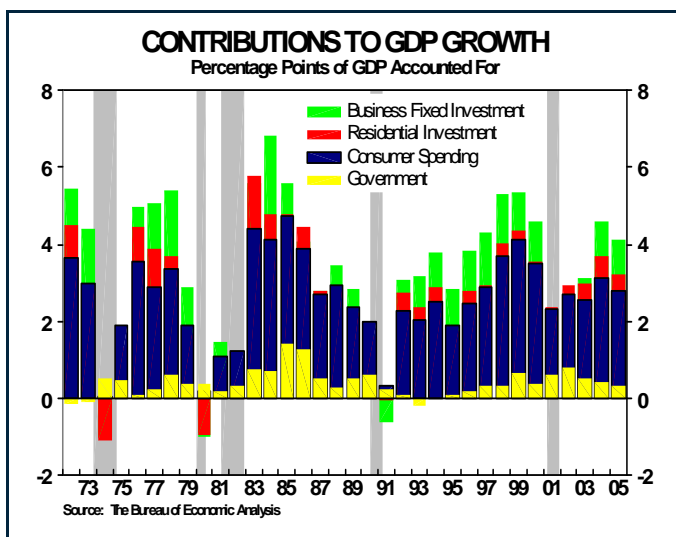
What largely goes unsaid, however, is that the transition from a consumer and housing-led economy to one led by business-fixed investment has rarely been seamless. In its zeal to rein in growth, the Fed might tighten too much or unwittingly set off a crisis in some part of the economy or in some economy overseas. The net result has typically been a soft landing or something actually a bit harder than that, which has sometimes even led the Fed to reverse course and cut interest rates a few times.

So will this time be different? The Fed has gone out of its way to create as little disruption as possible by moving in a very gradual and predictable fashion. The federal funds rate is now within the margin of error of its neutral level, where monetary policy is neither stimulating nor restraining economic activity. There is little doubt that growth is moderating, particularly in the housing sector. Mortgage applications for the purchase of homes have dropped nearly 17 percent since mid-August, while applications to refinance a home mortgage peaked out a month earlier and have since tumbled nearly 43 percent. The Fed's goal has been to take the speculative edge out of the housing sector and it looks like it is succeeding.

The critical questions now are whether the housing market will slow just enough, too much, or too little and will that bring about a harsh adjustment in consumer spending? Our read is that the housing market is slowing on pace to a soft landing. We expect total sales of new and existing homes to drop 20 percent by the middle of 2007 from their peak levels reached late last summer. Such a drop would be roughly equal to what occurred during the mid-point of the long expansions of the 1980s and 1990s.

A twenty percent pullback in home sales over a two year period should not be all that traumatic for the economy or consumers. Housing price appreciation is closely tied to home turnover, and a twenty percent reduction in sales, spread roughly evenly throughout a two year period, would still leave home turnover at a level consistent with at least a seven percent rise in home prices this year and at least a four percent price increase in 2007. As a result, we should not see any adverse wealth effect impacts on consumer spending. With housing wealth rising less rapidly there will also be less of a positive influence on consumer spending. Therefore, spending should fall back in line with after-tax income growth and rebuild the savings rate.

A soft landing for the housing market will translate into a perfect landing for the economy if business fixed investment ramps up. The early returns are encouraging. Business fixed investment in equipment and software jumped up at a 14 percent annual rate during the first quarter, while investment in other equipment rose at an 16 percent pace. Orders for nondefense capital goods have picked up in recent months, which suggest the momentum should carry over in the coming quarters, albeit at a somewhat reduced pace.



(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)	4.8	3.4	3.0	3.0	3.0	3.0	2.8	2.9	3.0	4.2	3.5	3.4	3.0	
PERSONAL CONSUMPTION	5.5	2.6	2.8	2.9	3.0	3.0	3.1	3.1	3.2	3.9	3.5	3.3	3.0	
BUSINESS INVESTMENT	14.3	13.2	9.0	8.9	8.7	8.7	7.9	7.8	7.2	9.4	8.6	10.1	8.8	
EQUIPMENT & SOFTWARE	16.4	10.5	9.8	9.7	9.6	9.6	8.7	8.6	7.9	11.9	10.9	10.8	9.4	
STRUCTURES	8.6	6.0	5.8	5.5	5.0	4.5	4.5	4.5	4.0	2.2	2.0	5.4	5.1	
RESIDENTIAL CONSTRUCTION	2.6	-2.1	-6.0	-8.0	-9.0	-9.5	-9.0	-8.5	-8.0	10.3	7.1	1.0	-8.1	
GOVERNMENT PURCHASES	3.9	1.1	2.0	2.2	2.2	2.3	2.2	2.2	2.2	2.2	1.8	1.9	2.1	
NET EXPORTS (\$ BILLIONS)	-678	-683	-689	-695	-701	-708	-714	-720	-727	-601	-633	-686	-711	
% Pt. Contribution to GDP	-0.8	-0.2	-0.2	-0.2	-0.2	-0.2	0.0	0.0	0.0	-0.8	-0.9	-0.8	-0.7	
INVENTORY CHANGE (\$ BILLIONS)	22	26	28	31	34	36	35	33	35	52	20	27	35	
% Pt. Contribution to GDP	-0.6	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.3	-0.3	0.1	0.1	
NOMINAL GDP	8.2	6.7	5.9	5.9	5.8	5.8	5.8	5.8	6.0	7.0	6.4	6.7	5.8	
REAL FINAL SALES	10.8	1.5	2.4	2.5	2.6	2.6	2.6	2.5	2.5	3.9	3.8	3.4	2.9	
"CORE" GDP (a)	6.5	3.7	3.1	3.1	3.1	3.1	3.1	3.1	3.2	4.9	4.4	4.0	3.1	
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	2.6	2.6	2.6	2.5	2.4	2.4	1.8	2.2	2.3	2.5	
WEST TEXAS INTERMED. OIL (\$/BBL) (f)	63.4	67.5	65.0	62.3	58.0	61.0	60.0	59.0	59.0	41.4	56.6	64.5	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	3.2	3.0	3.5	3.6	3.5	3.5	3.4	3.4	3.4	3.4	1.5	3.3	3.5	
UNEMPLOYMENT RATE (%)	4.7	4.7	4.6	4.6	4.5	4.5	4.4	4.4	4.4	5.5	5.1	4.7	4.5	
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	17.2	17.3	17.3	16.8	17.3	17.3	17.4	16.7	16.8	17.0	17.2	17.3	
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	5.00	5.25	5.25	5.25	5.25	5.25	5.25	5.25	1.56	3.50	5.06	5.25	
3 MONTH LIBOR	4.99	5.10	5.25	5.30	5.35	5.35	5.35	5.35	5.35	1.75	3.78	5.16	5.35	
PRIME RATE	7.75	8.00	8.25	8.25	8.25	8.25	8.25	8.25	8.25	4.50	6.50	8.06	8.25	
3 MONTH T-BILL (BEY)	4.81	4.90	5.30	5.30	5.30	5.35	5.35	5.35	5.35	1.53	3.37	5.08	5.34	
2 YEAR T-NOTE	4.82	4.95	5.35	5.35	5.35	5.40	5.40	5.45	5.45	2.50	3.98	5.12	5.40	
5 YEAR T-NOTE	4.82	5.00	5.40	5.40	5.40	5.45	5.45	5.50	5.50	3.40	4.09	5.16	5.45	
10 YEAR T-NOTE	4.86	5.15	5.50	5.50	5.55	5.60	5.60	5.65	5.70	4.21	4.28	5.25	5.60	
30 YEAR T-BOND	4.90	5.20	5.60	5.60	5.65	5.70	5.70	5.75	5.80	4.94	4.55	5.33	5.70	

(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

5/12/2006

The dollar has taken it on the chin versus most major currencies over the past few weeks. Indeed, the Federal Reserve's "Major Currency" index, which measures the value of the dollar versus seven major foreign currencies, has dropped about five percent since mid-April, a rather sharp move (see graph on front page). In addition, the "Other Important Trading Partner" (OITP) index, which measures the value of the greenback versus some important emerging market currencies, continues to follow the downward trend that has been in place for two years.

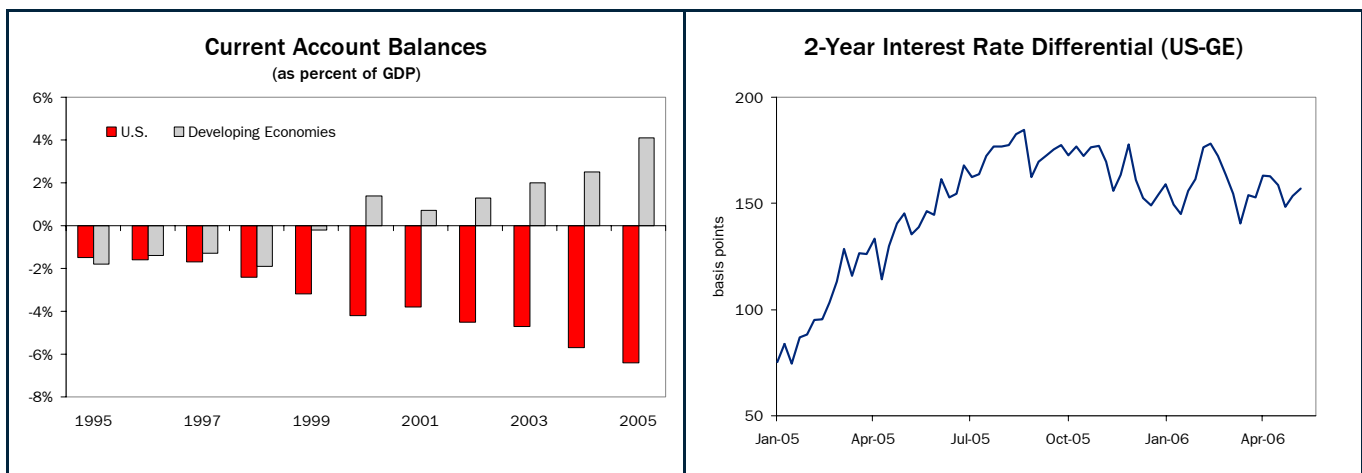
The behavior of the two indices over the past year or so illustrates some of the challenges facing the dollar going forward. Let's start with the dollar's trend depreciation versus many emerging currencies, which is captured by the OITP index. Some of this depreciation reflects the strength of capital flows to the emerging world as investors have become increasingly tolerant of risk over the past few years. In addition, many developing countries are currently incurring current account surpluses, which stand in stark contrast to the unprecedented current account deficit of the United States (see chart below). The difference in the current account positions naturally puts downward pressure on the dollar vis-à-vis many emerging currencies.

In contrast, the dollar strengthened last year against many major currencies due to the relative rise in U.S. interest rates. For example, the yield on the 2-year Treasury security relative to the comparable security in Germany rose by about 100 basis points in the first half of 2005 as the actual pace of Fed tightening exceeded the pace that investors had expected at the beginning of the year (see chart below). However, this spread has narrowed somewhat over the past few months as the European Central Bank has begun to tighten policy. This slight narrowing in interest rate differentials has eroded, at least at the margin, the relative attractiveness of U.S. assets.

Moreover, most investors expect that rates will narrow further going forward. Fed Chairman Bernanke and other FOMC members have suggested that the Fed's tightening cycle likely will come to an end soon. At the same time, most market participants look for further ECB rate hikes over the course of the year. In addition, the Bank of Japan, which has kept its policy rate at zero percent for nearly five years, will likely begin to tighten policy later this year. Although U.S. interest rates may remain above comparable rates in most other major countries for some time, some foreign investors are starting to question whether those differentials, which likely will narrow further, adequately compensate for the foreign exchange risk that exposure to dollar assets entails. This foreign exchange risk cannot be taken lightly due to the persistent gaping current account deficit of the United States.

Another factor that has weighed on the dollar has been the recent G-7 communiqué that called for "greater exchange rate flexibility ... for necessary adjustments to occur." This is a signal that central bank governors and finance ministers of the world's most developed economies would not object to further dollar depreciation. Therefore, central bank intervention to stem the dollar's decline is not imminent, giving currency traders free rein to sell the dollar, at least for now.

Indeed, we project that the dollar will trend even lower versus most major currencies going forward (see forecast on next page). The dollar has declined a fair amount in a relatively short period of time, so some retrenchment likely will occur along the way. That said, we believe that the fundamentals continue to point in the direction of further dollar depreciation. Namely, narrowing interest rate differentials will make it increasingly difficult for the U.S. to attract the net capital inflows that are needed to finance the gaping current account deficit. Furthermore, as the U.S. seeks to finance its deficits, this poses upside risk to rates.



May 12, 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	3.0	3.4	3.2	2.6	5.10	5.25	5.30	5.35	5.35	5.35	5.35	5.15	5.50	5.50	5.55	5.60	5.60	5.65
Japan	2.7	3.2	2.4	-0.3	0.6	0.8	0.20	0.40	0.70	0.90	1.20	1.40	1.60	2.10	2.20	2.40	2.50	2.70	2.80	2.90
Euroland	1.4	2.2	2.2	2.2	2.2	1.9	2.90	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	2.2	2.0	2.0	1.7	4.60	4.60	4.60	4.60	4.60	4.60	4.60	4.70	4.75	4.80	4.90	4.90	4.85	4.80
Canada	2.9	3.4	3.1	2.2	2.3	2.2	4.25	4.40	4.60	4.60	4.60	4.60	4.60	4.75	4.85	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/\$)	7.40	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 (¥/\$)	112	108	104	100	96	94	92	90
Australia (US\$/A\$)	0.76	0.77	0.78	0.79	0.80	0.81	0.82	0.82
Singapore (S\$/US\$)	1.58	1.55	1.52	1.50	1.48	1.45	1.42	1.40
Korea (KRW/\$)	940	920	900	880	860	840	820	800
China (CNY/\$)	7.95	7.90	7.80	7.70	7.60	7.45	7.35	7.30
Canada (C\$/US\$)	1.12	1.10	1.09	1.08	1.07	1.06	1.05	1.04
Mexico (MXN/\$)	11.00	10.90	10.80	10.70	10.60	10.50	10.45	10.40
Brazil (BRL/\$)	2.00	2.05	2.10	2.15	2.20	2.25	2.30	2.30

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