



## Monthly Economic Outlook

October 14, 2005

### U.S. Overview

Four factors have altered the economic outlook: Katrina, energy costs, inflation and the conduct of monetary policy. These factors suggest modestly slower growth next year driven primarily by slower growth in consumer spending, residential investment and less inventory building. Growth in real disposable income should slow. This would affect both consumer spending and residential investment. The major motor vehicle makers do not appear to be building inventories back up. In addition, inventories of gasoline, petroleum and natural gas are likely to be drawn down in coming months, as production and refinery output slowly recovers.

Consumer spending will likely suffer from higher gasoline and natural gas prices, renewed layoffs in the factory sector, the Delphi bankruptcy and worries about pension funds. All these factors could eat away at consumer confidence. Slower growth of real income and higher interest rates will moderate consumer spending. As for construction, very little hurricane rebuilding will take place in the fourth quarter, mostly repairs and clean up. Building activity will not pick up in a meaningful way until mid-2006. Business investment spending will likely end the year on a strong note but should slow as corporate profits come under pressure from rising energy prices and the continued inability (or limited ability) of firms to raise prices.

Inflation is very likely to rise over the next six to nine months, both on an overall and core basis. With growth slowing, however, inflation should subside somewhat during the latter part of 2006. The Fed appears poised to raise interest rates at each of the next four meetings, including the first meeting after Greenspan retires, taking the federal funds rate up to 4.75%. After that, we believe that the Fed will pause until spring 2006, when rates are nudged a bit higher.

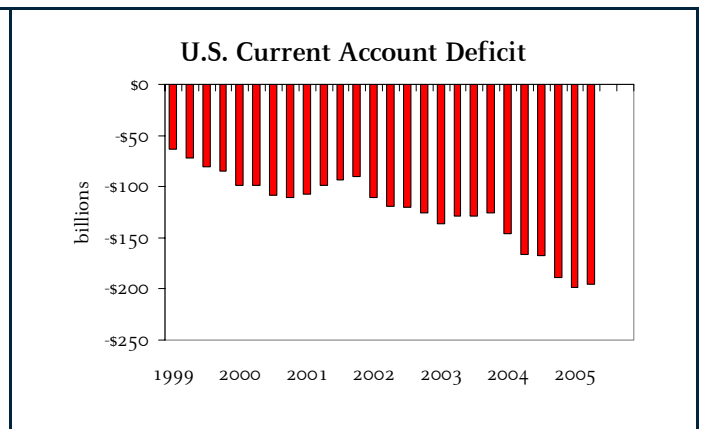
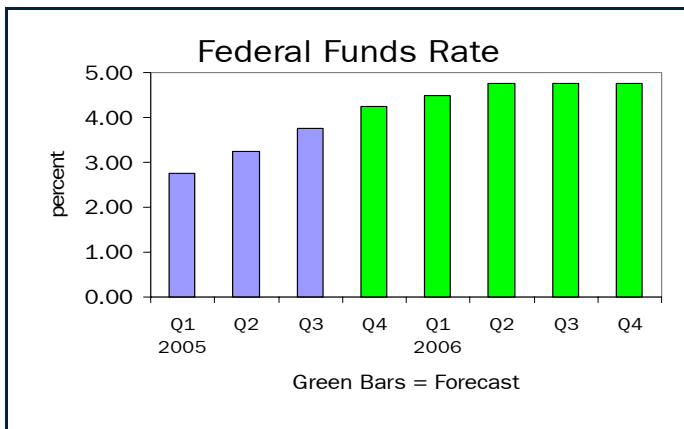
### International Overview

Despite widespread expectations of dollar depreciation a year ago that were largely based on the widening current account deficit, the trade-weighted value of the dollar has moved largely sideways on balance over the past twelve months. What happened?

As expected the current account deficit widened further. Indeed, the red ink in the nation's current account rose 25% between the first half of 2004 and the same period this year. However, the surprise has been the resiliency of the U.S. economy, which has led the Fed to tighten policy more than most investors expected a year ago. The rise in U.S. interest rates has underpinned capital inflows, which have helped to support the dollar. At the same time, capital outflows from the U.S. have flattened over the past year. Perhaps the rise in U.S. rates has reduced the willingness of U.S. investors to search for yield by investing in foreign assets.

Looking ahead, we are sticking with our forecast of dollar depreciation on a trend basis, because it seems likely that the current account deficit will widen further over the next few quarters. Exports must grow twice as fast as imports simply to stabilize the deficit. Although export growth has remained rather resilient, it does not seem likely that they will grow twice as fast as imports anytime soon. In addition, we expect that capital inflows will flatten as Fed tightening eventually comes to an end. On the other hand, we look for capital outflows to pick up again because we expect many foreign central banks to hike rates more than most investors currently expect.

We could be wrong if U.S. growth next year turns out to be stronger than expected, which probably would lead to even more Fed rate hikes. However, until events prove us wrong, we would be inclined to stick to our forecast of modest dollar depreciation through next year.



**Katrina Moderates Economic Momentum**

Last month we raised the issue that Hurricane Katrina and the extensive flooding that followed raised many questions about the outlook for U.S. economic growth, inflation, corporate profits and interest rates. Since then, we have seen significant evidence in the economic data to suggest more moderate growth with slightly higher inflation and higher interest rates. Moreover, over time, the risk profile in the economy has increased.

**Impact in the Short Run: Slower Consumer Spending**

Slower consumer spending growth is the major impact as growth in real disposable income slows and interest rates rise at the long end of the curve. Consumer spending was already decelerating prior to hurricane Katrina, reflecting the winding down of the employee-pricing incentives on motor vehicle purchases and higher energy prices. Renewed layoffs in the factory sector, the Delphi bankruptcy and worries about pension funds could all eat away at consumer confidence.

Inventory building also should take a small hit, as major motor vehicle makers do not appear to be building inventories. Additionally, inventories of gasoline, petroleum and natural gas are likely to be drawn down in coming months, as production and refinery output slowly recover. Very little hurricane rebuilding will take place in the fourth quarter, mostly repairs and clean up. Building activity may not pick up in a meaningful way until spring or summer and then only gradually ramp up.

**Intermediate Term: Inflation and Fed Response**

Looking out beyond the end of the year, business investment spending will likely slow as corporate profits come under pressure from rising energy prices and the

continued inability (or limited ability) of firms to raise prices.

We believe inflation will rise over the next six to nine months, both on an overall, and a core basis. With growth slowing, however, inflation should subside somewhat during the latter part of 2006.

The Fed appears poised to raise interest rates at each of the next four meetings, including the first meeting after Greenspan retires, taking the federal funds rate up to 4.75%. After that we expect the Fed to pause.

**Longer Term Issues: Higher Risk Profile**

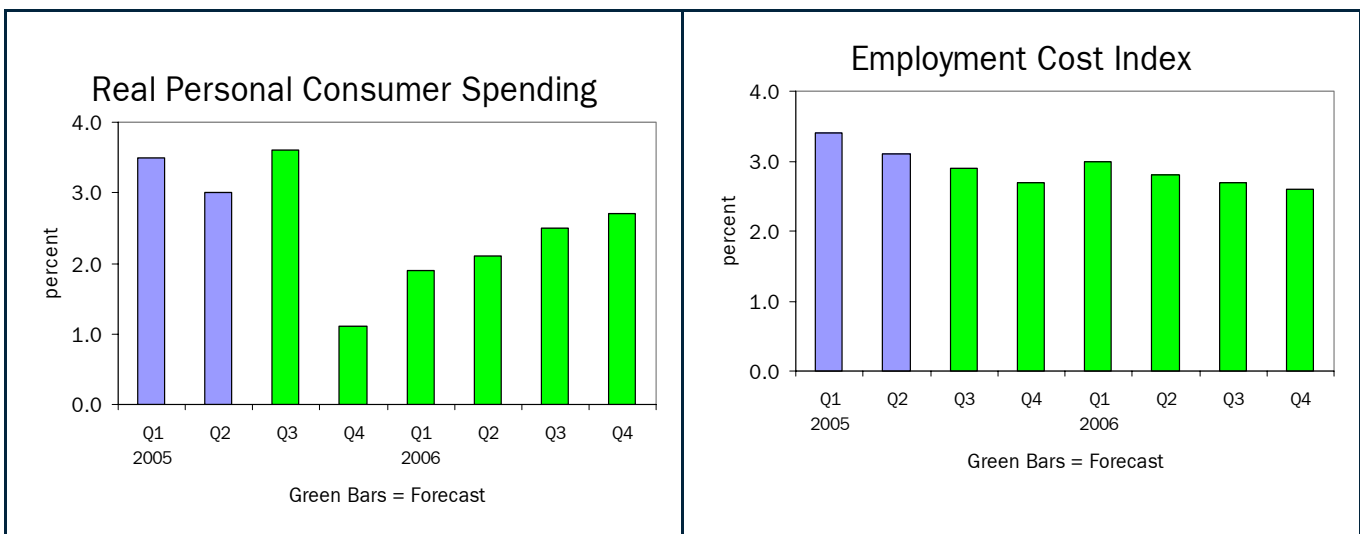
Three issues have emerged to influence the longer-term outlook. First, inflation expectations appear to be more embedded in the economy than earlier expected. This suggests greater wage/compensation gains and, therefore, a slight bump up in the employment cost index.

Second, higher labor costs and slower top line economic growth will put additional pressures on the outlook for corporate profits with a heightened risk of earnings disappointments. This would lead to wider credit spreads in fixed income markets.

Finally, the pace of Federal government spending is now expected to rise more rapidly than previously thought. This will influence the path and risk in the dollar and long-term interest rates, while also raising concerns on monetary policy. Already, Federal Reserve officials have voiced concern about potential political pressures on the Fed to monetize future federal government deficits.

**How Are We Different from the Consensus?**

We are below the Blue Chip consensus in real growth, consumer spending and slightly lower on business investment. We are above consensus for inflation and both the three month T-bill and the ten year Treasury rate.



*(Percentage Changes)*

QUARTER:	Actual 2005		Forecast 2005		2006				2007		Annual (d)		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	2004	2005	2006
<b>REAL GROSS DOMESTIC PRODUCT(e)</b>	3.8	3.3	3.2	2.5	2.5	2.5	2.8	3.0	3.4	3.4	4.2	3.5	2.7
PERSONAL CONSUMPTION	3.5	3.0	3.6	1.1	1.9	2.1	2.5	2.7	3.0	3.0	3.9	3.4	2.2
BUSINESS INVESTMENT	5.7	8.4	10.0	8.1	7.2	6.2	6.1	6.2	6.4	6.4	9.4	9.0	7.4
EQUIPMENT & SOFTWARE	8.3	10.4	8.8	8.2	7.3	6.2	6.2	6.2	6.4	6.4	11.9	10.8	7.4
STRUCTURES	-2.0	2.7	3.4	7.5	7.0	6.0	5.5	6.0	6.5	6.5	2.2	2.5	5.9
RESIDENTIAL CONSTRUCTION	9.5	9.8	-0.5	0.5	-0.5	-0.5	-0.5	-0.5	0.0	0.0	10.3	5.8	0.3
GOVERNMENT PURCHASES	1.9	2.7	1.9	2.7	2.7	2.6	2.6	2.5	2.4	2.4	2.2	1.9	2.6
NET EXPORTS (\$ BILLIONS)	-645	-611	-625	-634	-642	-650	-656	-661	-666	-670	-601	-629	-652
% Pt. Contribution to GDP	-0.4	1.2	-0.5	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	-0.1	-0.8	-0.9	0.0
INVENTORY CHANGE (\$ BILLIONS)	58	3	1	18	23	27	31	35	43	51	52	20	29
% Pt. Contribution to GDP	0.3	-2.0	-0.1	0.6	0.2	0.1	0.1	0.1	0.3	0.3	0.4	0.0	0.0
NOMINAL GDP	7.0	5.8	6.6	5.9	6.1	6.2	6.3	6.2	6.5	6.5	7.0	6.3	6.2
REAL FINAL SALES	2.3	1.6	2.8	3.5	3.5	3.2	3.1	2.9	2.8	2.8	3.9	3.8	2.7
"CORE" GDP (a)	4.1	4.1	4.2	2.0	2.5	2.5	2.8	3.0	3.3	3.3	4.9	4.3	2.8
CONSUMER PRICE INDEX (b)	3.0	2.9	3.8	3.7	3.7	4.0	3.7	3.5	3.3	3.2	2.7	3.4	3.7
"CORE" CONSUMER PRICE INDEX (b)	2.3	2.0	2.1	2.1	2.3	2.6	2.5	2.4	2.3	2.3	1.8	2.2	2.5
WEST TEXAS INTERMED. OIL (\$/BBL) (f)	50.0	53.1	63.5	62.5	61.5	59.5	61.0	60.5	60.0	58.0	41.5	57.3	60.6
EMPLOYMENT COST INDEX (b)	3.4	3.1	2.9	2.7	3.0	2.8	2.7	2.6	2.8	2.7	3.9	3.0	2.8
REAL DISPOSABLE INCOME	-3.4	1.5	-0.1	0.8	1.2	2.8	2.4	2.7	3.0	3.2	3.4	1.5	1.5
UNEMPLOYMENT RATE (%)	5.3	5.1	5.0	5.1	5.1	5.0	5.0	4.9	4.8	4.7	5.5	5.1	5.0
HOUSING STARTS (MILLIONS)	2.08	2.04	2.02	1.98	1.96	1.95	1.94	1.94	1.92	1.91	1.95	2.03	1.95
TOTAL VEHICLE SALES (MILLIONS)	16.5	17.2	18.0	17.2	17.3	17.3	17.3	17.3	17.3	17.4	16.8	17.2	17.3
INDUSTRIAL PRODUCTION (b)	3.8	3.0	2.7	2.8	2.6	2.7	2.8	2.8	2.8	2.9	4.1	3.2	2.9
CORPORATE PROFITS NIPA B/T (b)	12.3	17.7	12.3	10.0	7.8	7.0	7.0	7.4	7.6	7.8	12.6	13.0	7.3
<u>Quarter End - INTEREST RATES (%) (c)</u>													
FEDERAL FUNDS (Target)	2.75	3.25	3.75	4.25	4.50	4.75	4.75	4.75	5.00	5.25	1.56	3.50	4.69
3 MONTH LIBOR	3.12	3.46	3.90	4.40	4.65	4.90	4.90	4.90	5.15	5.40	1.75	3.72	4.84
PRIME RATE	5.75	6.25	6.75	7.25	7.25	7.50	7.75	7.75	8.00	8.25	4.50	6.50	7.56
3 MONTH T-BILL (BEY)	2.74	3.13	3.70	4.40	4.50	4.75	4.75	4.80	5.10	5.35	1.53	3.49	4.70
2 YEAR T-NOTE	3.73	3.66	4.10	4.50	4.60	4.70	4.75	4.85	5.20	5.50	2.50	4.00	4.73
5 YEAR T-NOTE	4.17	3.72	4.20	4.55	4.65	4.75	4.80	4.95	5.30	5.60	3.40	4.16	4.79
10 YEAR T-NOTE	4.50	3.94	4.35	4.60	4.75	4.85	4.90	5.10	5.40	5.65	4.21	4.35	4.90
30 YEAR T-BOND	4.85	4.25	4.50	4.75	4.90	5.00	5.10	5.30	5.60	5.80	4.94	4.59	5.08

(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

10/14/05

For the past year or so, we have been forecasting that the dollar would trend lower. This forecast was based on our expectation that net capital inflows would not keep pace with the gaping current account deficit. Fast forward a year, and the trade-weighted value of the dollar is essentially unchanged on balance. What went wrong with our forecast?

On the one hand, our expectation of more red ink in the nation's trade account proved correct. As shown on the front page, the U.S. incurred a current account deficit equal to nearly \$400 billion in the first half of this year, which is 25% greater than the deficit racked up during the same period in 2004.

However, as shown below, capital inflows have held up rather well, which has supported the dollar. The resiliency in capital inflows reflects the rise in U.S. interest rates over the past year. For example, the yield on the 2-year Treasury security has risen from about 2.50% last October to roughly 4.25% currently. In other words, solid growth in the U.S. over the past year has led the Fed to tighten more than most investors expected last autumn. The upside surprise in U.S. economic growth and Fed policy has contributed to the resiliency of the greenback. At the same time, capital outflows from the U.S., which accelerated in 2003 and 2004 when U.S. interest rates were so low, have flattened over the past few quarters (see chart on right below). Perhaps the rise in U.S. rates has left some U.S. investors less willing to search for yield by investing in foreign assets.

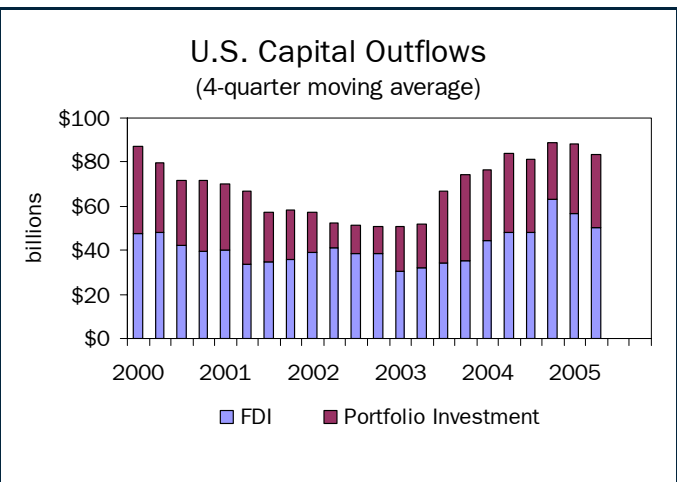
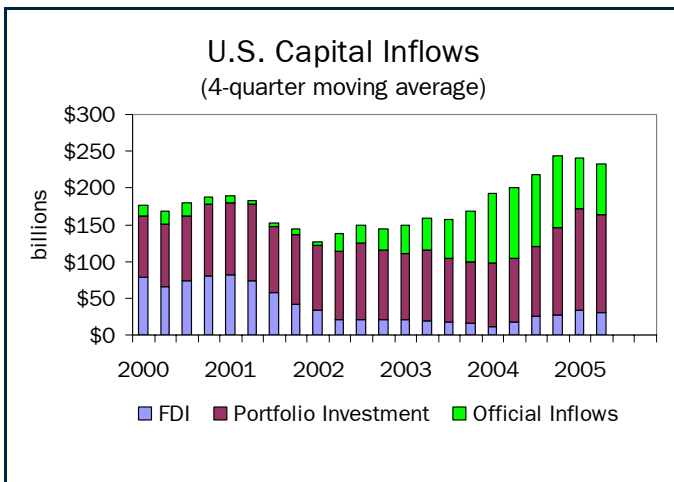
Despite the sideways movement in the value of the dollar over the past year, we continue to project that the greenback will depreciate modestly versus most major currencies over the next year or so (see our forecast on page 5). For starters, the U.S. current account deficit likely will widen further over the next few quarters. Exports must grow twice as fast as imports simply to stabilize the deficit, because the latter is twice as large as the former.

Currently, exports and imports are growing at roughly the same rate. Although export growth has remained rather resilient as economic growth in foreign countries has remained solid, it does not seem likely that exports will grow twice as fast as imports in the near term.

In terms of net capital inflows, we expect that foreign purchases of U.S. assets will flatten. Indeed, the chart below shows that this is already occurring. Foreign direct investment weakened in the second quarter, perhaps due to slowing profit growth abroad, and portfolio investment also downshifted a notch in the second quarter. Looking forward, our expectation of future Fed tightening is largely in line with market expectations. Significant acceleration in capital inflows does not seem likely if the amount of tightening that the Fed ultimately undertakes is in line with current market expectations.

On the other side of the ledger, we expect that U.S. purchases of foreign assets will accelerate. As we explained in our recent Quarterly Foreign Exchange Focus (posted at [www.wachovia.com/economics](http://www.wachovia.com/economics)), we expect that monetary tightening going forward in the Eurozone, Japan, and Canada will exceed the amounts currently priced into financial markets. If we are correct, then those currencies should benefit from the upward surprise to interest rates.

Where could we go wrong? Clearly, the resiliency of the U.S. economy over the past year has surprised many investors, and stronger-than-expected U.S. economic growth could lie ahead. If so, then the Fed likely would tighten more than investors currently expect, which could lead to dollar appreciation. In addition, foreign growth could turn out to be weaker than we expect, which probably would weigh on foreign currencies. However, until events prove us wrong, we would be inclined to stick to our forecast of modest dollar depreciation over the next year or so.



**October 14, 2005**

Country	GDP Growth			CPI Inflation			3-Month LIBOR (end of quarter)							10-Year Bond (end of quarter)						
	2004	2005	2006	2004	2005	2006	05-Q4	06-Q1	06-Q2	06-Q3	06-Q4	07-Q1	07-Q2	05-Q4	06-Q1	06-Q2	06-Q3	06-Q4	07-Q1	07-Q2
U.S.	4.2	3.5	2.7	2.7	3.4	3.7	4.40	4.65	4.90	4.90	4.90	5.15	5.40	4.60	4.75	4.85	4.90	5.10	5.40	5.65
Japan	2.6	2.3	2.2	0.0	-0.3	0.4	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	1.8	1.3	2.1	2.1	2.2	1.8	2.15	2.25	2.40	2.70	2.90	3.10	3.40	3.30	3.50	3.60	3.80	3.90	4.00	4.10
U.K.	3.2	1.7	2.2	1.3	2.2	1.9	4.50	4.15	4.15	4.15	4.15	4.15	4.15	4.30	4.35	4.50	4.60	4.70	4.80	4.80
Canada	2.9	2.8	2.7	1.8	2.3	2.5	3.20	3.50	3.70	4.00	4.20	4.40	4.40	4.10	4.30	4.50	4.60	4.80	4.90	5.00

Currency	2005-Q4	2006-Q1	2006-Q2	2006-Q3	2006-Q4	2007-Q1	2007-Q2	2007-Q3
Euro (\$/€)	1.24	1.27	1.30	1.31	1.32	1.33	1.34	1.35
U.K. (\$/£)	1.80	1.82	1.84	1.86	1.87	1.88	1.89	1.89
U.K. (£/€)	0.69	0.70	0.71	0.70	0.71	0.71	0.71	0.71
Switzerland (CHF/\$)	1.28	1.25	1.23	1.22	1.21	1.20	1.19	1.18
Sweden (SEK/\$)	7.60	7.30	7.10	7.00	6.90	6.80	6.70	6.65
Norway (NOK/\$)	6.50	6.30	6.00	5.80	5.60	5.50	5.40	5.30
Poland (PLN/\$)	3.20	3.10	3.00	2.90	2.85	2.80	2.75	2.70
Japan (¥/\$)	108	104	100	98	96	94	92	90
Australia (US\$/A\$)	0.75	0.74	0.72	0.71	0.70	0.69	0.68	0.68
Singapore (S\$/US\$)	1.68	1.64	1.60	1.58	1.56	1.54	1.52	1.50
Korea (KRW/\$)	1040	1020	1000	980	960	940	920	900
China (CNY/\$)	8.07	8.02	7.95	7.80	7.60	7.50	7.40	7.20
Canada (C\$/US\$)	1.18	1.17	1.16	1.15	1.14	1.13	1.12	1.11
Mexico (MXN/\$)	10.70	10.50	10.70	10.50	10.40	10.20	10.10	10.00
Brazil (BRL/\$)	2.25	2.30	2.40	2.60	2.70	2.80	2.90	3.00

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