



## Monthly Economic Outlook

November 15, 2005

### U.S. Overview

Economic growth is holding up much better than expected given the recent weather-related shocks. While the impacted regions continue to struggle, some degree of normalcy has returned to the rest of the economy. Consumers have also caught a break from the weather, which has been unseasonably mild throughout much of the country. Energy prices have fallen more quickly and much further than nearly anyone predicted. As a result, we have slightly boosted our estimate for consumer spending during the next two quarters.

Another major hurricane, Wilma, has been thrown into the mix. While the storm was nowhere near as devastating as Katrina, the storm did cause an extensive amount of damage to South Florida. More than 150,000 homes throughout the Sunshine State now require some roof repairs, and many of these homes have been waiting for materials and roofers for over a year. Rebuilding efforts from all these storms should help support the building sector as new home construction finally begins to wind down. Yes, the housing market is finally cooling off! We expect housing starts to fall about 5.0 percent in 2006.

Momentum in the economy is clearly shifting from the consumer toward business. Business investment spending is expected to grow at a low double-digit pace in 2006, reflecting increased investment in IT equipment, industrial products and energy and utility infrastructure. Inventory rebuilding should also add modestly to growth, as motor vehicle producers cautiously rebuild depleted inventories and build up some precautionary stockpiles.

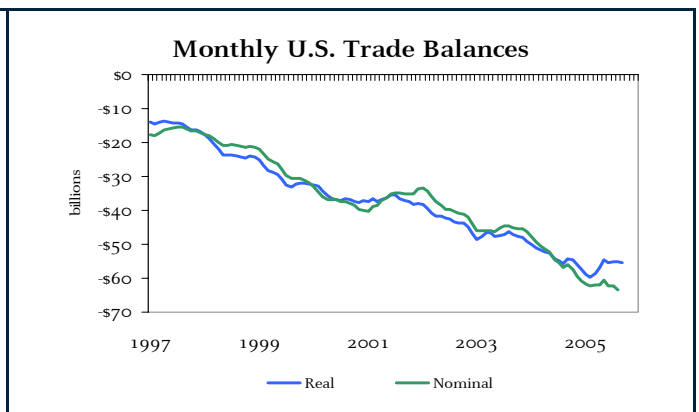
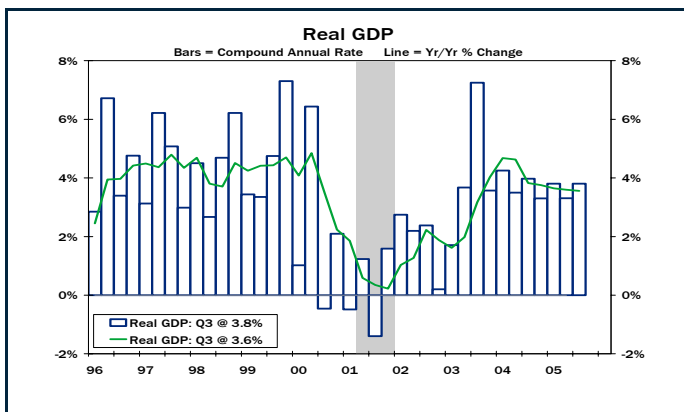
### International Overview

Recent indicators suggest that economic growth in the rest of the world remains very solid. Indeed, in some economies growth appears to have strengthened recently. As a result, growth in U.S. exports has remained solid, which comes as welcome news at a time when the outlook for U.S. consumer spending has deteriorated somewhat due to the significant rise in energy prices in recent months.

Export volumes are currently growing faster than import volumes, which has caused some narrowing in the real trade deficit. However, the nominal trade deficit continues to widen and, if the experience of the mid-1980s is any guide, it likely will increase further for some time yet. In that episode, in which the dollar depreciated significantly between early 1985 and early 1988, the real trade deficit started to turn around in late 1986. However, the nominal trade deficit did not begin to narrow until the first quarter of 1988 due to the J-curve effect. Only then did the dollar stabilize and begin to rally.

Thus, even if the real trade balance is now starting to narrow on a sustained basis (and it may still be premature to declare that unequivocally), the nominal trade deficit, which matters in determining the dollar's value, likely will widen further into next year. The rise in the current account deficit should put downward pressure on the dollar unless net capital inflows accelerate.

In that regard, the recent strength in foreign economic activity is important. Stronger growth means that very low interest rates are increasingly becoming inappropriate in many foreign economies. As central banks in foreign economies begin to tighten monetary policy, U.S. assets will lose some of their luster to foreign investors. When that happens, the greenback should depreciate.



**Switching Gears Can Be Tricky, But Shouldn't Be**

The U.S. economy is going through a few notable transitions that could lead to a set back or two, although that is not our outlook. Growth is increasingly being driven by business investment, especially structures, and government spending, as consumer spending and homebuilding, which have done much of the heavy lifting for the past four years, are showing some signs of slowing. Such a transition is not unusual for this stage of the business cycle, but the transition can sometimes result in an unexpectedly weak quarter or two. Just as a car will stall out if you take your foot off the clutch too quickly, the economy could stall or sputter if consumer spending and homebuilding pull back more quickly than business investment ramps up.

Another major transition the economy faces is the impending change at the Fed. Ben Bernanke is slated to replace Alan Greenspan on February 1. While the choice of Bernanke was widely expected, the global financial markets will still have to become accustomed to a new Fed chief and gain confidence that he will continue to contain inflation. The real test will come from the inevitable next financial crisis. But simply changing gears, or changing drivers, should not trigger a crisis by itself.

**Pop Up The Hood**

This month marks the fourth anniversary of the current economic expansion. When you pop up the hood, the economy shows some signs of wear and tear. Consumer spending and homebuilding have been running hard. Both now show some signs of slowing.

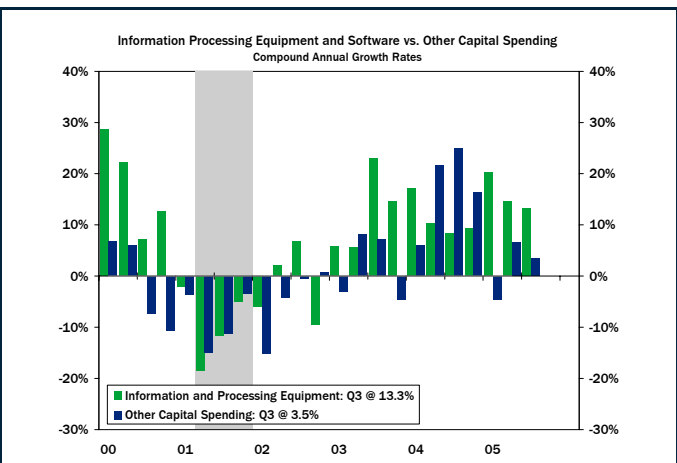
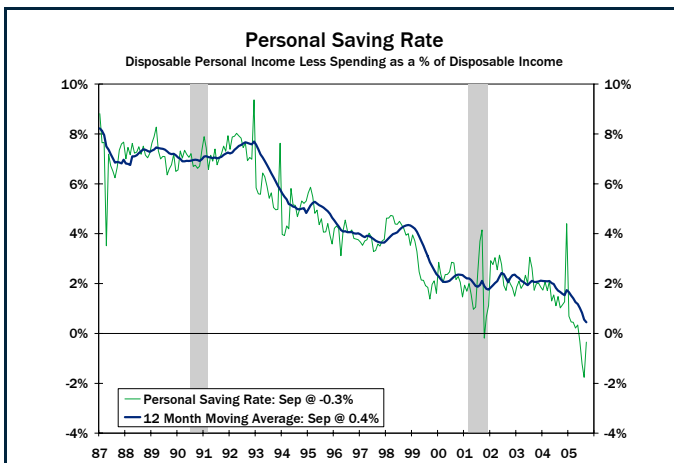
The saving rate has fallen to a minus 1.1%, which means consumers are spending more than they are taking home in their paychecks. The drop is tied to the recent round of pricing incentives for car and light truck sales. In addition, consumers have been tapping the rising equity values in their homes. Both of these influences will play less of a role in the coming year. Even though the major motor vehicle manufacturers will bring back certain types

of sales incentives, the most recent round likely pulled sales forward from 2006 and may cut into motor vehicle sales. Rising short-term interest rates will also curb spending by making it less attractive to add to home equity loan balances.

While consumer spending will slow, it will not grind to a halt. Energy prices have come down more quickly than just about anyone had projected, which should provide some much needed relief for the holiday shopping season. After slowing to a 1.1% pace in the current quarter, we expect consumer spending to accelerate to around a 2.5% pace for all of 2006. That should be enough to keep the economy moving and also allow the saving rate to begin to recover.

The housing market also appears poised for a slowdown. Sales of both new and existing homes are reported to have slowed abruptly following Hurricane Katrina, with some of the greatest impact in the higher priced segment. While sales have improved in recent weeks, they have not regained their red hot summer pace. We expect housing starts to decline 5.4% in 2006, with the entire drop occurring in single-family starts. Residential investment will not fall as much, however, as rebuilding efforts from the hurricanes continue to fuel outlays.

Business investment is expected to rev up in 2006, with spending for repairs to energy infrastructure leading the way. More than 100 production and exploration rigs were destroyed and another 88 sustained significant damage from hurricanes Katrina and Rita. Energy companies are expected to move quickly to bring these facilities back on line, which will require billions of dollars of new investment. Businesses are also expected to boost spending for IT equipment and industrial products. Inventory rebuilding will provide some added insurance. So even if the economy or the new Fed chairman has trouble with the clutch, the expansion should continue to move forward.



**(Percentage Changes)**

QUARTER:	Actual 2005		Forecast 2005				2006				2007				Annual (d)		
	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2004	2005	2006			
<b>REAL GROSS DOMESTIC PRODUCT(e)</b>	3.3	3.8	3.3	2.8	2.9	3.0	3.3	3.4	3.4	3.4	3.3	4.2	3.6	3.1			
PERSONAL CONSUMPTION	3.4	3.9	1.1	1.9	2.6	2.7	2.9	2.8	2.8	3.0	3.0	3.9	3.5	2.4			
BUSINESS INVESTMENT	8.8	9.1	8.7	9.9	9.0	8.1	8.2	8.7	8.7	7.8	7.8	9.4	9.0	9.0			
EQUIPMENT & SOFTWARE	11.0	8.9	8.8	10.1	9.1	8.4	8.7	9.2	9.2	8.1	8.1	11.9	10.9	9.3			
STRUCTURES	2.7	-1.4	8.0	9.0	8.5	7.0	6.5	6.5	6.5	6.5	6.5	2.2	1.9	6.6			
RESIDENTIAL CONSTRUCTION	10.8	4.8	3.0	-2.0	-2.6	-1.8	-1.6	-1.2	-0.5	-0.3	0.0	10.3	6.8	0.4			
GOVERNMENT PURCHASES	2.5	3.2	2.1	2.5	2.4	2.5	2.5	2.4	2.3	17.7	0.0	2.2	2.0	2.5			
NET EXPORTS (\$ BILLIONS)	-614	-612	-624	-634	-643	-651	-657	-663	-667	-672	-676	-601	-624	-646			
% Pt. Contribution to GDP	1.1	0.1	-0.5	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	0.0	0.0	-0.8	-0.9	0.0			
INVENTORY CHANGE (\$ BILLIONS)	-2	-17	18	28	30	32	36	41	48	50	50	52	14	32			
% Pt. Contribution to GDP	-2.2	-0.5	1.2	0.4	0.1	0.1	0.1	0.2	0.2	0.0	0.0	0.4	-0.1	0.0			
NOMINAL GDP	6.0	7.0	6.9	6.4	6.6	6.5	6.5	6.5	6.5	6.4	6.4	7.0	6.5	6.6			
REAL FINAL SALES	2.4	7.7	3.8	3.2	3.1	3.0	2.9	2.8	2.7	2.6	2.5	3.9	4.0	3.0			
"CORE" GDP (a)	4.5	4.3	2.6	2.7	3.1	3.1	3.4	3.4	3.4	5.8	5.8	4.9	4.4	3.2			
CONSUMER PRICE INDEX (b)	2.9	3.1	3.7	3.5	3.4	3.2	3.2	3.1	3.0	3.1	3.1	2.7	3.4	3.3			
"CORE" CONSUMER PRICE INDEX (b)	2.0	5.1	2.4	2.6	2.6	2.5	2.4	2.5	2.4	2.4	2.5	1.8	2.2	2.5			
WEST TEXAS INTERMED. OIL (\$/BBL) (f)	53.1	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			
EMPLOYMENT COST INDEX (b)	3.1	3.4	2.7	2.8	2.7	2.7	2.6	2.6	2.7	2.7	2.8	3.9	3.1	2.7			
REAL DISPOSABLE INCOME	1.5	-0.9	3.5	2.8	2.7	2.8	3.0	3.2	3.3	3.2	3.2	3.4	1.6	2.4			
UNEMPLOYMENT RATE (%)	5.1	5.0	5.0	5.0	5.0	5.0	4.9	4.8	4.7	4.6	4.5	5.5	5.1	5.0			
HOUSING STARTS (MILLIONS)	2.04	2.02	1.98	1.95	1.93	1.91	1.89	1.88	1.88	1.87	1.86	1.95	2.03	1.92			
TOTAL VEHICLE SALES (MILLIONS)	17.2	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			
INDUSTRIAL PRODUCTION (b)	3.0	7.6	2.8	2.6	2.7	2.8	2.8	2.8	2.9	2.9	2.9	4.1	3.1	3.0			
CORPORATE PROFITS NIPAB/T (b)	17.7	15.7	10.0	7.8	7.0	7.0	7.4	7.6	7.8	8.0	8.2	12.6	13.5	8.1			
Quarter End - INTEREST RATES (%) (c)																	
FEDERAL FUNDS (Target)	3.25	3.75	4.25	4.75	4.75	4.75	5.00	5.00	5.25	5.25	5.25	1.56	3.50	4.81			
3 MONTH LIBOR	3.46	4.00	4.40	4.90	4.90	4.90	5.15	5.15	5.40	5.40	5.40	1.75	3.75	4.96			
PRIME RATE	6.25	6.75	7.25	7.75	7.75	7.75	8.00	8.00	8.25	8.25	8.25	4.50	6.50	7.81			
3 MONTH T-BILL (BEY)	3.13	3.51	4.40	4.75	5.00	5.00	5.05	5.15	5.20	5.25	5.25	1.53	3.45	4.95			
2 YEAR T-NOTE	3.66	4.11	4.50	4.85	4.95	5.00	5.10	5.25	5.35	5.45	5.45	2.50	4.00	4.98			
5 YEAR T-NOTE	3.72	4.13	4.55	4.90	5.00	5.05	5.20	5.35	5.45	5.50	5.55	3.40	4.14	5.04			
10 YEAR T-NOTE	3.94	4.30	4.60	5.00	5.10	5.15	5.35	5.50	5.65	5.75	5.85	4.21	4.34	5.15			
30 YEAR T-BOND	4.25	4.56	4.75	5.10	5.20	5.30	5.50	5.60	5.80	5.95	6.10	4.94	4.60	5.28			

(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

11/15/2005

Economic growth in the second and third largest economies in the world, namely, the Eurozone and Japan, slowed late last year and earlier this year. However, there have been more hopeful signs recently. The year-over-year GDP growth rate in Japan, which bottomed at 1.0% in the first quarter of 2005, strengthened to 2.9% in the third quarter. In the Eurozone, the manufacturing and service sector PMI's have risen recently to the highest level in over a year, suggesting that growth is picking up there as well. In China, real GDP grew 9.4% (year-over-year) in 2005-Q3, little changed from the 9.5% rate registered in the previous quarter.

The bottom line is that foreign economic growth is holding up reasonably well, which has contributed to buoyant growth in U.S. exports. Indeed, the volume of goods exports rose 8% in the third quarter relative to the same period in 2004. Coming at a time when elevated energy prices are casting a pall over the outlook for U.S. consumer spending, this solid growth in exports certainly is welcome. Indeed, buoyant export growth, in conjunction with solid growth in business fixed investment spending and government spending, which reflects rebuilding along the hurricane-devastated Gulf Coast, should help to support U.S. GDP growth next year.

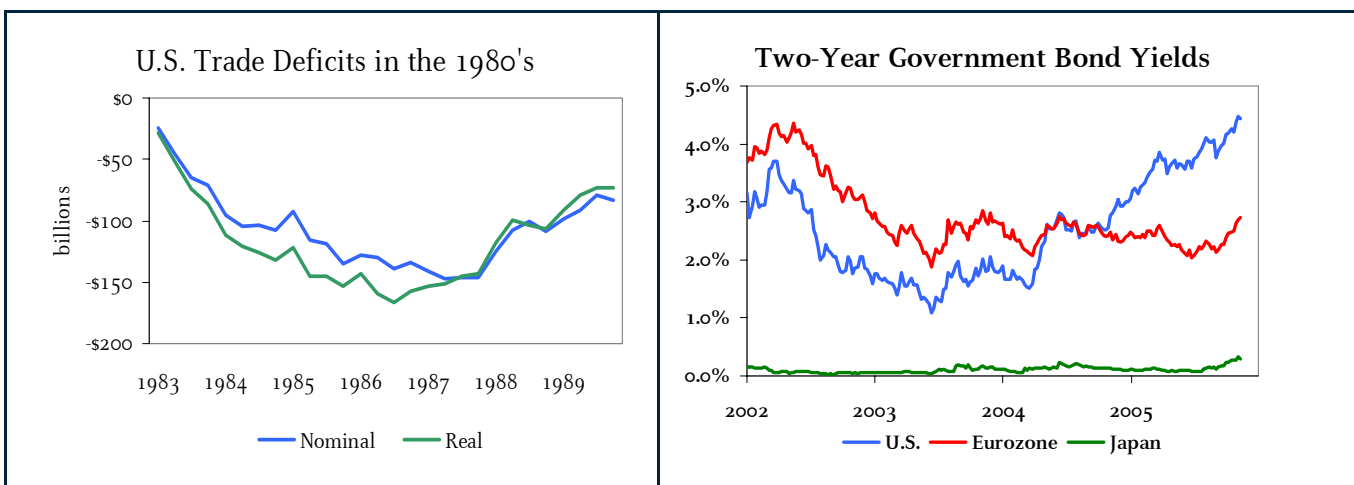
Moreover, the growth in import volumes has been remarkably well contained recently. In the same three-month period noted above, import volumes were up only 5% (year-over-year). Because export volumes are currently growing faster than import volumes, the "real" trade deficit has started to narrow somewhat. However, this recent decline in the real trade deficit does not necessarily mean that stabilization in the nominal trade deficit is imminent. Indeed, as the chart on the front page shows, the nominal trade deficit continues to widen.

The experience of the mid-1980's is instructive. In that episode, the dollar depreciated significantly between early 1985 and early 1988. The real trade deficit did not start

turning around until late 1986, nearly two years after the dollar had peaked. However, the nominal trade deficit continued to widen until the first quarter of 1988. This phenomenon is known as the "J-curve" effect. Because trade volumes react relatively slowly to currency depreciation, a weaker dollar inflates the dollar-value of imports, thereby causing the nominal trade deficit to widen further.

Fast forward to 2005. If the real trade deficit is just now starting to show signs of stabilizing, then a turnaround in the nominal trade deficit is probably not imminent. Importantly, it is the nominal trade deficit that matters in determining the value of the dollar, and the 1980's experience is again instructive. Even though the real trade deficit started to turn around in late 1986, the dollar continued to trend lower until the nominal trade deficit started to narrow in early 1988. A widening current account deficit today should put downward pressure on the dollar, unless net capital inflows accelerate.

That brings us back to the topic of solid growth in the rest of the world. As the chart below shows, rates in the U.S. have come up more significantly than rates in other major countries due to Fed tightening since June 2004. This rise in rates have made U.S. assets more attractive relative to comparable assets abroad, which has led to acceleration in U.S. net capital inflows over the past few quarters. However, stronger rates of growth in many foreign economies are making the extremely low level of interest rates in those countries increasingly inappropriate. Therefore, we look for significant monetary tightening in many foreign economies over the course of 2006. On the other hand, we project that the Fed's tightening cycle will come to an end early next year. As interest rate differentials between the U.S. and major foreign economies start to narrow, U.S. assets should begin to lose some of their luster for foreign investors. When that happens, the dollar should depreciate.



November 15, 2005

Country	GDP Growth			CPI Inflation			3-Month LIBOR (end of quarter)							10-Year Bond (end of quarter)						
	2005	2006	2007	2005	2006	2007	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	3.6	3.1	2.7	3.4	3.3	4.40	4.75	5.00	5.00	5.05	5.15	5.20	4.60	5.00	5.10	5.15	5.35	5.50	5.65
Japan	2.4	2.2	2.1	-0.3	0.4	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	1.3	1.9	2.2	2.2	1.9	1.7	2.45	2.70	3.20	3.60	3.90	3.90	3.90	3.60	3.80	4.10	4.40	4.50	4.50	4.40
U.K.	1.7	2.2	2.1	2.1	1.7	1.5	4.60	4.25	4.15	4.15	4.15	4.15	4.15	4.40	4.45	4.50	4.60	4.70	4.80	4.70
Canada	2.9	3.2	3.0	2.4	2.8	2.0	3.40	3.70	4.20	4.40	4.60	4.60	4.60	4.30	4.50	4.70	4.90	5.00	5.00	4.90

Currency	2005-Q4	2006-Q1	2006-Q2	2006-Q3	2006-Q4	2007-Q1	2007-Q2	2007-Q3
Euro (\$/€)	1.18	1.22	1.26	1.30	1.32	1.33	1.34	1.35
U.K. (\$/£)	1.74	1.76	1.79	1.83	1.85	1.87	1.88	1.89
U.K. (£/€)	0.68	0.69	0.70	0.71	0.71	0.71	0.71	0.71
Switzerland (CHF/\$)	1.31	1.28	1.25	1.22	1.20	1.19	1.18	1.18
Sweden (SEK/\$)	8.30	7.90	7.50	7.30	7.10	7.00	6.95	6.90
Norway (NOK/\$)	6.70	6.40	6.15	5.95	5.80	5.70	5.65	5.55
Poland (PLN/\$)	3.40	3.35	3.32	3.30	3.27	3.25	3.22	3.20
Japan (¥/\$)	118	112	108	104	100	96	94	90
Australia (US\$/A\$)	0.74	0.72	0.71	0.70	0.69	0.68	0.67	0.67
Singapore (S\$/US\$)	1.70	1.66	1.62	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\$)	1.22	1.20	1.18	1.16	1.15	1.14	1.13	1.12
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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