

# WEEKLY ECONOMIC & FINANCIAL COMMENTARY

January 09, 2009

## U.S. Review

### No, 2008 Wasn't Just A Bad Dream

This week brought a whole host of reports confirming the fourth quarter was every bit as bad as advertised. Reports earlier in the week showed manufacturing activity continuing to contract in December and factory orders were exceptionally weak in the three months ended in November. Employment conditions also continued to worsen, with nonfarm employment falling by 524,000 jobs. December's job losses were extremely widespread and brought the total loss over the past five months to over two million jobs. A total of over 2.5 million jobs have been lost since the recession began a little over a year ago. While the bulk of those earlier losses were in manufacturing and in housing-related industries, job losses have broadened and intensified.

Not only did employment weaken but the average workweek has also continued to shorten, as more and more businesses have chosen to reduce hours. Total hours worked plummeted at a 7.7 percent annual rate during the fourth quarter, which is consistent with our forecast calling for fourth quarter real GDP to decline at a 6 percent annual rate. *Please turn to page 2*

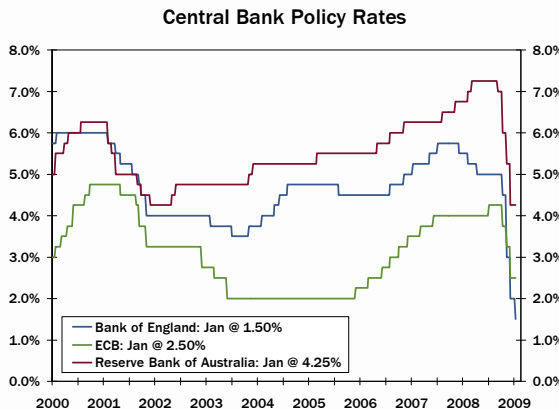
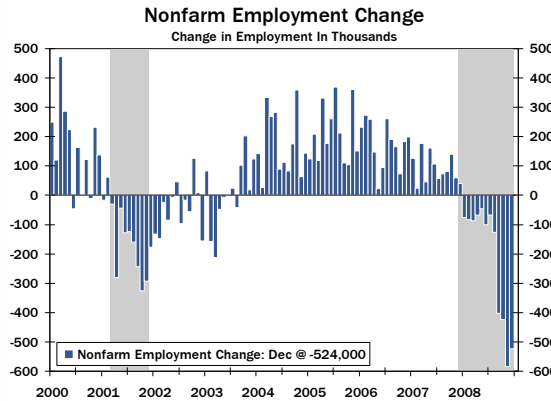
## Global Review

### Bank of England Eased Further

In a widely expected move, the Bank of England cut rates by 50 bps this week (see chart at lower left). In explaining the decision to reduce the main policy rate to only 1.50 percent, the lowest rate in the Bank's 315-year history, the Monetary Policy Committee (MPC) noted the sharp downturn in economic activity in the fourth quarter, not only in the United Kingdom but in most other economies as well.

Indeed, recent data confirm the MPC's grim assessment of the current state of the U.K. economy. Industrial production tumbled nearly seven percent in November relative to the same month last year, the sharpest rate of contraction since 1980. Unfortunately, manufacturers appear not to have fared much better in December. As shown in the top chart on page 4, the manufacturing PMI remained mired in deep contraction territory

*Please turn to page 4*



## Recent Special Commentary

Date	Title	Authors
December-18	Inflation Chartbook - December 2008	Vitner, York & Whelan
December-16	Global Chartbook - December 2008	Bryson & Quinlan
December-16	Commercial Real Estate Quarterly: 3rd Quarter	Vitner & Khan
December-11	Housing Chartbook - December 2008	Vitner & York

## U.S. Forecast

	Actual 2008				Forecast 2009				Actual 2005-2007			Forecast 2008-2010		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2005	2006	2007	2008	2009	2010
Real Gross Domestic Product <sup>1</sup>	0.9	2.8	-0.5	-5.9	-3.4	-1.8	1.0	1.9	2.9	2.8	2.0	1.1	-2.0	1.4
Personal Consumption	0.9	1.2	-3.7	-5.9	-1.7	-0.1	0.7	1.6	3.0	3.0	2.8	0.1	-1.8	1.4
Inflation Indicators <sup>2</sup>														
"Core" PCE Deflator	2.2	2.3	2.4	1.9	1.6	1.4	1.2	1.4	2.1	2.3	2.2	2.2	1.4	1.7
Consumer Price Index	4.2	4.3	5.3	2.6	1.6	0.7	-0.2	2.2	3.4	3.2	2.9	4.1	1.1	2.5
Industrial Production <sup>1</sup>	0.4	-3.4	-7.6	-8.5	-5.0	-2.7	-1.4	0.3	3.3	2.2	1.7	-1.4	-4.7	1.0
Corporate Profits Before Taxes <sup>2</sup>	-1.5	-8.3	-9.0	-17.5	-25.0	-24.0	-20.0	-14.0	17.6	15.2	-1.6	-9.1	-21.0	5.2
Trade Weighted Dollar Index <sup>3</sup>	70.3	71.0	76.1	83.4	86.8	89.3	91.5	92.5	86.0	81.5	73.3	83.4	92.5	93.8
Unemployment Rate	4.9	5.3	6.0	6.7	7.2	7.7	8.2	8.5	5.1	4.6	4.6	5.7	7.9	8.9
Housing Starts <sup>4</sup>	1.05	1.03	0.88	0.73	0.61	0.61	0.64	0.66	2.07	1.81	1.34	0.92	0.63	0.80
Quarter-End Interest Rates														
Federal Funds Target Rate	2.25	2.00	2.00	0.50	0.25	0.25	0.25	0.25	4.25	5.25	4.25	0.50	0.25	1.00
10 Year Note	3.45	3.99	3.85	2.85	2.95	3.10	3.10	3.10	4.39	4.71	4.04	2.85	3.10	3.80

Data As of: December 10, 2008

<sup>1</sup> Compound Annual Growth Rate Quarter-over-Quarter

<sup>2</sup> Year-over-Year Percentage Change

<sup>3</sup> Federal Reserve Major Currency Index, 1973=100 - Quarter End

<sup>4</sup> Millions of Units

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U.S. Review

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**Fourth Quarter Job Losses Will Undermine The First Half of '09**

The extraordinary cutbacks in nonfarm payrolls during the fourth quarter are likely to carry over into the first half of 2009. Various counts of layoff announcements, including the Challenger survey, show layoff announcements picking up toward the end of the year. Several companies, including Alcoa and Lenovo, have recently announced plans to trim payrolls in coming months, as sales and new orders weakened much more during the fourth quarter than expected. This past season's disappointing holiday retail sales are also expected to lead to widespread store closings, resulting in additional job losses.

With employment and hours worked down sharply in recent months, personal income will likely remain under pressure, which means lower interest rates and lower gasoline prices will provide less relief to shell-shocked consumers. The International Council of Shopping Centers reported that December chain store sales fell 1.7 percent year-to-year, amidst the worst holiday shopping season since 1970. The drop was not unexpected and many chains have announced plans to close underperforming stores and a few chains are shutting down entirely. With this new data, we estimate that retail sales fell 0.8 percent in December and that sales excluding motor vehicles declined just over 1 percent. Both declines are in line with our earlier forecast for fourth quarter GDP growth.

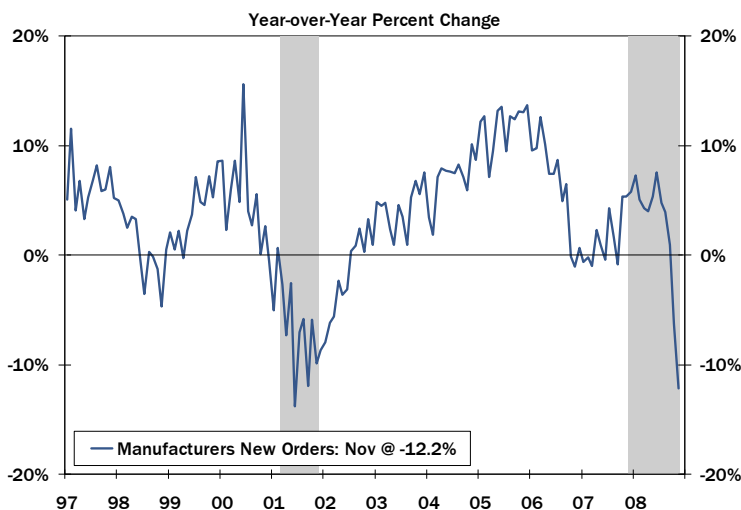
The current quarter is little more than a week old, but expectations for first quarter growth are already being ratcheted down. The major domestic motor vehicle producers announced extended plant shutdowns for January, which will pull industrial production down sharply and also lead to a sharp drop in inventories. There has also been a string of disappointing announcements by major companies, such as Alcoa, Intel and Wal-Mart. Most reported disappointing sales and have further reduced expectations for sales and earnings for the new year. With earnings coming under pressure the talk of a new bull market will likely prove short-lived and capital spending plans will likely be cut back further.

November factory orders data show non-defense capital goods orders plummeting at a 28.0 percent annual rate over the past three months. The drop will likely result in even weaker capital spending during the first quarter. Another surprise this week was nonresidential construction held up a little better than expected in November. The strength likely reflects projects started well before the onset of the credit crisis. Many firms are likely rushing to finish projects before their funding dries up. We have no doubt that commercial construction is headed much lower in 2009.

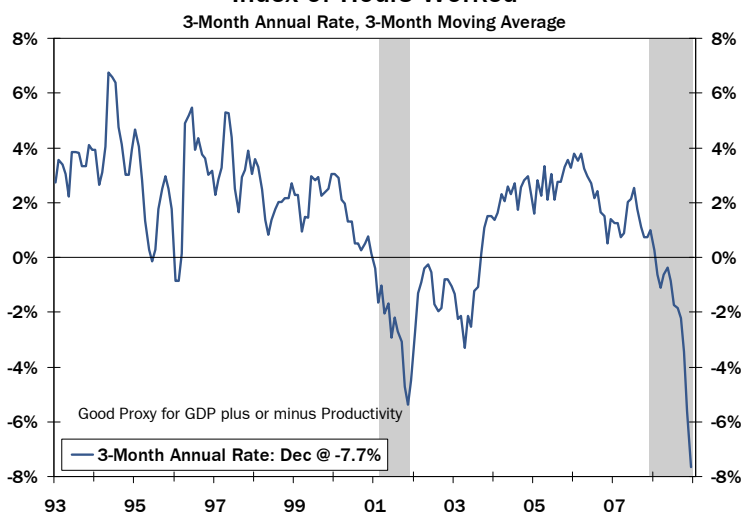
**Selected Current Data**

Gross Domestic Product - CAGR	Q3 - 2008	-0.5%
GDP Year-over-Year	Q3 - 2008	0.7%
Personal Consumption	Q3 - 2008	-3.8%
Business Fixed Investment	Q3 - 2008	-1.7%
Consumer Price Index	November - 2008	1.1%
"Core" CPI	November - 2008	2.0%
"Core" PCE Deflator	November - 2008	1.9%
Industrial Production	November - 2008	-5.5%
Unemployment	December - 2008	7.2%
Federal Funds Target Rate	Jan - 09	0.25%

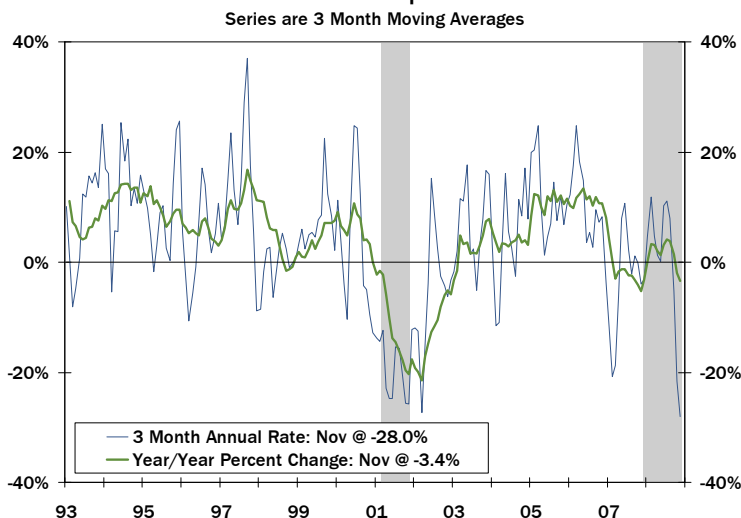
**Manufacturers' New Orders**



**Index of Hours Worked**



**New Orders Non-Defense Capital Goods Ex-Aircraft**



**Retail Sales • Wednesday**

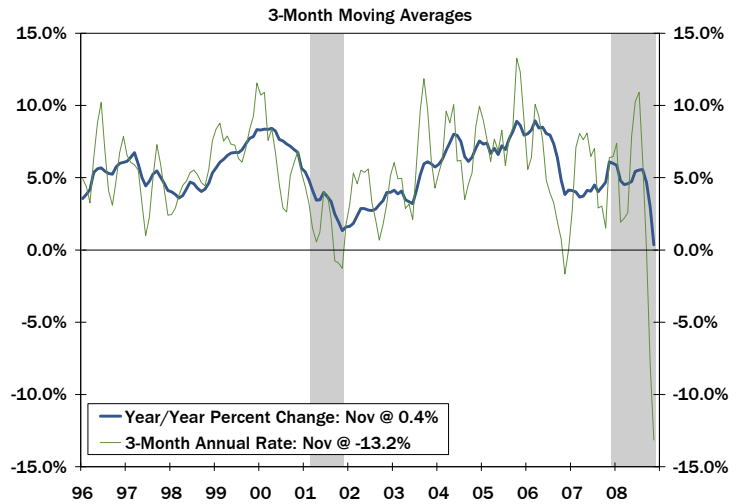
Overall retail sales declined 1.8 percent in November, which was largely in line with expectations. Sales excluding motor vehicles fell 1.6 percent, but that drop was exaggerated by plunging gasoline prices, which were down 14.7 percent. Motor vehicle sales are now down 43.7 percent annual rate over the past three months bringing the year-to-year drop in motor vehicle purchases to 28.3 percent.

We expect retail sales to fall 0.8 percent in December, which will make the 2008 holiday selling season the worst on record. Retailers are clearly struggling, as evidenced by the growing list of retail bankruptcies. Sales have been driven by extensive discounting which is hurting retail profit margins. The decline will continue to be led by a sharp drop in motor vehicle sales and sales at gasoline stations. The only wild card may be non-store retailers, which has fallen five consecutive months.

**Previous: -1.8%**

**Wachovia: -0.8%**

**Consensus: -1.2%**

**Retail Sales Ex-Motor Vehicles**

**Consumer Price Index • Friday**

Consumer prices declined 1.7 percent in November, the biggest monthly decline on record. Continued deterioration in energy prices continue to hold down consumer prices. Energy prices declined 17 percent in November, with gasoline prices falling 29.5 percent. Food prices rose 0.2 percent, but the pace of growth is slowing. Core prices, excluding food and energy were flat. Gains in core prices were seen in apparel, medical care and education.

We expect consumer prices to fall 0.8 percent in December. Core prices should remain flat. Weak domestic demand and falling energy & commodity prices should continue to pull down consumer inflation over the next few quarters. Growth prospects, not inflation, continue to be the Fed's primary concern.

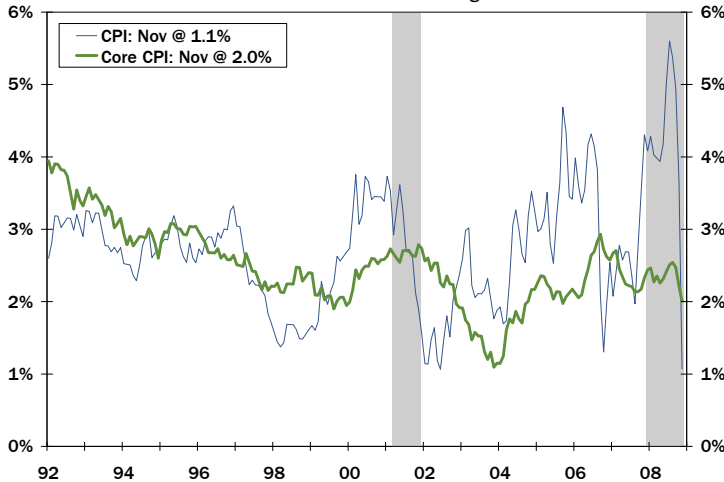
**Previous: -1.7%**

**Wachovia: -0.8%**

**Consensus: -0.9%**

**CPI vs. Core CPI**

Year-over-Year Percent Change


**Industrial Production • Friday**

Industrial production fell 0.6 percent in November driven by weakness in core manufacturing sectors: autos, machinery and computers and was down 5.5 percent from a year ago. Construction supplies fell again in November, which is consistent with the housing correction. Capacity utilization levels continued to decline, suggesting continued weak profits.

We expect industrial production to fall 0.7 percent and capacity utilization to decline for the second consecutive month to a level of 74.2 percent in December. In particular, over the last year we have seen utilization declines in manufacturing, utilities and sharp declines in computers. We should continue to see declines in these sectors including soft profits and further layoffs.

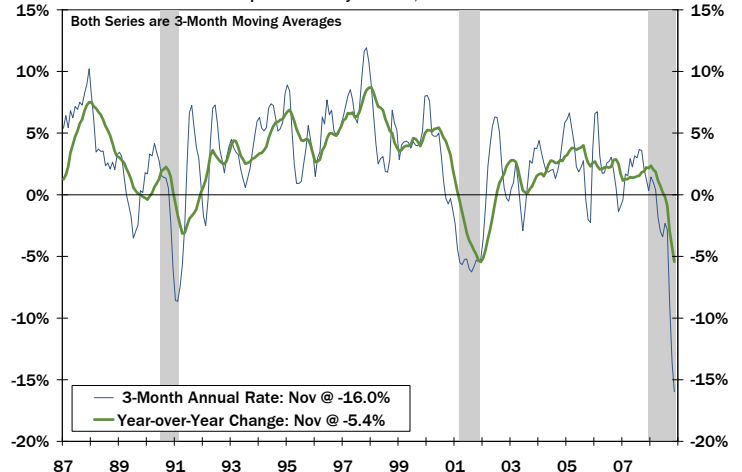
**Previous: -0.6%**

**Wachovia: -0.7%**

**Consensus: -0.9%**

**Total Industrial Production Growth**

Output Growth by Volume, not Revenue



**Global Review**

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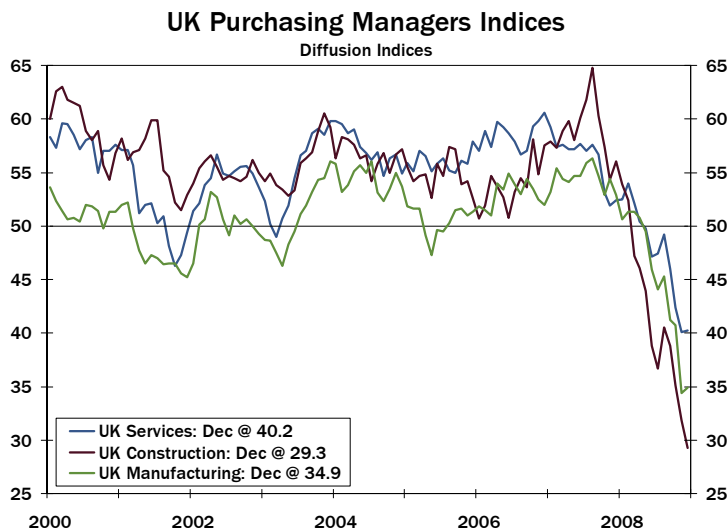
in December. Although the service sector PMI edged up a bit last month, it too remains at a very low level, and the construction PMI continues to plumb new lows. Speaking of construction, a widely followed index of U.K. house prices fell 2.5 percent in December relative to the previous month. Since peaking in late 2007 the index of house prices has dropped 17 percent, nearly as much as the 20 percent cumulative decline that occurred in the early 1990s. Little wonder that consumer confidence has collapsed. By our reckoning real GDP probably dropped at an annualized rate of roughly four percent in the fourth quarter, which would be the sharpest contraction since the early 1970s. Our forecast also projects that British real GDP will continue to contract for the next two quarters.

The bad news then is that the United Kingdom appears to be mired in a deep recession at present. If there is a glimmer of hope it is that the British authorities are responding to the crisis. For starters, the Bank of England has cut rates aggressively. (The main policy rate has been reduced by 350 bps since early October.) In addition, the government has taken steps to stimulate the economy via fiscal policy. Pre-announced public capital expenditures have been brought forward and the value-added tax was reduced by 2.5 percentage points. Although the British stimulus package is not as large as the program that the incoming Obama administration is putting together, it is a step in the right direction.

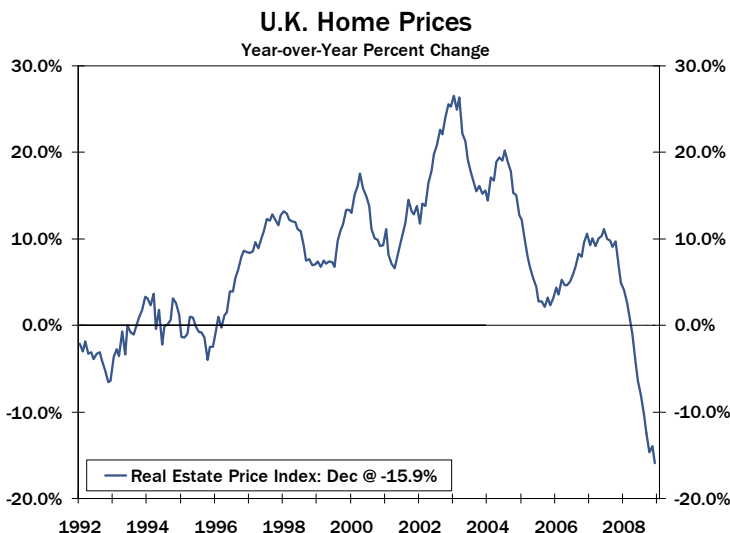
Another stimulative factor for the U.K. economy is the recent depreciation of sterling. As shown in the bottom chart, the British pound has weakened about 10 percent on balance versus the euro since mid-July. It's depreciation against the U.S. dollar totals 25 percent over that period. Everything else equal, currency depreciation should help to shore up U.K. net exports.

Whither the British pound? We look for sterling to depreciate a bit further against the dollar over the course of the year as the Bank of England cuts rates further. However, we expect the pound will continue to grind higher vis-à-vis the euro in the months ahead. Whereas the Bank of England has been very proactive in cutting rates, the European Central Bank has not been as aggressive. Therefore, the recession in the Euro-zone may linger longer than the downturn in the United Kingdom.

**UK Purchasing Managers Indices**



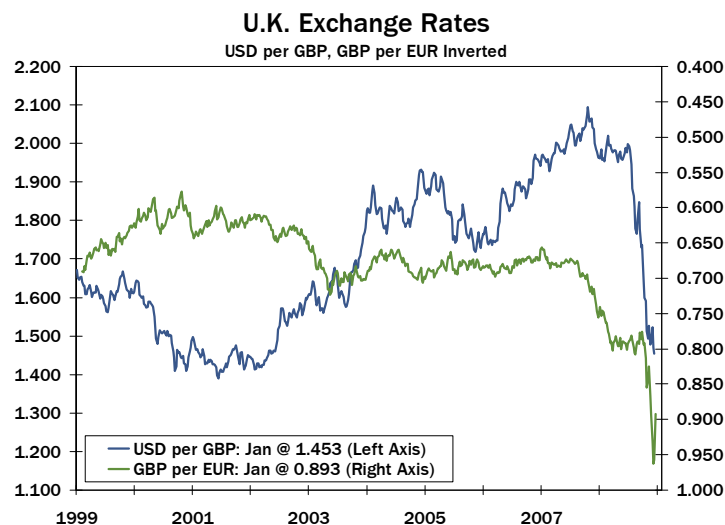
**U.K. Home Prices**



**Selected Global Data**

Japan	GDP Year-over-Year	Q3 - 2008	-0.5%
	CPI	November - 2008	1.0%
	Unemployment	November - 2008	3.9%
	BoJ Target Rate	Jan - 09	0.10%
Euro-Zone	GDP Year-over-Year	Q3 - 2008	0.6%
	CPI	November - 2008	2.1%
	Unemployment	November - 2008	7.8%
	ECB Target Rate	Jan - 09	2.50%
UK	GDP Year-over-Year	Q3 - 2008	0.3%
	CPI	November - 2008	4.1%
	Unemployment	November - 2008	3.3%
	BoE Target Rate	Jan - 09	1.50%
Canada	GDP Year-over-Year	October - 2008	0.2%
	CPI	November - 2008	2.0%
	Unemployment	December - 2008	6.6%
	BoC Target Rate	Jan - 09	1.50%

**U.K. Exchange Rates**



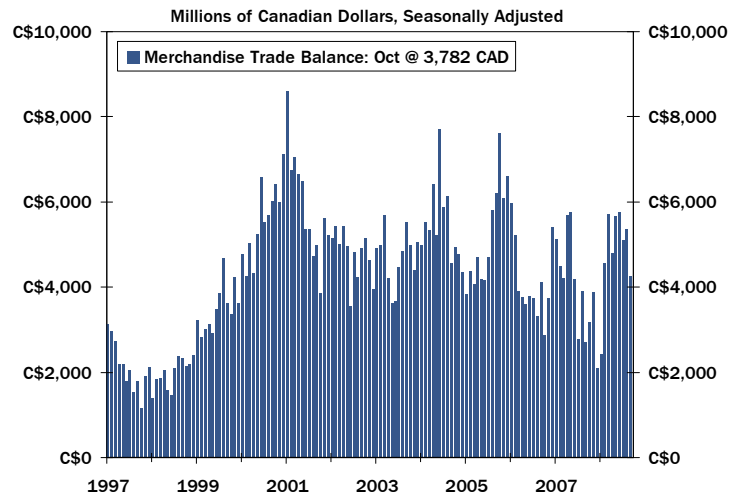
**Canadian Trade Deficit • Tuesday**

Data on Canada's international trade balance in November, which will print on Tuesday, will help market participants sharpen their estimates for Canadian real GDP growth in the fourth quarter. Due in part to the sharp decline in commodity prices since last summer, the dollar value of the trade surplus has been narrowing in recent months. Moreover, real net exports have exerted a drag on real GDP growth in five of the last seven quarters, due in part to the economic downturn in the United States.

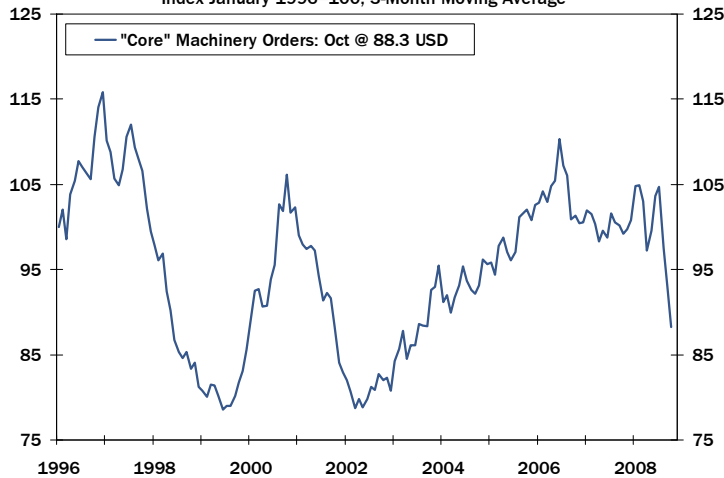
Speaking of the United States and Canadian GDP growth, we project that the sharp contraction in U.S. GDP that probably occurred in the fourth quarter has finally pulled the Canadian economy into recession. And our forecast projects that Canadian growth will remain negative in the first half of 2009.

**Previous: C\$3.8 billion**

**Consensus: C\$3.3 billion**

**Canadian Merchandise Trade Balance**

**Japanese Machinery Orders • Thursday**
**Japanese "Core" Machinery Orders**

Index January 1996=100, 3-Month Moving Average



"Core" machinery orders, a good leading indicator of Japanese capital spending, have plummeted 20 percent since May. Data on orders in November that will be released next week will help to quantify just how weak the Japanese economy was in the fourth quarter. Data on the trade balance in November and bank lending in December will give investors further insights into the current state of the Japanese economy.

Getting precise estimates of Japanese GDP growth on a quarter-by-quarter basis is notoriously difficult. We currently reckon that Japanese GDP contracted at an annualized rate of 3 percent or so in the fourth quarter, which we readily acknowledge could be too rosy. It is certainly clear, however, that the Japanese economy is in the midst of a nasty recession.

**Previous: -4.4% (month-on-month change)**

**Consensus: -8.0%**

**ECB Policy Meeting • Thursday**

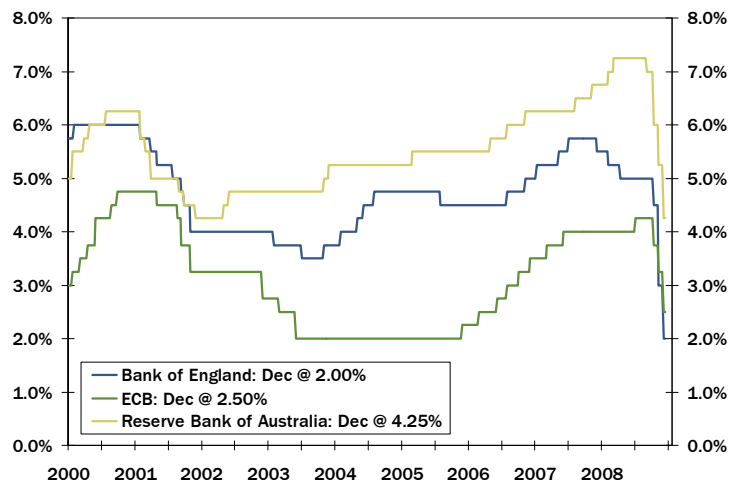
The European Central Bank holds its monthly policy meeting next Thursday, and most investors look for further easing. The amount of the cut is open to some debate. Although we would like to see the ECB reduce rates by 50 bps as the market consensus anticipates, we fear that only 25 bps will be in the offing. It appears that some ECB policymakers believe that they have already cut enough.

Although the ECB's only mandate is price stability, we believe inflation should be the least of the ECB's worries at present. Data that are slated for release on Thursday, the day the ECB meets, should show the overall rate of CPI inflation falling from 2.1 percent in November to 1.6 percent in December, which would be the lowest rate in more than two years.

**Current Policy Rate: 2.50%**

**Wachovia: 2.25%**

**Consensus: 2.00%**

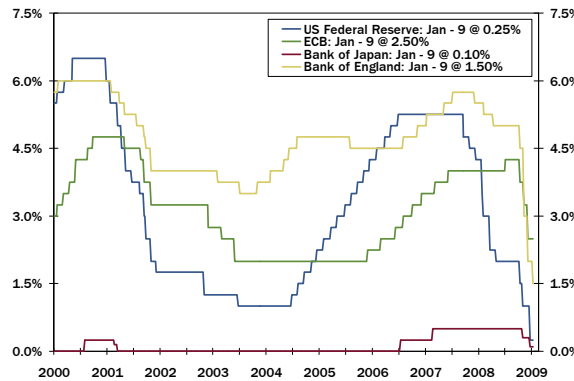
**Central Bank Policy Rates**


**Interest Rate Watch**
**Low Rates Now Bring Future Caution**

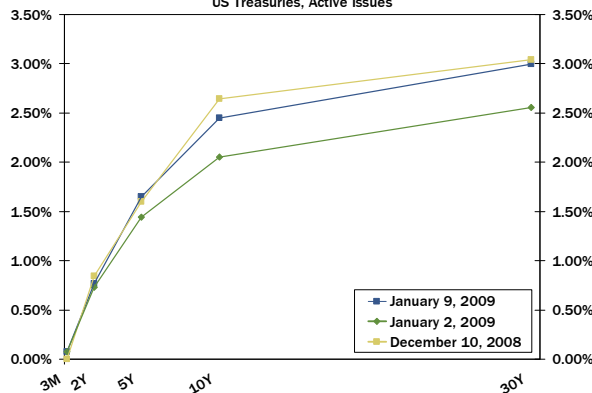
Fed policy is likely to remain very easy for the first half of this year. A low federal funds rate and ample balance sheet growth at the Fed suggest low private money market rates as well. However, we are concerned about two developments. Will the Fed act with deliberate speed to withdraw liquidity as the recovery begins in later this year? Second, will the federal spending associated with "stimulus" be moderated as the economy recovers such that future federal deficits are brought down to earth? We remain skeptical on both counts. Therefore our expectation is that longer term Treasury rates will rise despite a steady federal funds rate.

Reading the Fed's tea leaves, we suspect that the central bank appears committed to use all available policy tools to promote the resumption of sustainable growth as the top priority. Yes, inflation matters but it appears that the avoidance of deflation is a higher priority. This bias suggests that the trend in longer-term Treasury rates will be modestly upward. Direct buying of mortgage-backed securities by the Fed will moderate the upward pressure on mortgage rates but other private rates are likely to drift upwards after mid-2009. Effectively, the Fed is committing to a continued expansion of its balance sheet to support financial markets and the U.S. economy. This balance sheet expansion will reflect Fed priorities to favor growth rather than heading off modest inflation.

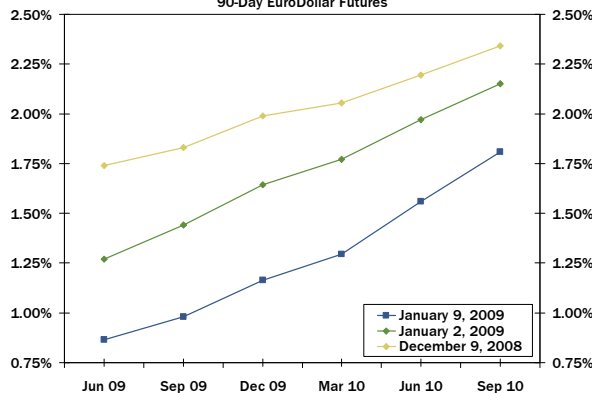
Over the long-run, however, we are very cautious. We remain concerned about the impact on the dollar's exchange value as well as inflation expectations. We believe decision-makers need to recognize the Fed's mandate to pull the punch bowl away before the party gets too exciting.

**Central Bank Policy Rates**

**Yield Curve**

US Treasuries, Active Issues


**Forward Rates**

90-Day EuroDollar Futures


**Topic of the Week**
**Historical Perspective on Job Losses**

At this point just about everyone in the country is well-aware that this is a lousy job market. Today's jobs report provides us with a complete set of data for 2008. The U.S. economy shed jobs every month of the year, with losses getting much worse in the last quarter. In fact, the last quarter alone, we lost over 1.5 million jobs, the worst quarterly contraction since the end of the second world war in 1945. At that point in our nation's history, the armed forces demobilized and women were leaving the work force en-masse as they left the factory jobs they held during the war. So aside from that seismic shift in the wake of the war, the job losses in the fourth quarter were the worst quarterly loss on record, **at least in terms of total number of jobs.**

While these losses are staggering, the employment situation may not be quite as dire as it seems at first blush. Since 1945, the U.S. population has gone from 139 million to more than 305 million, an increase of roughly 120 percent. The other consideration is that since the 1940s the participation of women in the labor force has changed considerably. Unfortunately, the Bureau of Labor Statistics didn't track employment stats by gender in that era. But the total nonfarm workforce has increased from 40 million in 1945 to more than 135 million today, an increase of over 237 percent, almost double the percentage increase in the overall population.

In percentage terms, job losses in the fourth quarter represent 1.1 percent of the workforce, on par with quarterly losses seen as recently as 1974 and 1975. Comparing that to a contraction of 6.4 percent in the third quarter of 1945 provides some perspective. No doubt these are awful job losses, but they are not nearly the worst ever.

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**Market Data ♦ Mid-Day Friday**
**U.S. Interest Rates**

	Friday 1/9/2009	1 Week Ago	1 Year Ago
3-Month T-Bill	0.06	0.08	3.23
3-Month LIBOR	1.26	1.41	4.44
1-Year Treasury	0.43	0.11	2.85
2-Year Treasury	0.75	0.82	2.72
5-Year Treasury	1.49	1.65	3.13
10-Year Treasury	2.38	2.37	3.82
30-Year Treasury	3.01	2.79	4.34
Bond Buyer Index	5.02	5.24	4.21

**Foreign Interest Rates**

	Friday 1/9/2009	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	2.69	2.85	4.60
3-Month Sterling LIBOR	2.38	2.71	5.68
3-Month Canadian LIBOR	1.80	2.12	4.40
3-Month Yen LIBOR	0.78	0.82	0.90
2-Year German	1.49	1.73	3.74
2-Year U.K.	1.58	1.01	4.25
2-Year Canadian	1.10	1.16	3.49
2-Year Japanese	0.38	0.38	0.67
10-Year German	3.00	2.96	4.09
10-Year U.K.	3.14	3.04	4.40
10-Year Canadian	2.80	2.84	3.87
10-Year Japanese	1.30	1.17	1.48

**Foreign Exchange Rates**

	Friday 1/9/2009	1 Week Ago	1 Year Ago
Euro (\$/€)	1.350	1.392	1.466
British Pound (\$/£)	1.523	1.455	1.959
British Pound (£/€)	0.886	0.957	0.749
Japanese Yen (¥/\$)	90.300	91.835	110.045
Canadian Dollar (C\$/ \$)	1.191	1.205	1.010
Swiss Franc (CHF/\$)	1.110	1.081	1.117
Australian Dollar (US\$/A\$)	0.708	0.711	0.883
Mexican Peso (MXN/\$)	13.708	13.760	10.939
Chinese Yuan (CNY/\$)	6.836	6.830	7.263
Indian Rupee (INR/\$)	48.255	48.753	39.285
Brazilian Real (BRL/\$)	2.279	2.318	1.768
U.S. Dollar Index	82.357	81.839	76.419

**Commodity Prices**

	Friday 1/9/2009	1 Week Ago	1 Year Ago
W. Texas Crude (\$/Barrel)	39.94	46.34	95.67
Gold (\$/Ounce)	864.80	875.40	878.80
Hot-Rolled Steel (\$/S.Ton)	475.00	550.00	520.00
Copper (¢/Pound)	153.35	144.40	326.45
Soybeans (\$/Bushel)	9.76	9.60	12.15
Natural Gas (\$/MMBTU)	5.45	5.97	8.10
Nickel (\$/Metric Ton)	11,462	11,609	29,620
CRB Spot Inds.	341.21	329.55	482.34

**Next Week's Economic Calendar**

	Monday 12	Tuesday 13	Wednesday 14	Thursday 15	Friday 16
<b>U.S. Data</b>		<b>Trade Balance</b> October -\$57.2B November -\$50.5B (W)	<b>Retail Sales</b> November -1.8% December -0.8% (W) <b>Retail Sales Less Autos</b> November -1.6% December -1.1% (W) <b>Import Price Index</b> November -6.7% December -6.0% (W)	<b>PPI</b> November -2.2% December -0.8% (W) <b>PPI Ex Food &amp; Energy</b> November 0.1% December 0.1% (W)	<b>CPI</b> November -1.7% December -0.8% (W) <b>Industrial Production</b> November -0.6% December -0.7% (W) <b>Capacity Utilization</b> November 75.4% December 74.2% (W)
<b>Global Data</b>		<b>Canada</b> <b>Int'l Merchandise</b> Previous (Oct) \$3.8B		<b>Japan</b> <b>Machine Orders (MoM)</b> Previous (Oct) -4.4% <b>Euro-zone</b> <b>ECB Announces Rates</b> Previous 2.50%	

Note: (W) = Wachovia Estimate (c) = Consensus Estimate

## Wachovia Economics Group

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