

WEEKLY ECONOMIC & FINANCIAL COMMENTARY

November 21, 2008

U.S. Review

Pricing In A Deeper Recession

We had been assuming the November data would post a slight rebound following October's plunge. Those hopes appear to have been dashed, however, as economic conditions continue to deteriorate. Most of this week's reports came in worse than expected and it is now abundantly clear that fourth quarter real GDP will decline more than even our most recent forecast projected.

The financial markets are clearly pricing in a deeper recession. Thursday's stock market sell-off and dramatic decline in bond yields was driven by increased concerns about the financial system and the ongoing difficulties at domestic automakers. The problems in the financial markets and many old line industries are not likely to be fixed quickly and significantly increases the odds this recession will be longer and deeper than either of the past two downturns.

The only good news this week was the better than expected inflation figures. Plunging oil prices sent both the headline PPI and CPI down sharply in October. Even more surprising, the core CPI declined 0.1 percent.

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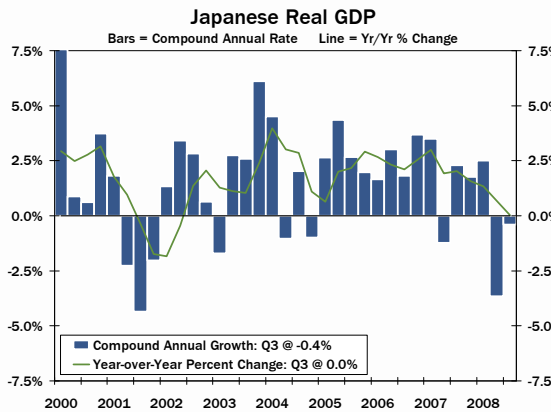
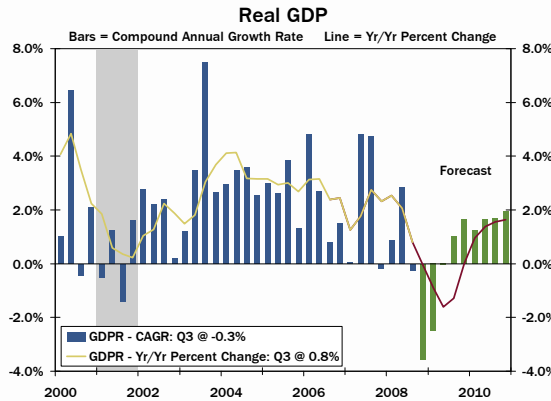
Global Review

Japan: Another One Bites the Dust

Data released this week showed that real GDP in Japan fell at an annualized rate of 0.4 percent in the third quarter (see chart at left). Coupled with the 3.7 percent drop that occurred in the second quarter, Japan has now experienced two consecutive quarters of negative GDP growth (technically a recession) for the first time since 2001. As we wrote in this report last week, the Euro-zone has also slipped into recession. With output in the United Kingdom dropping like a stone and with the U.S. economy likely to pull Canada under as well, every G-7 economy is already in or soon to slide into recession. Can you say "global downturn"?

Why is the Japanese economy contracting at present? After all, most Japanese banks did not have large exposure to U.S. subprime mortgages, and the credit crunch does not seem to have been as

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Recent Special Commentary

Date	Title	Authors
November-14	Trends, Cycles and Dangers of Historical Extrapolation	Silvia & Iqbal
November-13	Global Chartbook - November 2008	Bryson & Quinlan
November-05	The Grinch May Roil Holiday Sales This Year	Vitner & York
October-20	Japan's "Lost Decade": Implications for the U.S. Economy	Bryson

U.S. Forecast

	Actual				Forecast				Actual			Forecast		
	2008	2008	2008	2008	2009	2009	2009	2009	2005	2006	2007	2008	2009	2010
Real Gross Domestic Product ¹	0.9	2.8	-0.3	-3.6	-2.5	0.0	1.0	1.6	2.9	2.8	2.0	1.3	-1.0	1.4
Personal Consumption	0.9	1.2	-3.1	-3.3	-1.3	0.7	1.2	1.3	3.0	3.0	2.8	0.4	-0.9	1.5
Inflation Indicators ²														
"Core" PCE Deflator	2.2	2.3	2.5	2.2	2.0	1.9	1.7	1.9	2.1	2.3	2.2	2.3	1.9	2.0
Consumer Price Index	4.2	4.3	5.3	3.4	2.4	1.7	0.7	2.0	3.4	3.2	2.9	4.3	1.7	2.4
Industrial Production ¹	0.4	-3.1	-6.0	-6.7	-5.0	-2.7	-1.4	0.3	3.3	2.2	1.7	-1.0	-4.1	1.0
Corporate Profits Before Taxes ²	-1.5	-8.3	-12.5	-17.5	-25.0	-20.0	-16.0	-10.0	17.6	15.2	-1.6	-10.0	-18.1	6.3
Trade Weighted Dollar Index ³	70.3	71.0	76.1	81.8	85.6	88.7	91.6	94.3	86.0	81.5	73.3	81.8	94.3	96.5
Unemployment Rate	4.9	5.3	6.0	6.5	7.2	7.7	8.0	8.3	5.1	4.6	4.6	5.7	7.8	8.8
Housing Starts ⁴	1.05	1.03	0.88	0.76	0.66	0.65	0.68	0.73	2.07	1.81	1.34	0.93	0.68	0.98
Quarter-End Interest Rates														
Federal Funds Target Rate	2.25	2.00	2.00	0.75	0.50	0.50	0.50	0.50	4.25	5.25	4.25	0.75	0.50	1.00
10 Year Note	3.45	3.99	3.85	3.70	3.80	3.90	3.90	4.00	4.39	4.71	4.04	3.70	4.00	4.50

Data As of: November 12, 2008

¹ Compound Annual Growth Rate Quarter-over-Quarter
² Year-over-Year Percentage Change

³ Federal Reserve Major Currency Index, 1973=100 - Quarter End
⁴ Millions of Units

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U.S. Review

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Talk of Deflation is Way Too Premature

Even with these declines, the year-to-year change in the major price indices remains elevated. The overall Producer Price Index plunged 1.9 percent in October, following a 0.4 percent drop the prior month. Most of that drop was in energy costs, which plummeted 24.9 percent in October. Even with these declines, however, the overall PPI remains 5.2 percent above its year ago level. Excluding food and energy prices, the core PPI rose 0.4 percent in October and remains up 4.4 percent year-over-year.

The Consumer Price Index was also in negative territory, with the overall index falling 1.0 percent and prices excluding food and energy items declining 0.1 percent. The 0.1 drop in the core CPI marks the first monthly drop in this series since the early 1980s. That drop set off a great deal of discussion about deflation, and particularly a debt-deflation spiral. There is at least a grain of truth to these concerns. Debt laden car manufacturers, retailers and homebuilders are all slashing prices in order to clear out inventories in the face of incessantly weak consumer demand.

While consumer prices will likely post some modest declines in coming months, most of these drops are simply due to plunging commodity prices and oversupply issues. We do not believe a problematic deflation spiral is likely. Inflation will slow, however, and we expect the core CPI to return to levels well below the Fed's target zone and remain there for the next few years.

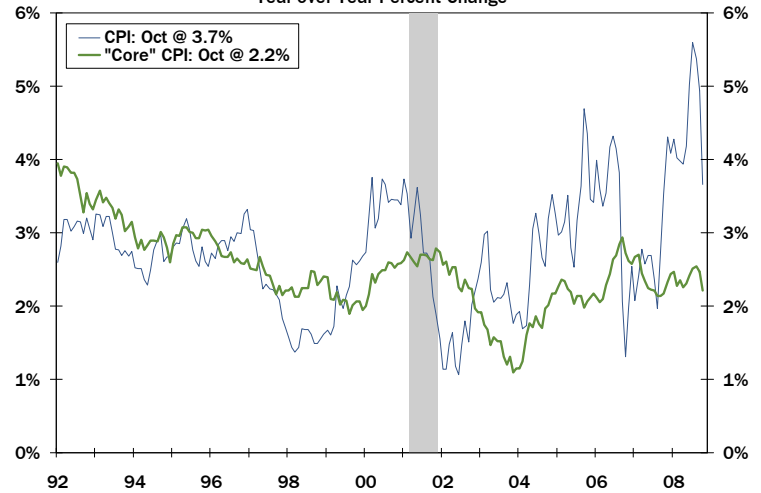
One other seemingly good bit of news was the 1.3 percent rebound in industrial production during October. The gain follows a 2.3 percent plunge in September and was largely due to disruptions in petroleum products and petrochemicals production surrounding Hurricane Ike. Excluding the rebound in energy output, the report was very weak. Output of motor vehicles plunged 3.5 percent in October and output declined sharply in most major components, including primary metals, wood products, apparel, and machinery. The early data for November show conditions continue to deteriorate across a broad front. Early indications from auto dealers hint that November will be worse than October. In addition, the NAHB/Wells Fargo Housing Market Index fell to its lowest level ever in November, as buyer traffic has all but vanished amid the credit crunch. Manufacturing activity also appear to have weakened further, with both the New York and Philadelphia Fed reporting substantial drops in activity in November. And finally, weekly jobless claims rose much more than expected, surging by 26,000 to 542,000. With the jump, our estimate for November nonfarm employment now calls for a decline of 350,000 jobs.

Selected Current Data

Gross Domestic Product - CAGR	Q3 - 2008	-0.3%
GDP Year-over-Year	Q3 - 2008	0.8%
Personal Consumption	Q3 - 2008	-3.1%
Business Fixed Investment	Q3 - 2008	-1.0%
Consumer Price Index	October - 2008	3.7%
"Core" CPI	October - 2008	2.2%
"Core" PCE Deflator	September - 2008	2.4%
Industrial Production	October - 2008	-4.1%
Unemployment	October - 2008	6.5%
Federal Funds Target Rate	Nov - 21	1.00%

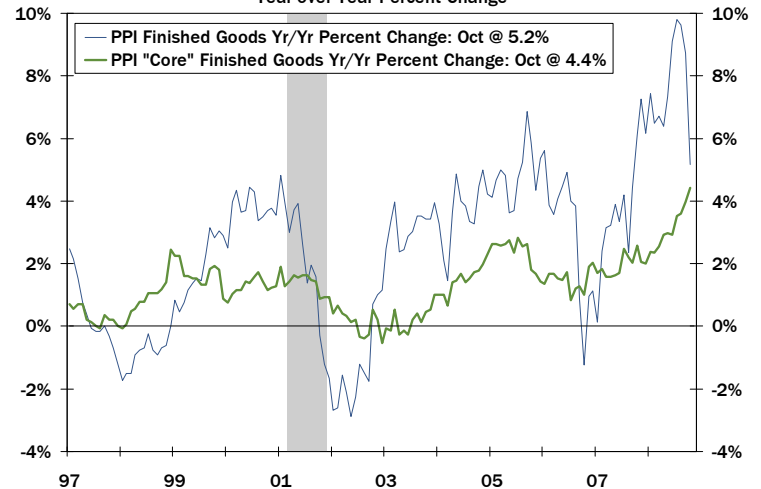
CPI vs. "Core" CPI

Year-over-Year Percent Change



Producer Price Index

Year-over-Year Percent Change



NAHB/Wells Fargo Housing Market Index

Diffusion Index



Existing Home Sales • Monday

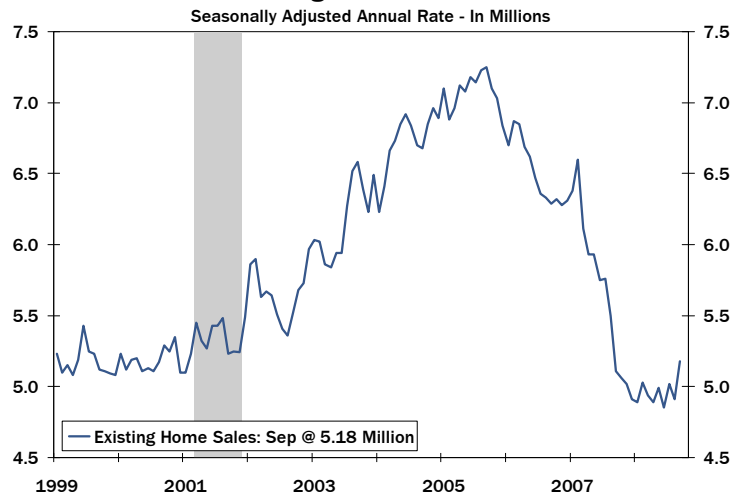
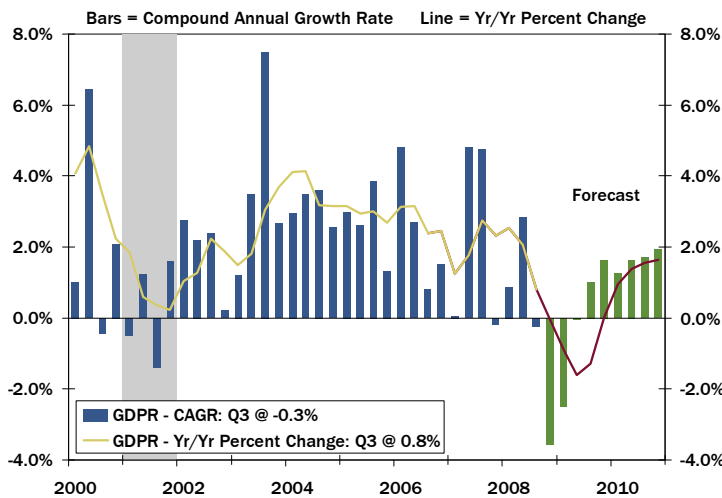
Since the beginning of the year, existing home sales have shown some tentative signs of bottoming. Foreclosure sales have been a big reason for the recent boost to total sales, particularly in the hardest hit markets of California and Florida. High inventories, however, will continue to pressure home prices well into 2009 and possibly further.

Despite recent monthly volatility, the forward looking pending home sales index appears to suggest a relatively stable existing home sales pace over the next couple of months. Obtaining financing, however, is still a major hurdle for many would-be buyers. We are forecasting a modest 3.5 percent decline to an annualized pace of 5.00 million units in October.

Previous: 5.18M

Wachovia: 5.00M

Consensus: 5.02M

Existing Home Resales

Real GDP

Real GDP • Tuesday

Finally registering what most consumers have been experiencing for some time, the advance reading of the GDP report fell at an annualized pace of -0.3 percent in third quarter. The decline was primarily attributable to sharp drops in personal consumption and business fixed investment.

While it appears no major revisions are expected in the preliminary report we are likely to see a haircut to personal consumption expenditures which could help knock a few percentage points off of real GDP in the third quarter. Adjustments to nonresidential structures investment and state & local government could also come into play.

Looking to the fourth quarter, we have forecasted as sharp decline of -3.6 percent. Given the weaker than anticipated start to the quarter, there is downside risk to that call.

Previous: -0.3%

Wachovia: -0.6%

Consensus: -0.5%

Consumer Confidence • Tuesday

After improving modestly in September, consumer confidence plunged 23 points to an all-time record low of 38.0 in October. Pessimism was broad based as both the Present Situation and Expectation indices recorded large declines.

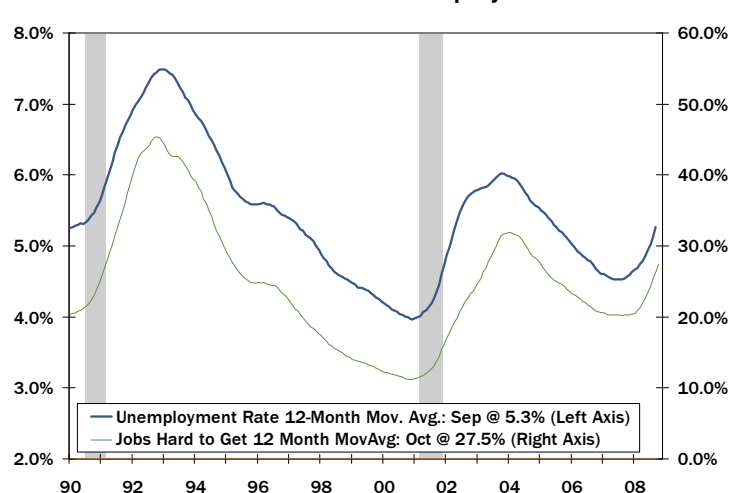
The labor market deterioration has accelerated since the last report with the unemployment rate jumping to 6.5 percent. Stock prices have headed lower which should also weigh on consumers' confidence. Falling gasoline prices, however, will likely be the sole bright spot in this month's report. On net, we expect further deterioration in confidence in November.

With the unemployment rate expected to continue rising throughout 2009, consumer confidence will likely remain depressed for some time.

Previous: 38.0

Wachovia: 30.0

Consensus: 39.0

"Jobs Hard to Get" vs. Unemployment Rate


Global Review

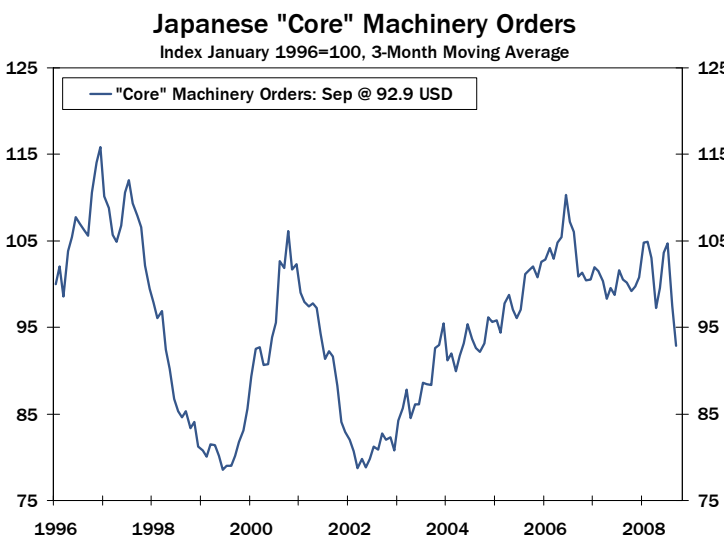
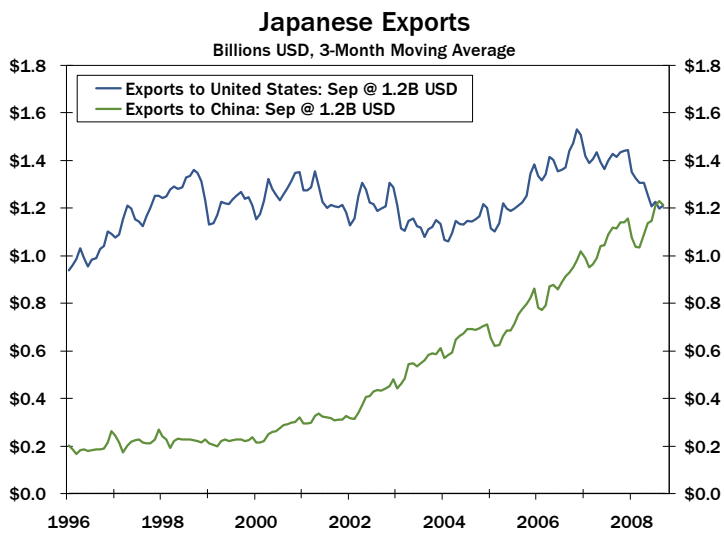
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severe in Japan as in other major economies. Japan, however, does have exposure to the U.S. economy via exports, and shipments destined for the United States have clearly weakened over the past few months (see top chart). Although total exports of goods and services rose at an annualized rate of 2.8 percent in the third quarter, it was hardly enough to offset the 10.2 percent drop registered during the previous quarter.

In addition, non-residential investment spending, which helped to pace Japanese economic growth between 2002 and 2006, is also starting to fade. "Core" machinery orders, a good leading indicator of investment spending, fell more than 10 percent in the third quarter, which does not bode well for capex in the current quarter (see middle chart). Finally, growth in consumer spending, which was never very strong anyway, has slowed over the past few quarters (it not yet turned negative though), as the earlier rise in energy prices and deteriorating labor market conditions weighed on real disposable income growth.

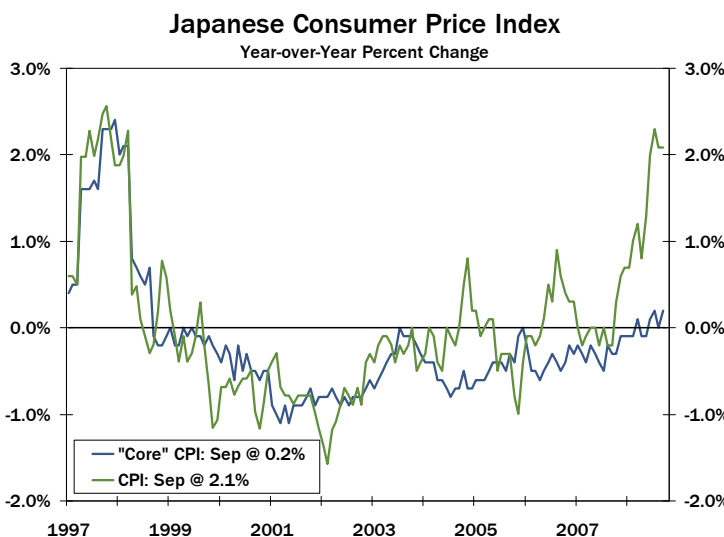
Whither the Japanese economy? In our view, real GDP growth likely will remain negative for the next quarter or two, and the total contraction in the Japanese economy could approach 2 percent. Although certainly painful, this recession may not be quite as deep as the downturns in the late 1990s and the earlier years of this decade. For starters, the Japanese banking and corporate sectors are financially stronger today than they were during the previous downturns. Growth in important trading partners in Asia clearly will weaken, but a mass collapse in regional economic activity à la 1997-98 is not likely. Finally, Japanese authorities have announced plans to support the economy via a ¥5 trillion (about 1 percent of GDP) fiscal stimulus package.

The sharp run-up in energy prices earlier this year caused the overall CPI inflation rate to shoot up to an 11-year high this summer (see bottom chart). However, core inflation remained very low, and the overall rate should quickly recede to the core rate now that energy prices have collapsed. The Japanese yen, which rose to a 13-year high in early October as the global financial system tottered on the verge of collapse, remains the currency of choice among risk averse investors. Once risk aversion starts to subside, the value of the yen should start to trend lower.



Selected Global Data

Japan	GDP Year-over-Year	Q3 - 2008	-0.1%
	CPI	September - 2008	2.1%
	Unemployment	September - 2008	4.0%
	BoJ Target Rate	Nov - 21	0.30%
Euro-Zone	GDP Year-over-Year	Q3 - 2008	0.7%
	CPI	October - 2008	3.2%
	Unemployment	September - 2008	7.5%
	ECB Target Rate	Nov - 21	3.25%
UK	GDP Year-over-Year	Q3 - 2008	0.3%
	CPI	October - 2008	4.5%
	Unemployment	October - 2008	3.0%
	BoE Target Rate	Nov - 20	3.00%
Canada	GDP Year-over-Year	August - 2008	0.6%
	CPI	October - 2008	2.6%
	Unemployment	October - 2008	6.2%
	BoC Target Rate	Nov - 21	2.25%



German Ifo Index • Monday

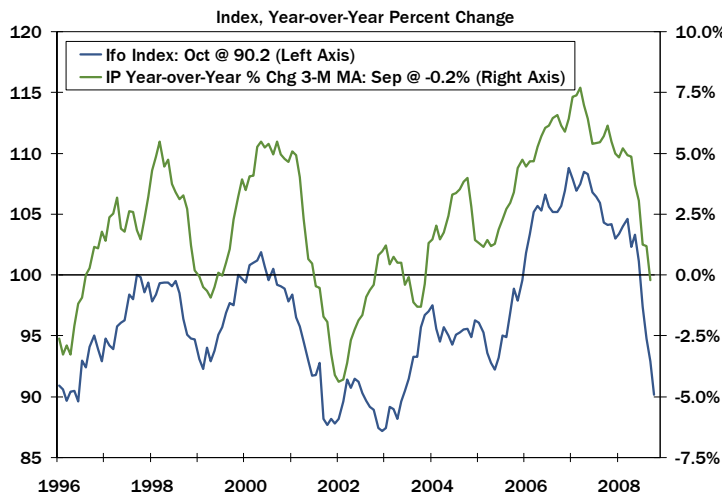
The Ifo index of German business confidence is a widely followed indicator because it is very current (the November outturn will be released next week) and is highly correlated with growth in industrial production. In that regard, the recent plunge in the index to its lowest level since 2003 does not bode well for German output.

Indeed, preliminary data show that the German economy contracted at an annualized rate of 2.1 percent in the third quarter. Data released on Tuesday will provide a breakdown of GDP into its underlying demand components. The unemployment rate has declined to 7.5 percent, the lowest rate since the heady days of reunification. However, labor market data that are on the docket on Thursday may show the rate starting to edge higher.

Previous: 90.2

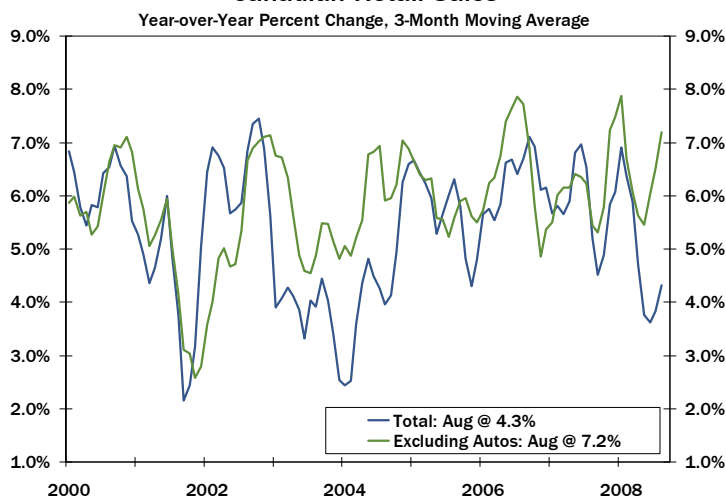
Consensus: 88.7

German Production Indicators



Canadian Retail Sales • Tuesday

Canadian Retail Sales



Unlike the United States, where growth in consumer spending has been on a weakening trend, growth in Canadian retail sales has held up fairly well this year. Indeed, overall GDP growth in Canada looks to have remained in positive territory in the third quarter, aided in part by decent growth in retail spending.

Data on Canadian retail sales in September are slated for release on Tuesday, and the market consensus forecast anticipates a 0.3 percent gain (month-on-month) following the 0.3 percent contraction registered in August. The outturn is likely to influence the Bank of Canada's decision on December 9, when it meets next to decide whether to cut its policy rate, which currently stands at 2.25 percent, further.

Previous: -0.3% (month-on-month change)

Consensus: 0.3%

Japanese Industrial Production • Friday

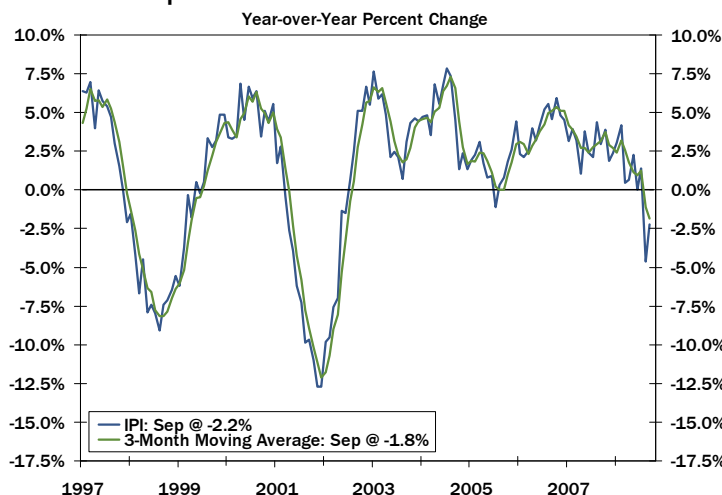
Japanese real GDP contracted at an annualized rate of 0.4 percent in the third quarter, and next week's data barrage will give investors some sense of how the Japanese economy is faring thus far in the fourth quarter. An important indicator will be industrial production data for October, which will print on Friday. IP has been bouncing around on a month-by-month basis, but the underlying pace of growth clearly has slipped.

Other indicators for October that are on the docket on Friday include the labor market report, CPI inflation, retail sales and housing starts. Although upside surprises on anyone of these individual indicators is possible, we generally look for further weakness in the Japanese economy over the next few quarters.

Previous: 1.1% (month-on-month change)

Consensus: -2.5%

Japanese Industrial Production Index



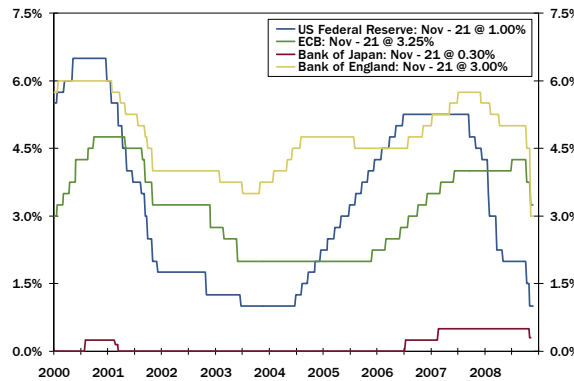
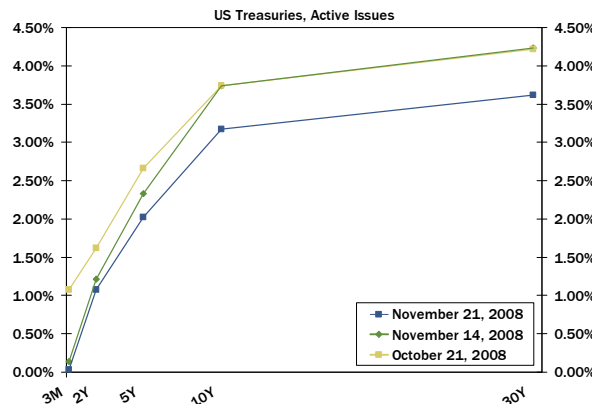
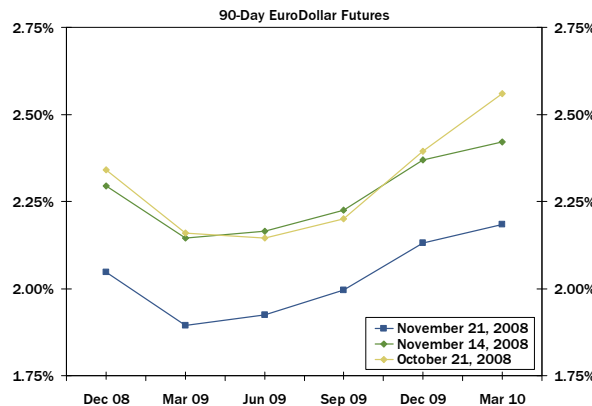
Interest Rate Watch
Secular Turn in the Credit Cycle?

Since 1982, credit expansion has supported the gains in both consumer spending and business investment. Financing the federal deficit has also been eased by capital inflows from abroad. Yet over the last year we have witnessed a change in the willingness of investors to supply credit at the narrow credit spreads experienced during the 2002-2006 period. The issue before us remains how much will credit spreads adjust to the new balance of risk and reward in this global economy? As a follow-on, the new risk/reward balance will also set the pace for credit-financed growth in the economic recovery ahead.

With investors now focused on risk avoidance, the consequent deleveraging of the American financial system suggests that economic growth will remain sub-par next year and therefore we expect the Fed will keep the funds rate below one percent all year. Risk avoidance will also bias long Treasury rates to remain below what might be considered equilibrium as the flight to quality dominates investor thinking.

Global Interplay: Dollar and Deficits

One of the most interesting credit developments for 2009 will be the willingness of foreign investors to export financial capital to the U.S. in the face of changing politics and rising federal deficits. There are several factors at work here. In the short run, there is a strong flight to safety which has benefited both the dollar and the Treasury market. However, as the U.S. economy recovers we may see that the character of the recovery, inflation uncertainty and expected after-tax returns may alter foreign investor willingness to invest here. We enter an era of change with caution.

Central Bank Policy Rates

Yield Curve

Forward Rates

Topic of the Week
Tighter Lending Conditions Persist

To little surprise, conditions to acquire a business or consumer loan tightened even further in the three months ending in October according to the Federal Reserve's Senior Officer Loan Survey. Economic conditions since the last time this survey was taken (July), continued to deteriorate as the economy, while not officially named, is in recession.

For businesses, lending standards tightening significantly, from 60 percent to 85 percent, for commercial & industrial (C&I) loans to medium and large firms. That marked a record high for this series. While issues regarding the residential sector are more familiar, lending to commercial real estate has just recently started to tighten. A record 87 percent of banks reported higher standards over the past three months. Demand for both commercial real estate and C&I loans should remain sluggish in 2009.

As dire as banks are with businesses, lending to consumers has proved even worse. The net percentage of banks willing to lend to households has deteriorated to a record 50 percent. Banks are increasing minimum payments, charging higher spreads and requiring higher credit scores for credit cards and other consumer loan products.

Bank loan officers are becoming increasingly more cautious with their capital given that the current and future economic landscape remains treacherous. Until there are signs of some stability in home prices and a bottoming in business activity, lending conditions should remain restrictive. With two more quarters of forecasted negative GDP, business and households that rely on credit will remain under pressure as the credit crunch continues to play out in 2009.

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

	Friday 11/21/2008	1 Week Ago	1 Year Ago
3-Month T-Bill	0.03	0.13	3.08
3-Month LIBOR	2.16	2.24	5.02
1-Year Treasury	0.60	0.76	3.20
2-Year Treasury	1.06	1.21	3.00
5-Year Treasury	2.01	2.33	3.35
10-Year Treasury	3.18	3.73	4.01
30-Year Treasury	3.64	4.23	4.46
Bond Buyer Index	5.13	5.14	4.45

Foreign Interest Rates

	Friday 11/21/2008	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	4.00	4.22	4.65
3-Month Sterling LIBOR	4.04	4.18	6.52
3-Month Canadian LIBOR	2.95	3.05	4.95
3-Month Yen LIBOR	0.92	0.89	0.92
2-Year German	2.10	2.22	3.65
2-Year U.K.	1.97	2.18	4.41
2-Year Canadian	1.85	1.90	3.56
2-Year Japanese	0.56	0.56	0.74
10-Year German	3.41	3.67	4.01
10-Year U.K.	3.86	4.07	4.56
10-Year Canadian	3.45	3.63	4.00
10-Year Japanese	1.40	1.50	1.44

Foreign Exchange Rates

	Friday 11/21/2008	1 Week Ago	1 Year Ago
Euro (\$/€)	1.258	1.261	1.486
British Pound (\$/£)	1.493	1.474	2.065
British Pound (£/€)	0.842	0.855	0.720
Japanese Yen (¥/\$)	95.050	97.135	108.420
Canadian Dollar (C\$/\\$)	1.280	1.237	0.987
Swiss Franc (CHF/\\$)	1.224	1.196	1.102
Australian Dollar (US\$/A\\$)	0.622	0.648	0.871
Mexican Peso (MXN/\\$)	13.799	13.061	10.988
Chinese Yuan (CNY/\\$)	6.831	6.825	7.414
Indian Rupee (INR/\\$)	50.020	49.010	39.392
Brazilian Real (BRL/\\$)	2.408	2.242	1.776
U.S. Dollar Index	87.581	86.365	75.073

Commodity Prices

	Friday 11/21/2008	1 Week Ago	1 Year Ago
W. Texas Crude (\\$/Barrel)	49.96	57.04	97.29
Gold (\\$/Ounce)	767.46	742.10	800.32
Hot-Rolled Steel (\\$/S.Ton)	770.00	770.00	520.00
Copper (\\$/Pound)	160.85	170.15	288.70
Soybeans (\\$/Bushel)	8.24	8.58	10.52
Natural Gas (\\$/MMBTU)	6.43	6.31	7.55
Nickel (\\$/Metric Ton)	9,825	11,317	29,975
CRB Spot Inds.	342.26	351.54	481.00

Next Week's Economic Calendar

	Monday 24	Tuesday 25	Wednesday 26	Thursday 27	Friday 28
U.S. Data	Existing Home Sales September 5.18M October 5.0M (W)	GDP (QoQ) 2Q 2.8% 3Q -0.6% (W) Consumer Confidence October 38.0 November 30.0 (W)	Durable Goods Orders September 0.9% October -4.2% (W) Personal Income September 0.2% October 0.4% (W) Personal Spending September -0.3% October -0.8 (W)	Thanksgiving Day U.S. Markets Closed	
Global Data	Germany IFO - Business Climate Previous (Oct) 90.2	Canada Retail Sales (MoM) Previous (Aug) -0.3%		Germany Unemployment Rate Previous (Oct) 7.5% Euro-Zone Consumer Confidence Previous (Oct) -24	Japan Indus. Production (MoM) Previous (Sep) 1.1% Japan Jobless Rate Previous (Sep) 4.0%

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

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