



WACHOVIA

ECONOMIC COMMENTARY



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The Holiday Season Is Upon Us

Halloween is over, so the holiday music is playing, the online shopping promotions have begun, and forecasters are releasing their best guesses as to how the holiday season will turn out this year. There seems to be about an even split so far between the pessimists, who believe still-high gas prices and struggling sales at discount chains will be too much to overcome, and the optimists, counting on recent strength in wage numbers to help pull shoppers into malls. We'd like to throw our hat into the optimist camp - Holiday 2006 looks like it will be a jolly one for the nation's retailers. Despite a tough comparison to a very strong season last year, we expect sales¹ in November and December to grow 7.4 percent this year (Exhibit 1).

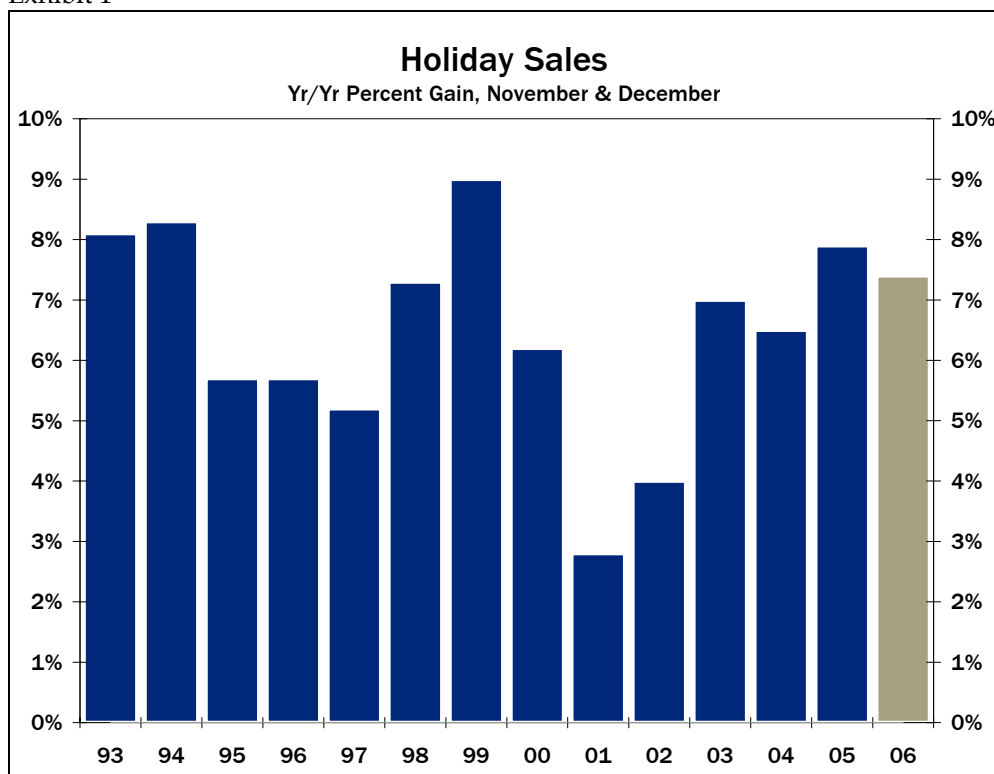
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Make Way - Wages Coming Through

Our forecast reflects a combination of factors. First, consumers tell us they intend to spend. Two different surveys show that consumers intend to purchase more than they did last year. The UBS/ICSC Holiday Shopping Survey 2006 found that, on average, consumers intend to spend \$676 per person - nine percent more this holiday season than last. Meanwhile, the National Retail Federation's 2006 Holiday Consumer Intentions and Actions Survey, conducted by BIGresearch, found that, on average, consumers plan a 7.2 percent increase in spending. While consumers do not always do what they say they will do, they usually do spend more than they plan to spend, especially around the holidays.

¹ Holiday sales include sales at the following retailers, reported by the Bureau of Economic Analysis: Sporting Goods, Hobby, Book & Music Stores, Electronics & Appliance Stores, General Merchandise Stores, Clothing & Clothing Accessories Stores, Furniture & Home Furnishing Stores, Health & Personal Care Stores, Nonstore Retailers, Building Material, Garden Equipment, & Supplies Dealers.

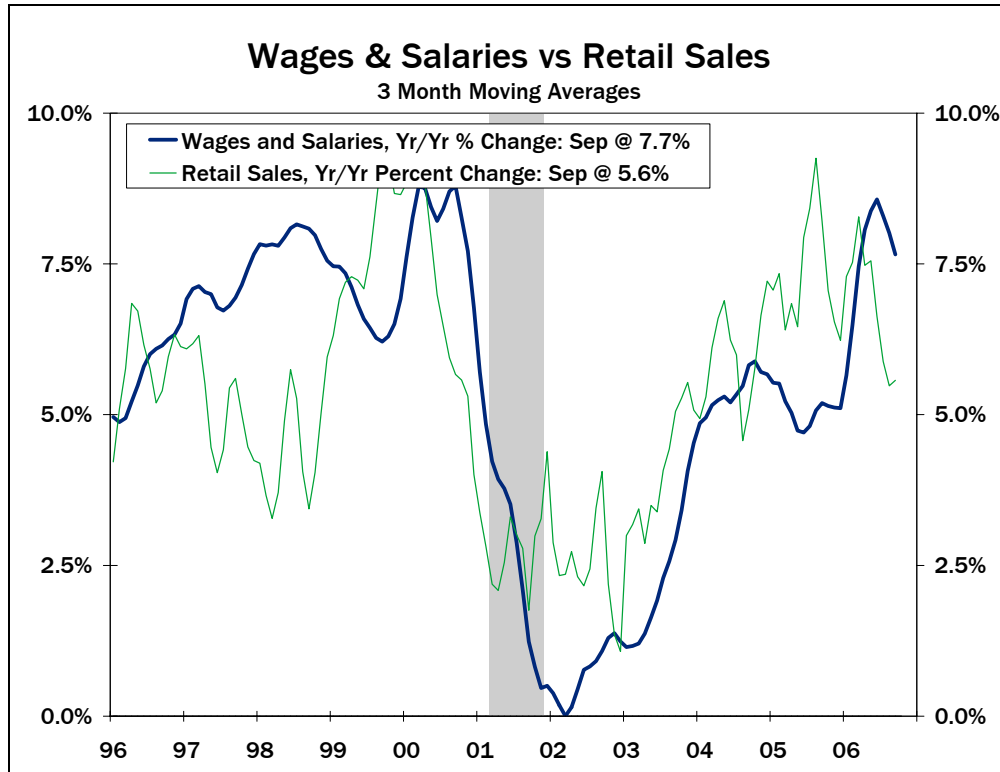
Exhibit 1



Tight labor markets and solid gains in wages form the economic basis for our forecast for another solid year of sales.

Tight labor markets and solid gains in wages form the economic basis for our forecast for another solid year of sales. Consumers that earn more tend to spend more. While sales last year were supported by wealth from the booming housing markets, this year's sales will be supported by steady gains in pay. As the unemployment rate has continued to fall throughout the last year, average hourly earnings have steadily risen and are now up 3.9 percent in comparison to this time last year. Likewise, wages and salaries are nearly eight percent higher than a year ago. As Exhibit 2 shows, retail sales tend to rise with wages. While the equity withdrawals from the booming housing market likely supported retail sales gains that outpaced wage gains in 2004 and 2005, wages are now increasing more quickly than sales. Additionally, the UBS/ICSC survey found that the most popular reason for increased holiday budgets this year was a new job or more income. The faster pace of wage gains should be the support consumers need to keep shopping through the holiday season.

Exhibit 2



Wages are not the whole story, however, as they currently only comprise 56 percent of the incomes received by consumers. Personal income was 6.8 percent higher than a year ago in September, driven not only by a strong increase in wages, but from other sources as well. Income receipts on assets, for instance, which include interest and dividend income, were up 9.8 percent in September compared to receipts in September 2005.

Higher income should support a higher level of overall sales, but there are certain segments that are likely to benefit more than others. For instance, retailers that offer luxury goods and/or cater to higher income levels are likely to continue to post stronger results this holiday season as a result of the macroeconomic trends. Average hourly earnings growth has been strongest in financial activities positions and professional and business services jobs, two categories that already pay above average wages. Consumers that hold financial market investments that pay interest or dividend income tend to fall in the higher income ranges as well. Further supporting the forecast for continued gains at luxury retailers, the UBS/ICSC Holiday Shopping Survey 2006 found the average holiday budget for consumers earning more than \$75,000 per year increased ten percent to \$1,120.

Luxury retailers are likely to see another year of above-average sales gains.

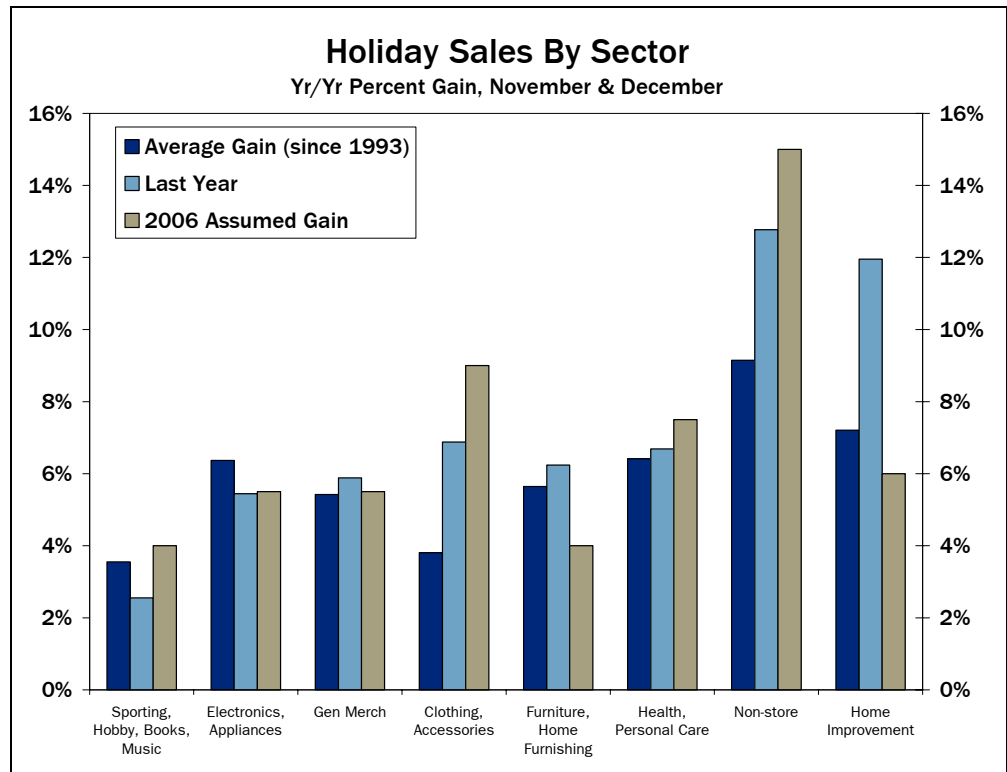
On the other side of the spectrum, stores that cater to the lower income ranges have continued to report that the recent moderation in gasoline prices has not benefited their target consumer enough to stimulate more shopping. While worries over high prices at the pump seem to have faded with recent price declines, gas prices may continue to be a story for retailers that cater to consumers in the lower income ranges.

Sector By Sector - Clothing Stores and Online Retail to Shine

Apparel retailers and online stores should shine this year, while furniture and home improvement store sales may lag.

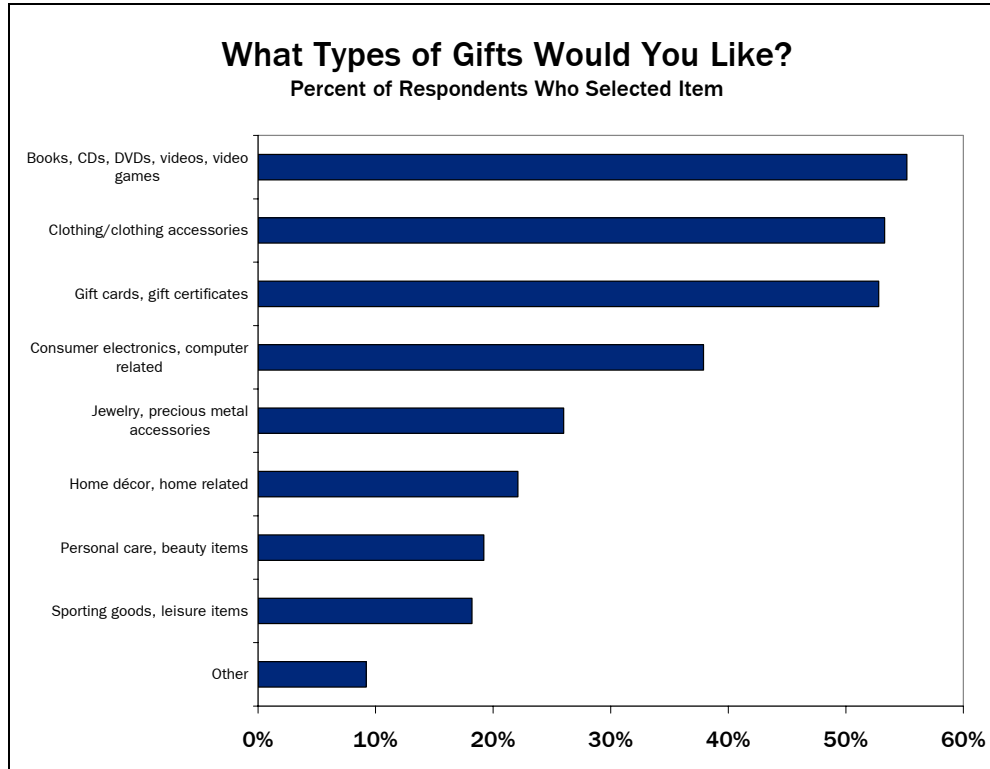
Not all gains this holiday will be shared equally (Exhibit 3). The two sectors that seem most likely to shine this year are apparel retailers and online stores. Both segments have been steadily gaining momentum and consumer interest for the last few years, and are primed to continue to do so this season. Meanwhile, the two segments that are likely to be the biggest drags on headline sales are home improvement stores and furniture retailers. Slowing housing markets are mostly to blame for a slower pace of sales at these retailers.

Exhibit 3



Clothing and clothing accessories stores enjoyed a strong gain last year, and the momentum has continued into this year. Since 1993, the average holiday sales gain for the sector has been a mere 3.8 percent. However, last year sales jumped nearly seven percent with the help of strong fashions. This year, sales are likely to rise nine percent as fashions continue to draw consumer interest. Two different consumer surveys show clothing is still one of the top items on wish lists this year. In the UBS/ICSC Holiday Shopping Survey, more consumers noted clothing as their most desired gift this year in comparison to last year, and in the BIGresearch survey conducted for the National Retail Federation, clothing came in a close second as the most desired gift (Exhibit 4).

Exhibit 4



Source: National Retail Federation's 2006 Holiday Consumer Intentions and Actions Survey, conducted by BIGresearch

Retailers with a presence online are likely to see green this year as well. Nonstore retail, which includes online purchases, posted the strongest growth in sales among all retail segments last year. Some of the strength in online sales last year was likely due to a resistance to driving due to high gas prices. While fewer consumers cite high gas prices as reason to shop online this year, we expect the convenience of shopping from home to win a greater share of busy consumers' dollars yet again this year. Retailers are keenly aware of consumer interest in shopping from home, and are poised to offer shipping deals and price discounts to draw consumers to their sites. According to the BIGresearch survey, 47.1 percent of consumers plan to shop online for holiday items this year, and on average, consumers plan to make 28.9 percent of their purchases online. Likewise, UBS/ICSC found that 25 percent of shoppers plan to do more than 10 percent of their purchasing online this year, a jump from 22 percent last year.

Housing Market and No Hurricanes Spell Trouble for Some Retailers

Due to the broader macroeconomic slowdown, there are a few retail sectors that are unlikely to see strong gains this year, namely furniture stores and home improvement retailers. While outright declines are unlikely, a moderation in the pace of sales at these retailers seems likely. Furniture stores have started to see decelerating sales as a result of the slowdown in many housing markets around the nation. While consumers will still probably shop for decorative furnishings and other small ticket items, fewer sales of big ticket items such as sofas, beds and tables will be a drag on other sales. Home improvement retailers find themselves in similar circumstances, with sales of heavy duty

building materials slumping with slower residential construction. Additionally, home improvement stores have reaped the benefits of tough hurricane seasons that spurred sales of materials for rebuilding during the last few holiday seasons. A quiet Atlantic this year adds to the pressure of the housing market slowdown. While gift cards, tools, and other smaller purchases should keep sales afloat, after three seasons of double-digit gains in holiday sales, home improvement stores should see sales moderate to a pace closer to their longer-term average this holiday season.

Gift Cards Also a Drag

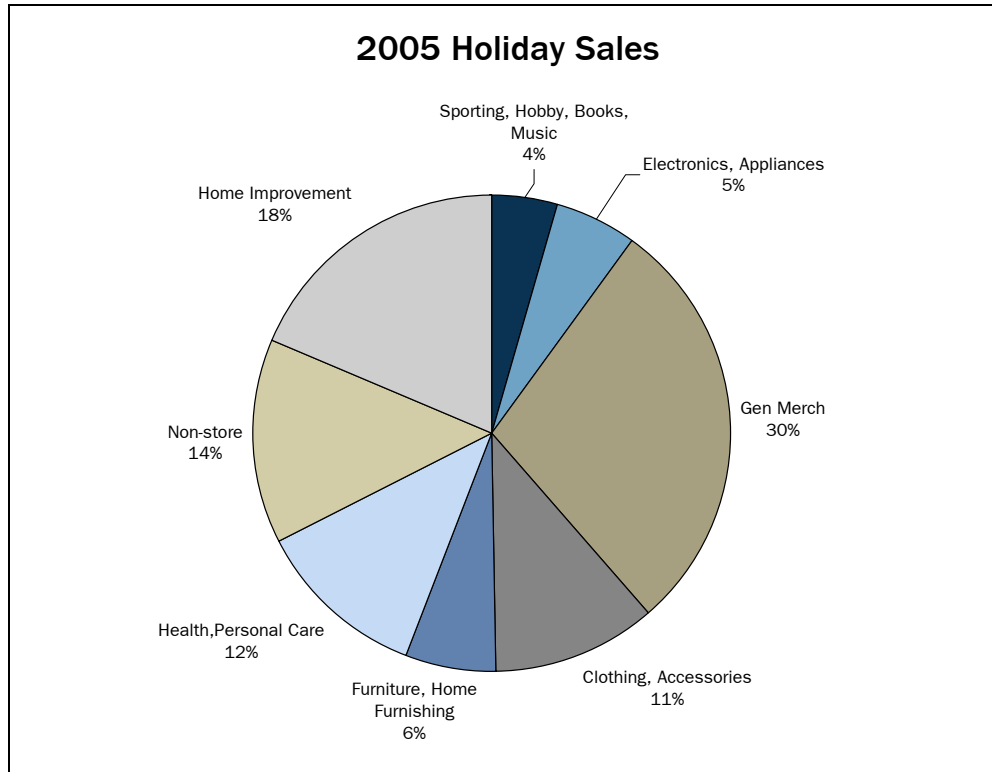
Gift cards maintain great popularity, causing an extension of the holiday season into January every year.

Next year may be the year that our holiday sales forecast period will be modified to include January so as to capture the effect of gift card purchases. Unfortunately, until then, gift card sales are effectively a drag on holiday sales, as the cards are recorded as a sale at redemption, and are usually redeemed after December. As Exhibit 4 showed, gift cards are a close third on the lists of consumers' preferred gifts. While the effect is difficult to measure in our forecast, the increasing popularity of gift cards is likely to be a drag on recorded holiday sales this year. There is also a possibility that many gift cards from last year will be put to use this holiday season. The trend is simply too new to get a handle on. Our belief, however, is that the most significant impact of the gift card craze is to extend the holiday season into January; hence our intentions to expand our calculation of holiday retail sales.

General Merchandisers - Still a Key Component

While gains in online sales and appealing fashions will likely provide a boost to retail sales this holiday season, the fate of the retail season still hinges significantly on how general merchandisers fare, simply because general merchandisers still garner a majority of sales dollars. As shown in Exhibit 5, sales at general merchandise stores were nearly a third of total holiday sales last year. Sales at general merchandisers increased 5.9 percent in 2005; a growth rate we anticipate will be tough to match this sales season.

Exhibit 5



Department Stores Back in Vogue?

While a slightly slower gain of 5.5 percent is expected this year for sales of general merchandise, the composition of the gain is likely to be far more interesting. For the last decade, department stores have been ceding market share in the sector to warehouse clubs and superstores. In 1995, 41 percent of general merchandise sales went to department stores, and 12 percent went to warehouse clubs and superstores. Last year, only 31 percent of sales were at department stores and the warehouse clubs and superstores garnered 33 percent of general merchandise sales.

However, it seems increasingly likely that department stores might grab back some of that share this year. Last year, holiday department store sales dropped 0.9 percent. While discount department stores managed a one percent gain for the season, the total department store sector was dragged down by a 3.4 percent decline in conventional department store sales. So far this year, department stores have staged a comeback, and it appears that the strength is likely to continue into the holiday shopping season. The BIGresearch survey found that department stores are a close second to discount stores as consumers' shopping destination of choice this year, and are actually at the top of the list of stores to hit for consumers aged 18-24.

Stronger department store sales are expected this year, as shoppers look for more than just price to drive spending.

Department stores are also becoming much savvier in marketing their wares. Shopping at traditional department stores is now much more event-oriented, with specific programs targeting various market segments. Many merchants have also followed the

discounters into open-air shopping centers, taking on the discount chains on their home turf and appealing to shoppers that do not have time to stroll through the malls.

While some discounters have had a tough time drawing shoppers as of late, we do not expect the slowdown to be enough to drag sales rates into negative territory, as discount stores are still the number one destination of choice for shoppers, particularly lower income and middle aged shoppers. According to BIGresearch, 70.3 percent of consumers plan to purchase holiday items at discount stores this season. Of consumers that earn less than \$50,000 per year, 73.4 percent expect to shop at discount stores. Consumers aged 35-64 are also most likely to look to discounters for holiday items. We should also note that while discounters may have trouble drawing spending from their traditional customers, they may have a broader reach due to product offerings and pricing flexibility during the holiday season. Consumers still cite their top reason for choosing a shopping outlet as sales or price discounts, an offering that discounters and warehouse clubs have mastered. Merchandise selection is the second most important factor consumers consider in selecting their shopping locale. This year, discount chains might do just fine if they can get a few extra gaming systems or offer more plasma televisions at a discount to grab the attention of today's savvy shoppers.

Merchants in the South and West Will Ring Up the Strongest Sales

Holiday sales should rise the fastest in the South and West and lag in the Midwest, reflecting the economics of each region.

Spending will reflect underlying economic conditions throughout most of the country, which means that sales will rise the fastest in the South and West and lag in the Midwest. The strongest gains are likely to occur in the Rocky Mountain region, where job and income growth has soared. One of the recurring themes we are seeing around the country is that, with a few exceptions, spending is rising the fastest in markets that did not fully participate in the housing boom. Markets where housing has gone bust are not necessarily seeing widespread weakness, but most are seeing smaller spending gains than they have in recent years.

Phoenix has seen particularly strong growth this past year, with employment surging 5.0 percent over the past year and income estimated to have increased 10.0 percent. Strong employment growth and the continued in-migration of close to 150,000 new residents per year have sent spending sharply higher in recent years. While home sales have plummeted recently, raising fears of a broader-based slowdown, there is still enough fuel in the fire to produce another strong holiday shopping period. Retail sales in Arizona expected to climb 10 percent this year, with **Phoenix** posting a slightly larger gain of around 11 percent.

The other bright spots in the Rocky Mountain region are **Boise** and **Salt Lake City**. Both areas avoided the bulk of the housing boom and, thus, are not bearing the brunt of the housing bust. Both continue to see solid job gains across a broad assortment of industries. Hiring is up nearly 5.0 percent in Boise and is up 4.6 percent in Salt Lake City, while the unemployment rate has fallen to just 2.8 percent and 2.7 percent, respectively. Both areas should see exceptionally strong gains this holiday season, with retail sales expected to climb 12.0 percent in Boise and 9.0 percent in Salt Lake City.

Albuquerque is also seeing strong economic gains, with employment rising 3.5 percent and the unemployment rate falling to just 3.9 percent. Retailers should reap the benefit of that strong tailwind this holiday season, likely ringing up gains of around 8 percent. Retailers in the **Denver** area, where employment is rising a much more modest 2.0

percent, will likely see holiday sales rise more in line with the national average. We are looking for an increase of around 6.5 percent this year.

The Pacific Northwest is another stand out area, particularly the **Seattle** area. Once again, this is a market that largely missed the housing boom and is not seeing much fall out from the housing bust. Job and income growth have strengthened during the past year, reflecting a pick up in the technology sector, wholesale trade and professional services. Nonfarm employment has increased 4.0 percent and income is up close to 9.0 percent. Those increases should propel holiday sales up at least 8.5 percent this year.

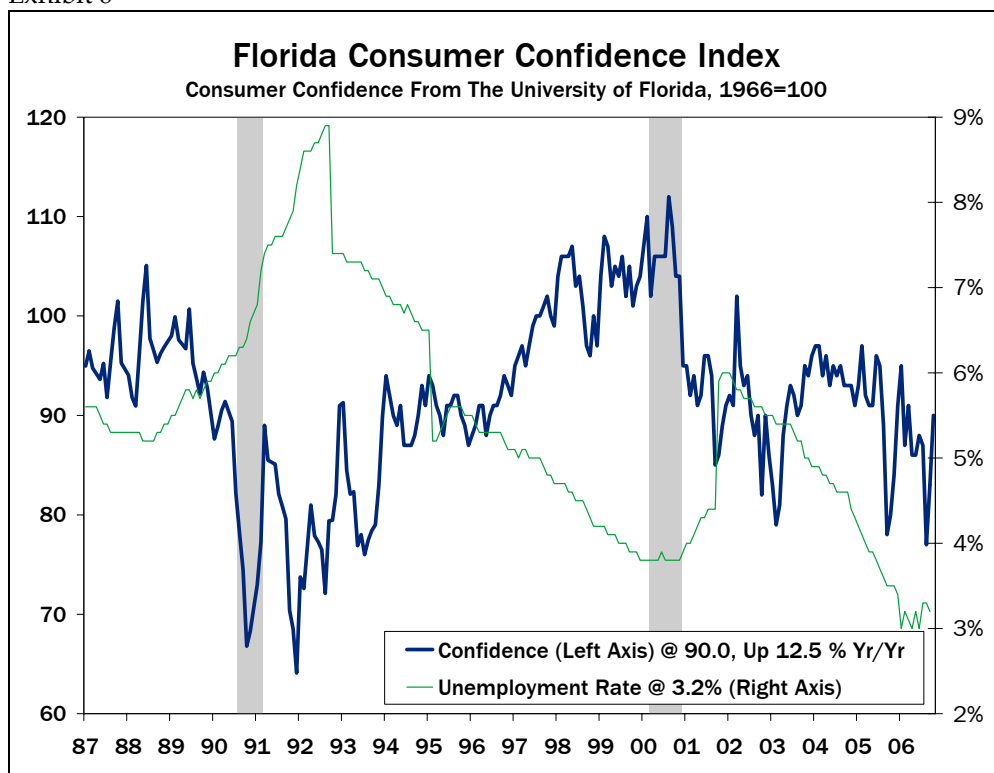
Bright spots in the West include Phoenix and Seattle, while sales in Denver and San Diego may lag the national average gain this year.

By contrast, **California** is seeing somewhat more modest growth. The large absolute size of the Golden State's economy makes it extremely difficult for the state to post gains much different than the national average and that will likely be the case this year as well, with holiday sales rising between 6.5 percent and 7.0 percent. Naturally some areas will do better than others. On the plus side, Los Angeles, San Jose, Oakland and San Francisco are seeing stronger job and income gains and will all see retail sales rise around 7.5% this holiday season. San Diego, Sacramento and Riverside will all likely see gains slightly below the state average.

Merchants throughout the South should also see plenty of green this holiday season. Overall job growth in the South is outpacing the nation, with Texas and Florida leading the way. Nearly all of the major metropolitan areas in the South are seeing solid jobs gains and nine of the nation's twenty largest year-to-year employment gains have occurred in metropolitan areas located within the region.

Florida has been the growth leader for most of this decade, often leading the nation in employment growth. Hiring has risen throughout the state, with the strongest gains occurring in South Florida, Orlando and Tampa Bay. Employment conditions remain red hot in the Sunshine State, with nonfarm employment up 2.9 percent and the unemployment rate falling to just 3.2 percent. Personal income is also up solidly, rising nearly 8 percent.

Exhibit 6



The strength in employment and income should help offset concerns about Florida's weakening housing market. Sales of new and existing homes have fallen more than 25 percent over the past year, which has led many sellers to reduce their asking prices. Most of the oversupply issues, however, are not in the state's largest metropolitan areas and this is where employment, income and retail sales are rising the most. We are looking for retail sales to rise 8.5 percent this holiday season for the state as a whole and are looking for sales to rise 11 percent in **Fort Lauderdale**, 10.0 percent in **West Palm Beach-Boca Raton** and 8.5 percent in **Miami**. Sales in **Orlando** and the **Tampa-St. Petersburg** area will also likely rise around 8.5 percent, while sales in **Jacksonville** look set to increase 7.5 percent.

Southern states, such as Florida and Texas are likely to see strong gains in sales, reflecting employment conditions.

The **Texas** economy has gained considerable momentum in the past year, benefiting from an investment boom in the energy business as well as a rebound in the state's important technology sector. Dallas and Houston are leading the way but job and income growth have picked up in virtually every area. Statewide, nonfarm employment has increased 2.2 percent over the past year, while the unemployment rate has fallen to just 4.8 percent. Personal income is on a pace to rise 9.3 percent this year, which should allow holiday retail sales to rise at least 8.5 percent this year.

Houston and **Dallas**, which have both seen job and income growth accelerate during the past year, will see the largest gains, with retail sales rising 10 percent and 9 percent, respectively. Both areas missed out on the housing boom and have seen little fall out from the housing bust. **Austin** and **San Antonio**, where job and income growth have been somewhat more modest, are expected to post gains closer to 8 percent. Many of the state's smaller metro areas should also post solid gains, particularly McAllen, Midland and Amarillo.

Virginia's economy has cooled off a bit recently, as Washington D.C.'s formerly booming housing market has cooled off. Overall economic conditions remain quite strong across the state, however, particularly in the northern suburbs around the nation's capital. Nonfarm employment has risen 2.5 percent in the greater **Washington D.C.** area, with the strongest gains occurring in northern Virginia. Personal income growth is expected to rise 8% across the metro area but worries about the region's softening housing market will likely hold holiday retail sales growth to around 6 percent in the Washington D.C. area.

Economic growth in the rest of Virginia has been somewhat more restrained but so has the housing market. As a result, holiday retail sales will likely increase more in line with the state's more modest economic fundamentals. Job growth in the **Virginia Beach-Norfolk** metropolitan area has averaged around 1.7 percent over the past year, while employment growth in the **Richmond** area is up somewhat less. Personal income is rising at around an 8.0 percent annual rate in both areas, which should allow holiday retail sales to climb at least 7.5 percent this year.

For other states in the South, look to housing markets and employment conditions to set the tone for sales growth.

The Carolinas comprise another market that largely missed the housing boom and is currently enjoying robust economic gains. Hiring in **North Carolina** has increased 1.8 percent over the past year and the unemployment rate has fallen to 4.9 percent. Personal income is expected to climb 6.5 percent this year, which should result in holiday retail sales gains of around 6.0 percent.

Raleigh and **Charlotte** are growing considerably faster than the rest of the state, with employment climbing 3.5 percent in Raleigh and 2.5 percent in Charlotte. Both areas are also seeing rapid population inflows, which is helping drive personal income up at nearly a 9.5 percent annual rate in Raleigh and an 8.5 percent pace in Charlotte. Holiday retail sales are expected to rise 9.0 percent in the Raleigh area this year and increase 8.0 percent in Charlotte.

Georgia's economy gained considerable momentum during 2006, as hiring picked up in Atlanta and along the coast. Nonfarm employment has risen 1.8 percent over the past year and the unemployment rate fell to 4.5 percent. Personal income is on a pace to increase 7.4 percent. The Atlanta area accounts for most of that increase, with nonfarm payrolls rising 2.5 percent. Strong population growth and a resurgent travel and leisure industry have helped send retail sales up at a 9.0 percent pace this year and we expect holiday sales to come in roughly in line with that gain.

Growth is somewhat less robust outside of Atlanta, but every major metropolitan area in Georgia is seeing solid gains, and growth along the coast is particularly robust. **Savannah** is seeing employment gains in the 3.5 percent range and personal income is up 8.0 percent over the past year. Holiday spending is expected to rise a relatively strong 7.5% this year, which is a touch above the national average.

Alabama may be enjoying the quietest boom in the nation. Nonfarm employment has increased 2.0 percent over the past year and the unemployment rate has fallen to 3.3 percent. The strongest gains continue to be in Huntsville and Birmingham, where job growth has increased 2.8 percent and 2.3 percent, respectively. Holiday retail sales have risen solidly in both areas in recent years and should once again post solid gains this

year. We are looking for sales in Huntsville to jump close to 10.0 percent this year and expect holiday sales in Birmingham to increase 8.0 percent. Sales in Montgomery and Mobile will rise somewhat less rapidly, increasing 7.6 percent and 7.0 percent, respectively.

Holiday retail sales in the Northeast may slightly trail the national average and sales will likely be dampened by the struggles of the domestic automobile manufacturing industry.

Holiday retail sales in the Northeast are expected to slightly trail the national average, with overall sales climbing around 7 percent. **New York City** remains a stand out, however, with strong job and income gains in financial services helping drive income growth up 8.0 percent over the past year. The unemployment rate has fallen to 4.7 percent. We are looking for holiday retail sales to rise 7.5 percent this year, which is particularly strong considering the large base on which the gain is taking place and the strong gains reported last year.

Other areas of the Northeast will not see gains nearly as strong. Economic growth has moderated considerably in **New Jersey** and Eastern Pennsylvania. New Jersey's job growth has slowed to just a 1.0 percent pace and the unemployment rate has inched up to 5.2 percent. Moreover, the state's formerly booming housing market has softened considerably. Personal income is rising at around a 7.0 percent pace, which should allow for holiday retail sales growth of around 5.5 percent.

Job growth in the greater **Philadelphia** area is holding up much better, thanks to solid gains in financial and business services. Nonfarm employment has risen 1.5 percent over the past year and the unemployment rate has essentially held steady at 4.7 percent. Income growth remains quite solid, which should help send holiday retail sales up at around a 7.0 percent pace.

The ongoing difficulties in the domestic motor vehicle industry continue to weigh on economic conditions in the Midwest and that will put a damper on holiday spending this year. Most of the weakness is in Michigan and Ohio, where income growth has risen a paltry 4.5 percent and 5.6 percent over the past year, respectively. But even the Motor City's woes will not put the kibosh on holiday spending. Merchants in the Detroit area should still see sales climb around 3.5 percent this year and merchant in Ohio should see gains around 4.5 percent.

Illinois remains a relative bastion of economic stability in the Midwest, with personal income climbing 7.3 percent this past year, which is roughly in line with the nation. Most of that gain can be attributed to strong job gains in the Chicago area, particularly in financial and business services. The **Chicago** area will likely be the lone bright spot in the Midwest this holiday season. Overall economic conditions are quite solid, with nonfarm employment rising 1.6 percent and the unemployment rate falling to 4.4 percent. Both figures are in line with the nation and should support holiday retail sales close to the national figure of 7.4%.

Discussion

The slowdown in economic growth has some forecasters worried about the ability of consumers to maintain a steady spending pace this holiday season. However, consumers report they intend to spend, and we believe them. Shoppers, as always, will keep a close watch on prices and look for convenient ways to spend, but the shopping experience and fashion trends are also likely to play a significant role in spending patterns this year. Housing will have a hand in driving sales trends, from an expected moderation in sales growth of housing related merchandise, to slower sales in areas of the country where prices are moderating most. However, tight job markets and steady income gains in most areas of the country should provide solid support for a holiday sales gain of 7.4 percent this year.

Happy Holidays!

Wachovia Corp. Economics Group

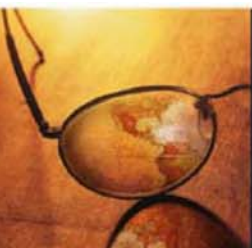
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