



SPECIAL COMMENTARY

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ABA Economic Outlook Strategic Session

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Five economic fundamentals provide the framework for any proper economic baseline for the year ahead. These short run, business cycle fundamentals are growth, inflation, interest rates, corporate profits and the dollar. In addition, strategic planning must also account for longer run behaviors. This discussion therefore takes a peak at key long run influences such as demographics, education and global growth.*

Five economic fundamentals provide the framework for any proper economic baseline for the year ahead.

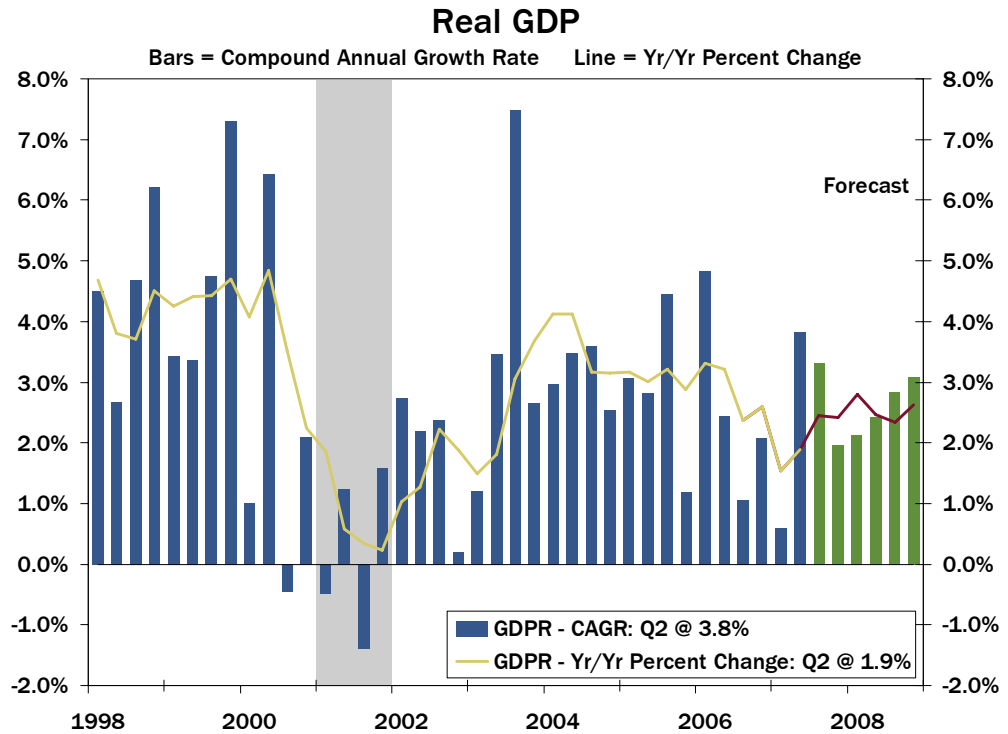
Slower Growth but No Recession

Discerning between slower growth and recessions (negative growth) requires a more nuanced examination of economic trends. In Figure 1, next page, the slower pace of economic growth is evident in the year-over-year growth rate of real gross domestic product (GDP). There remains a significant difference, however, between current activity and the experience of 2000-2002. Over the last few months, the worst fears about the near-term economic outlook subsided considerably following the release of the September employment figures, manufacturing surveys and retail sales. Job gains were stronger than expected in September while the August decline in jobs was revised to a modest gain. The ISM manufacturing survey and retail sales numbers suggest continued growth.

For the intermediate term, we will get our first look at third quarter real GDP on October 31. Our latest estimate has third quarter real GDP rising at around a 3.5 percent pace and there is a good chance that growth will come in above our estimate. Any recession talk is contradicted by two reliable indicators of growth. First, jobless claims, which come out every Thursday morning, remain in the positive growth range of 310,000 to 330,000 on a four week moving average basis. Second, the Institute for Supply Management (ISM) index remains in the positive growth range of 52 to 54 percent, where 50 is considered break even. The ISM indicator subcomponents of production, new orders and supplier deliveries remain above the 50 break even level.

* As prepared for the ABA Banking Leaders Forum and Annual Convention, San Diego, Oct. 7-10, 2007

Figure 1



Source: U.S. Department of Commerce and Wachovia Corp.

The outlook is for slower growth but growth nonetheless.

Recent economic strength reflects the impact of robust consumer outlays during the quarter as well as strength in non-residential construction, government and trade sectors. Consumer spending is being helped by income and labor market fundamentals. Household net worth has benefited from gains in equity markets. Meanwhile, labor market improvements have slowed in terms of actual job gains, to a pace slightly below what is necessary to hold the unemployment rate steady. However, labor compensation has improved along with continued low inflation. Real household incomes have continued to improve enough to sustain a positive trend in real income. Looking ahead, spending for big-ticket items such as automobiles and household furniture is expected to slow in coming quarters, as adjustable rate mortgages reset upward. Slower job and income growth will also curb consumers' willingness to spend this holiday season. The outlook is for slower growth but growth nonetheless.

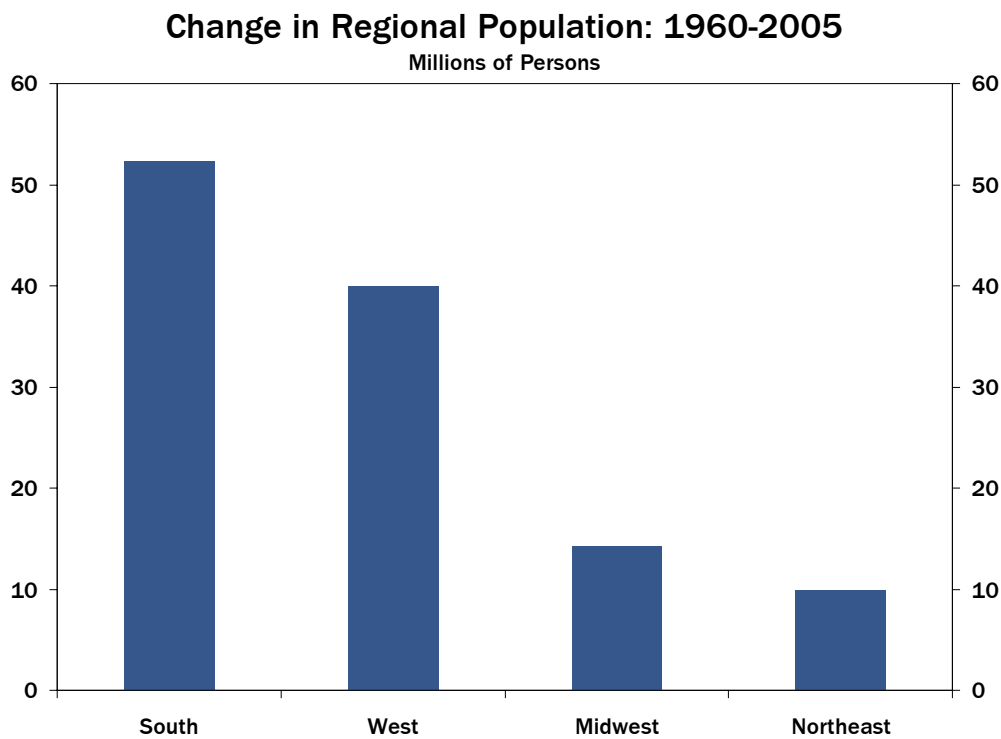
Longer Term Influences on Growth and the Strategic Vision

Over the last forty years there has been a consistent shift in population growth from the Northeast and Midwest to the South and the West as evidenced in Figure 2. This pattern reflects the fundamentals of the cost of land, labor, and personal income taxes and, over the last two decades, the rising tide of retirees living in the South and West. This population shift drives the top line revenue growth for community banking.

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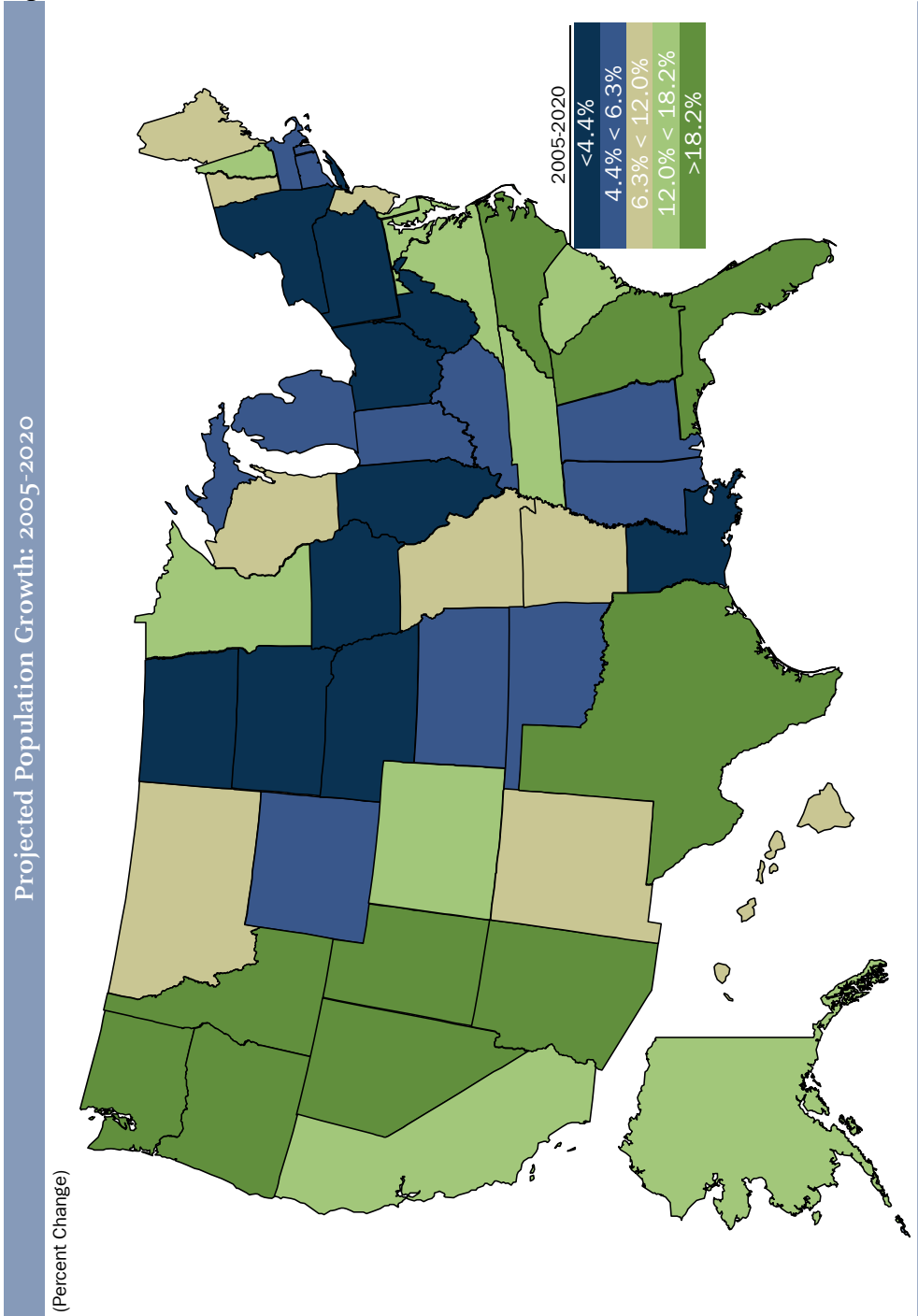
These same trends should hold over the next 15 years according to the U.S. Census bureau (Figure 3, next page). The upper Midwest and the Northeast will continue to shed population, as baby boomer retirees and job seekers alike seek opportunities in the Sunbelt and the West.

Figure 2



Source: U.S. Census Bureau and Wachovia Corp.

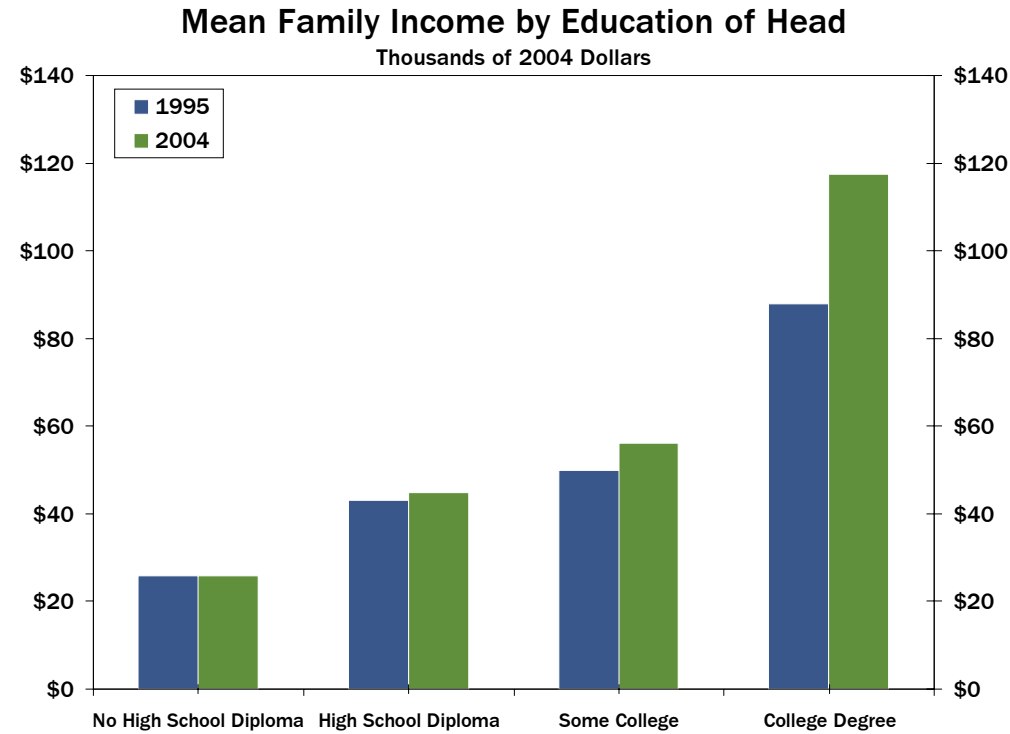
Figure 3



Another demographic trend has been the rising returns to education. Mean family income data from the Federal Reserve's Survey of Consumer Finance (Figure 4) shows that income growth for high school graduates and those that fail to graduate is far slower compared to those who even obtain some college education. This suggests that banks will increasingly benefit from rising income/educated households as a source of deposits and credit quality loans in the years ahead.

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Figure 4



Source: Federal Reserve Board and Wachovia Corp.

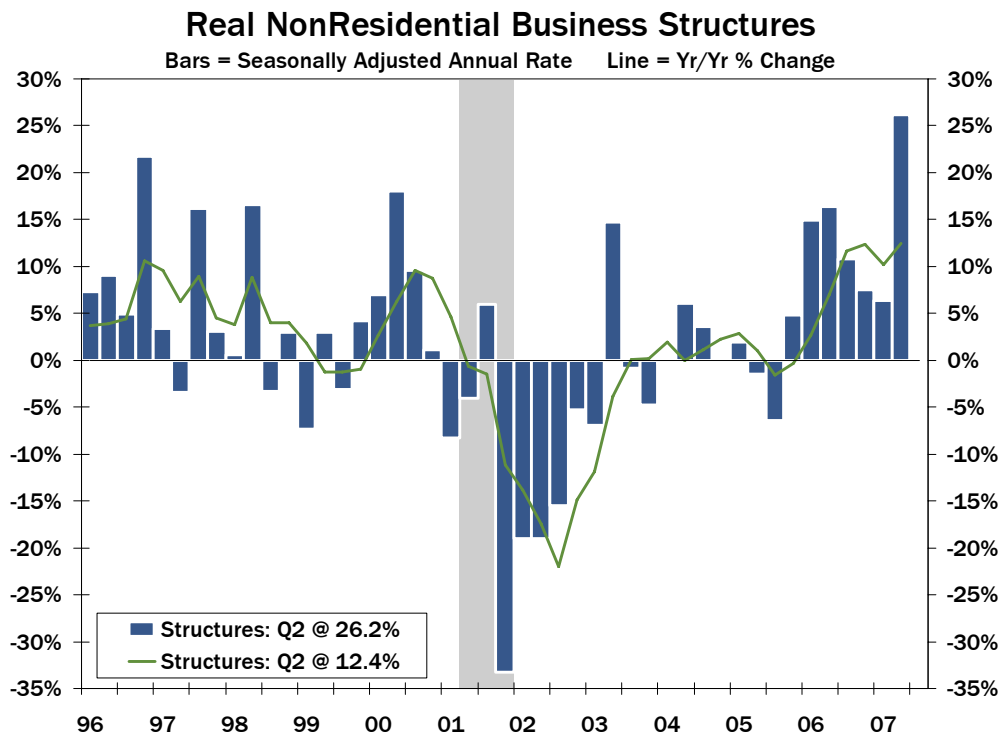
Gains in Capital Spending, Non-Residential Construction – Housing Correction Continues

Over the last year we have witnessed strength in business equipment spending for information processing and software equipment while other capital spending has slowed sharply. Strength for spending in the information economy appears to be a secular story. Global competition compels competitors to invest to compete effectively.

Non-residential construction has been solid for the last six quarters.

Meanwhile, non-residential construction has been solid for the last six quarters (Figure 5). Lending for takeovers and sales of commercial real estate properties will now be more prudent and based on much more conservative assumptions of future revenues. Prices of commercial properties may fall back a bit as well, but commercial construction should be restrained only modestly, as office vacancy rates remain relatively low across the country and rents are increasing. A repeat of the second quarter’s solid 26 percent annualized gain in structures spending is unlikely anytime soon, but a sharp downturn is just as improbable.

Figure 5

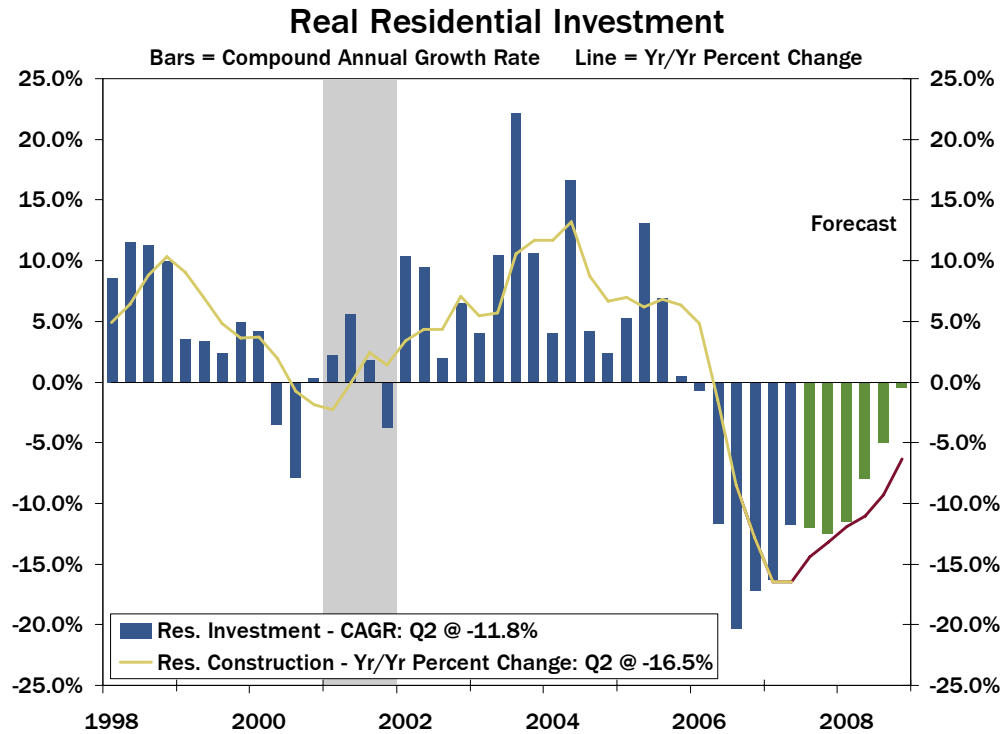


Source: U.S. Department of Commerce and Wachovia Corp.

Residential housing spending continued to weaken during the year. Now that conditions in the credit markets appear to have stabilized somewhat, we have a better, but still uncertain, idea of the potential impact. Credit is being constrained for riskier borrowers and will likely remain tight. Some loosening in the sub-prime market will eventually occur, particularly for fixed-rate mortgages, where credit quality remains relatively good. Our view is that real residential investment will be less of a drag on growth in the year ahead (Figure 6).

Credit is being constrained for riskier borrowers and will likely remain tight.

Figure 6



Source: U.S. Department of Commerce and Wachovia Corp.

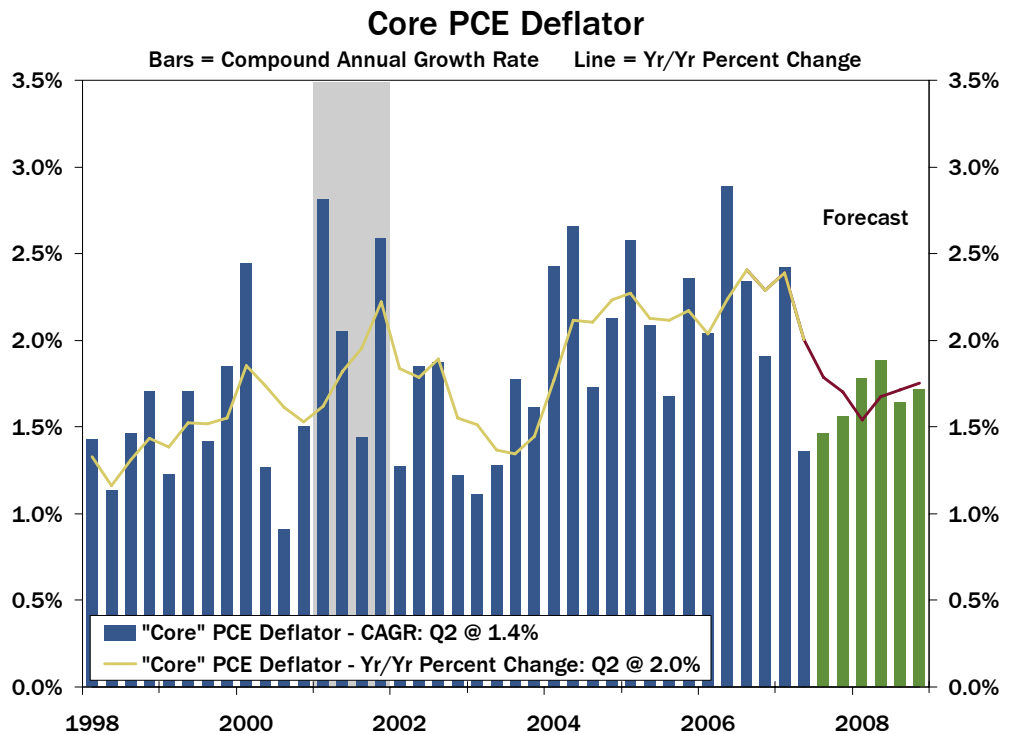
Inflation: Within Fed’s Target Range but Limited Further Progress

While inflation data suggest that the core personal consumption deflator (Figure 7) remains in the top end of the Federal Reserve’s range, further progress does not appear to be in tow. Core producer prices are up 2.2 percent over the last year as of August 2007 compared to a mere 1.2 percent reading a year ago. Meanwhile, the ISM prices-paid index came in at 59.0 compared to a peak of 73 in April where 50 is the breakeven point between rising and falling prices paid. The prices paid index has been above 50 all this year. Finally, productivity growth has slowed and we witnessed a rise in unit labor costs of 5.1 percent in the second quarter. Unit labor costs have climbed since 2004, the bottom of the recent cycle.

The core PCE deflator should remain near the top-half of the Fed’s comfort zone.

While higher gasoline prices remain a risk, there is a growing probability that most of the damage is behind us. We are beginning to see some moderation in housing costs, which should also help to contain core inflation. The core PCE deflator should remain near the top-half of the Fed’s comfort zone.

Figure 7



Source: U.S. Department of Commerce and Wachovia Corp.

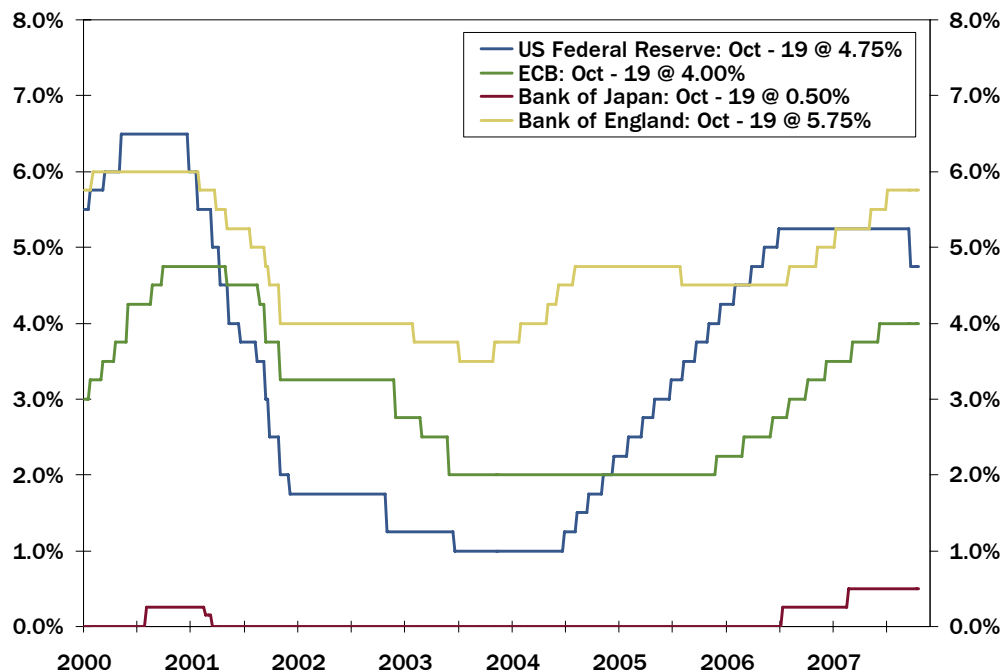
Fed Takes a Wait and See Attitude

From mid-2004 to early 2006 the Fed has followed a policy of getting the funds rate back to “neutral” and then keeping the funds rate steady for over a year (Figure 8). Longer-term, however, we suspect the Fed remains cautious on the inflation outlook and is unlikely to ease very much despite the current set of economic numbers. As for inflation over the last few quarters, we have seen a steady rise in unit labor costs along with steady gains in the core finished goods component of the producer price index. These developments suggest the Fed will take its time to ease. The minutes from the latest FOMC meeting contained one surprise in that the Fed decided not to provide a balance of risks assessment. We interpret this move as an attempt by the Fed to make it clear to the financial markets that they can react to a financial crisis without giving in on inflation. Carried a step further, the Fed’s comments seem to indicate to us that September’s half point rate cut and any additional cuts we might see are intended to provide a temporary respite for the economy and financial markets. Interest rates will climb once the economy and financial markets firm up.

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Figure 8

Central Bank Policy Rates

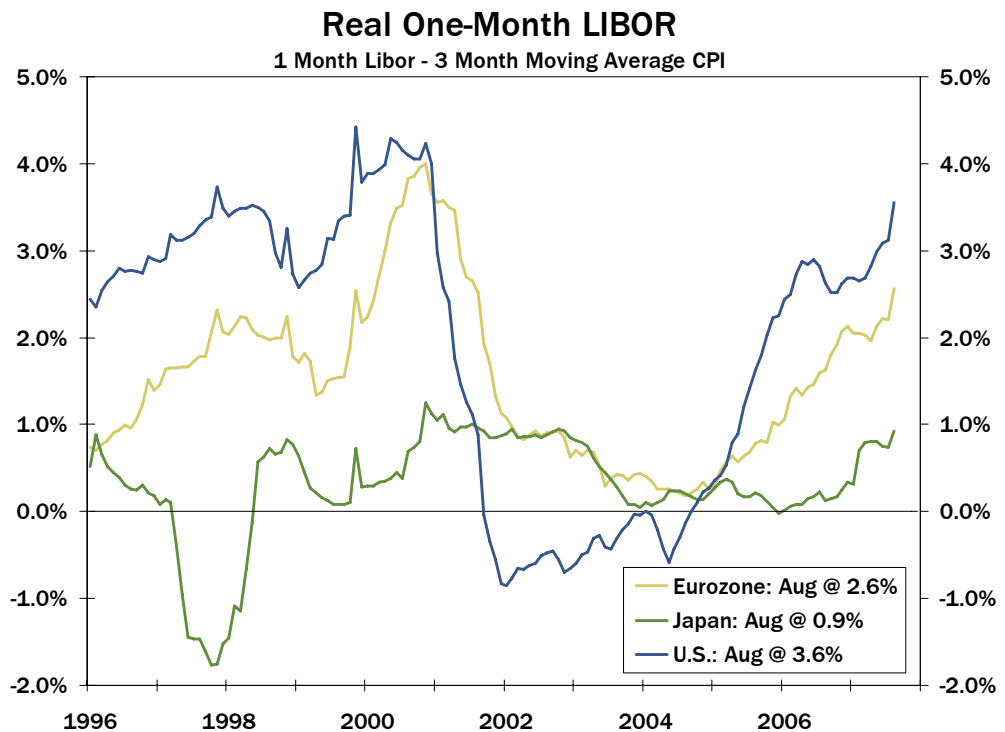


Source: Bloomberg LP and Wachovia Corp.

Rising LIBOR rates suggest bank credit quality concerns still exist in the private sector.

We now have the Fed on hold, with a bias to ease, through all of next year. With real GDP growth expected to be around a two percent pace for the next two quarters, there is a risk that some sort of exogenous shock coming from the financial markets or overseas will trigger some additional moves by the Fed. Any such moves would come after the October 31 FOMC meeting, when the economy is likely to look pretty solid. Current Fed policy inaction appears primarily designed to prevent the problems in the sub-prime mortgage market from spilling over into other parts of the economy. The Fed will also likely remain alert to taking further steps to restore liquidity to credit markets, especially the asset-backed commercial paper market, possibly by reducing the discount rate further and broadening the rules on what can be pledged as collateral at the discount window. Rising LIBOR rates (Figure 9) suggest bank credit quality concerns still exist in the private sector and may point to similar anxiety at the Fed as well. This credit restraint will impact the availability and supply of credit in the coming year.

Figure 9

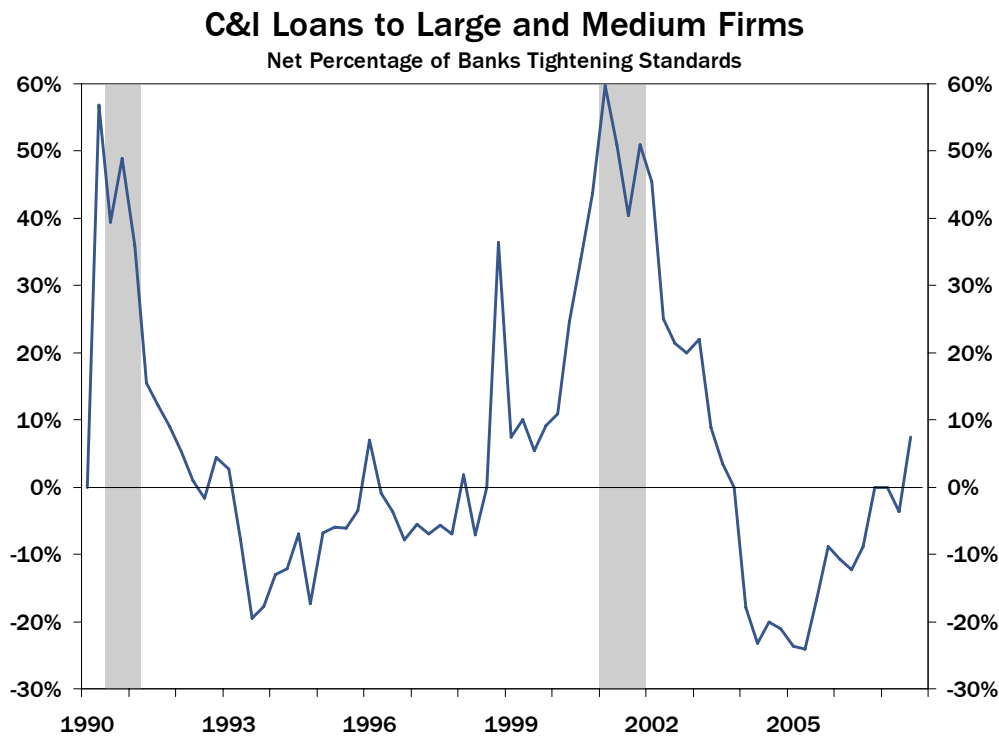


Source: Bloomberg LP and Wachovia Corp.

Up to this point inter-bank credit tightening has not filtered down to the commercial lending segment, as it appears credit quality in the private, non-mortgage, sector continues to be solid. Credit card delinquency rates have increased modestly but remain much lower than that experienced during the last recession. Meanwhile, auto loan delinquency rates remain low relative to their performance over the past decade. Finally, credit supply does not appear to be severely constrained. As illustrated in Figure 10, the percentage of banks tightening credit standards on commercial and industrial (C&I) loans remains far below the credit restraint level associated with the 2001 recession.

Credit quality in the private, non-mortgage, sector continues to be solid.

Figure 10



Source: Federal Reserve Board and Wachovia Corp.

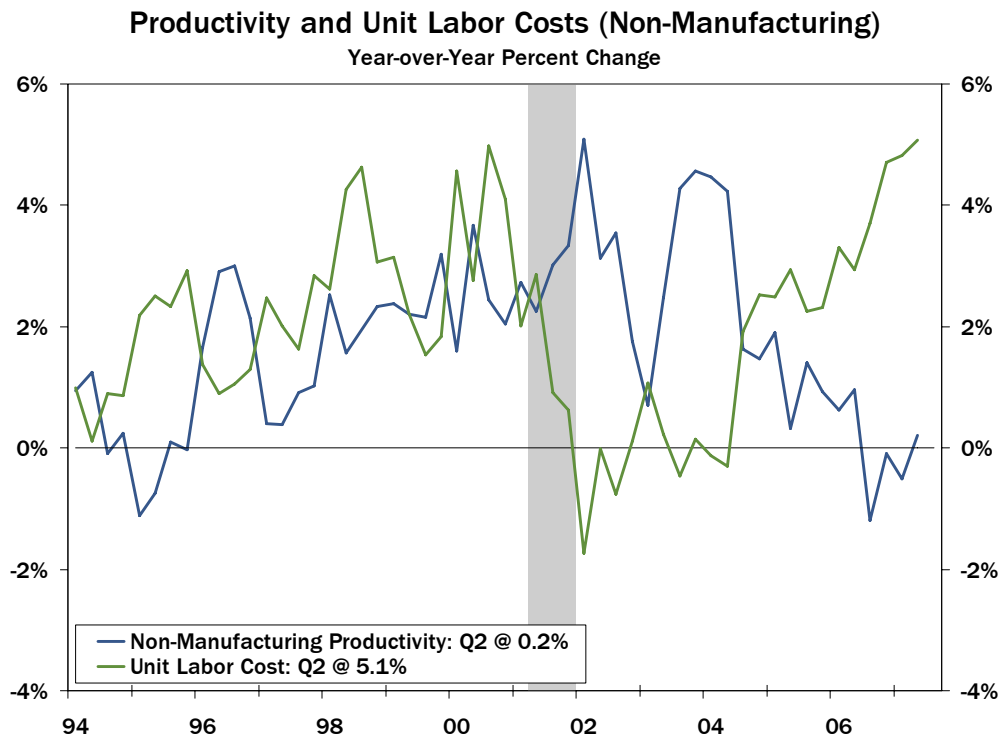
Rising unit labor costs are the product of the combination of slowing productivity gains and rising compensation to labor.

Corporate Profits; Slower Growth

While growth has slowed for corporate profits, it remains fairly solid for this stage of the business cycle. After a few years of recovery, the typical economic expansion goes through a period of slower top line revenue growth accompanied by rising input costs. From our discussion of growth above we note that aggregate economic growth is slowing in the economy. On the cost side, there has been a rising trend in unit labor costs as illustrated in Figure 11. Rising unit labor costs are the product of the combination of slowing productivity gains (also shown in Figure 11) and rising compensation to labor. This rising compensation reflects the increasing shortage of skilled labor that occurs as the economic expansion moves ahead.

A new twist during this economic expansion is the boost to profits of major multinationals with large international operations that occurs when the dollar depreciates relative to key foreign currencies. In this case, multinational companies headquartered in the U.S. earn higher valued dollar returns when those returns are earned in currencies such as the euro and Canadian dollar that are appreciating relative to the U.S. dollar. This complicates the picture for calculating the dollar's effect on overall corporate profit growth.

Figure 11



Source: U.S. Department of Labor and Wachovia Corp.

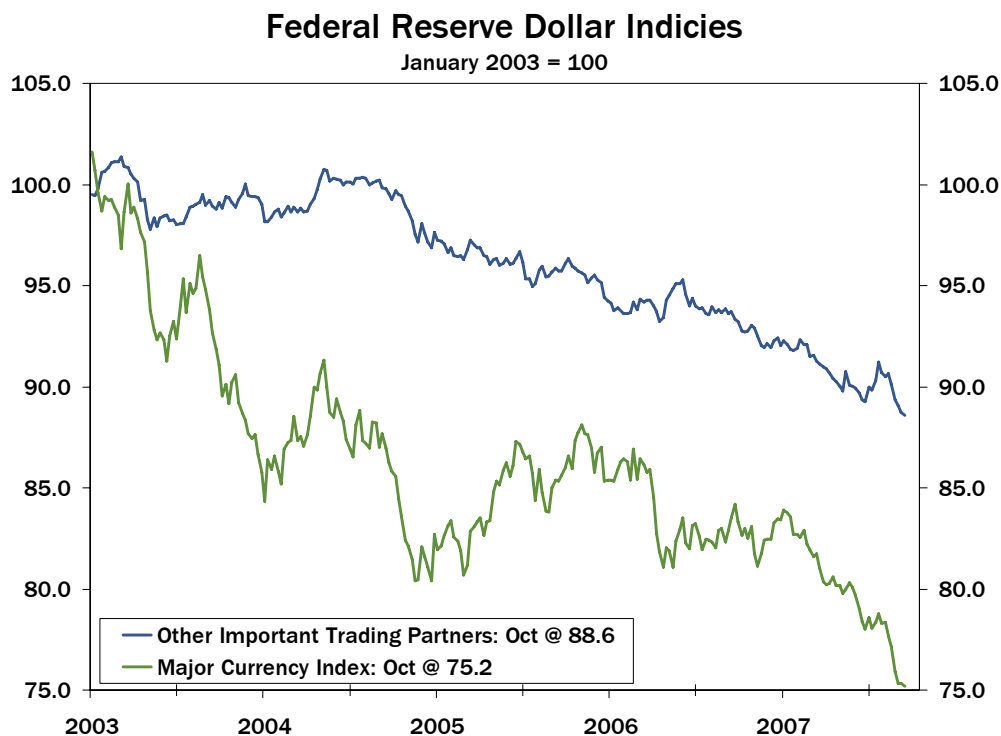
Dollar: Losing Ground

When benchmarked by the Fed’s “Major Currency” index, which measures the dollar’s value against seven major foreign currencies, the dollar continues to lose ground (Figure 12). Looking forward, we project further dollar depreciation in the quarters ahead. Why? For starters, the current account deficit, although beginning to narrow a bit, should remain “large” for some time. Second, interest rate differentials between the United States and most major foreign countries are not very supportive for the greenback at present. U. S. interest rates are likely to remain stable or decline slightly. Euro rates are likely to remain stable for some time.

Looking forward, we project further dollar depreciation in the quarters ahead.

In addition, recent dislocations in credit markets, which should keep new issuance of structured fixed income products depressed for some time, will give foreign investors fewer U.S. securities to purchase, which will weigh on net capital inflows. The dollar decline last month after the Federal Reserve cut its target for the fed funds rate by 50 basis points. Not only did the larger-than-expected reduction in the Fed’s policy rate cause short-term U.S. interest rates to decline, which reduced the relative attractiveness of U.S. assets, but it also stoked expectations of further Fed easing.

Figure 12



Source: Federal Reserve Board and Wachovia Corp.

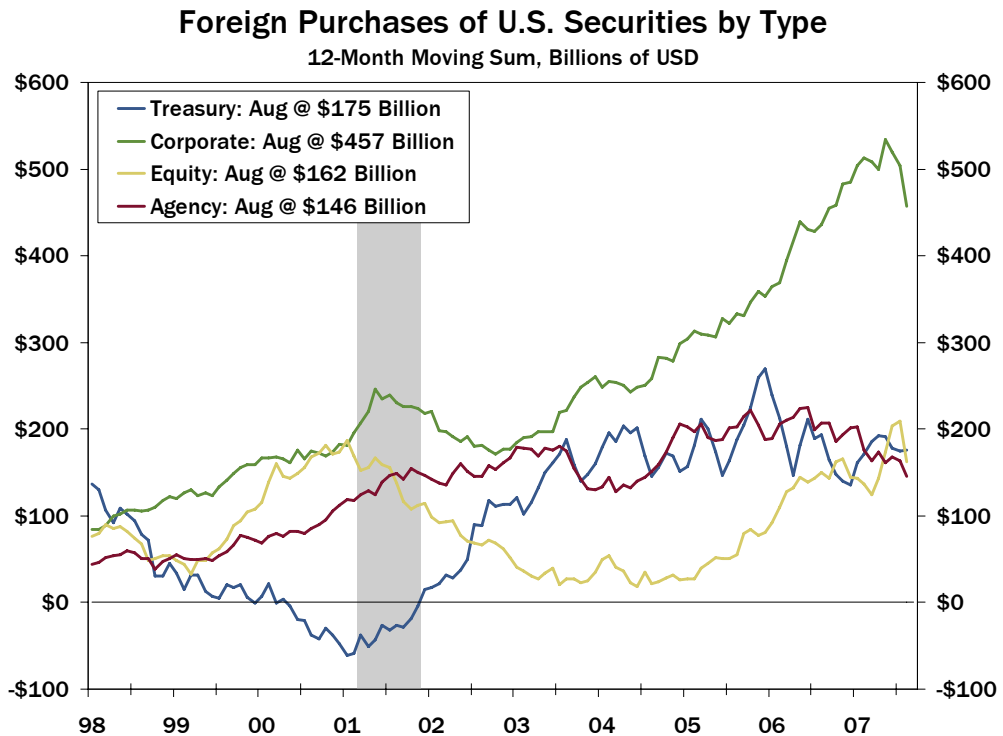
Capital Inflows and the Depreciating Currency

One risk to the outlook that we should recognize is the delicate balance between foreign investor's willingness to purchase U.S. assets and the risk of currency loss on those assets.

One risk to the outlook that we should recognize is the delicate balance between foreign investor's willingness to purchase U.S. assets (Figure 13) and the risk of currency loss on those assets. Since net capital inflows to the U.S. (demand for dollars) continue to fall short of the current account deficit (supply of dollars) this exerts downward pressure on the dollar. To the extent foreign investors anticipate continued future dollar depreciation, the risk to U.S. capital markets is that interest rates will rise to compensate foreign investors for the currency losses. This pattern of weaker dollar, higher rates and an aversion to U.S. assets remains a risk but we do not expect a dollar meltdown to take place, i.e., foreign investors dumping their holdings of U.S. assets on a large-scale basis.

Our capital markets remain the broadest, most liquid, and most transparent capital markets in the world, and we do not expect foreign investors to lose all faith in the ability of U.S. consumers, businesses, and government to honor their financial obligations on a widespread basis. In our view, the probability of a complete meltdown in the value of the greenback is rather low. Notwithstanding the possibility of a near-term dollar correction, the most likely scenario is for the greenback to continue to depreciate at a modest pace over the foreseeable future.

Figure 13



Source: U.S. Department of the Treasury and Wachovia Corp.

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