



WACHOVIA

ECONOMIC COMMENTARY



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Supervisory Challenges at the Mid-Cycle of the Economic Expansion Nov. 6, 2006*

Sustained, below trend, real economic growth remains the dominant theme for the outlook and yet, beneath that umbrella lies significant changes in the distribution of that growth and the perceptions of financial risk. At the sector level, differences in the pace of growth would suggest alterations to the perception of risk. However, risk spreads do not appear to be reacting to economic fundamentals. Currently the biggest challenge to bank supervisors appears to be to convince private sector agents that perhaps bank regulators are not as good as private agents have come to believe they might be. Perhaps credit risks are greater today than currently discounted in the “age of the Great Moderation?”¹

In our presentation today we will first review the economic outlook. Second, we cover the economic fundamentals underlying that outlook along with the associated measures of credit risk. Finally, we will contrast those economic and risk measures and draw observations on the supervisory challenges in the year ahead.

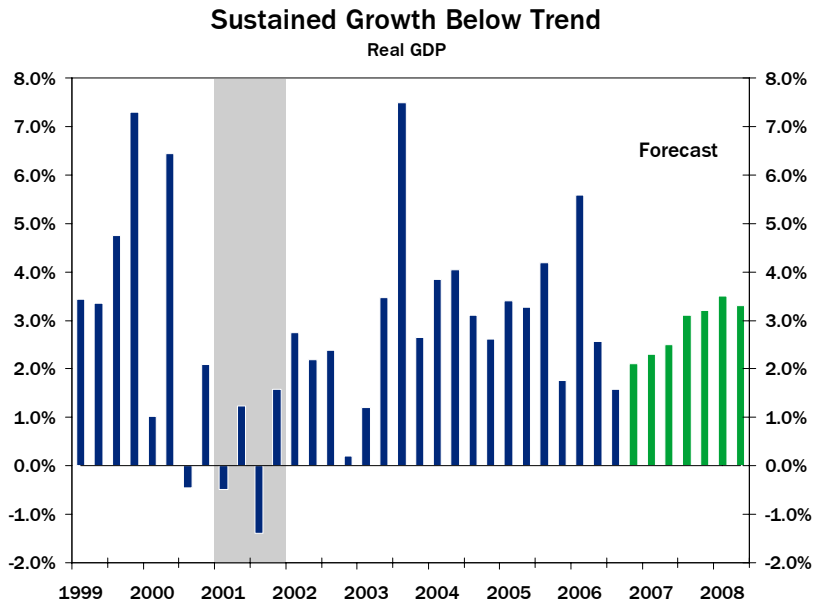
Economic Outlook: Below Trend Growth, the Inverted Yield Curve and a Smaller Margin of Error

A difficult duo for banks and their regulators is the combination of below trend economic growth and the inverted yield curve. Moreover, we expect that this rather unusual combination will persist for the rest of 2006 and for the first half of next year. Economic growth is expected to average 2.5 percent from the fourth quarter of this year through the first half of 2007 according to the November Blue Chip Economic Survey. For all of next year the Blue Chip Consensus estimates real growth at 2.5 percent. The Wachovia outlook (Exhibit 1) is for 2.5 percent real growth.

*As presented at the Interagency Bank Supervision Conference, Nov. 6-7, L. William Seidman Center, Arlington VA. Interagency includes representatives of the Federal Reserve, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and Office of the Comptroller of the Currency. Special thanks due to Bradley Brown, Phillip Neuhart and Adam York.

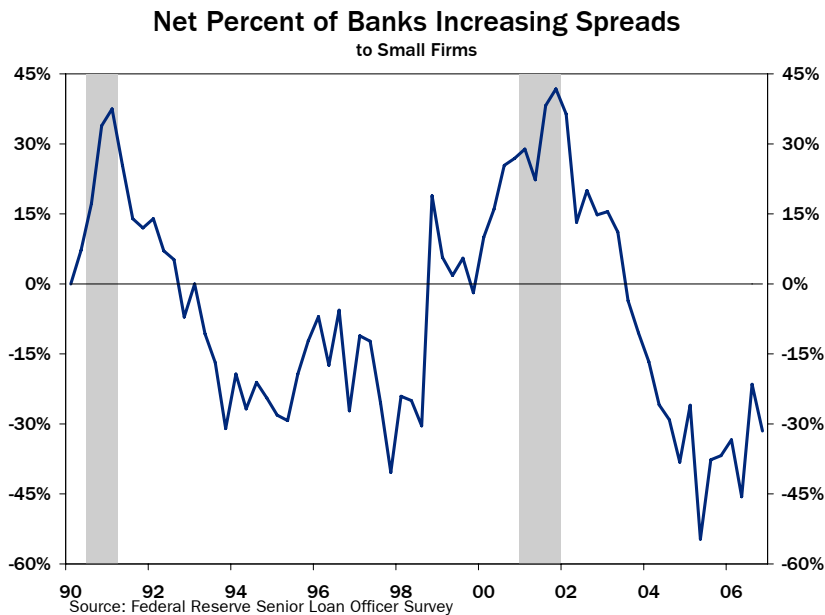
¹ The Great Moderation refers to the decline in the volatility of both growth and inflation since the early 1980s. See Ben Bernanke “The Great Moderation,” Remarks at the Eastern Economic Association, Feb. 20, 2004.

Exhibit 1



Consensus expectations are for below trend growth. Yet the October, 2006 Senior Loan Officer survey noted that the net percentage of domestic banks that increased the spread of loan rates over the cost of funds remains significantly negative at 30 percent (Exhibit 2). This indicates that banks were reducing their spread over the cost of funds while the growth of the economy was slowing to a below trend pace. Financial institutions appeared confident that policy makers would employ the means to avoid a recession since these institutions were willing to lend at smaller spreads despite the smaller margin of error associated with slower growth.

Exhibit 2



Key Indicators for Growth

Three short-term economic indicators suggest slower but still positive growth. First, jobless claims remain remarkably low and thereby intimate continued positive momentum in the labor market. Second, while the Institute for Supply Management index has declined to the low 50s, the index remains in positive territory and is consistent with economic growth at a 2 to 2.5 percent rate. Finally, the Institute for Supply Management non-manufacturing survey remains in the mid-50s range and consistent with positive growth in the service sector.

As for recession indicators, three (among a slightly larger set of the indicators we follow) are split on the outlook. The yield curve, a frequently cited indicator of recession, does suggest a problem. However, leading indicators suggest more moderate growth while professional & services employment growth remains positive (Exhibits 3 and 4). We do not expect a recession in 2007. The yield curve, taken alone, has historically provided too many false signals of recession. Meanwhile, other recession indicators do not corroborate the yield curve indicator.

Exhibit 3

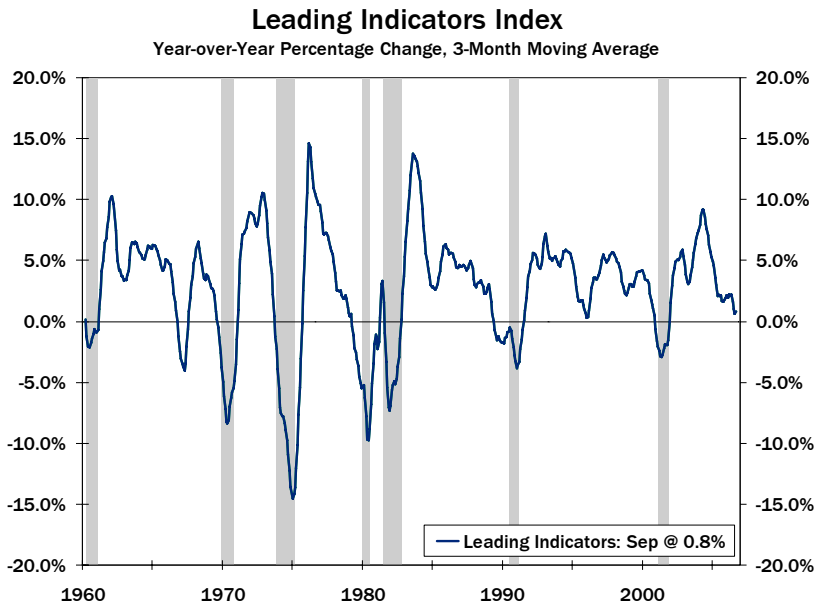


Exhibit 4



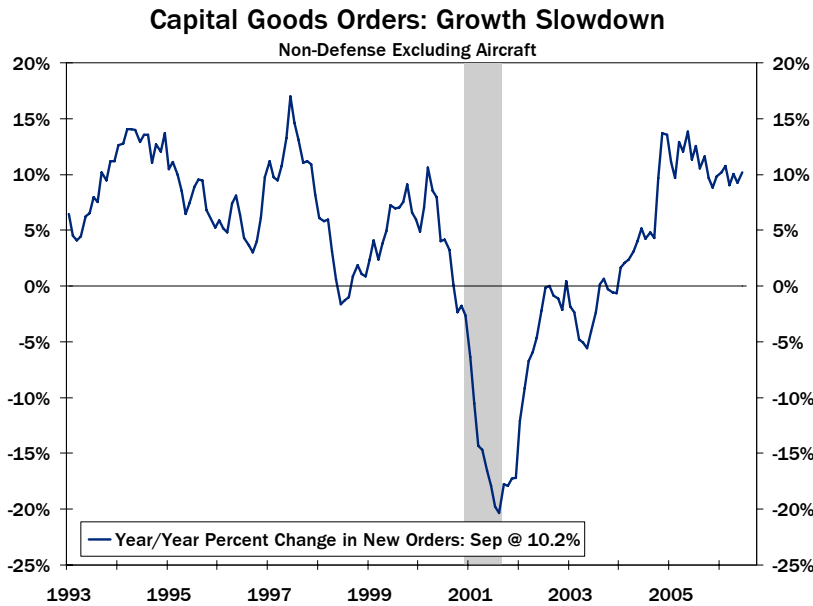
Sector Review

Consumer spending has downshifted over the last two quarters (second and third quarters of 2006) to a pace of 2.8 percent compared to 3.5 percent last year. Real personal income growth has been 3.3 percent over the last two quarters. Over the last two quarters the downshift has been particularly noticeable in consumer durable and non-durable goods spending.

As for consumer fundamentals, sentiment has improved along with lower gasoline prices and higher equity valuations. Looking forward, the tightening labor market (unemployment rates have declined) has been associated with rising rates of labor compensation and thereby provides the basis for consumer income and spending going forward.

Investment spending continues to move ahead with particular strength in nonresidential spending. Fundamentals still favor continued capital expenditures. On a cyclical basis, interest rates remain low, while capacity utilization remains high relative to its long term average. One historically reliable leading indicator of capital spending has been capital goods orders (non-defense, ex-aircraft). The remarkable stability of such orders in recent months (Exhibit 5) supports the case for continued capital spending. Meanwhile, non-residential construction spending has picked up in recent quarters and is expected to add to growth. The private, non-residential construction component of GDP is up 21 percent over a year ago as office vacancy rates have fallen over the last twelve months.

Exhibit 5



Government spending, the third major component of economic growth, has continued to add to the economy’s forward momentum. Over the last four quarters, nondefense federal spending is up three percent while state and local government spending is up 2.5 percent. Given the strength of tax receipts, we expect growth in government spending to continue at a solid pace for the year ahead.

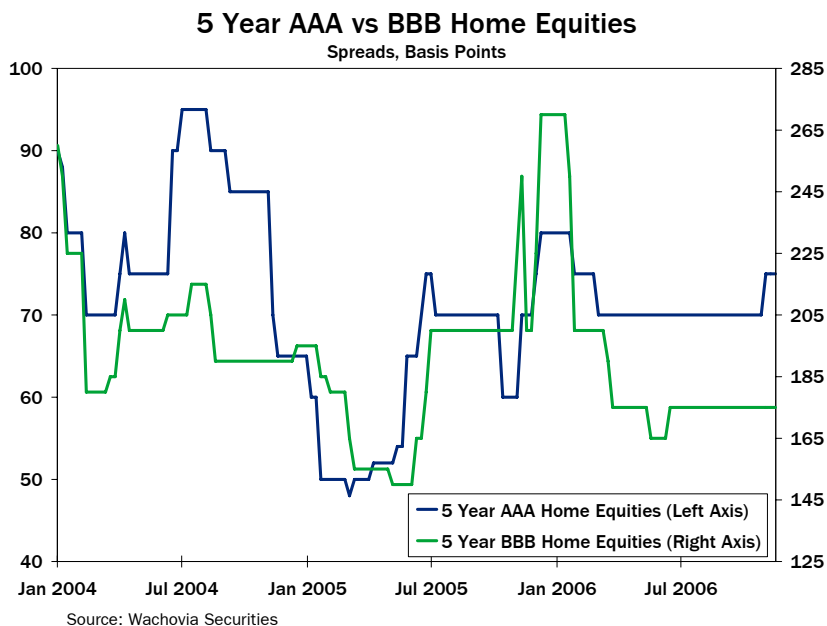
On the downside, residential investment is expected to subtract from growth this year. However the size of the impact is much less than one percent and certainly much less than enough to lead the economy to recession. For perspective, we can see in Exhibit 6 the relative contribution to economic growth of selected sectors in recent years. On a cyclical basis, we follow the Mortgage Bankers Association (MBA) index as an indicator of where housing is headed in the short-term. In recent months the lower MBA index suggests that housing will continue to subtract from overall economic growth for the fourth quarter and the first half of next year.

Exhibit 6

Percentage Point Contribution to Real GDP			
	2002-2004	2005	2006(e)
Consumer Spending	2.22%	2.48%	2.22%
Residential Investment	0.39%	0.41%	-0.17%
Business Fixed Investment	0.95%	0.73%	0.89%
Government Spending	0.58%	0.16%	0.39%
10/13/2006			

Meanwhile, weakness in housing starts this year has not, however, given rise to wider spreads in AAA and BBB 5 year home equity products (Exhibit 7). This provides the first example where deteriorating economic fundamentals have not led to wider risk spreads in financial markets. The home equity market is not yet convinced that the slowing housing market will significantly affect delinquency rates. We expect housing data to continue to show weakness over the intermediate term, and would look at any more sharp spread tightening as an opportunity to reduce exposure, particularly in the weakest underwriters and tranches. The next quarterly home price data from OFHEO is due to be released on December 1, 2006, and that data set should give us a further indication of the potential severity and duration of this slowdown in housing.

Exhibit 7



As another measure of risk, we note that sub prime loan delinquencies as a percentage of total loans has moved up modestly from 10.5 percent in mid-2005 to 12 percent in mid-2006. Another note on mortgage risk that needs to be considered is the regional nature of house price weakness. For the four quarters up to and including the second quarter of this year, seventeen of the twenty bottom housing markets in the U.S. are located in three states: Michigan, Ohio, and Indiana. The case of South Carolina is interesting as it is the only state with metropolitan areas in both the top and bottom 20 markets. The distinguishing factor is that the top 20 market (Charleston) is a coastal community while the bottom 20 market is a manufacturing based inland community (Spartanburg).

Is there evidence of credit issues in the housing market? Delinquency rates do suggest some modest pressure at present. Additionally, as illustrated in Exhibit 8, sub prime adjustable rate mortgage (ARM) loan delinquencies have risen significantly more than delinquencies of prime ARM loans. Both the prime and sub prime delinquency rates are already significantly higher in 2006 than they were last year. With a further slowing in the economy, we expect the climb in delinquency rates to continue. Historically, delinquency rates tend to lag the pace of growth so that slower economic growth today suggests even higher delinquency rates tomorrow.

Exhibit 8

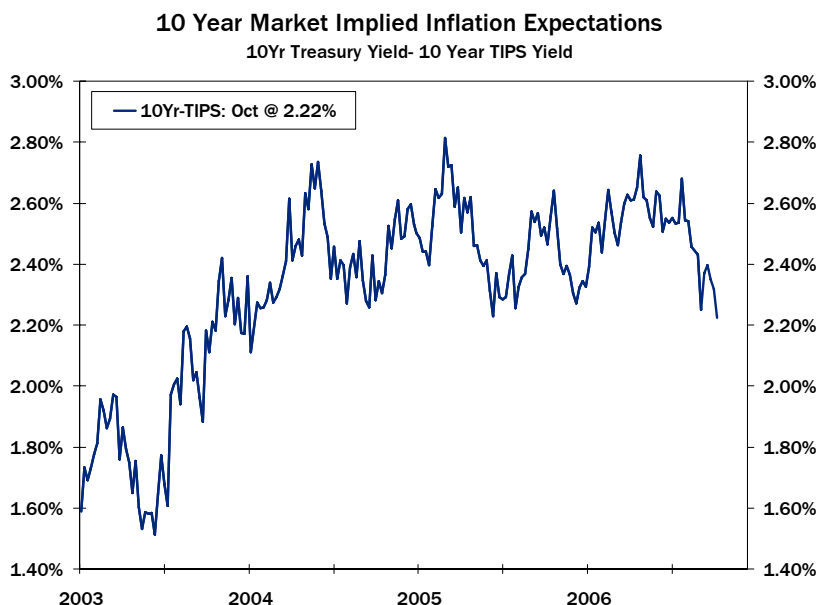
ARM Loans Percentage of Loans Delinquent 2nd Quarter				
	Prime ARM		SubPrime ARM	
	2005	2006	2005	2006
United States	2.09%	2.58%	10.03%	12.20%
Nevada	1.26%	1.85%	4.91%	7.03%
California	1.32%	1.81%	5.83%	8.18%
District Of Columbia	1.48%	1.82%	7.03%	8.84%
Arizona	1.32%	1.40%	5.91%	6.10%
Florida	1.94%	2.44%	8.06%	10.10%

Source: Moody's Economy.com and Wachovia Corp.

Inflation: Defining the Limits to Non-inflationary Growth

Both inflation and interest rate expectations depend upon the market's and the Fed's estimate of non-inflationary growth. In the first half of this year, core inflation measures rose steadily and yet, more recently, these measures appear to have reached a plateau. Unfortunately, the level of this plateau has been above the perceived target of the Federal Reserve. This persistence of above target inflation in recent months has upset inflation expectations and has been compounded by the rise in labor compensation/decline in productivity/rise in unit labor costs triple play combination that has implied upward cost pressures on corporate pricing. Since mid-2004, long-term inflation expectations have remained in a range of 2.2 to 2.8 percent (Exhibit 9). This steady range of expectations is reassuring in one way but this range is entirely above the perceived 1-2 percent target range often cited by the Federal Reserve. How will the market assess above target but steady inflation as it influences market expectations for the path of interest rates.

Exhibit 9



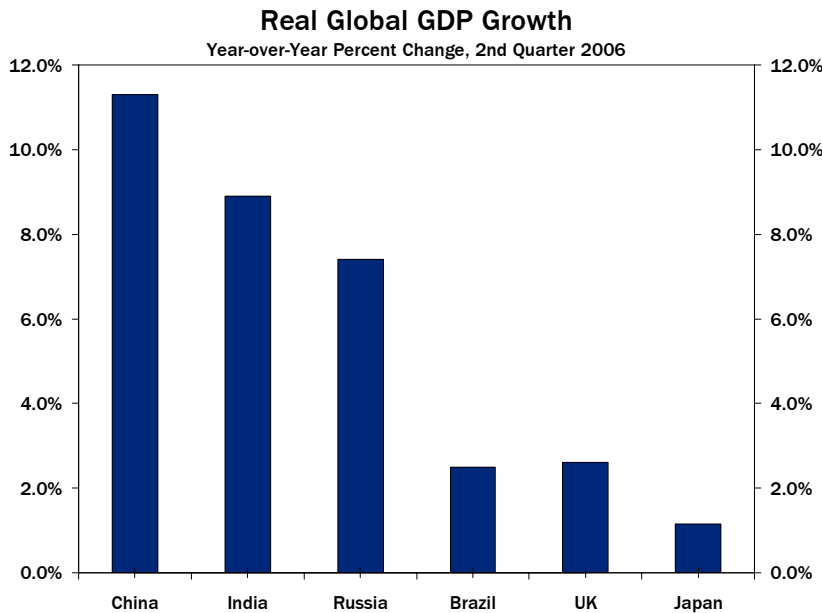
For bank supervisors, this persistence of above target inflation indicators helps to explain why the Fed has not lowered the funds rate so far and why we do not expect the Federal Reserve to lower the Fed funds rate in the near term. This stability of the funds rate suggests that there is no easy out for financial institutions faced with the dual challenge of slower economic growth and the inverted yield curve. For financial market supervisors, there is no easy out from the rigors of careful oversight of credit risk in a mid-cycle economy.

Meanwhile, commodity market prices reinforce the sense that while commodity prices may have peaked for energy there remains ex-energy commodity cost pressures for business and thereby the overall economy. West Texas Intermediate prices remain in the \$50/barrel range, which is significantly higher than levels during the 2003 to 2005 period. At the same time, prices of industrial commodities such as copper, nickel and silver remain significantly higher than a year ago. These prices, combined with higher labor costs, suggest that the inflation issue remains, and, therefore, so do interest rate pressures facing banks.

International Outlook: Downward Pressures on the Dollar

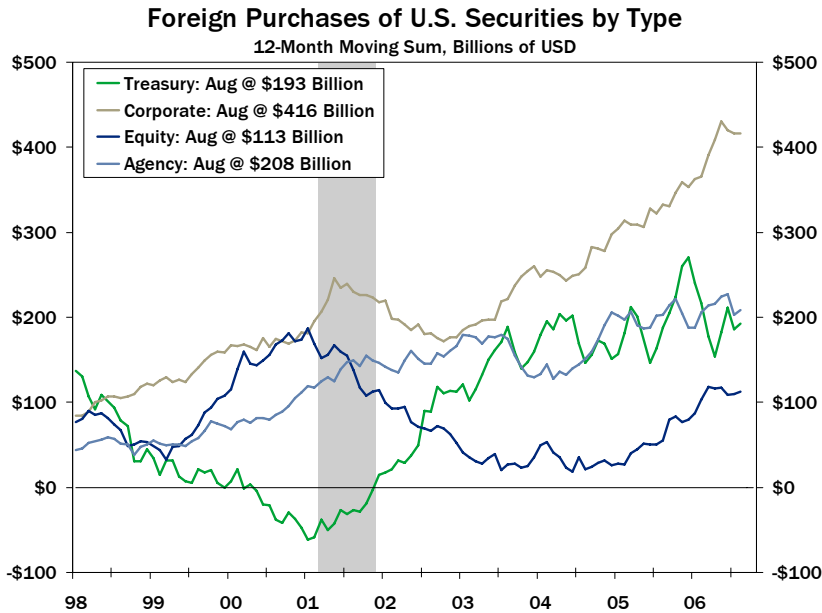
Continued growth in the European community suggests that the European Central Bank, along with the Bank of England, will be raising rates this quarter. At the same time, economic growth in three (China, India and Russia) of the four BRICs (not Brazil) remains solid (Exhibit 10). Over the short-term, U.S. export growth should continue its recently stronger pace and this will limit the negative impact of continued import growth.

Exhibit 10



Meanwhile, financial flows reflect the maintained strength of foreign demand for U.S. financial assets. Since 2003 foreign purchases of Treasury, corporate and agency bonds have continued to rise (Exhibit 11). In the meantime, equity purchases have risen since mid-2005 and are expected to be continued in the year ahead given the recent record of solid returns over recent years. For bank supervisors, the growing interest of foreign investors in U.S. financial instruments suggests that exchange rate and interest rate risk has widened to a broad set of financial instruments. The pricing of U.S. financial assets has taken on a global dimension. This is compounded by the combination of the lack of mark-to-market pricing and the exchange rate targeting of foreign central banks. These two aspects of fixed income asset pricing continue to distinguish current global capital markets from the academic assumptions of many pricing models. One challenge for bank supervisors is to bring up-to-date the pricing and possible volatility of fixed income assets in the context of 21st century global capital markets.

Exhibit 11

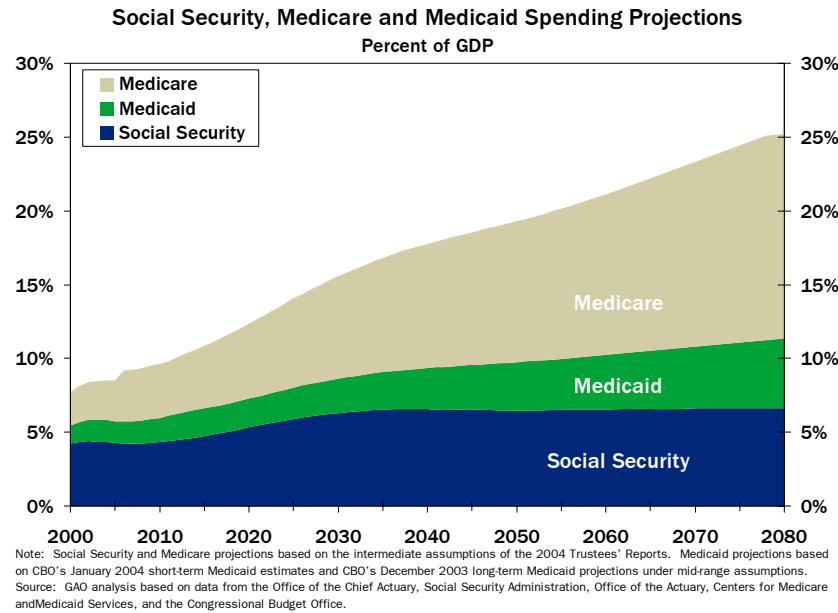


Asset Pricing and Risk

At present, we expect that the yield curve will remain inverted through the first half of next year. Fed funds futures markets are pricing the funds rate for December at 5.25 percent and Feb. 2007 at 5.2 percent. Meanwhile, long-term bond futures suggest that a ten year rate below five percent will persist over the same time period. The net result is that the inverted yield curve is likely to persist for some period ahead. This suggests earnings pressures on depository institutions which are more comfortable working within the historical model of a positive yield curve. Waiting for the yield curve to “correct” may be costly to depository institutions as well as regulators.

Persistence of the inverted yield curve appears contradictory to the apparent forthcoming pressures that are suggested by the projected rise in entitlements portrayed in Exhibit 12. All three of these entitlement programs suggest the possibility of some combination of higher taxes or greater federal/state government debt issuance. In both cases, this would suggest bond rates would rise to account for this combination. Given this risk, the balance of global demand for U.S. fixed income assets and U.S. issuance of such debt suggests that bank supervisors stay on top of global capital market developments.

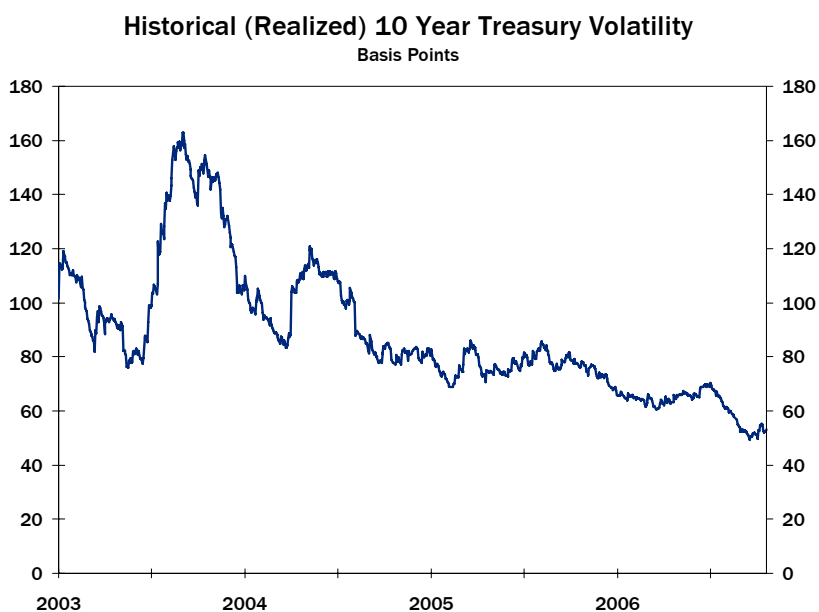
Exhibit 12



How Has Diminished Volatility Made the Job of Regulators More Difficult?

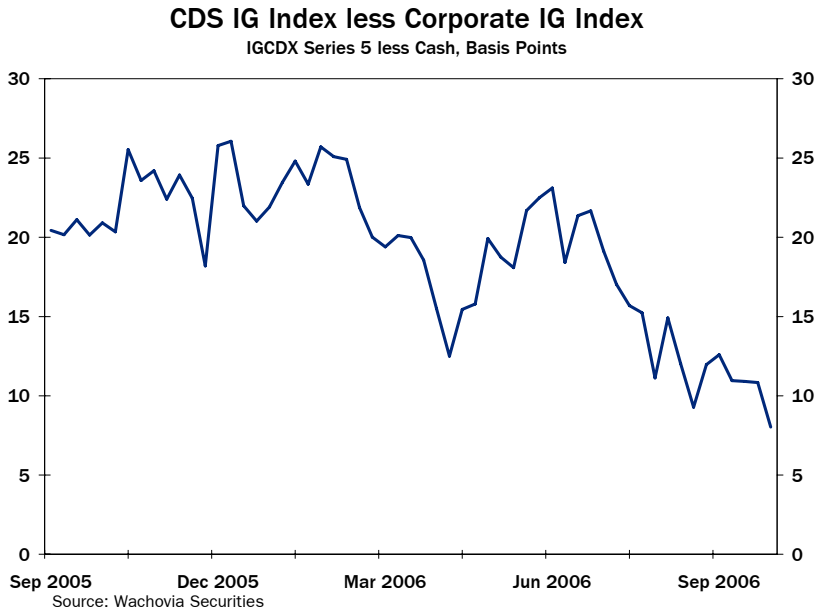
Over the last three years the historical (realized) volatility of ten-year Treasuries has declined fairly steadily, as illustrated in Exhibit 13. Unfortunately, this has become a mixed blessing. Lower volatility in fixed income has also been accompanied by lower volatility in the VIX index for equities. In part, we can ascribe this lower volatility to the great moderation in economic growth and inflation that has become apparent in recent years. However, on the other side, the decline in volatility has led to an apparent decline in risk premiums that may not be adequate given the risk of financial shocks in the marketplace.

Exhibit 13



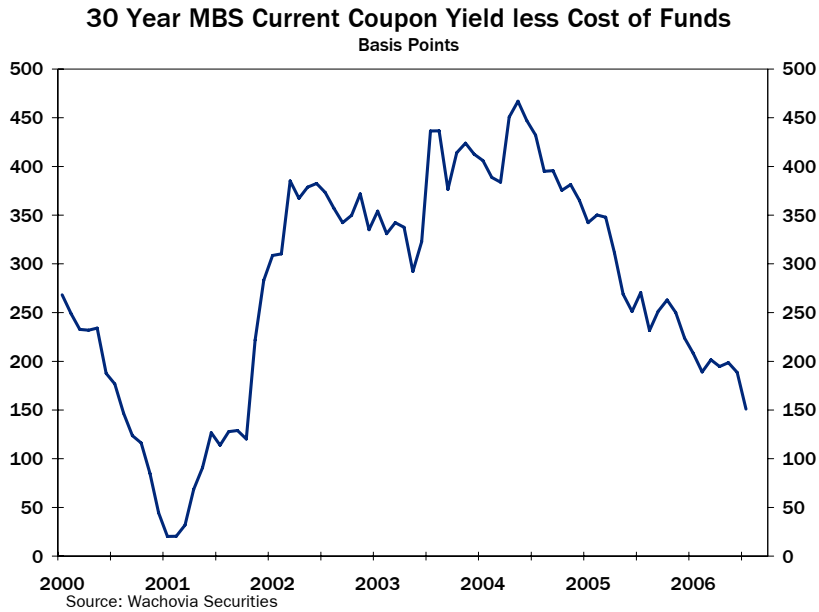
Since the beginning of this year, we have witnessed a steady decline in the spread of synthetic corporate bonds relative to the cash market (Exhibit 14). This decline reflects a narrower accounting for risk than what may make bank supervisors comfortable. Are synthetic credit spreads too tight? Synthetic credit spreads have been well supported by a strong bid from CDOs (collateralize debt obligations) and other fixed income buyers (correlated equity tranches). This has helped the synthetic basis tighten by 10 bps over the past several months. However, for most of this year price movements on credit default swaps (CDS) have been highly correlated with equity prices. The correlation is negative as credit spreads generally tighten as equity prices rise, and vice versa. The correlation over the past six months has been very strong at -84 percent. This piece of data suggests that the changes in synthetic credit pricing this year have been largely justified, or alternatively that both synthetic credit spreads as well as equities are both too rich, and therefore vulnerable to corrections. Based on the strength of this relationship, it is prudent that credit investors watch the stock market very closely in the coming weeks for any signs of a technical reversal to the recent strength.

Exhibit 14



For another example, we can see in Exhibit 15 that the spread of MBS (Mortgage Backed Securities) current coupon yields has narrowed relative to the cost of funds over the last two years. The declining spread is consistent with the flatter yield curve which, in turn, is reflective of the lowered expectations of both growth and inflation expectations and thereby lowered volatility of monetary policy itself. The summer bond rally significantly reduced the book losses in those portfolios, and some banks have taken the opportunity to sell securities and either deleverage or redeploy funds in better yielding assets. This took two forms. One was the purchases of whole loans and consumer debt, and the second was the simple repurchase of banks' own equity. Like the inverted yield curve, these narrowing spreads also likely reflect large amounts of risk seeking investors entering these markets, which pushes up demand and could possibly be artificially depressing credit spreads.

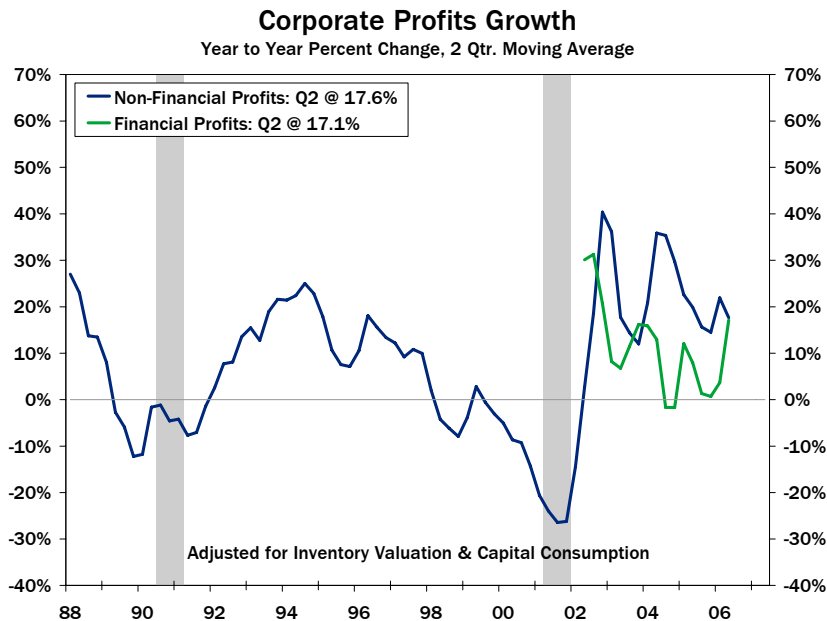
Exhibit 15



Corporate Profits and Credit Risk Assessments

In recent quarters the growth of corporate profits has slowed. This has been particularly evident for non-financial corporations as shown in Exhibit 16.

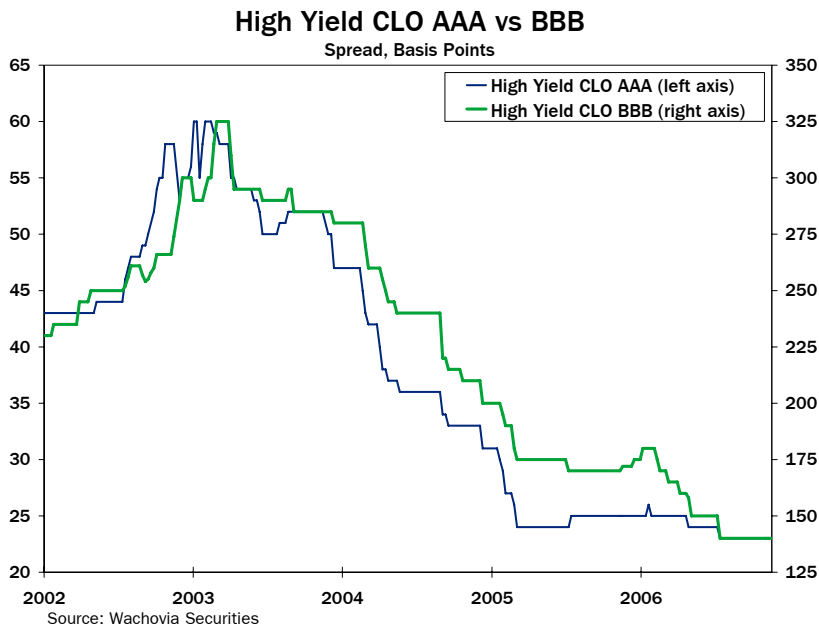
Exhibit 16



However, the decline in profit growth, as well as economic growth, has not been reflected in capital market spreads. For example, high yield spreads range from 300-400 basis points compared to 800 basis points plus at the beginning of 2003. Collateralized

loan obligation (CLO) spreads have been approximately 150 basis points this year compared to 325 basis points at the beginning of 2003 (Exhibit 17). Throughout October and the first few business days of November, we saw tiering (spread between various credits) continue to increase. Once again, investors are not convinced that credit quality is declining greatly and are willing to pay for higher returns. The widely expected year-end discounting has yet to take place but we do feel as though there is some weakness in the cash market in specific transaction

Exhibit 17



More than \$130 B of new leveraged loans has been issued in the last six weeks, the heaviest issuance in more than three years. Much of this supply is merger and LBO (leveraged buyout) related. The deals have been well received, and pricing has been realistically set by issuers. As a result, most of these recently issued loans are trading at, or slightly above par. Leveraged loan spreads for BB/BB- credits have stabilized over that same time period after a year of being somewhat volatile. Finally, the demand for leveraged loans remains very strong and 67 percent of the market now trades at or above par, even though all of the paper is currently callable at par.

Summary and Conclusions

Significant challenges will face banks and their regulators in the year ahead. If our forecasts hold for below trend growth, coupled with the persistence of an inverted yield curve there will be little margin for error in 2007. While a recession is not currently in the cards, in our view, for the overall economy, notable declines in key sectors—residential construction and consumer durables—will force credit officers and regulators alike to be ever more vigilant. The persistence of elevated inflation expectations and an inverted yield curve will continue to pressure margins at lending institutions just as credit losses begin to rise as a result of the slower economic growth. Finally, as institutions seek alternate sources of revenue in new and developing markets, regulators will need to adapt their analysis to account for these new sources of risk.

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