



# ECONOMICS GROUP

## MONTHLY OUTLOOK

August 06, 2008

### U.S. Overview

#### Has The U.S. Come Down With German Disease?

Much of the benefit from the economic stimulus checks was siphoned away by higher energy prices during the early summer months. As a result, most of the benefit from the rebate checks showed up in the May consumer spending figures. Spending weakened in June, particularly for big-ticket discretionary items. Motor vehicle sales declined even further in July, hitting their lowest level in 15 years. The net result should be an outright decline in consumer spending during the third quarter, marking the first drop in 18 years. We expect another drop in the fourth quarter.

Energy prices finally broke in late July and the national average for regular gasoline could be close to \$3.50 a gallon by Labor Day. Reduced energy prices will not produce an immediate rebound in consumer outlays but should moderate the recent drop. Motor vehicle sales will remain weak through year-end and the Fed will remain on hold.

Overall GDP growth should slow during the second half of 2008 but remain in positive territory. Weak consumer spending is leading to a dramatic slowing in imports, while production cuts at major auto producers and other manufacturers have led to a sharp slowdown in inventories. Inventories liquidation subtracted 1.8 percentage points off second quarter GDP growth. That pace will not be maintained in the second half of 2008, which will provide downside protection to the overall economy.

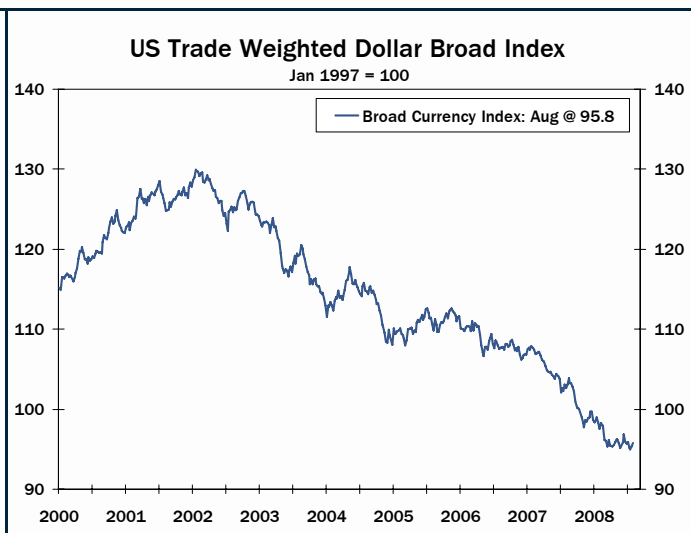
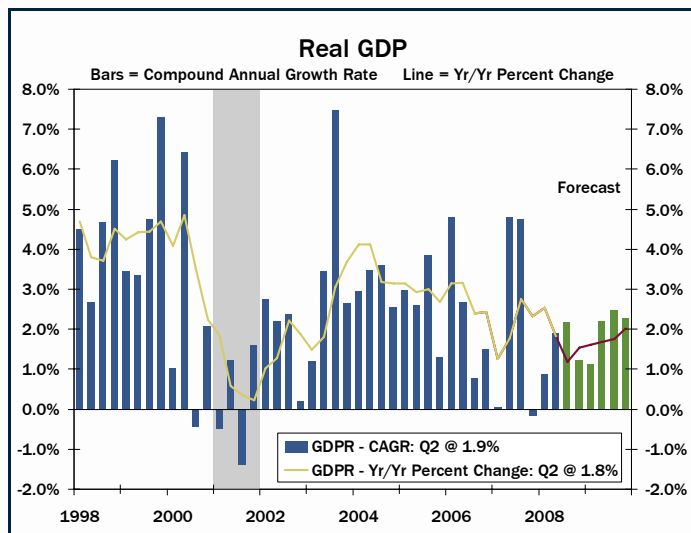
### International Overview

#### High-Yielding Currencies Strengthened Recently

Although a broad measure of the dollar's value has been rather stable over the past few months, there are some interesting developments occurring beneath the surface. Namely, the U.S. dollar has weakened against some emerging market currencies but the greenback has strengthened a bit vis-à-vis most major currencies.

Central banks in many developing countries have hiked rates recently in response to rising rates of CPI inflation. Not only are interest rates in these countries above comparable rates in most major economies, but they have gotten higher. Currency appreciation in these economies likely reflects flows of speculative money in search of higher returns. The greenback will probably depreciate further versus these high-yielding currencies, at least in the near term.

In contrast, interest rates in many major economies are not especially high nor are they expected to rise further. Although the ECB hiked rates by 25 basis points in July, recent signs of sharply slowing growth in the Euro-zone have led investors to scale back expectations of further tightening. The U.K. economy may be slipping into recession, which should open the door to easing by the Bank of England. That said, the greenback could grind higher versus many major currencies, a significant dollar rally probably awaits Fed tightening, which likely will not occur for some time.



Note: This report was initially published on August 6, 2008 and corrected the same day to reflect corrected international forecast tables on page 5. Except as otherwise noted, this report is identical to the original report.

Senator Jim Bunning (R-KY) noted in a recent Senate Banking Committee hearing that “when I picked up my newspaper yesterday, I thought I woke up in France.” While the Senator’s ire was aimed at the Treasury’s rescue package for Fannie Mae and Freddie Mac, the same conclusion can be arrived at by looking at recent U.S. economic performance. The U.S. economy is beginning to look a lot like the German economy over the past decade, with sluggish top line GDP growth and high unemployment among the young and less skilled. The primary driver is the changing mix of economic growth, with more growth from net exports and less growth from domestic demand.

However, the U.S. is not Germany. Americans will never stop shopping, but the recent jolt from higher energy prices has clearly altered consumer behavior. Consumer spending got a short-term boost from the economic stimulus checks but a good portion of that was eaten up by higher gasoline prices. Spending fell in June and motor vehicle sales were exceptionally weak in July. We are now expecting consumer spending to decline at a 0.7 percent annual rate during the third and fourth quarters.

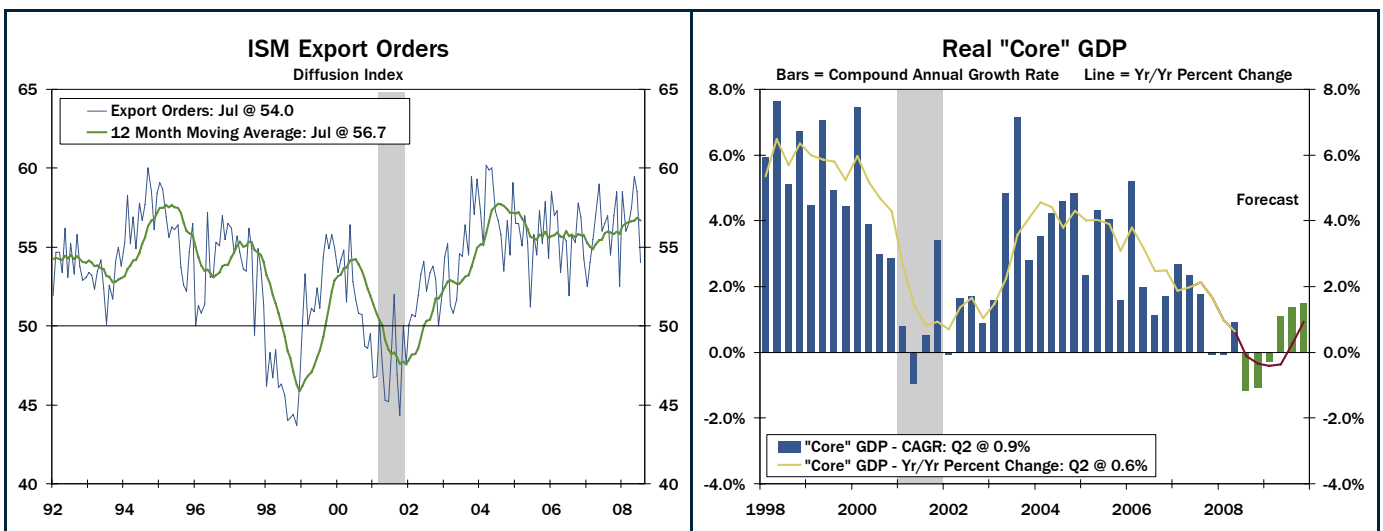
The slowdown in consumer spending will not fall completely on domestic producers. Consumers are cutting back mostly on discretionary items and a large proportion of those items are produced overseas. As a result, the weakness in consumer spending will further weaken imports and will also likely reduce the pace of inventory liquidations.

While imports are slowing, demand for exports remains strong. The ISM manufacturing survey’s new export orders series has remained above 50 for 68 straight months. Even with some slowing in exports, however, the nation’s trade gap is expected to continue to narrow.

With inventories falling less in the third and fourth quarters and the trade gap continuing to narrow, real GDP will likely remain solidly in positive territory. Real GDP is expected to rise 2.2 percent in the current quarter and 1.2 percent in the fourth quarter. For 2008, real GDP is expected to rise 1.8 percent. The strength here is illusory, as final domestic demand will remain exceptionally weak.

Years ago we developed a concept called core GDP, which measures private final domestic demand. Core GDP includes three items: consumer spending, business fixed investment, and residential construction. The concept excludes swings in inventories, net exports and government spending. The net result is a measure much closer to how Main Street views the economy. Core GDP is expected to decline at a 1.2 percent pace in the third quarter and fall at a 1.1 percent pace in the fourth quarter. Growth for the year is expected to be a paltry 0.3 percent. The weakness in core GDP helps explain why three-quarters of Americans believe the economy is in recession even though the GDP data remain solidly positive.

The changing mix of economic growth presents real challenges for policymakers. Exports are good but their benefits are not spread evenly throughout the economy. U.S. exports tend to be capital intensive and tend to employ more skilled workers. This means export-led growth boosts productivity but does relatively little to lift job growth. On the flip side, weaker consumer fundamentals cut demand for a whole host of goods and services that tend to employ workers with a lower skill set. As a result, unemployment is rising among the young and less skilled. The teenage unemployment rate increased by a record 4.9 percentage points over the past three months and unemployment has also risen sharply among workers with only some college completed or an associate degree.



Wachovia U.S. Economic Forecast

	Actual																Forecast				
	2006				2007				2008				2009				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2006	2007	2008	2009	2010
Real Gross Domestic Product (a)	4.8	2.7	0.8	1.5	0.1	4.8	4.8	-0.2	0.9	1.9	2.2	1.2	1.1	2.2	2.5	2.3	2.8	2.0	1.8	1.8	2.1
Personal Consumption	4.3	2.8	2.2	3.7	3.9	2.0	2.0	1.0	0.9	1.5	-0.7	-0.7	0.2	1.9	2.0	2.1	3.0	2.8	0.9	0.7	2.2
Business Fixed Investment	15.9	6.4	5.4	-1.0	3.4	10.3	8.7	3.4	2.4	2.3	-0.6	-0.6	-1.5	-2.3	-2.0	-2.0	7.5	4.9	3.2	-1.2	-1.1
Equipment and Software	16.3	1.8	2.0	-2.4	0.0	6.9	3.6	1.0	-0.5	-3.4	-0.3	-1.8	-0.4	0.3	2.0	2.2	7.2	1.7	0.1	-0.3	2.0
Structures	15.5	19.7	14.3	2.5	11.2	18.3	20.6	8.6	8.7	14.3	8.5	3.5	-5.0	-10.0	-14.0	-15.0	8.2	12.7	11.3	-3.5	-9.6
Residential Construction	-3.6	-16.6	-21.5	-19.5	-16.2	-11.6	-20.6	-27.0	-25.0	-15.6	-14.0	-11.0	-7.0	-4.0	1.1	1.5	-7.1	-17.9	-20.3	-7.3	1.3
Government Purchases	3.9	1.3	1.7	1.6	0.9	3.9	3.8	0.8	1.9	3.4	0.3	0.2	0.7	0.9	1.2	1.3	1.7	2.1	2.0	0.9	1.4
Net Exports	-636.0	-619.4	-623.0	-584.3	-618.6	-571.2	-511.8	-484.5	-462.0	-395.2	-375.1	-338.5	-306.6	-280.6	-259.2	-243.5	-615.7	-546.5	-392.7	-272.5	-227.8
Pct. Point Contribution to GDP	0.1	0.6	-0.1	1.4	-1.2	1.7	2.1	0.9	0.8	2.3	0.7	1.3	1.1	0.9	0.7	0.5	0.0	0.6	1.3	1.0	0.4
Inventory Change	45.9	56.9	53.3	13.1	-15.0	-2.8	16.0	-8.1	-10.2	-62.2	-35.0	-8.8	-3.8	3.1	13.2	20.4	42.3	-2.5	-29.1	8.2	20.4
Pct. Point Contribution to GDP	-0.3	0.4	-0.1	-1.4	-1.0	0.4	0.7	-0.8	-0.1	-1.8	0.9	0.9	0.2	0.2	0.3	0.2	0.0	-0.4	-0.2	0.3	0.1
Nominal GDP	8.6	5.5	3.6	3.7	4.3	6.9	6.4	2.3	3.5	3.0	6.3	4.0	3.7	4.7	4.8	4.6	6.1	4.8	4.1	4.4	4.5
Real Final Sales	5.1	2.3	0.9	2.9	1.1	4.3	4.0	0.8	0.9	3.9	1.2	0.3	1.0	2.0	2.1	2.0	2.8	2.4	2.0	1.4	2.0
Retail Sales (b)	7.6	6.0	5.0	4.6	3.3	4.1	3.9	4.7	3.0	2.6	2.9	0.4	0.8	0.8	1.0	3.6	5.8	4.0	2.2	1.5	3.9
Inflation Indicators (b)																					
*Core* PCE Deflator	2.1	2.3	2.5	2.3	2.3	2.1	2.0	2.2	2.2	2.2	2.2	1.9	1.8	1.8	1.7	2.0	2.3	2.2	2.1	1.8	1.9
Consumer Price Index	3.7	3.9	3.3	1.9	2.4	2.6	2.4	4.0	4.2	4.3	5.1	3.5	2.9	2.2	1.2	2.1	3.2	2.9	4.3	2.1	1.9
*Core* Consumer Price Index	2.1	2.5	2.8	2.7	2.6	2.3	2.1	2.3	2.4	2.3	2.4	2.1	2.0	2.0	1.9	2.2	2.5	2.3	2.3	2.0	2.1
Producer Price Index	4.5	4.3	2.8	0.3	2.0	3.4	3.6	6.7	7.2	7.6	9.4	7.7	6.0	4.2	2.8	2.7	3.0	3.9	8.0	3.9	2.4
Employment Cost Index	2.8	3.0	3.3	3.3	3.5	3.3	3.3	3.3	3.3	3.1	3.0	2.9	3.1	3.0	3.0	2.9	3.1	3.4	3.1	3.0	3.0
Real Disposable Income (a)	5.1	1.3	2.3	5.8	4.4	-0.6	3.1	0.6	-0.1	11.3	-9.2	1.5	2.0	2.0	2.2	2.3	3.5	2.8	1.3	1.0	2.3
Nominal Personal Income (b)	7.3	7.2	7.5	6.3	6.4	6.1	6.1	5.8	4.4	5.3	2.1	0.3	0.3	-0.3	3.0	5.2	7.1	6.1	3.0	2.1	5.0
Industrial Production (a)	3.2	2.6	1.9	-0.9	1.5	3.2	3.6	0.3	0.5	-3.1	0.2	2.0	2.2	2.9	3.6	3.9	2.2	1.7	0.4	2.0	3.3
Capacity Utilization	80.8	81.0	81.2	80.7	80.7	81.0	81.3	81.0	80.6	79.8	79.3	79.1	79.0	79.1	79.4	79.9	80.9	81.0	79.7	79.4	80.2
Corporate Profits Before Taxes (b)	13.6	14.2	27.6	6.9	-1.0	-0.5	-2.7	-2.0	-1.5	-8.0	-6.0	-10.5	-2.0	5.0	8.0	9.2	15.2	-1.6	-6.5	4.9	9.2
Corporate Profits After Taxes	14.5	13.8	28.3	8.8	-0.9	-0.2	-0.8	-0.6	1.8	-9.6	-6.5	-12.0	-1.0	6.0	9.5	11.0	16.0	-0.6	-6.6	6.2	11.0
Federal Budget Balance (c)	-183.6	96.5	-41.7	-80.4	-178.0	137.5	-40.6	-106.8	-205.9	44.1	-130.0	-144.0	-238.0	6.0	-139.0	-151.0	-248.2	-161.5	-398.7	-515.0	-385.0
Current Account Balance (d)	-196.0	-199.9	-210.9	-181.4	-196.9	-194.1	-173.0	-167.2	-176.4	-185.0	-170.0	-155.0	-142.0	-135.0	-130.0	-127.0	-788.1	-731.2	-686.4	-534.0	-478.0
Trade Weighted Dollar Index (e)	85.2	81.4	82.0	81.5	80.5	78.7	74.4	73.3	70.3	71.0	72.5	73.6	75.9	78.3	80.3	82.4	81.5	73.3	73.6	82.4	90.0
Nonfarm Payroll Change (f)	255	88	206	151	109	105	71	80	-82	-55	-67	-75	-65	-17	40	63	175	91	-70	5	95
Unemployment Rate	4.7	4.7	4.6	4.4	4.5	4.5	4.7	4.8	4.9	5.3	5.7	5.8	6.0	6.1	6.2	6.3	4.6	4.6	5.5	6.2	6.3
Housing Starts (g)	2.12	1.86	1.70	1.57	1.45	1.46	1.30	1.15	1.05	1.02	0.91	0.90	0.93	0.96	1.01	1.11	1.81	1.34	0.97	1.00	1.30
Light Vehicle Sales (h)	16.9	16.4	16.5	16.3	16.3	16.1	15.9	16.0	15.2	14.1	13.1	13.2	14.1	14.0	14.2	14.3	16.5	16.1	13.9	14.1	14.7
Crude Oil - WTI - Front Contract (i)	63.48	70.70	70.48	60.21	58.16	65.03	75.38	90.68	97.90	123.98	121.00	110.00	110.00	112.00	112.00	114.00	66.22	72.31	113.22	112.00	115.0
Quarter-End Interest Rates																					
Federal Funds Target Rate	4.75	5.25	5.25	5.25	5.25	5.25	4.75	4.25	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00	5.25	4.25	2.00	2.00	3.00
3 Month LIBOR	5.00	5.48	5.37	5.36	5.35	5.36	5.23	4.70	2.69	2.78	2.60	2.40	2.30	2.20	2.20	2.20	5.36	4.70	2.40	2.20	3.20
Prime Rate	7.75	8.25	8.25	8.25	8.25	8.25	7.75	7.25	5.25	5.00	5.00	5.00	5.00	5.00	5.00	5.00	8.25	7.25	5.00	5.00	6.00
Conventional Mortgage Rate	6.32	6.68	6.40	6.14	6.16	6.66	6.38	6.10	5.97	6.04	6.20	6.00	5.80	5.65	5.65	5.60	6.14	6.10	6.00	5.60	6.80
3 Month Bill	4.63	5.01	4.89	5.02	5.04	4.82	3.82	3.36	1.38	1.90	1.80	1.80	1.80	1.90	1.90	2.00	5.02	3.36	1.80	2.00	3.20
2 Year Note	4.82	5.16	4.71	4.82	4.58	4.87	3.97	3.05	1.62	2.63	2.60	2.60	2.50	2.40	2.50	2.60	4.82	3.05	2.60	2.60	3.70
5 Year Note	4.82	5.10	4.59	4.70	4.54	4.92	4.23	3.45	2.46	3.34	3.30	3.30	3.20	3.10	3.20	3.30	4.70	3.45	3.30	3.30	4.50
10 Year Note	4.86	5.15	4.64	4.71	4.65	5.03	4.59	4.04	3.45	3.99	4.00	3.90	3.80	3.80	3.90	4.00	4.71	4.04	3.90	4.00	5.20
30 Year Bond	4.90	5.19	4.77	4.81	4.84	5.12	4.83	4.45	4.30	4.53	4.60	4.50	4.40	4.40	4.50	4.60	4.81	4.45	4.50	4.60	6.00

Data As of: August 6, 2008

Notes: (a) Compound Annual Growth Rate Quarter-over-Quarter  
 (b) Year-over-Year Percentage Change  
 (c) Quarterly Sum - Billions USD; Annual Data Represents Fiscal Year  
 (d) Quarterly Sum - Billions USD  
 (e) Federal Reserve Major Currency Index, 1973=100 - Quarter End

Notes: (f) Average Monthly Change  
 (g) Millions of Units  
 (h) Quarterly Data - Average Monthly SAAR ; Annual Data - Actual Total Vehicles Sold  
 (i) Quarterly Average of Daily Close

The Fed's "broad" trade-weighted dollar index, which measures the value of the dollar versus the currencies of 26 important trading partners, has generally moved sideways over the past few months (see graph on front page). However, the broad stability of the overall index masks some interesting movements beneath the surface. For example, the Mexican peso, which has a 9.8 percent weight in the index, has risen to its highest level versus the greenback since 2002 (see graph below). The Brazilian real (2.0 percent weight) has also risen to multi-year highs vis-à-vis the greenback recently. In contrast, the dollar has strengthened somewhat versus major currencies (e.g., the euro and the Canadian dollar), although the greenback generally remains within well-established trading ranges versus those currencies (see graph below).

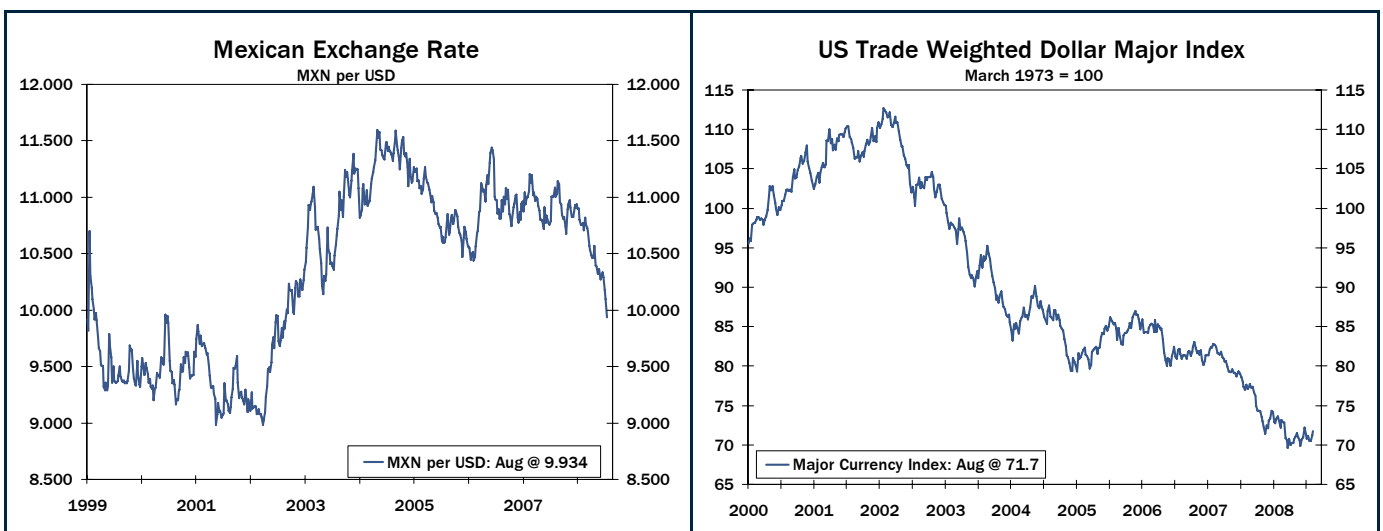
In our view, the dollar's mixed performance versus the currencies of America's major trading partners reflects recent interest rate developments around the world. For example, the Banco de Mexico (the country's central bank) has raised its target for the overnight inter-bank interest rate by 50 basis points since mid-June, and Brazil's central bank has hiked rates by 175 basis points since April. Central banks in South Africa and Turkey have tightened policy recently, and these currencies have also appreciated against the U.S. dollar. In each case monetary policy has been tightened in response to rising rates of CPI inflation in each respective country.

So how else are Brazil, Mexico, South Africa and Turkey similar? Each country has relatively high interest rates that have risen further over the past few months. With interest rates in the United States remaining relatively low, investors appear to be searching for higher returns in some developing countries, leading to currency appreciation in those economies.

In contrast, the U.S. dollar has appreciated somewhat versus many major currencies recently. Although there are some country-specific factors at play (e.g., the Aussie and Canadian dollars have depreciated as commodity prices have cracked), there is also a common thread here. Namely, interest rates in these economies are low (at least relative to many developing economies), and they are expected to remain low. Although the ECB raised its policy rate by 25 basis points in early July, investors have subsequently scaled back expectations of further tightening as recent data suggest that growth in the Euro-zone is slowing sharply. Indeed, most market participants no longer expect further ECB tightening. The U.K. economy may be slipping into recession, which would lead the Bank of England (BoE) to ease policy. The Reserve Bank of Australia (RBA) recently hinted that rates could be cut if growth down-under slows further.

In the near term, it seems likely the U.S. dollar will experience further depreciation against some emerging market currencies (e.g., the Mexican peso and the Brazilian real). Interest rate differentials between the United States and these countries are not likely to narrow much in the foreseeable future, which should continue to attract flows of speculative money into these relatively high-yielding economies. Once the Fed begins to hike rates the U.S. dollar should start to strengthen against these currencies, but that is a story for later.

We look for the greenback to grind slowly higher versus major currencies between now and the end of the year as investors ramp up expectations of eventual rate cuts by the ECB, the BoE, and the RBA. However, significant U.S. dollar appreciation will need to await Fed tightening, which we do not foresee happening in the near-term.



**August 6, 2008**

Wachovia International Economic Forecast						
(Year-over-Year Percentage Change)						
	GDP			CPI		
	2007	2008	2009	2007	2008	2009
Global	4.9%	3.6%	3.3%	3.9%	5.7%	4.0%
Major Economies						
United States	2.0%	1.8%	1.8%	2.9%	4.3%	2.1%
Eurozone	2.7%	1.7%	1.4%	2.1%	3.4%	2.1%
Germany	2.6%	1.7%	1.3%	2.3%	2.9%	1.8%
France	2.1%	1.6%	1.2%	1.6%	3.4%	1.9%
Italy	1.4%	0.3%	0.7%	2.0%	3.7%	1.9%
UK	3.1%	1.4%	0.9%	2.3%	3.2%	2.0%
Japan	2.0%	1.3%	0.9%	0.1%	1.3%	0.6%
Canada	2.7%	0.9%	1.5%	2.1%	2.4%	1.9%
Developing Economies						
China	11.8%	9.5%	9.0%	4.8%	6.8%	3.6%
India	9.0%	7.5%	7.3%	6.5%	6.6%	5.4%
Mexico	3.3%	2.4%	2.3%	4.0%	4.7%	3.8%
Brazil	5.4%	4.5%	3.5%	3.6%	5.6%	4.6%

<sup>1</sup>Data As of: August 6, 2008

Wachovia Currency Forecast								
(End of Quarter Rates)								
	2008		2009				2010	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Major Currencies								
Euro (\$/€)	1.56	1.54	1.50	1.45	1.40	1.35	1.30	1.26
U.K. (\$/£)	1.96	1.94	1.90	1.85	1.80	1.75	1.72	1.70
U.K. (£/€)	0.80	0.79	0.79	0.78	0.78	0.77	0.76	0.74
Japan (¥/\$)	108	110	114	116	118	120	122	125
Other Industrialized								
Canada (C\$/US\$)	1.04	1.06	1.10	1.14	1.16	1.18	1.20	1.22
Switzerland (CHF/\$)	1.04	1.06	1.08	1.12	1.15	1.18	1.23	1.26
Norway (NOK/\$)	5.10	5.20	5.30	5.40	5.60	5.80	5.90	6.10
Sweden (SEK/\$)	6.00	6.10	6.20	6.40	6.60	6.80	7.00	7.20
Australia (US\$/A\$)	0.92	0.90	0.88	0.84	0.80	0.76	0.72	0.70
Developing Economies								
Mexico (MXN/\$)	9.80	9.60	9.50	9.60	9.80	10.00	10.20	10.40
Brazil (BRL/\$)	1.50	1.45	1.40	1.45	1.50	1.60	1.70	1.80
Poland (PLN/\$)	2.10	2.05	2.00	2.10	2.20	2.30	2.40	2.50
Russia (RUB/\$)	23.60	23.40	23.20	23.00	22.80	22.60	22.40	22.20
Turkey (TRY/\$)	1.15	1.12	1.10	1.15	1.20	1.25	1.30	1.35
South Africa (ZAR/\$)	7.00	6.75	6.50	6.70	6.90	7.20	7.40	7.50
China (CNY/\$)	6.85	6.80	6.70	6.65	6.60	6.50	6.45	6.40
India (INR/\$)	43.00	42.75	42.50	42.20	42.00	41.90	41.85	41.80
Korea (KRW/\$)	1050	1040	1030	1020	1015	1010	1005	1000
Singapore (S\$/US\$)	1.38	1.38	1.37	1.37	1.36	1.36	1.35	1.35
Taiwan (TWD/\$)	31.00	30.90	30.80	30.60	30.40	30.20	30.10	30.00

<sup>2</sup>Data as of: August 6, 2008

Wachovia International Interest Rate Forecast																
(End of Quarter Rates)																
	3-Month LIBOR								10-Yr Government Security							
	2008		2009				2010		2008		2009				2010	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
United States	2.60%	2.40%	2.30%	2.20%	2.20%	2.20%	N/A	N/A	4.00%	3.90%	3.80%	3.80%	3.90%	4.00%	N/A	N/A
Japan	0.85%	0.75%	0.70%	0.70%	0.70%	0.90%	0.90%	0.90%	1.50%	1.55%	1.60%	1.80%	2.00%	2.10%	2.05%	2.00%
Euroland	4.95%	4.80%	4.50%	3.90%	3.90%	3.90%	4.20%	4.40%	4.40%	4.25%	4.00%	4.05%	4.10%	4.40%	4.60%	4.70%
U.K.	5.70%	5.30%	4.80%	4.15%	4.15%	4.15%	4.40%	4.70%	4.70%	4.40%	4.30%	4.25%	4.40%	4.70%	4.90%	5.00%
Canada	3.30%	3.15%	3.15%	3.15%	3.50%	3.75%	4.00%	4.20%	3.70%	3.75%	3.90%	4.10%	4.20%	4.30%	4.40%	4.50%

<sup>3</sup>Data As of: August 6, 2008

## Wachovia Economics Group

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