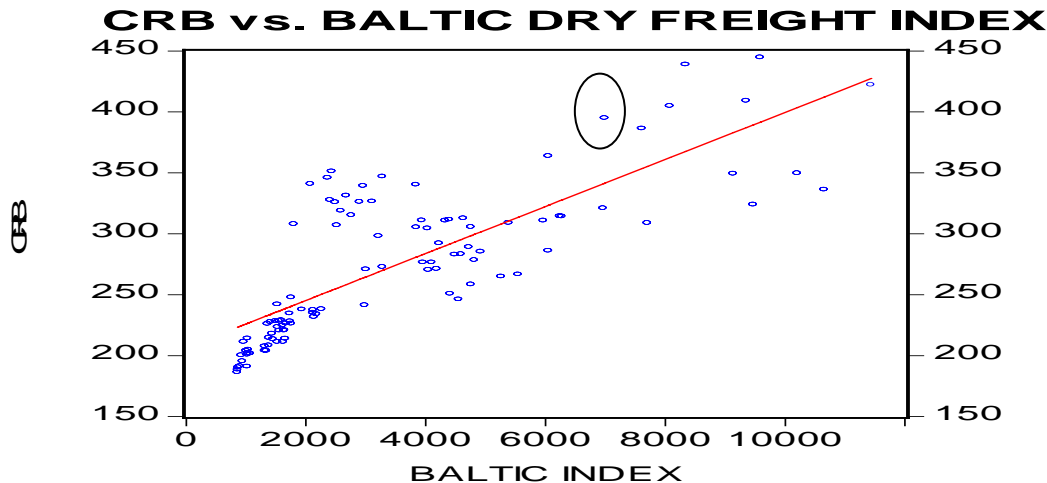


Splitting the Horns of a Dilemma

- In the June 16 report, we discussed the key problem facing policy makers. On the one hand, financial system problems and the collapse in home prices have hurt households. The unemployment rate for July rose to 5.7%, one full percentage point higher than July 2007. Consumer confidence remains near 28 year lows. These issues tend to weigh on consumption and depress economic growth, as consumers feel less affluent. Such conditions would likely call for lower interest rates.
- While economic conditions were deteriorating, commodity prices were increasing. Rising commodity prices, coupled with a weaker dollar, boosted inflation concerns. July's reading on CPI, with the yearly change in inflation at 17-year highs, exacerbated this issue. With inflation concerns increasing, the Federal Reserve would normally raise interest rates.
- Thus, the Federal Reserve found itself on the 'horns of a dilemma'. If they cut rates to support a weak economy, they run the risk of sparking inflation. If they raise rates to contain inflation, there is a risk that the economy, which is probably in a mild recession at this point, could suffer a more profound growth decline. In the last two deep recessions, the 1974-75 and the 1981-82 periods, the policy makers increased rates during the downturn, exacerbating the weakness.
- Relief started to come in early July. Commodity prices, measured by the CRB index, peaked on July 3rd. From that high, the index has dropped more than 18%. Oil prices have declined from a peak of \$147.27 per barrel on July 11th to \$113.00 per barrel, a drop of over 22%. The dollar also rose as investors finally noticed that the European economies were slowing rapidly and the tight monetary policy was due to come to an end. The dollar index made a low of 71.31 on July 15th. It has appreciated by 8.1% since then. The sharp decline in commodity prices coupled with the rise in the dollar has effectively eliminated one of the "horns". In other words, policy makers can now more easily concentrate on the economy and worry less about inflation concerns.
- Currently, the fed fund futures are signaling steady policy into year's end. In mid-June, these contracts were forecasting a 90% chance of a rate hike by December. While improved inflation sentiment does not guarantee that the current slowdown won't turn into a deep recession as seen in 1973-74 and 1981-82, it does improve the likelihood that the current slowdown is a more normal one. Given that equities have been performing more akin to a deep recession, recent action in commodities and the dollar should be a supportive for equities in our view.
- One of the key issues is if commodity prices will remain weak. That is the topic of this week's Chart of the Week.

Chart of the Week:



For illustrative purposes only. This does not reflect the performance of any specific investment.
Past performance is no guarantee of future results

Sources: Bloomberg, Haver Analytics, Wachovia Securities

This chart shows a scattergram of the Baltic Dry Freight Index on the bottom axis and the CRB index of commodity prices on the left axis. The former is an index that measures the cost of shipping dry freight, which is essentially any good that is not liquid and not shipped in a container. Examples would be soybeans, scrap iron, cement mix, etc. The latter is a broad based index of commodity prices. A scattergram coordinates the data pairs of the two series; in a given time frame, the combination of the two series is plotted on the graph. The data run from 1999 to the present.

We have plotted a regression line through the two data series, which indicates that higher commodity prices are generally associated with rising shipping costs, as shown by the upward sloping line. Why are the two related this way? This is because rising demand for commodities not only boosts the price of those goods but it also increases the demand for shipping services.

The Baltic Dry Freight Index peaked on May 20th and has fallen 38% from that peak. The index started falling before commodities peaked in early July and suggests that demand for commodities is declining.

We have circled the most recent data point, which represents August. Because this data point is above the regression line, it would suggest that, given where shipping costs are, commodity prices are probably too high. Thus, we would expect commodity prices to remain soft in the near term.

Bill O'Grady

Commodities: Basic goods used in commerce that are generally interchangeable with other commodities of the same type. Commodities are most often used as inputs in the production of other goods or services. Buying commodity based investments allows for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations.

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. The Reuters-CRB Continuous Commodity Index is an unweighted geometric average of 17 individual commodity prices. Individual investors cannot directly purchase an index. **Additional Information Available Upon Request**

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