Weekly commentary by Professor Jeremy J. Siegel

More Banking Problems; Stimulus Package to Offset higher Saving

2:15 p.m., EST, 1/16/2009, Philadelphia PA

Overall CPI inflation was not quite low enough to bring about a negative year-over-year reading (now at +0.1%), but next month's number is likely to turn year-over-year negative. December's core inflation was zero, bringing core year over year numbers down to 1.8%. The Fed watches the PCE deflator derived from the GDP accounts, which won't be announced until February 2nd. That number is expected to put year-over-year core inflation at about 1.6%. These are well within the Fed's implied target of zero to 2% and do not suggest that deflation (outside of food and energy) is a problem. Nevertheless, I believe the Fed will still be very aggressive at making sure deflation does not become a reality.

BankAmerica won the same sort of deal that Citibank got two months ago – another infusion of funds and a fence around troubled assets where the Fed absorbs the lion's share of the loss. After an initial spurt in price, BAC has fallen to new lows, as investors rightfully question the viability of the bank despite the government help. The bad assets it brought on its balance sheet through the purchase of Merrill late last year and especially through the purchase of Countrywide earlier are overwhelming its capital base. The entire financial sector is now just 10% above its November 21 panic low and the S&P 500 bank index has hit new lows. It will be difficult for the market to mark a sustained rally without a turnaround in the financial sector.

The good news is that the record low mortgage rates are leading to record mortgage re-financings. And lower interest costs, along with the lower gasoline prices, are boosting consumer's disposable income. The problem is that most consumers are saving the difference and personal savings has now turned positive for the first time in many years. The personal saving rate (disposable, or after-tax income that is not consumed (graphed below)) is estimated to be up to 4% (around $300 billion annual rate) in December, up from zero in recent years, the highest rate in over ten years. The Obama administration 2-year stimulus package of $825b (or $925b if you add the expected extension of the AMT tax break) will generate just enough annual spending (dollar for dollar for government purchases, less than one-for-one for tax cuts) to offset the decline in consumption. However, if the saving rate goes higher, and if businesses cut their investment spending, aggregate demand will still be depressed. Furthermore, most of the stimulus will not be felt until late 2009 and 2010 as it takes time for government programs to be up and running. All this points towards a number of years before aggregate demand returns to the pre-recession path, but it does suggest the economic downturn could be arrested by the second half of the year.

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PERSONAL SAVING AS A % OF DISPOSABLE INCOME

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