Weekly commentary by Professor Jeremy J. Siegel

GDP Revised Way Down; Citibank Move Good, Stress Tests Critical

11:30 a.m., EST, 2/27/2009, Philadelphia PA

This morning we had two pieces of important news: The preliminary GDP data, which showed a much sharper downward revision in fourth quarter GDP than expected, and the Citibank (Citi) plan to eliminate dividends on preferred (and common) stock and convert preferred stock into common.

First GDP: the new estimate down 6.2% (annualized) is 2.4 ppts (percentage points) below the advance estimate, a much larger than average revision. One bright light is that real final sales fell by less, down 6.4 ppts versus the 5.1 ppts originally reported. This means the downward estimate of inventory accumulation accounted for 1.1 ppts drop, almost half the downward revision. Personal consumption was revised downward by 0.5 ppts and the back-to-back drop of 2.75 ppts in the second quarter and 3.01 ppts in the fourth quarter is the largest two-quarter fall in consumption since quarterly records began in 1947. This clearly is a consumption-led recession. The 1.3 ppts drop in investment from the advance estimate was almost entirely accounted for by the inventory drop.

One negative consequence of the downward revision is that productivity growth, which was reported to have risen a surprising 3.2% in the fourth quarter is apt to be revised mostly away (announced on March 5). Although it is gratifying to get any increase in productivity in the teeth of a vicious recession, the lower estimate means that efficiency gain through the layoffs have been modest and that unit labor costs have risen more than expected.

Citi's move to raise its common share base is on balance a good one. Given the dire situation of the bank, it is not appropriate to pay preferred dividends, and eliminating them will save many billions of dollars. I have long said that common shareholders cannot be a tiny tail that is wagged by all the prior claimants, including the preferred shareholders. This move increases the common equity base and increases the chance the bank can weather the storm.

In my opinion, far more important than the action with preferred stocks, will be the result of the "stress tests" that are now being undertaken on twenty banks. The Treasury is supposed to provide a realistic view of the value of tainted assets, particularly under the "worst-case" scenario that sees unemployment rising to 10% and home prices falling another 25%. Bernanke implied in his testimony this week that banks may have sufficient equity to weather the storm. His remarks buoyed the markets, particularly the financial sector. The market clearly expects the worst for financials; there is room for an upside surprise when these reports are released.
