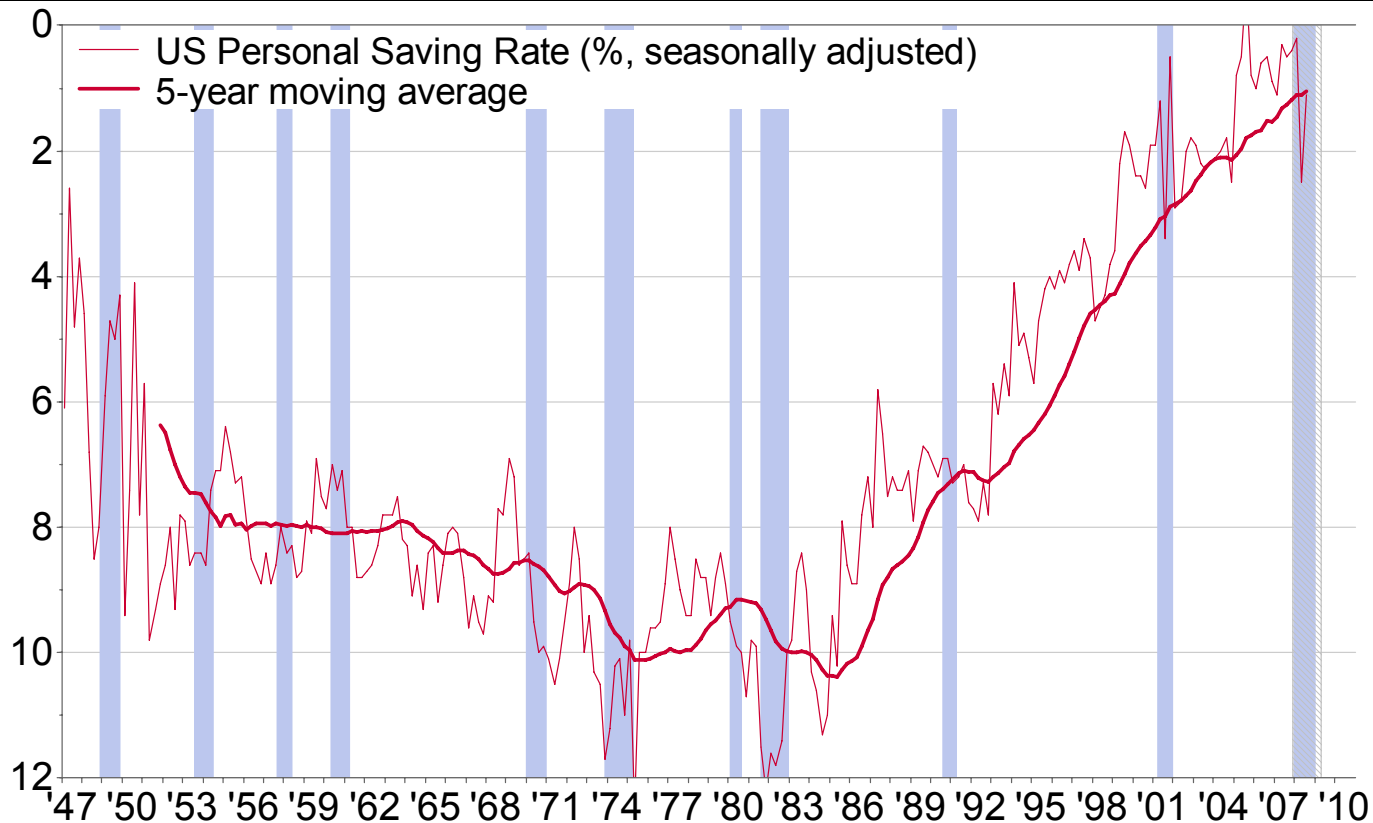


Rising Savings Rate May Limit the Cyclical Bounce

- Economic reports continue to disappoint the published consensus forecasts, yet popular stock market averages seem to be taking the news in stride. For the second time in as many weeks, a confluence of downbeat news has pulled the averages lower at the opening bell – only to see the market battle back and close higher on the day – and the week. The stock market’s resilience in the face of bad news since the November lows is a hopeful sign that economic recovery may begin sometime in mid-2009. But this recovery may not match those of prior cycles.
- Retail sales figures for November showed a significant contraction, mostly due to a substantial decline in both the pace of auto sales and the price of gasoline. Auto sales fell –30% from a year ago on scarce credit and slumping consumer confidence. Meanwhile, gasoline stations’ sales totaled \$30 billion for the month, down from a \$50 billion monthly pace from May through August, and down from \$40 billion in the same month a year ago.
- While the drop in gasoline prices is certainly a welcome development, especially for less-affluent consumers, we note that \$30 billion of retail gasoline sales in November 2008 were roughly the same as November 2004, November 2005, and November 2006. This fact refutes the notion that energy price declines are a meaningful tax-cut, especially when one considers the offsetting decline in household wealth, which has been cut by a third since 2005.
- Looking beyond the auto and gasoline sales, one should not be surprised to see that “non-discretionary sales” – those at supermarkets, drugstores, restaurants and general merchandise stores – have been less impacted by the economic gloom. These increased +2.2% from a year earlier to \$161 billion, while a wide range of stores concentrating on more discretionary items saw sales drop –8.1% to \$107 billion. In the typical recovery, easier credit combines with pent-up demand to boost confidence and reverse the trend for discretionary sales.
- The deleveraging process – where households and businesses shed assets to repay debt and thus shrink their balance sheets – is a difficult one for lending institutions and other establishments that thrive on consumers’ willingness to do just the opposite. Unfortunately, it appears that the U.S. consumer had become too accustomed to an overabundance of credit on easy terms, and the U.S. economy – perhaps even the global economy – had become too accustomed to the free-spending ways of the U.S. consumer.
- It is our sense that the stock market’s recent resilience means that the deleveraging process is transitioning from a massive storm – one where large financial institutions are at risk of imminent failure – to its aftermath, a still-difficult period of cleanup and repair, but one with less risk of further catastrophic losses. Consumer delinquencies on credit cards and other loans are still on the rise, and it appears that the economy may struggle until housing prices begin to stabilize. Affordability measures have improved meaningfully, and new construction has dropped well below the rate of inherent demand, so we are hopeful that home prices will bottom sometime in 2009.
- Our Federal government has already pushed briefly on the fiscal accelerator in 2008, sending \$163 billion in rebate checks and other spending designed to provide a near-term stimulus. Now it appears that Congress – with the support and encouragement of President-elect Obama -- is preparing to “push the pedal to the metal,” considering a much larger package of infrastructure investments designed to support the economy through a difficult period. Perhaps targeting the relief away from rebate checks is a signal for consumers not to return quickly to their old habits.

Personal Saving Rate May Have to Increase Further as Confidence in Investments Falters



Note: *Personal saving as a percentage of disposable personal income. Reverse scale. Recession periods shaded. Source: Bureau of Economic Analysis.

Given steep losses in household wealth caused by the decline in housing and stock markets, it is no surprise that personal spending – of which purchases at retail establishments comprise a substantial portion – is under great pressure. Government accounts define “savings” as the portion of after-tax income that remains after consumption expenditures and interest payments. Savings as a portion of after-tax income dropped from 7% in 1990 to zero in 2006 (see chart above), as home prices were peaking. Our chart is oriented to illustrate the fact that households were consuming an increasing portion of their earned income over the past 25 years, and suggest this pace of consumption is vulnerable to a correction.

Many households were apparently relying on gains from their investments and increases in their borrowings to supplement their earned income in support of an unrealistic spending pace. The chart shows how consumption binges of the past were often corrected by an increase in savings during or after a recession. In this cycle, we expect the savings rate to climb meaningfully -- back toward 4% from current readings near 1%. Much of the increase will result from households diverting a significant portion of their earned income toward reducing debt and rebuilding investments.

If the savings rate rises as we expect, a stabilization for the economy may not offer as much of a boost in discretionary retail sales as prior cycles might suggest. Thus the securities of manufacturers, distributors and vendors of discretionary consumer products are not as well positioned to benefit as they were in the two most recent recoveries, in our view.

Tom McManus

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