Weekly commentary by Professor Jeremy J. Siegel

Stocks Want to Go Up if Bonds and Oil will Let It; Important FOMC Meeting

9:45 p.m., EST, 6/19/2009, Philadelphia PA

The stock market wants to go up, but the bond and oil markets won't let it. Whenever there is a strong economic report, or even a good rally in stocks, the bond vigilantes sell Treasuries and push their yield upward. I believe that the strength in the economy will eventually trump interest rates and send stocks upward, but it won't be quite as easy as I had hoped. As I write this, oil is at $72.00, about $1 from its recovery high and the 10-year Treasury at 3.87%, 13 bps below the 4% level it reached two weeks ago. If oil and bonds could stay at this level, stocks could easily rise. But investors are worried about how much higher oil and interest rates will go. The good news is that the dollar is well off its low and gold off its high, but oil and bonds are more important.

The best economic news of the week came yesterday when the large drop in continuing claims combined with a much better-than-expected Philly Fed report to boost the market. Usually continuing claims are not as good a turning point indicator as the initial claims number (the latter holding just above 600k). But the drop in the continuing number was large enough that some forecasters claimed the recession ended in May or June.

Next Tuesday and Wednesday we have an important FOMC meeting. And the outcome, announced Wednesday at 2:15p may be quite significant. There is some speculation that, in response to recent market worries that the Fed will have to tighten in the second half of the year, the Fed will strongly reiterate its intention of keeping the funds rate in the 0% to 0.25% range. The key sentence in the April 29 report was The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period. Any change in the wording here will be closely watched as well as any comment on the rising commodity prices.

The Fed funds futures market has backed off a bit from the sharp rise in rates it forecast two weeks ago, but the market still predicts higher rates than a month ago. The March 2010 contract, which had hit 1.02%, is now at 0.765%. That still is more than 50 bps above the top of the current Funds range. In addition, the market is wondering whether the FOMC will comment on the sharp rise in long rates, perhaps reiterating or expanding its policy of buying long-dated Treasures. My expectations are that, given the better-than-expected PPI and CPI reading this week, that the Fed will basically hold firm. But Wednesday's report may have more market-moving news than usual.
