Weekly Commentary by Professor Jeremy J. Siegel

Europe Begins to Get It Together (Kind of) and Good Labor Market Report

10:45 PM EDT, 12/2/2011

If there were any doubt about how important the European situation is for U.S. markets, the reaction to the steps taken by the Europeans to quell the crisis, including the coordinated 50 basis drop in the swap lending rate of dollars between international central banks, should erase any doubt. The strong rally we saw in equities this week stems from hope that the ECB finally has its hands around the European crisis, which is the major negative hanging over world equity markets.

But I am not yet convinced. Certainly the steps taken are positive, but they have had little influence on either the Libor spread in the U.S. or the Euribor spread in Europe. These are the spreads between direct lending rate of the central bank and the rate charged for lending between the banks. Recall it was the Libor spread that jumped to an astounding 364 basis points following the Lehman crisis that assured a severe global recession. That spread is now only 43 basis points, but it was only 15 bps early in July. The comparable Euribor spread surpassed 100 bps Thursday and is down only a couple of basis points today. (This spread hit 207 bps at the height of the Lehman crisis). The Euribor spread implies there is more work to be done to quell fears of a banking crisis in Europe.

On the domestic front I liked today's labor market report. The headline number of 120k total payroll gain (+140k private payrolls) was not that impressive, but the upward revision to previous months was solid and the household report, which showed the unemployment rate dropping to a surprising 8.6%, was quite strong. Hourly earnings were down 0.1% and labor costs are up only 1.6% year over year, far less than the rate of inflation. This is one reason for the positive profit picture in the third quarter despite lackluster growth. On balance other indicators released this week were strong, particularly the PMI report, construction spending, and domestic vehicle sales.

The specter of another banking crisis from Europe still spooks the equity markets, which, in my opinion would be 15% to 25% higher without that threat. One way or another that problem will be solved, and it will come from extra liquidity supplied by the ECB. That has never been bad for the equity markets.
