Weekly commentary by Professor Jeremy J. Siegel

Data a bit Downbeat but Credit Markets Mend Further

11:00 p.m., EST, 5/16/2009, Philadelphia PA

The economic data was frankly disappointing this week, especially the April retail sales report. The consumer is backtracking and the excuses made for the weak March report, in particular the late Easter selling season were not supported by this month's data. Nonetheless, the report was not disastrous. Despite the fact that forecasts that the consumer will continue to boost spending in this quarter have been tempered and GDP growth for the second quarter has been marked down by between ½ and 1 percentage points, the second quarter GDP growth is now forecast to be about minus 1.5% annualized growth.

Earnings in the second quarter actually came in a bit below April estimates after strong early showings. Most of the shortfall came from the energy sector, which suffered from very poor oil prices in the first quarter. Now that oil prices have recovered, earnings should be better in this sector. Despite the fact that we import nearly 2/3 of our oil, the energy sector is a large part of the market, with a market value of $1 trillion against $7.7 trillion for the whole S&P 500. Another factor hurting earnings was the strong dollar, which is up about 15% against developed currencies (and more against EM currencies) from a year ago. In fact, in many cases the reasons why a number of firms did not match their revenue projection was due to translation of foreign sales into dollars. The dollar has recently become weaker and is now about 4% lower than its first quarter average. As the crisis fades I expect the dollar to weaken further and this should provide a boost for foreign earnings.

The markets have taken a more skeptical view of the bank stress tests. Investors are asking: Are the commercial and credit card losses believable or not? Those who follow my writings know that I wanted outside observers to certify the results of the stress test. This was not done. The news that "negotiations" took place between bank management and regulators (which reduced some of the capital needs) did not enhance credibility of this report.

Nevertheless, there is undeniable healing in the credit markets. The graph below of the three-month libor shows that current libor rate of 82 basis points is just 57 bps above the upper end of the Fed fund range. This is higher than the 20 bps before the first glimmers of the financial crisis in early 2007, but well below the spread that prevailed even pre Lehman collapse. All risk spreads and stress levels are down markedly. Given the estimated $350 trillion dollars of loans and derivates that are based on these libor rates, this has to be good news for borrowers. Clearly banks that have access to government financing are cleaning up on their performing loans.

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3 Month Libor Rate

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