Weekly commentary by Professor Jeremy J. Siegel

Anniversary of Crisis Week; Data Favorable; Fed on Hold

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The fundamental trends are still in place: slow and steadily rising equity prices and stable bond and commodity prices. Only gold has been making new highs, and this is due mostly to the decline in the dollar. Although many attribute this to the buildup of massive US government indebtedness, the real reason for the greenback's fall is that the risk premium is being squeezed out of the FX market by the increased stability of the world economy.

This past week marked the one-year anniversary of the greatest crisis in the credit markets since the Great Depression. A look back is revealing. The spread between libor and Fed funds was 100 basis points immediately preceding the Lehman bankruptcy. After the bankruptcy it soared to 364 bps, but now is only 10 bps. Just before the Lehman bankruptcy the spread between BBB bonds and government bonds was 221 bps. This soared to 438 bps, and it is now 190 bps. The VIX volatility index was 25.66 just prior to the crisis and soared to 90. Now it is 23.65. The fact that the VIX is still relatively high is bullish in my estimation, as it means that there is still substantial fear in the equity market. Before the subprime crisis, VIX fell as low as 9.39. It probably will not fall that low again for many months (if not years), but it should decline to the 15 range, which I believe indicates substantial upside for equities.

The most important event next week will be the FOMC announcement on Wednesday, although the data on Durable Goods and Jobless Claims will also be of interest. The latter dropped to 545k in the last week which, save for artificially low reading in early July due to the timing of auto layoffs, was the lowest since January.

The economic data since the last FOMC meeting on August 12 must be gratifying to the Fed. Economic activity has certainly ticked up, risk premiums continue to decline, and core inflation remains firmly under control. The Fed does not view the dollar decline – or the gold rise – as threatening. Clearly the Fed will keep the wording of the directive with respect to the Fed Funds rate the same, specifically to maintain, "exceptionally low levels of the federal funds rate for an extended period". Any changes to those words would be an extraordinary event and cause a large negative reaction in the equity markets. The Fed intends to keep this accommodative stance unless commodities in general, and oil in specific, rise much further or the dollar takes a sharp move downward, breaking below the levels reached before the crisis (which would mean 1.60 on the Euro). As of now the Fed's medicine is working, and there is no reason to change the dose.
