

Weekly Commentary by Professor Jeremy J. Siegel

Data Still Very Weak; All Eyes on the Fed

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Today is our last full day in Provence, France and it has been a wonderful week, not only for my wife and me, but also for the stock market, where the S&P 500 registered its third best weekly gain in 2 years. Perhaps I should take such a vacation more often. It is of interest that stocks rose despite poor economic data—jobless claims up, disappointing retail sales and CPI up slightly more than expected. These announcements ratcheted down estimates of third quarter GDP growth by about 20 or 30 bps, to about 1.5% to 2%. Again, this is nowhere near recession mode, but still reveals an extremely sluggish economy. Stocks had a good week because of statements from Trichet that the ECB is ready to support European banks in the case of a default. As a result, spreads on sovereign debts tightened and the fear of an imminent crisis ebbed. The equity market is worried more about a second Lehman-style banking collapse than the slow economic growth, at least at the present time.

That will change, however, this week. Upcoming economic data are thin, but the Fed's 2-day meeting looms large. The market is expecting some action, but forecasters are all over the place on what that action will be. The two options discussed the most are "operation twist" where the Fed buys long-dated Treasuries and sells short-dated bonds, keeping the balance sheet unchanged but putting downward pressure on long-rates. The second is lowering the interest rate the Fed will pay on excess reserves to 0 from 25 bps. Some believe that both measures will be taken.

It is my feeling that lowering the interest rates on reserves is slightly more likely. Interest on reserves is indeed an extremely valuable tool of the Fed, and I have no doubt that when the Fed eventually decides to tighten, raising such interest rates will come before increasing the Fed Funds target. However, there is no good reason for reserves to be paying 25 bps when short-dated Treasuries are paying essentially zero. Lowering the interest on reserves to zero will at the margin encourage banks to lend funds, raising the velocity (circulation rate) of money (such a move, by the way, will be costly to the banks, which have over \$1 trillion of such reserves.)

Operation Twist is a possibility, but there is a legacy of doubt about the effectiveness of such a move when it was last tried in the 1950s. In any case, I don't think both will be done at this meeting. If any measure is taken, however, stocks will stage a good rally, but if no action is taken, expect the equity market to fall.

Professor Jeremy Siegel is a Senior Investment Strategy Advisor to WisdomTree Investments, Inc., and WisdomTree Asset Management, Inc. He is also a registered representative of ALPS Distributors, Inc. This article speaks of his research and expresses his opinions and is not to be considered a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product, and it should not be relied on as such. The user of this information assumes the entire risk of any use made of the information provided herein. Neither Professor Siegel nor WisdomTree nor any other party involved in making or compiling any information makes an express or implied warranty or representation with respect to information in this article. Past performance is no guarantee of future results.