Weekly Commentary by Professor Jeremy J. Siegel

Europe provides spark but U.S. economy main reason for rally

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The market was already breaking out on the upside and just a little good news was needed – and it came from Europe – to power one of the strongest and broadest stock rallies in many months. World equity markets have now rallied 20% or more in just the 17 days since the "head fake" downside breakout on October 4. Despite the cheers for the European action, it is the steadying U.S. economy that is driving much of the action. GDP came in just about as expected at 2.5%, but final sales came in at a very healthy 3.6% gain (inventory subtracting 1.1 percentage points) which suggests the 4th quarter will be even stronger. It should also be emphasized that government added no growth last quarter so that the percentage increase in the private sector output was even stronger. Most of the government in GDP is computed on the basis of cost – primarily labor cost. This is because the vast majority of government spending – such as for national defense or educational services is not sold to the public and has no "market price". Therefore when the government lays off workers, its GDP contribution goes down no matter what the productivity of these workers are. As a result, during a period of government layoffs, calculated GDP growth may be biased downward. Indeed productivity growth for the 3rd quarter is scheduled to be released Thursday and is expected to print up 2.8% which means last quarter's GDP increase is due entirely to productivity growth while hours worked actually fell.

Also on the docket next week is a 2-day FOMC meeting, capped off by a Bernanke press conference on Wednesday. Expect no new policy or any significant change in statement or guidance since for the first time since April economic news is coming in better than expected. Bernanke gave hints of increased "guidance" in future Fed statements but I don't expect anything this month. The most important event next week is the employment report on Friday, where expected private sector gains are 125k, enough to keep the unemployment rate unchanged but little more.

Recent consumer sentiment indicators look dismal, but the very recent pickup in stock prices, if sustained, should improve sentiment going into the holiday season. There is usually a fairly good correlation between stock prices and year-end retail sales. Investor's 401k's looked very gloomy for the 3rd quarter which undoubtedly added to negative sentiment. Stable food and gas prices and a higher stock market augur well for this quarter.
