Weekly Commentary by Professor Jeremy J. Siegel

Right Words from Fed and Europe Could Spark Strong Rally

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Many of the growth indicators continued their steep fall, especially the New York and Philly Fed manufacturing indexes. These indicators have fallen much faster than they did in the slowdown last year, but they started from much higher levels. Retail sales were poor, but not much below expectations, while housing starts were a bit above expectations, one of the few bright spots in another dismal week of downbeat data and European angst.

The Fed is meeting next week but don't expect a QE3 announcement. A year ago, core CPI inflation was running at +0.8% and heading down. The threat of deflation was real and Bernanke used the threat to beef up support for his QE2 program. Year over year core CPI inflation hit its bottom at +0.6% last October and has headed steadily up since then, reaching 1.5% last month. Bernanke held the threat of deflation – not slow growth – as the plague to be avoided. Clearly he cannot do the same now. Yes, there is good news on the sensitive commodity front, as energy and food prices continue to edge downward, but this is clearly too thin a reed to warrant another dose of easing.

Nevertheless, the "risks" to the Fed's forecast are now "balanced", in other words not just to the upside as they had been over the last several meetings. There is a possibility that the Fed will suggest, after stating that they are completing the purchases of QE2, that they are monitoring the situation closely to see whether any further stimulus is necessary. Any words that hint of any stimulus would spark a very strong stock market rally since investors are convinced that the QE1 and QE2 were major factors in stock market rallies over the past two years.

Whatever the Fed says, the most important factor impacting world stock markets now is the euro situation, which continues to deteriorate. As I have noted for weeks, there is a fear that a Greek government default could spark a contagion that brings down the European banking system and possibly spreads to the U.S. and Asia. Although this is an extremely low probability event, since the ECB will turn on the liquidity spigot to prevent any wholesale run on the European banks, its mere possibility keeps stocks defensive. Any easing of that crisis, albeit temporary, could spark a strong rally. The right words from both the Fed and Europe next week could turnaround this deeply oversold equity market.
