Weekly commentary by Professor Jeremy J. Siegel

Progress on Thorny Issues Spurs Markets

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Could we have a triple play this week? Potential agreements on the U.S. debt ceiling limit, Greek debt, and yes, the end of NFL owners/players lockout, all seem on the horizon. I won't comment on the latter, but the former have already spurred the markets, which are now less than 2% from their yearly highs reached last April.

The most important issue for the U.S. markets now is not the U.S. debt ceiling debate, but the European sovereign debt crisis. Here there was substantial progress made as European leaders agreed that some "haircut" must be made on Greek debt and under those circumstances the ECB will continue to accept Greek paper as collateral. It is important to understand that the markets are not worried about Greek default per se but the implications of such a default on the banking system. The specter of a Lehman-like run on the banks hangs over the markets and any moves that allay that fear are most welcome. Before Wednesday's agreement, the market feared that the Europeans were "in denial" of the necessity of a restructuring and that the ECB would refuse to honor Greek bonds if a default occurred. The ECB's more conciliatory line on this issue was most encouraging, but not surprising. As I have long claimed, despite Trichet's ostensible hardline, the ECB will provide whatever liquidity necessary to prevent a banking crisis.

On the domestic front, it was encouraging that Obama seemed to embrace the broad outline of the Senate's "Gang of Six" proposal to curb the deficit. The Gang of Six proposal is similar to the Bowles-Simpson plan which received much praise when it was first released last November. The Bowles Simpson proposal eliminates nearly all deductions and sharply lowers tax rates. The Gang of Six proposal did not go that far, as it specified a lower 20% tax rate on capital gains and dividends, while the Bowles-Simpson plan taxed capital gains and dividends at ordinary rates. Despite Obama's claim that he can work within this structure, I believe it is very unlikely that such a proposal will be passed by August 3. Instead a temporary debt ceiling increase, lasting for about 18 months, will most likely be negotiated. Since both sides believe that they can win next November, there is little incentive to negotiate a permanent fix. The market regards the debt-ceiling drama as perhaps important for consumer confidence, but does not believe that default is a real possibility. Nevertheless, coming to some agreement on the debt issue will be a positive for equity markets that seem set to rally to recovery highs.
