Weekly commentary by Professor Jeremy J. Siegel

Retail Sales Disappoint, but Low Inflation and Low Yields Drive Stocks Higher

8:55 a.m. PDT, 8/14/2009, Philadelphia PA

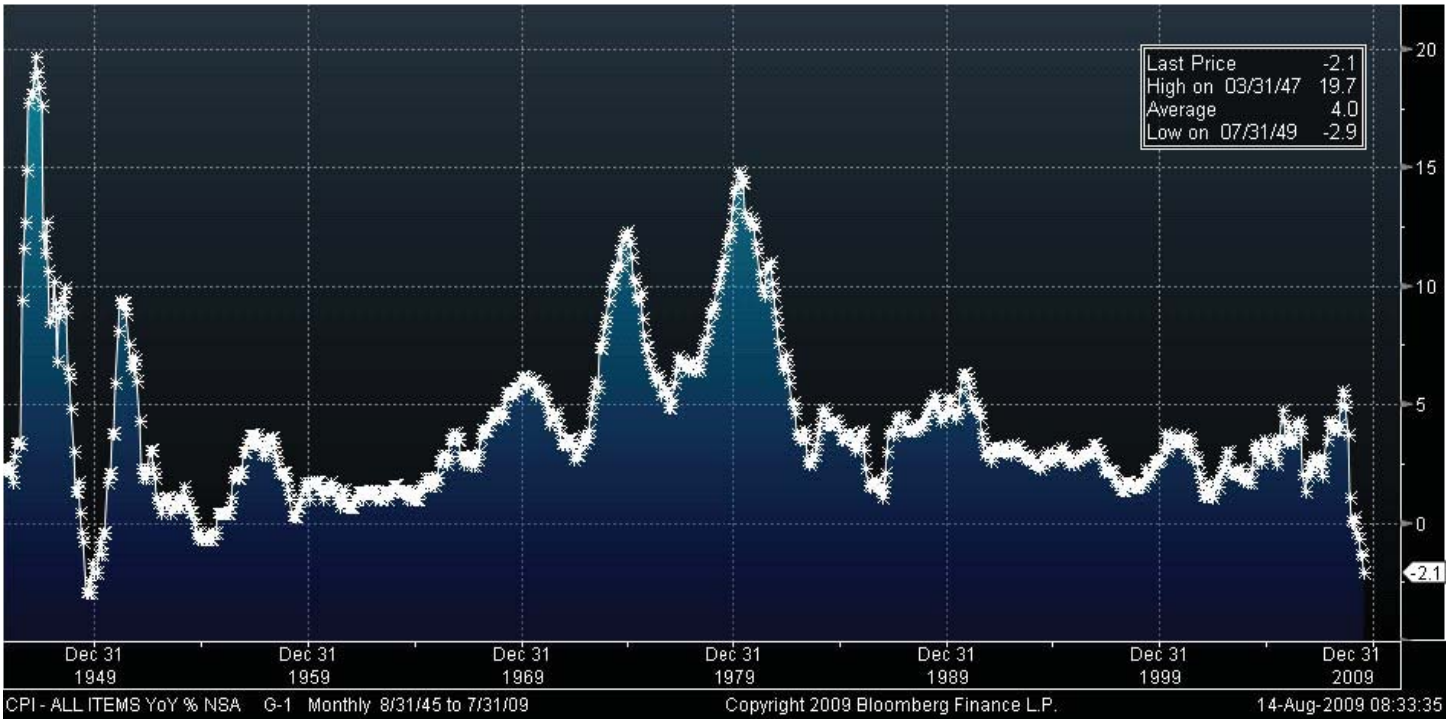
Stocks were set up yesterday morning for a 150 to 200 point gain until the disappointing retail sales report was released. In spite of that, all major indices (Dow, S&P, Russell 3k, Russell 2k, Russell Value and Russell Growth) hit new closing recovery highs. I don't think the rally is over, as there is still a lot of skepticism about the durability of this move. The emerging markets, especially China, have taken a pause, and volume is fading as it usually does in the second half of August. But the big support comes from the Treasury bond market, which, despite the prodigious supply, still finds plenty of buyers. Yesterday, yields on the 10-year fell 12 basis points to 3.60%. With "safe" yields so low, it is just too tempting to dip into equities, as the indicated dividend yield on the S&P 500 Index is 2.61%, only 99 bps below the treasury rate.

Nevertheless, the poor retail sales data did give a significant downward bump of about one-half percentage point to GDP estimates in the current quarter, which now look to be up between 2.5% and 3%. We have commented that in the third quarter the consumer is missing the cash infusions from the tax and social security coming from the stimulus passage. I have maintained that spending on big ticket items won't really pick up until workers' fears of unemployment subside and that will take several more months. In the meantime, new data show that inventories were brought down even further than first estimated in the second quarter, which can offset the soft consumer data as business restocks.

Just released consumer inflation was right on estimates of zero overall and 0.1% rise for the core. But because of minor revisions to past data, the year-over-year data look better than expected, and the core rate is now down to 1.5%, the lowest in almost 6.5 years, while the overall CPI inflation is negative 2.1%. As the graph on the next page shows, this is the lowest inflation in more than 60 years, and was only exceeded when the economy was cooling off from the removal of price controls right after World War II.

With persistent downward pressure on labor costs (unit labor costs were down a whopping 5.8% in the second quarter) and commercial real estate rents, cost pressures are clearly absent. This means that the Fed can easily maintain its zero to 25 bp range a while longer. When the consumer spending returns, however, as I expect later this fall, pressure to increase the funds rate will increase. In the meantime, equities can continue to enjoy the ride.

YEAR OVER YEAR CHANGES IN THE CONSUMER PRICE INDEX 1946-2009



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