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Economic Momentum Builds

All indications are that the economy is continuing its slow but steady recovery from the recession brought on by the financial crisis. Although there are still job losses, most economists expect that by December or January the labor market will turn around and the economy will begin gaining jobs. Although the unemployment rate will probably still rise into 2010, due to new entrants seeking work, the labor market turnaround will be an important stimulus to consumption.

Many workers will not spend on durable goods if there is any chance that they will be out of work. That fear runs high now, but anxiety will ease once the labor market turns. Just getting through September and October, which have historically been turbulent months and were so dreadful last year, without another crisis will convince many that the recession has indeed ended.

The third quarter, as expected, was a good one for stocks, and I expect more of the same for the fourth quarter. As I write this, most companies have yet to report their third-quarter earnings, but I expect earnings will once again beat expectations by a wide margin. Firms are still cutting costs, and inventories have been pared down to a minimum. This sets the stage for an expansionary earnings cycle.

The Fed has remained on hold at near zero interest rates and will continue to do so for the rest of this year. But I expect them to start raising interest rates early next year. Not because inflation will flare up—I expect inflation in the zero to 2% range over the next two years—but because the economy will be getting stronger and real Gross Domestic Product (GDP) growth could accelerate to 4% to 5%. Zero short-term interest rates would be inconsistent with this growth, and if the Fed didn't tighten, the dollar could fall sharply. Although a decline in the dollar may boost export growth and profits of firms that derive a good share of their sales abroad, it will ratchet up the rate of inflation.

Dollar to Continue to Decline

But even if the Fed does raise rates, I believe the dollar will work its way lower. As I write this commentary, the dollar is still 7% above its low reached in early 2008, after appreciating nearly 26% during the financial crisis. Most of the recent decline in the dollar is due to the recovery in the U.S. and world economies. The dollar became a "safe haven" currency during the crisis. As the crisis has abated and world economies have recovered, the greenback's safe-haven premium has eroded.

In the long run the fate of the dollar is determined by the difference in inflation rates between the U.S. and abroad. Since the world has went off fixed exchange rates in 1971, the dollar has depreciated by an average of 1.1% per year against the developed world's currencies and the U.S. has experienced about 1 percentage point higher inflation.* Given the looming government budget deficits, I expect longer-term U.S. inflation to increase to between 3% and 4%, so the dollar will likely continue to depreciate.

Actually, a sinking dollar and moderate inflation can be a "sweet spot" for equities. Equities are claims on real assets: land, capital, copyrights, trademarks, brand loyalty, etc. With labor costs stable, rising prices should widen profit margins. And as the dollar depreciates, U.S. firms will seem like a bargain to foreign investors.

Summary

The increasing pace of economic activity continues. Interest rates will be higher, but not high enough to compete with stocks. There are good fundamentals behind the recent stock market rise, and these fundamentals should remain in place through the rest of this year.

[Register for the Quarterly Economic Call with Professor Siegel.]

*Bloomberg

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