Weekly Commentary **December 18, 2015**

JEREMY SIEGEL .com

Fed Hikes into Deflationary Storm; Equities to Struggle

Friday, 9:15 a.m. EST

It is very hard for any central bank to hike in the face of a deflationary storm, but that is what the Federal Reserve did last Wednesday. In the October meeting they had committed to hike barring extreme circumstances and those circumstances did not materialize. Nevertheless, it is unlikely that the Fed will hike 4 more times next year, as the median estimate of the new "Dot Plot" indicates. It is true that the median estimate for the funds rate in December next year is between 1.25% and 1.50%. But only 3 FOMC participants predict a higher rate (and that is down from 8 is September) and 7 are below. And that number would be 8 had Narayana Kocherlakota, the dovish Minneapolis Bank President, chosen not to skip his last meeting as a Fed official before returning to academia. Furthermore, the January 2017 Fed Funds futures is trading at 87.5 bps, exactly 50 bps above the midpoint of the current range, indicating just 2 quarter-point increases. I have written that the Fed Funds futures likely understates the actual estimate of future funds rates because of the risk premium in these instruments, but that bias is certainly less than 25bps. So I claim the futures markets predicts 2 to 3 increases and my own estimate is at the lower end of this range. It is a virtual certainty that the FOMC will take a pass at their January meeting and I expect a lively debate in their March meeting, with an increase then far from assured.

All this means that the equity market is going to struggle. Oil prices continue to sink and the earning of the oil producers and related stocks go with it while earnings on the S&P 500 are already estimated to be down 6% to 7% this year. That puts current P-E ratios based on operating earnings around 19 and over 20 on the basis of reported earnings. These valuations are not unreasonable in a low interest rate environment, but until the Street casts off its fear of a more aggressive Fed, these valuations appear lofty. I had predicted a good rally in stocks after the uncertainty of the Fed hike was out of the way. But in the face of continued new lows from commodity prices and the fear of a stronger dollar and a hawkish Fed, the rally lasted just one day.

As commodities get crushed, it is important to look at the big picture. In my 215-year analysis of asset price returns, the long-term return on gold, the commodity we have the longest data series on, is only 0.5% ahead of the rate of inflation, versus 6.5% for stocks. The commodity super cycle was predicated on the exhaustion of key commodities such as oil as emerging market growth exploded. As that growth gets marked down and technology enhances the available supply of energy, that cycle has been broken. Commodity price returns have reverted to their long-term mean which matches or slightly exceeds the inflation rate.

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