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BY **JEREMY J. SIEGEL**

Economic Momentum Builds

The longest and deepest economic contraction since the Great Depression ended last summer. Fourth quarter gross domestic product (GDP) will be higher than most expect, exceeding 5% on an annualized basis. I believe the economic recovery will extend into 2011, which will also be stronger than most forecasters expect, with GDP growing 3½% to 4% or even higher. Even though consumer spending will be subdued for the first part of the year, investment will increase as firms find themselves with record-high cash balances. Furthermore, the extreme inventory liquidation that occurred in 2009 will reverse itself by the middle of 2010 as firms rebuild inventories and retail sales pick up.The housing market should also show some life as the inventory of unsold houses finally dwindles to a manageable size.

Interest Rates Will Rise

The strength in the economy does not come without some downside. I believe that the Federal Reserve will be forced to raise interest rates much sooner than most forecasters now expect. This increase will be in response to a stronger economy, rising bond yields and higher commodity prices. Crude oil, now at nearly $80 a barrel, is at the level it was in the summer of 2007, before the subprime crisis broke out. Most other commodities have also recovered most, if not all, of their previous decline, while gold reaches new highs. In order to defend the dollar and stem the inflationary impact of rising commodity prices, the Fed will have to act.

At first the financial markets will react poorly to the increase in interest rates. After all, stocks and bonds represent the present discounted values of cash flows, and if the discount rate is going to increase, then prices should fall. But for stocks, future cash flows depend on economic growth, and since the economy should be stronger than expected, stocks should fare much better than bonds in the face of a rate hike. Even bondholders might take heart in the fact that the Fed is fighting inflation, an action that ultimately is good for bonds.

As the markets acclimate to rising Fed rates in a strengthening economic environment, stocks should do well. I see at least 10% to 12% returns in equities by year-end. Expectations are for operating earnings on the S&P 500 Index to be about $75.00 this year and at least $85.00 next year. At a modest 15 times, next year's earnings would put the market over 1200. Bond yield should move up, but I don't think that the 10-year will rise much about 5% as long as the Fed shows its anti-inflation resolve.

Dollar Strength

I believe that the dollar will also be stronger than most believe, especially against the euro. First, as the Fed raises interest rates, dollar-denominated assets will become more attractive. Furthermore, most forecasters believe that European growth will lag at least one percentage point behind that in the United States.

I also believe that the current economic problems in Greece may spell problems for the whole euro area. Before the advent of the euro, if a country faced balance of payments or deficit problems such as Greece today, it would devalue its currency to make its exports more competitive. But that solution is impossible under the euro system. To become more competitive, Greece must suffer through deflation, a painful economic process. To a lesser extent, Greece's problems extend to Portugal, Spain and Ireland. These difficulties in the eurozone may make it more difficult for the European Central Bank (ECB) to raise rates, giving the dollar a boost.

Despite the strengthening of the dollar against the Euro, I expect the emerging economies to be strong and their currencies to rise relative to the greenback. Despite the strong performance of emerging market equities last year, stocks in these countries should also continue to register double-digit gains through 2010.

Final Words

The bottom line is that the improving economic trends that we saw in the latter half of last year should continue throughout 2010. This will cause the Federal Reserve to raise interest rates, which will at first unsettle U.S. stocks and bonds. However, strong economic growth should give equities a good return by year-end. Like last year, 2010 should be a good year for the equity markets.

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