ADVISOR PERSPECTIVES

Jeremy Siegel on the Undervaluation in US Equities

By Robert Huebscher
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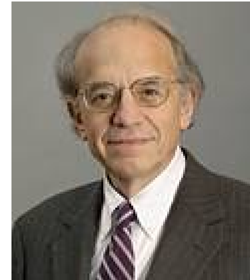
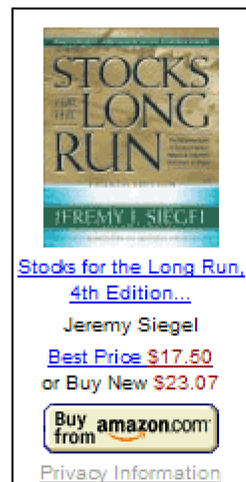


Jeremy Siegel is the Russell E. Palmer Professor of Finance at the Wharton School of the University of Pennsylvania, and a Senior Investment Strategy Advisor to Wisdom Tree Funds. His book, *Stocks for the Long Run,* now in its fourth edition, is widely recognized as one of the best books on investing. It is available via the link below. He is a regular columnist for Yahoo Finance and is frequently quoted in the financial press.

We spoke with Professor Siegel on December 23.



We interviewed you on November 11 of last year, when the S&P was at 899, and you said stocks were "dirt cheap." The S&P is now at 1,118, 24% higher. That turned out to be a very good call.

It's actually over 30% higher since you published the article, a week later on November 18th.

I did not foresee that the first quarter of this year would be as disastrous as it was. We were just beginning to see how much global finance would grind to a halt. That just killed the world economy. We saw how potent that was when its full effect was felt in the first and second quarters of this year.

Since then, we have seen a substantial world recovery. Almost all countries moved to positive GDP growth in the third quarter. There were a couple of countries near zero growth. The fourth quarter looks positive for almost every country. That's quite a comeback.

At the time of that interview, you said the fair value of the S&P was 1,380. What is the fair value of the S&P now?

Today, at current levels of interest rates – and if those rates persist – the fair value is fairly high – 1,300 or 1,350. I think interest rates are going to go up. That makes the fair value closer to 1,250 now.

I think that earnings growth next year will be stronger than anticipated and will break the all-time high for the S&P, which was in the second quarter of 2007, when

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earnings for the trailing 12 months were in the low 90s. In 2011 or 2012 we will break that amount. With $90 in earnings and a 15 P/E ratio, you get 1,350 for the S&P.

That is a conservative P/E ratio. The long-term P/E should be higher, given a number of factors – for example, if interest rates don't go too high. A P/E ratio of 15 covers a range of scenarios, including double-digit interest rates, which is when P/E ratios went to single digits. Take out those double-digit interest rates and you get P/E ratios closer to 18.

If you apply a P/E ratio of 18 to your forecast of $90 earnings you get a valuation of 1,620.

We won't get to $90 next year. On the S&P next year we should expect closer to $70, which at a P/E ratio of 18 is a valuation of 1,260. That's coming from earnings of approximately $56 this year.

Those are operating earnings?

Yes. Operating and reported earnings are coming in very close to one another. In fact, in the second and third quarters operating earnings were only three percent less than reported earnings. Actually, believe it or not, we may get conditions where reported earnings are greater, if some of these greatly marked-down assets retain some of their value. We may see write-ups, as opposed to write-downs, of assets. That would give a boost to reported earnings, but not to operating earnings.

Let's talk about your forecast for interest rates and inflation and how that affects your forecast for equity valuations.

I see interest rates starting to rise much earlier than the consensus suggests. The Fed will act in the first half of next year. It will surprise everyone. That will create a little trouble for the stock market at first, because its psychology is to keep interest rates low. But it will be done in the context of a much stronger economy and rising earnings.

There will be a short-term shock, maybe even a 10% downward reaction as people say "oh my God, the Fed is tightening so early." But people will see that those actions are being taken only when the economy is strong and the market will bounce back. That will be the first meaningful correction in this bull market that started in March.

So you are in the v-shaped recovery camp. What are the chances of a double-dip recession or a w-shaped recovery?

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Yes, I am in the v-shaped camp.

The probability of a second recession is very low and the only thing that could trigger that is if oil suddenly soars to $100 or $120/barrel again. That would be a problem. That won't happen, though, unless there is a shortage, a major disruption or a spike in demand from China. The fundamental price of oil is much lower than its current price of $76. It is probably $50 or $55. There is a lot of speculation in the oil market. If oil stays in its current trading range, we are going to be fine.

I don't see any major shocks as a threat. Of course, the definition of a shock is that you don't see it coming.

What are your thoughts on Bill Gross' "New Normal" paradigm of lower economic growth leading to lower returns in the capital markets?

I very strongly disagree with that. I believe that it's a very old fashioned way of looking at how the economy works. It looks at aggregate demand alone. In the long run, that's not a good way to look at what leads to growth. It's productivity growth that leads to economic growth. Productivity is rising very rapidly now, and I expect it will continue to rise, although not as strongly as it has in the last two quarters, which were extraordinary. It will continue to rise above its long-term normal rates and that will bring about growth in the economy.

Productivity has been rising at close to 6% during this recession. Doesn't that have implications for unemployment? How can we expect to add jobs when productivity is rising so rapidly?

There are a couple of things.

That 6% won't persist. The long term rate is 2.2% and to get it to 3% will be remarkable. Productivity is what lowers costs in the long run. That will keep inflation down and increase the purchasing power of the 90% of Americans who are working. It will spur demand.

Real wages have actually been going up recently and will continue to rise and will rise more if productivity continues to increase.

The other half of the "New Normal" is the "New Frugality." Will depressed consumer spending impede economic recovery?

Consumer spending won't be as high as it was during the splurge period from 2003 to 2006, but we have had strong economic growth at much higher saving rates. We are already at a savings rate of 5%, and that is close to where it is going to be

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There is a little bit of distortion in savings rates. They are not directly comparable to what they were in the 1960s, 1970s and 1980s. They are actually higher now than they were then. There is saving taking place by corporations that are substituting for personal savings.

We have made a lot of adjustments, and consumer spending will not hold us back going forward.

Can the economy recover without additional fiscal stimulus initiatives?

Yes. We don't need any more stimulus packages.

I don't want any heavy taxes, either. This is not the time to start putting on any heavy taxes. I think the stimulus still has room to grow. There are still expenditures in the works. I don't think we need anything more.

The economy is improving on its own.

Are you opposed to allowing the Bush tax cuts to expire at the end of next year?

It depends on what they will be replaced with. Even Obama didn't want them to be replaced with the old tax rates. We will have to see how it actually turns out. There may be some increases in high income tax rates. That increase may have to wait a year or two to see that the economy gains good footing.

I'm not at this point worried that heavy taxes will snuff out the recovery.

But your forecast depends on keeping tax rates pretty close to where they are now.

Not too much different.

At what point will inflation become more of a long-term threat in the context of projected deficit levels?

I expect inflation to be higher in the long term than it is now. I think it will be in the 3%-4% range, which is doable. In the long run it will erode the real value of the huge indebtedness that we have without causing any rapid depreciation or devaluation in the dollar.

For a long-term, retirement-oriented investor, do you recommend a 100% allocation to equities?

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Bonds are terrible now. I would not go into commodities. I would be internationally diversified. I think emerging markets are going to do very well. US stocks, especially global ones, will do well. European stocks, again especially the global ones, will do well.

Your dislike of bonds is based on your secular forecast for interest rates.

There will be higher inflation so there will be higher inflation rates.

What about TIPS?

TIPS yields are too low. The 10-year is at 1.37%. You are going to have principal erosion. When these TIPS were issued they were 3.5%, and now they are half of that. TIPS yields will go up to 2% or 2.5% and you will have capital losses.

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