

## Jeremy Siegel on Why Stocks are 'Extremely Attractive'

By Robert Huebscher

November 29, 2011

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*I spoke with Professor Siegel on November 21.*

**We spoke [last year](#) on November 9th when the S&P was at 1,223. Today it closed at 1,192. You had forecast 10% to 20% gains last year. What surprised you, and what does that tell you about where the market is valued today?**

From November 11, 2010 through today, the return on the S&P has been a half a percent, even with the big drop today. So it has basically been zero.

There are two overwhelming reasons why my projection did not turn out. One was a much-slower-than-expected and disappointing recovery in the economy. The second was the euro crisis, which is getting worse and is a big depressant on the world markets right now.

My estimate of the earnings has been quite good. Earnings continue to rise, so it isn't an earnings shortfall, because it looks like the earnings this year are going to be even higher than last year.

The market is still extremely attractive and, in fact, more attractive given that interest rates are much lower.

In a way, with the stock market really doing nothing and 10-year Treasury rate going from just under 3% to under 2%, we have a more attractive equity market relative to bonds.

The equity premium today, which is the difference in expected return on stocks and bonds, is more than twice its historical average. The historical average has been 3% to 4%, and right now the expected return on stocks after inflation is around 8% given current P/E ratios. For bonds, real returns are about zero for the 10-year.

You've got a very, very large gap between bonds and stocks.





**To what extent do you think the market has priced in fears from the euro zone, and what scenarios with respect to the euro zone would cause the market to move up or down?**

Any big bold move on the part of the ECB would bring about a huge rally in equities. The ECB is not coming up big like it must. The ECB will ease eventually as the economy – even in Germany – slows down and pressure develops from Germany. The ECB needs to lower their interest rates. They need to lower the euro. Both those things are definitely going to happen.

**Does the ECB need to print more money? Is that the inevitable endgame then for this crisis?**

You could call it printing more money. To lower interest rates, they have to do an open market purchase that involves creating reserves.

Yes, that is the end game for this crisis. The question is how bad they will let it get before they come up big. The longer they wait, the worse it will be. They can't just turn it around on a dime. Our Fed acted aggressively after the Lehman failure. But just letting Lehman fail caused chaos and a huge recession.

**Do you think the crisis in Italy has the potential to be another Lehman Brothers?**

Yes, I do, but not for the United States. People are beginning to worry about the banking system in Europe. There is a credit freeze. People are taking their money out of deposits, particularly in countries like Greece, for fear that the government is going to take them over and turn them into a new drachma, or some other currency that's going to be worth less.

**Coming back to interest rates, is the fact that the real rate on 10-year TIPS is zero an indication that the market is pricing in very slow growth?**

It is pricing in a combination of very high risk aversion and very slow growth. People are so scared that they are putting their money away in TIPS, actually at negative yields. It's mind-boggling to me that people would give their money to the government for 10 years and say "alright, give me back less money 10 years from now in terms of what it could buy, and I get no income at all in the interim." That's pretty incredible.

That has to be a sign of extreme risk aversion.



**Looking at the economy, the Reinhart and Rogoff work has been widely cited. One of their primary theses was that when the debt-to-GDP ratio gets to 90%, that inevitably leads to slow growth. That was their historical finding. To what extent do you think that applies to the US?**

My question is what is the burden of that debt in terms of taxation? You also have to consider the assets of the government as well as its liabilities.

Reinhart and Rogoff is a monumental work. Don't misunderstand me. But a lot of their evidence as they go back in history was before we were on a flexible-exchange-rate fiat money standard. When we were on a gold standard, countries would have to default. That becomes critical.

What happens today is more of an inflation bent rather than an outright default. There would be no question that if Greece still had the drachma, we would never be talking about default. We would be talking about a devaluation of the drachma.

For the US, I don't see 80% to 90% as being a big barrier. We know that Medicare is the big, huge elephant out there, an 800-pound elephant going into entitlements. That has to be controlled into the far future. But we haven't reached a critical point. The bond market doesn't think so either, or you wouldn't have interest rates as low as they are.

**There was an interesting [debate](#) last week between Paul Krugman and Larry Summers in Canada. They debated the idea that US faces a Japan-like era of slow growth and high unemployment. Where do you come down on that proposition?**

No, there are two things that will not lead us there – two important differences. We are a much younger country. We are a country of growing population and not a shrinking population. We also have a central bank that is committed not to have deflation, which has never been the case for the Bank of Japan.

Those two factors are very, very important in giving us a different forecast for the US than you would have in Japan.

**Krugman argued essentially for unprecedented Keynesian policies, both fiscal and monetary, and called on policymakers to recognize that we are in a position that we've never been in before.**

We were in the Great Depression, so I don't know what he meant about "never before." That was a much worse position than we are in.

Did he mean never in the post-World War II period?



**He didn't qualify it that way.**

Let's go back a little bit and talk about this.

We just experienced the deepest recession since World War II, but not by a big amount. The unemployment rate has stayed higher longer, but we've never ever had such generous unemployment insurance, ever. There are some economists that think that up to two percentage points of the unemployment rate are actually caused by the extremely generous unemployment insurance. Now that still gives you 7% unemployment, and I am not saying that that is low. It has been a very disappointing recovery. But it is qualitatively extremely different than the Great Depression of the 1930s. Its characteristics are still much more like the recessions of the postwar period than they are about going back to the 1930s.

**Although the federal government has been running deficits of 10% of GDP, and FDR never ran deficits in excess of 6%. Do you think that calls for bolder policies than we have been pursuing?**

A year ago I was in favor of quantitative easing. If the US economy doesn't pick up, I'd be in favor of another QE. And I want those payroll tax cuts to be continued in 2012. I think that's important. I don't like a lot of new government programs though, because I don't think that they are always very efficient. I like the idea of tax cuts. I'm very positive on more QE if necessary. I'm not positive on a whole bunch of new government programs – infrastructure or whatever.

**The contrasting school of thought – what Krugman advocated – is that we should not incur more debt. That's not the solution to high deficits. What we really need to do is cut spending and keep taxes low. It sounds like that's really the line of thought with which you are most sympathetic?**

I'm not for at this point cutting spending. I'm not concerned with the current deficit, so I share that view with Krugman. I don't want to reverse; I'm willing to let the current deficit go higher. I like Obama's double-payroll tax cut which is also for individuals as well as businesses. I am in favor of short-run stimulus through tax cuts.

I'm not for closing the budget gap. I don't think we need any spending cuts. Now would not be good. Over the long run, we need to of course rein in spending, but not in the short run. You could call me Keynesian on that, but I don't particularly think we should start a lot of infrastructure projects at this juncture.



**Robert Shiller has written a lot about the lack of investor confidence and the fact that it becomes a self-fulfilling prophecy. That was basically the thrust of his latest book, *Animal Spirits*. Given events like the impasse that appears to be occurring with respect to the super committee, to what degree do you think political gridlock is at fault for the problems in the economy, and what does that say about our longer-term future?**

Honestly, very little. Investment actually hasn't been that horrible. If you really want to look at what it is, it's housing. If you take out housing, investment hasn't been bad. I don't have all the details, but it's not as severe as many other recessions once you take out the housing sector. There has been some consumption slowness as you would expect going forward.

But honestly, the reason why businesses are not investing now in plant and equipment is because of the lack of demand for their products. I just don't buy that the regulatory uncertainty or the tax uncertainty is major. What drives investment is demand for your products.

When demand is very weak, you are just not going to have a lot of investment. Outside of housing, investment has held up very well in this recession.

The housing collapse was unprecedented. You have to go back to the Depression to find something like this housing collapse. Housing starts, that were running two million a year, are now down to 500,000. That's 75% in one of the biggest sectors of our economy. Some people have said that directly or indirectly there are four million jobs that are connected to that sector. We've wiped out three quarters of housing. That's huge.

Housing will eventually pick up. We can't continue to build only 500,000 new units. It doesn't begin to match population growth. There's got to be an absorption point coming where the housing market is going to pick up and that's going to be a major boost to the entire economy.

**Are there any policies that you would advocate with respect to reviving the housing market, such as a principal reduction program?**

You should have principal reduction. It would be in the interest of a lot of financial institutions, because investors who've got a mortgage are not valuing it at 100 cents on the dollar. As long as the regulators come in and say "hey, I will let you mark this down and won't hit you with more capital," and they provide an incentive for banks to do that, that could have a very positive effect.

But a lot of it just has to be worked out on its own. As I said, we can't continue to just produce 500,000 units a year. The long-run average over the last half century is one-and-a-half million units, so we are running at 33% of that. We are running at 25% above the



boom years of the 10 years before, so I won't use that as a baseline, but we are running 33% of the 50-year average, and that is clearly not sustainable. Think about automobiles, if we only produced one-third the average you would use up that stock pretty quickly.

**But there is still a lot of stock in the housing market.**

There is still some stock, with housing formations going way down because of the recession. If the economy begins to improve, people are going to start moving out and seeking housing. Of course, we already have some very good activity in the multi-housing sector; it's just single-family housing that is the problem. Part of it is financing. Interest rates are low, but you've got to come up with a 20% down payment, which is not easy for many people to do.

**In the current environment people have taken your "stocks for the long run" as an indication that they should really be looking at a fairly long holding period for equities. Was that your original intent? Is there any aspect of the current environment that calls for a more tactical approach?**

That's a very good question. Fair market value of the S&P is 20% to 30% higher than the S&P is today. Valuations are below average. Interest rates are below average. People say, "Oh Jeremy, your book says you have to wait 20 or 30 years." But from these levels you do not have to wait 10, 20 or 30 years.

In fact, from these valuations and under these interest rates, you are generally going to get good returns in three to five years. When you are selling at a high P/E, then you need many years to guarantee you are going to be good and you will eventually be bailed out. You could call that tactical.

Basically stock prices depend on earnings and interest rates. That's the fundamentals. Right now they are even more favorable toward equities than last year. Does this mean that in 12 months returns are going to be good? No. But does it mean three to five years returns are going to be good? That's a much higher probability.

If you invest at cheaper-than-average prices you don't have to wait long. You may have to wait a year. Yes, I thought last year was cheap. I think this year is cheap. The S&P has generated a zero return the year, the same as money markets. You haven't done worse. Until today, you actually earned 2% on the S&P. But relative to nominal bonds, which are down 80 basis points over the last year, and TIPS, which are down at least as much, your outperformance potential for equities is higher than it was last year.



**Have you changed any aspect of your own personal asset allocation in the last year?**

I have moved more into dividend-paying stocks. I like that sector more than ever. With interest rates so very low, there is no income in the bond market, except in the junk bond market, which has its degree of risk. I am switching to dividend-paying stocks that are blue chips and well covered by analysts. They are going to be the new bonds that people are going to be seeking for income, because I don't see bonds as being attractive for years and years and years.

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