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Jeremy Siegel: The S&P 500 is Fairly Valued

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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 fifth edition, is widely recognized as one of the best books on investing. It is available via the link on this page. He is a columnist for Kiplinger's, a "Market Master" on CNBC and regularly appears on Bloomberg, NPR, CNN and other national and international networks*

I spoke with Jeremy on Monday, November 20th.

Our interview was on November 21 of last year, when the S&P 500 was at 2,182. On Friday it closed at 2,579. That's a gain of 18.2%, which is consistent with the optimistic outlook you had last year. What is the fair value of the S&P 500 now and what is your outlook for the coming year?

We're just about at fair market value. Lower interest rates justify a higher than average price-earnings valuation. A PE ratio of 18 to 20 is reasonable, given that interest rates have remained even lower than I anticipated. From what I see with earnings right now, we are basically there.

The Republican tax plan and the corporate tax cut are important to the market, and they will be the driving force over the next month or so. I expect next year to be a tougher time for the market, but not necessarily a decline. We've had a huge gain since 2009, one of the biggest bull markets ever. It will take a year to digest those gains.

When we spoke last year, you noted that S&P operating earnings were coming in approximately $109 per share. They are now approximately $122 per share. That's an increase of approximately 11.9%, while at the same time PE ratios have increased from 20.0 to 21.1. Looking forward, do you expect future returns to come from multiple expansion or from increased earnings?

We are going to have some increased earnings with the corporate tax cut, but certainly not to the extent that we have seen this year. Earnings per share growth might settle down to a 5% per year average increase. We are looking at about 20.5 PE right now on 2017 S&P 500 operating earnings. Of course, we've got the fourth-quarter yet to go.

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S&P predicts operating earnings of $144 next year. I can see $10 more than this year from the tax cut, but I have a hard time seeing another $10 on top of that. That's way too high.

We have rebounded from the terrible earnings in 2015 that, as I pointed out then, were due to the oil price collapse. Obviously, we have seen an increase in the price of oil, which is now $56 a barrel. That's a good rate for the U.S. It's profitable for producers and yet low enough for users.

Certainly we are going to see a pop on the corporate side if the tax cut gets passed, which I anticipate will happen, although it is uncertain whether it will start in 2018 or 2019. But it will be hard for stocks to get much above 20- to 21-times earnings. That's rich enough even for these low interest rates.

Virtually all the common stock-market valuation metrics, such as the Shiller CAPE ratio, the price-to-revenues ratio and the Buffett indicator, show valuations that are approaching the extremes of the dot-com era. What do you say to advisors who have pulled back on their equity allocations because of historically-based fears of overvaluation?

I have a lot of arguments to pick with the CAPE ratio. I published a *Financial Analyst Journal* article last year called The Shiller Cape Ratio: A New Look. I explained why his ratio is biased and way too bearish. When I first circulated my paper three years ago I got a lot of resistance. Now people are looking at it saying, "Jeremy, I think you're right. It's been so wrong for so long." In fact, there are a number of papers that are circulating, some of which are going to be published, which are talking about why the CAPE is very biased toward bearishness. My reason had to do with the use of 10-year average earnings, which took into account the financial crisis with its near-zero earnings, which was due to the change in accounting procedures with GAAP that were not present in the earlier data.

The Buffett rule of stock value-to-GDP is totally silly, given that over 40% of the profits of the S&P 500 are gained from international, not domestic, operations. Why should you look at stock values relative to domestic GDP when a large part of the valuation comes internationally?

Margins are high on a historical basis, but there are very good reasons why they are high, and why they might stay high.

The U.S. economy has become progressively more service-oriented since World War II, as our manufacturing sector has contracted. Service businesses can establish much stronger competitive barriers than manufacturing businesses, which is why companies like Google, Amazon and Microsoft have high margins and have become so profitable. Does this trend to a service economy explain the increase in metrics like the CAPE ratio?

It does help explain the increase in profit margins more than it explains the too-high CAPE ratio. The bias in the CAPE ratio is due to other factors. But technology has always had higher margins than other sectors. It has become by far the biggest sector, so you would expect overall margins to go up.

Margins are higher on foreign sales than on domestic sales, part of which is because of our tax system. Lower taxes abroad make those margins higher. Technology revenues, for example with Apple in China and elsewhere, are one of the reasons why we were having higher margins.

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Whether or not it has to do with stronger competitive barriers, everyone likes to use the same technology platform. If everyone is on Facebook, then it's easier for people to use Facebook versus another community. The rest of my family is on Apple, but I stick with Samsung, maybe just to be a little different and make sure that Apple has some competition.

But we've seen a lot of what used to be indomitable tech companies that failed. Look at Blackberry; it cornered the market and now basically doesn't exist. Companies like Google and Apple have executed enormously well. It's not just that they've been able to erect barriers. It is that they have been the best at what they do. In today's world, we are willing to try someone else that can do better at a cheaper price. Competition is alive and well, and you get some of the very smartest people migrating to work in the technology sector.

Microsoft has lost some of its edge. It was dominant and rode the Windows wave. But Windows is not the big source of profit for it any longer, and it is in the cloud space. The cloud is very competitive.

But when you talk to Millennials, no one is wedded to anything that they wouldn't change if someone else constructed a better mousetrap.

Does a lack of volatility across all markets scare you at all?

It's interesting. For years, we economists have been scratching our heads as to why stock markets have been so volatile. As Bob Shiller, who is a Nobel Prize economist, has said, they are far more volatile than would be predicted based on the historical pattern of earnings and dividends. So emotions seems to drive stock prices much more than they should. This should give opportunities for investors who come into the market when stocks are too low and leave the market when they are too high. It looks like volatility is migrating to what we economists think is more reasonable given the historical and expected future path of the economy.

There's also a lot of liquidity in the market. With interest rates near zero, there are not a lot of other threats. One thing that slaps down volatility is the Fed and the bond market. Whenever we get a bad event, people go to Treasury securities and drive down the yield. Expectations that the Fed will reduce their aggressive tightening stance is positive for equity prices. There is a self-correcting mechanism built into the markets that when bad events happen, this lowers bond yields and keeps more people in equities than would have happened say, in the 1970s and 1980s when we were in a very different monetary environment.

U.S. corporations have increased their leverage since the financial crisis. The ratio of net debt-to-cash flow has increased from approximately 2.6 in 2009 to 3.5 now. To what extent does this translate to increased risk in the equity market?

That is true with respect to net debt-to-cash flow, but what about interest costs? I don't have the figures at my fingertips, but I would imagine they are down. You would expect firms with record-low interest rates to increase their debt. In fact, I would say they would be irresponsible if they did not lock in these low rates into their corporate financing. Given these record-low interest rates, I'm not at all fearful about a higher debt ratio. It doesn't mean that there is a higher interest-cost ratio.

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You could ask, "What happens if interest rates go up?" That's one reason why corporations are locking themselves into 10-, 15-, 20- and 30-year bonds. If interest rates to go up, it means more inflation and growth. They think that the cash flows will take care of that in terms of their short-term financing.

When we spoke last year, the 10-year Treasury yield was 2.34% and you expected it to be between 2.5% and 3.0% at this time. It is now 2.35%. What is your forecast for interest rates?

The biggest surprise we economists and those in the finance community have had over the past five years is how little interest rates have gone up. That is partly because of how little inflation there has been and how slow growth has been.

We see some preliminary indications that growth might be picking up. It is picking up in the rest of the world, which is going on all engines after a long period of languishing. Europe, the emerging markets and the U.S. are not growing at gangbuster speeds, but at least they are not in recession or stagnation. There is definitely increased growth.

Whether we've gotten to 3% real GDP growth in the U.S. is yet to be seen. We don't have enough new data on that question. But clearly, there is faster economic growth and a continued drop in the unemployment rate. There must be some unemployment rate that will spark higher wages. It just happens to be lower than the Fed and many economists have predicted. I am referring to the natural rate of unemployment, which the Fed originally thought was in the low 5s and then in the 4s. Now we are at 4.1% unemployment and still see virtually no wage increases that exceed productivity.

The most optimistic economists say the natural rate is as low as 3.5%. That would be a 50-year low. There's got to be some point where we use up all the labor that is easily supplied, which would mean higher wage growth and an increase in interest rates. It's just been a much slower process of getting there than we economists expected.

Now that being said, I've been saying for years that we are not going to get back to the regime of 5% to 6% long-term Treasury yields or 4% to 5% Fed funds rates. I think 2% to 3% will be the highest on Fed funds rate and maybe the 10-year will reach 3% to 3.5% at the top of the cycle. But even that increase in the 10-year means that bond returns are not going to be good over the next several years. Stocks will still easily beat them.

Will Jerome Powell have an impact on interest rates?

He's a consensus builder. I would like to see who the vice chairman will be. That will be very important, given the fact Powell hasn't had formal training in economics as previous chairs have had.

As you know, there are two or three more openings for the Fed. But Powell is going to be moderate and follow the consensus, which means the Fed is going to be data-driven, just like Yellen. The Fed is not going to be aggressive as long as it doesn't see inflation and wage growth being excessive.

I know that the dot plot says thee rate increases next year. That's definitely on the aggressive side. I

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think you would have to really have higher wage growth to get that many increases. That's clearly something that the market has to watch.

In the past couple of years, you've recommended emerging market equities. Those stocks have done very well this year. Do you still see upside for them over the long term?

As we discussed last year, the emerging markets got totally demolished when we had the oil and commodity price collapses in early 2016. The recovery from that has been very good for emerging markets, yet they are still very reasonably priced. Their economies are still growing faster than the developed world. As I look across markets, we still have an average of 15 price-earnings ratios, which is very, very good in a low interest rate world. By the way, interest rates have dropped a lot even for emerging-market debt. This is still a positive environment for emerging-market stocks.

Europe is also cheaper than the U.S. I still advocate an equity portfolio that is tilted globally. It's not because I'm bearish about the U.S., but there will be higher returns in Europe and emerging markets in the next three to five years.

What are the biggest risks, particularly with respect to U.S. equities?

There are always risks. A terror strike involving nuclear material scares me. I do not fear the North Korean situation. It's a lot of posturing on both sides. The terrorist potential in the nuclear area is much more frightening. I'm not saying it's likely, but it is something that one has to watch.

On the more mundane economic front, if we continue to have job gains 150,000 to of 200,000 a month, which we've had ever since we bottomed in the recession of 2009, it will keep on driving the unemployment rate down. Even if you're the biggest optimist and think that natural rate is 3.5%, we're only about half a percent away and that figure will be reached in six or seven months with that job growth.

We want to see some moderation in job growth – although not a recession – because the pool of skilled or qualified workers is just not big enough to keep up with that job growth. If we keep on getting that job growth, it's going to eventually push wages that will exceed productivity growth. That will cause the Fed to tighten more aggressively. Faster economic growth is positive for earnings, but it will drive interest rates upwards. Earnings are going to have to be capitalized at higher rates, and that will definitely put a pause on the market gains.

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