Jeremy Siegel on 'Dow 15,000'

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.

I spoke with Siegel on Monday, December 10.

In our last interview, on November 29 of last year, you said that the fair market value of the S&P was 20 to 30% higher than it was priced at that time. It closed at 1,192 that day. It closed last Friday at 1,424, which is 19.5% higher, at the lower bound of your estimate. Very few people predicted that the market would perform as strongly as it did. Congratulations.

The market in 2012 certainly did better than in 2011. Actually, on the economic front, this wasn't a particularly good year, with Europe getting worse, China slowing down, Japan struggling and our GDP basically under 2%.

Where do you see the fair value of the S&P now, relative to its current level?

We're going up. We could get another 15 to 20%. I'm on record saying that I think there is an overwhelming probability that we're going to get Dow 15,000 by the end of next year, so if the current level is 13,180, that's a 14% rise. There is a possibility – if we get some good work done on the entitlements, if we set the tax rates appropriately – with the housing recovery, it's very possible to get 25% next year. That would certainly be a very-good-case scenario.

What resolution of the fiscal cliff do you think is priced into the market now, and what outcomes do you think would drive the market higher or lower?

As we always know, when there's uncertainty, the market tends to price in almost the worst possible outcome. If we get a compromise on the top income tax rates, which I will say is halfway between 35% and 39% – say something like 37% – and we get a compromise on capital gains tax rates, which are now 15%, rising to 17.5% instead of 20%, and a compromise on dividends, that would be enormously favorable for the market. Even tax rates splitting down the middle would be enormously favorable. But even if we go to 20% on the capital gains rate and even if we go to the top marginal income rates, I still think we're going to have a good market.

My feeling is that we're not going to go to the top rates on dividends. There's a lot of support among Democrats to keep the dividend tax lower. We'll see how low it will be. It would be very disappointing if the tax rate on dividends went back up to the marginal income rates that we had before the Bush tax cuts.

Many people worry that market prices are artificially elevated now because of Fed policy or that our excessive debt will eventually force prices lower. What advice would you offer to those investors?

The prices of bonds are being sent artificially high, and that is where the real concern is. We're in the biggest bond bubble in history right now, even greater than the bond bubble right after World War II, when rates were also kept artificially low. The danger is definitely on the bond side, with stocks still selling below 15-times earnings. Earnings estimates for this year look pretty much like 100 per share, and for next year operating earnings look like 105 to 107 per share.

For those people who ask, "Well, what happens if interest rates go up?" one should remember that bull markets are never killed at the beginning of an interest rate up-cycle. Those markets usually go on for many months if not years after the increase in rates. Only when rates get very high and the squeeze gets very hard does that signal the end of the bull market, so I do not fear higher rates. In fact, if the Fed forces higher rates, in my opinion that's a sign that they think the economy is improving and it would actually be a favorable sign for the market.

Corporate profits are up about 8.7% since a year ago, and reported earnings per share for the S&P 500 are at an all-time high. To some degree, this has distorted Shiller PEs to the upside, whereas there was a downside distortion during the financial crisis in 2008, as you have correctly pointed out. Now, Jeremy Grantham of GMO has warned that profits are eventually going to revert to the mean, at least over the long term, and he uses a seven-year time horizon. What is your feeling about an eventual reversion to the mean for profit margins and corporate profits?

You've got to be very careful about that. Profit margins are high, but they're not at an all-time high. There are two very good reasons why profit margins are high. One is because the percent of profits coming from foreign sales is a steadily increasing fraction, and the margin on foreign sales is higher, probably because the tax rate on foreign sales is lower. It's often been advertised that our corporate tax rate is the second-highest in the world. In fact, even Obama has proposed lowering our corporate tax rate. So one of the reasons the margin is high is foreign sales.

Another is the growing importance of technology sales, which automatically have higher margins because of the way accountants expense R&D. It looks like they're getting higher margins because of the fact that so much of their cost structure is in development costs. It looks like their margins are high. Technology is going to continue to be a strong part of the S&P, so I don't see that reverting to mean nor do I see foreign profits reverting immediately to the mean.

So I'm very skeptical that we're going to get a big reversion of profit margins to the mean. They're high, and they're going to stay higher than normal. Corporate profit as a percent of GDP is distorted because more firms are being classified in the corporate sector and less in what's called proprietors' income or private income. The return on total capital, both public and private, is not rising as a percent of GDP. What we see rising as a percent of GDP is corporate, because more firms are incorporating and we have less proprietors' income than we used to in the economic data.

Profit margins are not high, and I challenge Jeremy Grantham to say why they are high. He said they were high two years ago. That was one year out from the worst recession. Unemployment was high. There were a lot of unsold goods. There was very little pricing power. Now, he's not telling us why they are unusually high. I can understand them being high at the top of a business cycle. Clearly, where there is a boom in demand, firms can get almost any price that they ask when there are shortages of certain goods, but why would there be artificially high profit margins coming off the worst recession in 75 years?

Unfortunately, the story doesn't fit with the economic facts on the ground. There is the same problem with Shiller's P/E ratio. His cyclically adjusted P/E ratio two years ago showed profits too high. Well, again, one year, two years off from the worst recession, they're not cyclically too high. That doesn't make sense. Ten years off from the recession you can be cyclically too high. In 1999 you were cyclically too high, but not in 2010, 2011 and 2012.

These stories are not jibing with the economic facts of this cycle. I would not worry about profits being artificially high or margins being artificially high, given the economic data.

Let me ask you about another of Grantham's positions. In his latest quarterly commentary, titled "On the Road to Zero Growth," he expanded on research by the economist Robert Gordon, and he argued that the US will no longer enjoy the 3%-or-more economic growth as it has in the post-war era, and that growth will slow to 0.9% for the next two decades and 0.4% through mid-century. What are your thoughts on that forecast?

I completely reject that. I read the Gordon article. It totally ignores one of the basic facts that drives productivity growth and technological change, and that is collaboration among researchers, academics, and those that are working on common problems. If you go back in history – to the introduction of the printing press, the telephone, and even the development of paper in China in the 2nd century – there was a surge of growth because people could communicate with each other in ways that they could not before. All progress is built on the shoulders of others that have done the research.

The Internet revolution, globalization, and China and India joining the world community are driving research with the best minds and smartest people working on common problems and technologies to solve them. We could be in for a golden age of technological growth. I don't understand why growth should be lower. I understand population growth will be lower, and it's an older population, and that's a valid reason for slower growth. More people are retiring. But productivity is output per man-hour; it's not the total GDP. GDP has a lot of room to expand and very likely offset the other forces of the aging economy and slower growth.

Also, one has to realize that the emerging economies are nowhere near as aged as the developed economies, and they've got a lot of young people to drive growth – in India particularly and elsewhere in Asia and the Middle East. Eventually I hope Africa comes on board. It has been sluggish but it is beginning to show signs of growth.

This idea that growth is finished does not look at the broad historical facts about what drives growth in an economy. It's not just population growth. It's the development of new technologies that come from common research.

Turning back to stocks for a second, you've been an advocate of high-dividend stocks in the past. Is that still your view?

Yes. People are worried about what the taxes are going to be on dividends. My belief is that there will be, at the end of the day, a lower tax on dividends. I'm not going to say 15%. My prediction is close to 20%. But one should remember that that high tax only applies to high-income people, those making over $250,000, and of course is not applicable to the 50% of all dividend-paying stocks that are held in 401(k)s, IRAs, and other tax-exempt accounts. Those account holders don't care at all about the dividend tax. We've had good returns from dividend-paying stocks when the tax rates were 80% and 90% in the 1960s and '70s. If they go up to 20% or even higher, with interest rates extremely low, high-dividend stocks are going to be the assets of choice for the retiring baby-boomers.

Given the sovereign debt risk in Europe and the risk of a slowdown in Chinese growth, should US-based investors be any less diversified and more concentrated in dollar-denominated holdings at this point?

Not necessarily, because those two markets are now selling at extremely reasonable price-to-earnings ratios. The Shanghai composite is selling between 9.5- and 10-times earnings. This is very reasonable and very good. Europe is selling for 10- to 11-times earnings. Europe's periphery is going to be a problem for a while. Spain, Greece, Portugal, even Italy are going to be depressed.

I call for a lower euro. That's going to help growth in Europe, and I would pick those firms that are concentrated in the export industries, because with a lower Euro they're going to do extremely well. They're selling at very reasonable prices. There are a lot of opportunities in Europe, despite the slow growth. They're selling at very, very good prices, so do not remain dollar-centric. The US is going to be the strongest developed economy. But given the prices abroad, it's worth diversifying internationally.

The 5th edition of your book, "Stocks for the Long Run," is coming out next year. Can you provide any hints as to where those revisions or expansions are going to focus?

It's going to be the broadest and biggest of all the revisions. The first edition came out in 1994.

Between the last revision in 2007 and this one, we had the financial crisis, the question of the "new normal," and all the rest. The first three or four chapters of the new edition are devoted to looking at what caused the crisis and what the outcome of the crisis is going to be. Some of my views about demography and technology I mentioned previously will be more developed in the book. I also look at correlations between asset classes, how they've changed during the crisis, and what that means for your portfolio allocation.

I'm giving you little hints about what new material is in the book. Of course, it will update all the other data, including things like calendar anomalies, but it's going to be a very major revision.