ADVISOR PERSPECTIVES

Jeremy Siegel – The Market is 10% to 15% Undervalued

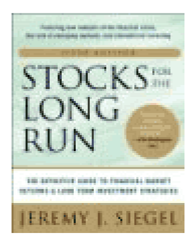
By Robert Huebscher
December 3, 2013

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 below. He is a regular 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 Siegel on Friday, Nov. 29.

In our interview on Dec. 10 of last year, you said that investors could expect a 25% return this year. On that day the S&P 500 closed at 1,424, and Wednesday it closed at 1,815, which is a 27% gain. Congratulations. What do you consider the fair value of the S&P 500 to be today?

Thank you. I've gotten quite a few media contacts and congratulations because I said in January 2012 that the Dow would finish this year between 16,000 and 17,000. I've learned that humility, rather than hubris, is the proper response to a good market prediction. You know how uncertain market direction over the short term is. But, that said, I think fair market value for the stocks today is 10% to 15% higher, and that might even be on the conservative side.



Stocks for the Long Run 5/E
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As I mentioned last year, when you are in a low-to-moderate interest-rate environment, the average price-earnings ratio for stocks is 18 to 19. If you use reported earnings, which I think are too conservative in terms of their predictive value, we're at 16.7 times next year's estimate of forward earnings. That's slightly above the long-term median but it's below the average. In a low-to-moderate interest-rate environment, the average is 18- to 19-times earnings.

I think this bull market has definitely more to run.

A lot of factors are weighing on investors' minds about equity prices, particularly those investors who look out over 10-year or longer time horizons. Let me ask you about some of those concerns. Let's start with quantitative easing (QE). To what extent do you believe QE has inflated stock prices, and should investors be fearful that the Fed might taper or otherwise become less accommodative?

The biggest myth in the market today is that this bull run is because of quantitative easing. I'm not going to deny that an easy Fed is helpful, but this market is really being driven by fundamentals.

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Earnings are up 10% to 13% this year over last year, and this is despite very slow GDP growth both in the United States and the rest of the world. I expect GDP growth next year to be 3.5% or higher. I admit that it might not reach that, and I have been a bit overly optimistic when predicting GDP in the past. But we got 2% growth this year, and most economists agree there was about 1.5% fiscal drag due to the higher taxes and the cutback in spending. If you add that 1.5% back you get 3.5%. I wouldn't be surprised if GDP pushes 4%.

My feeling is that the market is far too focused on QE, and people are incorrectly calling this "a QE-driven market." I don't understand why they do that, because if they looked at P/Es, earnings and interest rates, they would realize that the fundamentals support this bull run.

Another concern is that corporate profit margins are at historically high levels, as are corporate profits as a share of GDP. When we talked about this last year, you said it was due to the increased share of revenue from foreign sales and because more high-margin technology sales were showing up in corporate revenues. Are those are still the dominant trends?

One factor yielding higher margins is that we have very low leverage among corporations today. They have $1.5 trillion in cash on their balance sheets. This leads to higher margins because corporations don't have to spend that much on interest expense.

Today, 80% of corporate liabilities are long-term debt. In 1996, which was the last time that we were not in a recession and were at average margin levels, only 50% of corporate debt was long-term. Firms have now locked in these low interest rates on longer-term debt. Even if interest rates rise, their exposure is relatively small. And if rates rise, they're going to start getting some interest on their $1.5 trillion of cash. Corporations have locked in their long-term debt, while their assets are short-term. I don't think they will be hurt much by any rise in interest rates.

The tech sector has become a larger slice of S&P, but the P/E of the technology sector is still very low from a historical standpoint. As you mentioned, the margins for technology are historically always higher because most of their assets are intangibles, such as copyrights and patents, which don't get expensed. That is a source of those high margins.

Margins are still high compared to the long-term average, but secular – not cyclical – factors are driving them up. High margins investors should worry about occur when you are at a top of the business cycle with demand that is so strong that firms can raise their prices and know that their products will still sell. That's not the case today. There is still a general over-supply of goods. That's one reason why inflation remains at historic lows.

If you go back historically, it's only been at the top of the business cycle when demand has outstripped supply that one should worry. We do not see that phenomenon occurring now in the economy.

The household savings rate is also at a historically low level, as households continue to de-lever and save more. Does that concern you at all?

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The savings rate is still higher than what it was pre-crash. We have ratcheted saving up a little bit. Don't forget that with rising asset prices – and now we also have rising home prices – savings are taking place in the form of capital gains. Households are not going to cut back on their spending, because they're going to look at their balance sheets and find themselves more comfortable than they were before. The number of homeowners who are underwater has decreased sharply since the 2008-2009 crash. There's more liquidity in the market. There is still a lot of cash in money market funds. No, I don't think we're going to see a cutback in consumer spending.

As opposed to last year, when we faced a Social Security tax increase of 2% for everyone and higher rates for virtually all high-income tax payers, there are no increases in taxes scheduled or anticipated in 2014. That hit to the pocketbook is not going to occur, and with more comfortable 401(k) and home-equity positions, consumer spending should become stronger in 2014.

The Shiller cyclically adjusted P/E (CAPE) is now above 25. That is a level that was seen only in the three weeks prior to the 1929 peak and leading up to the late-1990s bubble. It's a high level that has been correlated with disappointing equity returns over a 10-year time horizon. Even if you ignore the bear-market earnings decline between 2008 and 2010, the market is still expensive, according to the Shiller CAPE. What's your take on that?

I wrote a paper last summer, "The CAPE Ratio: A New Look." I presented it at a Q-Group conference in October. Bob Shiller and I debated it the day after he won the Nobel Prize. (Because of all the media coverage he appeared by videoconference rather than in person.)

The bottom line of the paper is I have a lot of problems with the CAPE predictions using S&P data, but not with the CAPE methodology. The CAPE methodology is brilliant and works. The data are the problem. I showed that the S&P 500 earnings data over the last 15 to 20 years, particularly in recessions, have been much different that prior to that, primarily due to the change in accounting conventions and the forced write-downs of assets. When I looked back at the historical data, S&P earnings compared to the business cycle, it was like night and day. You are not dealing with the same series.

I used the corporate profits from the National Income and Products Account (NIPA) data and plugged them in. Guess what? The Shiller overvaluation almost completely disappeared. And the cyclical behavior of the NIPA data is very consistent with the business cycle over the last 85 years.

When you normalize for the data, the market is not overvalued by much at all. Because Shiller's CAPE is based on the average of the last 10 years, the crash in earnings during those recessions really pumped up the CAPE ratio, and that is a major, major reason for today's over-valuation.

Bob Shiller is my best friend. He invited me to the Nobel ceremony in Stockholm. I'm thrilled that he won. We have certainly a friendly back-and-forth on the direction of the market, but he is very well-deserving of his award.

It's not the CAPE methodology; it's the fact that S&P 500 started dishing him a very different series from the one that he had constructed back at 1871. It was very interesting is that the S&P 500 series used to be

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more stable than the NIPA profit series but over the last 15 years has become less stable because of the new FASB guidelines. That's the major problem.

The editor of the *Financial Analyst Journal* was at that Q-Group meeting. He came up to me afterwards and asked me to publish this. Bob acknowledged that there may be some inconsistencies with the series over time.

Have you looked at the CAPE-based fund that Shiller developed with Barclays and Doubleline?

It is sector-based investing using the CAPE. The interesting thing is that he uses a five-year rolling average for CAPE. So he re-computes the CAPE values based on the five-year average and uses that in his strategy. I pointed this out at the conference: When the five-year average is applied to the whole stock market, stocks became far less overvalued than when using the traditional CAPE model.

Now, Shiller wasn't dealing with the whole market with his sector strategies, and the bull market this year increased the five-year CAPE-based valuation. But his new methodology nowhere shows anything like the dramatic overvaluation that the standard CAPE actually shows.

Let's turn to interest rates. Last year you warned about the bond bubble. Since then, 10-year rates have risen by a little over 110 basis points, from 1.63% when we spoke last year to 2.74% on Wednesday. What should investors expect over the next year? At what level would you expect rates to normalize?

I expect them to continue to rise, especially with stronger GDP growth. I expect we will finally get a surprise on the upside with GDP growth. GDP growth has been so slow, below the Fed's forecast over the last three years. I think Interest rates will be 3.75% by the end of next year. That's a hundred basis points above today's level.

Looking two to three years out – and nothing goes in a straight line – I expect interest rates of no more than 4.5%. The Fed funds rate is going to settle closer to 2% to 2.5%. We're in a period of lower rates with more subdued inflation than we have been used to in most of the last half-century.

Although interest rates are going to be higher, that's not going to depress the stock market because earnings are going to grow faster. If earnings growth is due to a stronger economy, and higher interest rates are due to a stronger economy, then that is not bearish for stocks.

When I look at the Fed-funds futures, they are indicating far into 2015 for the first tightening. I think the Fed is going to tighten sooner. I will admit, though, that I have been predicting that over the last several years. But I think that the Fed, if the economy picks up more than expected, will probably have to start raising the Fed funds rate by the end of 2014.

At one point you were considered for the Federal Reserve Board. What advice would you give the incoming chairwoman with regard to the policy on short-term rates, or the policy towards continued purchases of securities and open market?

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Janet Yellen will have to establish her credentials. Her first meeting as chair will be the March forecast meeting when she could announce the taper. She is viewed certainly as very dovish, so she has to establish her credibility as a tough central banker.

By March, we will also have some resolution of the budget negotiations coming up. The Fed will want to wait to get past those for the first taper. I am not anticipating a taper in December or January. Although, if the data come in really strong this Christmas season, it could happen. But I definitely think it's going to begin by at least March. She definitely should start tapering by then.

Nonetheless, we will still have to look at inflation and see if it is still running below the target of the Fed. But even if inflation is low I think Yellen is going to have to start the tapering. And if the economy is strong, finish the tapering and end QE by the fall of next year.

If we only get 2% GDP growth next year, which is what it looks like for this year, then the market could be right that raising the funds rate will not happen as soon as I think

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