Jeremy Siegel: The Market is Cheap on a Long-Term Basis

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by Robert Huebscher

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 "Market Master" on CNBC and regularly appears on Bloomberg, NPR, CNN and other national and international networks*

I spoke with Jeremy on Wednesday, November 21th.

Our interview last year was on November 20, when the S&P 500 was at 2,579. Yesterday it closed at 2,641. That's a gain of 2.4%. Last year, you said the market was "about at fair value," so you were not far off in your forecast, given that the average annual return has been about 9.8%. But, in fairness, you did say last year that 2018 would be tougher than was 2017, which it was. What is the fair value of the S&P 500 now and what is your outlook for the coming 12 months, including December of this year?

The market is trading at 15-times next year's estimated operating earnings on the S&P 500. That entails about a 12% increase from 2017 earnings, which I think is too high. The earnings increase next year might be much more modest, like 4% or 5%, which then gives us about 16-times earnings multiple.

"I think that 16-times earnings is, on a long-term basis, relatively cheap, as long as interest rates stay in the 3% range." For the long run, I believe the fair market value of the S&P is closer to 17- to 18-times earnings which gives us a 5% to 6% real return. This P/E multiple is higher than the historical average, because of all the liquidity in the market, the ability to get index returns and low interest rates. The equity risk premium is still pretty hefty compared to bonds.

We may now be below fair market value based on current earnings, but, next year we will be 10 years into an economic expansion. This expansion will likely break the record now held in the 1990s.

There are people talking about a 12- or 13-year expansion. Clearly, we are nearer to peak earnings

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than trough earnings, which means that we cannot always consider current earnings to be in a long-run steady state.

If the expansion continues, I assume that earnings are going to be $165 next year, $175 in 2020, and go up at a steady 4% to 5% a year. Then we should be at 18-times earnings. But if there's a possibility of recession and a 20% drop in earnings, you want to be a little bit more cautious. The current decline means the market is positioning itself for a potential recession.

Why are you forecasting a slower growth in earnings next year than there has been this year?

I admit, I underestimated earnings growth this year. I knew we were going to get a pop because of the corporate tax cut, but we went well beyond it. Last year's operating earnings on the S&P was $124. This year, it looks like it's going to be $155. (Final numbers obviously depend on the fourth quarter.)

Actually $158 is the current estimate from Standard & Poors. I'm shaving it down three dollars.

Even then, it is an extraordinary 20% increase, beyond my expectations. The steady-state increase in per share earnings after inflation is only 3% or 4%, and most of that is generated by buy-backs.

I've been saying for the last six months that estimates for 2019 earnings are too high. Indeed, they're coming down. They were $180 three or four months ago. Now, they're $175. I expect them to decline further.

Those who keep projecting 10% to 12% earnings don't understand long term data. 2018 has been a good year for GDP growth, but next year looks very much like 2.5% GDP growth. I don't see how you're going to generate 10%-plus earnings out of 2.5% GDP growth.

A key difference since last year has been the increase in market volatility. What is driving that volatility and how should advisors and their clients react to it?

There was a period this year when there was very little volatility. The VIX was all the way down at 10. I believe what is going on is that we have more momentum players in the market.

These are trend followers. To be sure, we've always had trend followers, but today they wrap themselves up in a sophisticated term – *momentum players* – and they ride a trend without any regard to valuation. Then they all jump off at once and that generates a lot of volatility.

We had a very smooth period in the summer when the market was going up and there was almost no volatility day-by-day and then "bang," we broke the trend in October.

The average daily change in the stock market is recorded in my book, *Stocks for the Long Run.* It's held up throughout history. Going back over 100 years, it is two-thirds of one percent. That means that if you have a 25,000 Dow, 150 points is the average daily swing.

Incidentally, that was the amount the market moved today.

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Right. People tell me, "My God, there's been so many 100-point-plus moves." But that should be the average. Less than 100 would be less than historical average daily change.

I believe periods alternating between a relatively low and relatively high volatility are a result of momentum players in the market.

What is the likelihood of a recession in the next couple of years? Are there any developments that would cause you to think a recession could come sooner than you expect?

The probability of a recession is 50% in two years. There are a couple of problems the economy faces. We're at an extremely low unemployment rate – 3.7%. We've never come out of an extremely low unemployment rate without at least a mild recession. That's history.

Some people blame the Fed for that. I've seen headlines, "The Fed has never given us a smooth landing from a booming economy."

But it's not always the Fed fault. The Fed tries its best. Recession is part of a free market economy. We have very tight labor markets. We're squeezing out 200,000-plus jobs every month, but we're only producing 100,000 people through population growth. That's what is eating into the unemployment rate. We're drum tight in the labor market.

Furthermore, there is a threat of a trade war. And there is political uncertainty. The Democrats did not do badly in the last election. The Republicans should be concerned. They lost the House. At this point any reasonable Democrat – not one from the far left -- would beat Trump.

Republicans did very badly in Wisconsin, Michigan and Pennsylvania, and these states are the only reason that Trump won two years ago. If he loses those three states, he's got almost no chance. And there is not just the presidency. There is the Senate to worry about.

A big part of the boost in earnings this year was the corporate tax cut, which was the best thing that Congress and the Trump Administration did.

If the Democrats take hold of the three branches of our government – the presidency, House and Senate – they're vowing to largely reverse it. That's not good. That's not good for corporate earnings, no matter what is the state of the business cycle.

If the Republicans can keep the Senate, then they can block any repeal of the tax cuts, even if the presidency goes to the Democrats.

Remember, a lot of the boost of earnings was due to the corporate tax cut. We have to keep that corporate tax cut to have a good market.

There was an op-ed by Paul Krugman this week on the corporate tax cut. His argument was that it essentially had little impact because corporations didn't spend the money on

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investment. They chose to use it to buy back stocks. What is your counter to that?

I never thought there was going to be an investment boom. I knew a lot of the saving was going to be used for buy backs. We had the highest corporate tax rate in the entire developed world. We suffered all this off-shoring, all these “corporate inversions” and firms escaping to other countries. There was crazy accounting to avoid these high tax rates that took billions of dollars out of our economy. The tax cut eliminated most of that. That's a huge gain. Forget about the investment.

The simple reason we don't have a lot of investment is because there's not much in which to invest. Firms are supplying all of the goods that people demand. You invest because you need more capacity to do that. We have enough capacity. And there's enough R&D in the economy. There's a huge amount of venture capital and private equity. One of the reasons for low investment is that we are in-between major technologies now. We're gearing up on artificial intelligence, robotics and autonomous driving, but it isn't making a strong impact yet. Peanuts are being spent on it now in comparison to what we spent when we wired the world for the internet. Hundreds of billions of dollars invested that made superb gains in productivity in the 1990s. There's little investment now because there's no little value to create.

By the way, productivity has shown some improvement recently. That is not due to investment. It’s deregulation, which improves productivity.

Krugman is going off on the wrong tangent. He is biting on what a lot of Republicans did to sell the tax cuts, but the truth that the corporate tax cut adds a tremendous amount of positives that went far beyond whether or not it stimulated investment.

You said that any reasonable Democrat would defeat Trump. Who would you include in the reasonable category?

We have to see who runs. Clearly, if Michael Bloomberg runs, he's someone I would support. I am a Republican. I'm not a “Trumper” at all. I don't like him. I just like the Republican platforms generally. But not his specific policies that don’t jibe with the Republican establishment.

I could not support left wing Democrats such as Bernie Sanders. I think Elizabeth Warren did herself in with her genetic testing. She's down in the polls. She’s anti-corporate and anti-business. Some people talk about Kamala Harris from California. Some people say she's extreme. Others say no, she's not. Some like Amy Klobuchar from Minnesota, who is more moderate.

Just like the Republicans have the trouble on their right, Democrats have the trouble on their left. If we have an extreme left candidate against an extreme right candidate, then you don't know what happens. Someone in the middle would likely beat Trump, but you don’t know whether he or she could get nominated. Now the odds are definitely that Trump will win the GOP nomination. But it’s not a given; things happen.

Given how great the economy was, the Republicans did not perform that well in the midterms. They didn't show well in the three states they need to win to have the presidency.

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But it's very early. Two years is a lot of time for a lot of things to happen, including a peak in the business cycle. There's no reason we can't have a 12-year economic expansion. Back in the 1990s, no one believed we could have a 10-year economic expansion, but we did.

There are countries that have had 12-year or longer expansions. Australia's on a 28-year economic expansion. There's no natural death to the business cycle, but it is not reasonable to continue to reduce unemployment rate from 3.7% while creating 250,000 jobs a month. Where do you get those people?

Right now I see a little wobble that the Fed has to take be aware of. If you look at the post-war period, whenever we've gotten below 4% unemployment, we've had a recession within two or three years.

What is your outlook for inflation? Related to that, how do you explain the recent significant drop in oil prices? WTI has gone from approximately $75 to $55 in the last couple of months.

There's a couple of reasons why oil dropped. Oil ran up on the expectations that the Iran sanctions were going to be much tougher than they turned out to be. There were a lot of country exemptions. Also there's been a boost in supply from the U.S. Big oil is finally getting into fracking. And production is at a record

Finally, we've got a world-wide economic slow-down. The U.S. and China are the world's top economies, but Germany and Japan are number three and four and they had negative GDP growth in the last quarter.

Furthermore the emerging market growth has been very slow, although there's promise there in terms of valuation of their stock market. And, hey, it looks like Trump and the Saudis are friends again, so OPEC does not want to ruin’s Trump’s chances of re-election.

The oil price collapse doesn't surprise me. I thought oil was way too high at $80 to $90/barrel. I always thought the equilibrium price for oil was approximately $60. It's not far from that at the present time.

Going back to the inflation issue, we just don't have inflation. If you look at other commodity prices, they are soft. The core PCE deflator, which is the Federal Reserve’s preferred indicator for inflation and the one it uses to satisfy for its dual mandate, was 2..0% year of year for the last reading in September. The next PCE is coming out on the November 29th.

I believe The year-over-year PCE is going to drop below 2% and may even drop to 1.8%. This is going to be huge as ammunition for the doves in the Fed. They're going to say, "Look it, we're below that 2% that we targeted."

I don't see inflation imminently. I do see a tight labor market. There may be some cost pressures coming there. But outside of that, particularly with energy down so dramatically, I don't see inflation, over the next 12 months as being a problem.

How do you expect the trade war, specifically with respect to China, to be resolved? There are

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142 items on the list of demands made by the Trump administration. How many of those are likely to be resolved in a way that significantly impacts trade?

Everyone agrees that China steals technology and has some have unfair practices. On the other side of it, China has provided us cheap goods that we couldn't get anywhere else. Particularly lower income people who buy at Walmart and Dollar General and similar stores are getting almost everything from China. You put a tariff on China, who are you going to be hurting? You're going to be hurting lower income people more than those who have the income to spend on non-Chinese imports.

That said, China does not have to accede to all those demands.

We resolved Mexico and Canada much more easily than I and many people expected. I therefore set the expectation that Trump will give in on the vast majority of his demands. The economy is a little more delicate now. He doesn't have quite as much to boast about economically as he did, even three months ago.

Trump is going to cave in on most of his earlier demands. He will get something, but the market is not expecting a trade war with China. It doesn't mean it won't happen. But look at how he came to agreement with Canada. He was really tough a week before the deadline of the NAFTA negotiations and then conceded almost everything a week later.

Given the political and economic situation, he'd much rather have an agreement than a trade war.

When we spoke last year, the 10-year Treasury yield was 2.35%. You said then that the "10-year will reach 3% to 3.5% at the top of the cycle." It is now at 3.06%, so that was a very good prediction. Are we at the top of the cycle? Where are rates headed over the next year?

It hit 3.25%. Up until the collapse of oil and the slowdown that we've seen in economic activity, I was thinking the 10-year next year would be 3.5 to 3.75%. I'm beginning to revise that down a bit and perhaps 3.5% might be the peak of the 10-year next year.

By the way, if the probability of a recession increases, we may not even get rates that high. We are nearer the top of the cycle. If there's a resolution of the trade situation a and we keep on creating 200,000 to 250,000 jobs, then we're going to press against labor supply and the Fed is going to have to be more aggressive. Then we could see a higher rate.

In that case A rate of 3.5% or 3.6% is not out of the question. But I do not have to deviate much in my forecast. We might see 3.25% as the high if we've got the current slowdown continues. This doesn't necessarily mean a recession. We had a slowdown in 2016 that did not turn into a recession. We had the same stock market decline – actually and ever larger bigger reaction and we bounced back. Of course, then we had oil collapsing all the way down to $28 a barrel.

In summary, I think 3.5% to 3.6% might be the high point of the cycle and we might not even see that.

One of the big fears surrounding the fixed-income markets is in corporate bonds.

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Corporations have issued a significant amount of debt in the post-crisis period, particularly in BBB-rated bonds (the lowest investment-grade rating). Analysts repeatedly comment that the covenants on those bonds are "lighter" than historically was the case. Yet spreads, in both the investment-grade and high-yield markets, remain fairly tight. What is your outlook for corporate bonds?

Spreads have gotten a less tight in the last week, but are nothing like two and a half years ago. The peak spreads in this expansion were in the early part of 2016. But still, we've definitely seen a beginning of that increase in spreads.

I am not worried about a "debt bomb" for a number of reasons. The average corporate bond has a longer maturity than it used to be. Secondly, our banks are extremely well capitalized – better than ever before. They are flooded with liquidity. We talked about this last year, also and it's definitely true.

Since the crisis, a lot of the rating agencies have been applying stricter rules that they didn't apply before. They say, "Well, I now have to build in a cushion for a crisis as big as 2008 or 2009."

My response is, "I don't think 2008-2009 was an 'average' recession. I think it was a one-in-70-year recession." We saved the financials and that's why we didn't have a depression. That type of a shock was a perfect storm of very unlikely events that just cannot happen today. We just don't have the debt build ups in crucial financial institutions to lead to anything like what we experienced a decade ago.

Building in a probability of another crash that big and then downgrading everything doesn't make sense to me. I'm not sure corporations are any more fragile than they ever were before the financial crisis. It's harder to get the same ratings that you had before. It looks like they've downgraded debt, but what they've really done is changed their criteria for what they consider AAA, AA, etc. ratings

I don't fear a corporate debt bomb, I don't think the banks are at all vulnerable. But we do have a huge deficit in the U.S federal budget. It's actually the U.S. government's debt build up that is much worse than what we have in the corporate or even the personal sector.

The ratio of debt-to-income in the household sector is well below what it was in 2005 or 2006, during the subprime mortgage boom. That debt all liquidated and mortgages are harder to get and more secure than they have been for decades.

There are always going to be high-yield bonds that are stretched when there's a recession. But in terms of that tumbling into another crisis such as we had in 2007 and 2008, I don't believe that's going to happen.

Are there any asset classes or regions in either the equity or fixed-income markets that are particularly attractive now?

Absolutely. We see a really big discrepancy between valuations outside the United States and within. Europe is at a 12- or 13 price-earnings ratios. The emerging markets are 10 to 11. The latter have been beat up so much that I think three to five years hence, investors who take diversified positions in

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emerging markets are going to be strong outperformers.

Don't forget, half the world's equity capital is outside the United States. On a valuation basis, foreign equity is more attractive than U.S. equity. As painful as it's been for investors over the last couple of years to maintain that global portfolio, my belief is that such a position will pay off handsomely in the future.

What are the biggest risks that should concern advisors and their clients?

I would like to highlight the risk that the two things that spurred a lot of the Trump rally – the corporate tax cut and the deregulation – would be threatened by a Democratic taking over the government. That's not an impossibility at all. That has to be factored in as a concern going forward.

There's also risk of a recession of a normal business cycle. By the way, I was on CNBC yesterday and I said that the Fed is going to slow down its increases into 2019. We might see one or two, not three or four hikes. The Fed going to be very cognizant of the potential economic slowdown. We might face a recession in 2020. I think it will be very mild, if it happens, but this has to be taken into account.

Be careful about projecting big increases in earnings. But I think that's one reason the market has come down recently: investors are getting a little bit more squeamish about next year's earnings. These expectations of 8% to 12% increases in earnings, from the top of the cycle, are just unreasonable. Investors should be aware of that.

Short-term interest rates going up, though. The Fed is probably going to raise in December. You're going to get 2.5% on your CDs that are market-oriented, money-market funds. A lot of people in this type of world will be happy to sit on a 2.5% return rather than risk the stock market.