Weekly Commentary with Professor Jeremy J. Siegel

My Bottom-Line Year-Ahead Outlook

Tuesday, 27/12/2022

The real economic data is holding in, while inflation data continues to come in very favorable.

Just last Friday we had a new survey from the University of Michigan and the 1-year ahead inflation expectations came in at the lowest levels in 18 months. The Personal Consumption Expenditure (PCE) deflator came in quite benign, and I maintain my view the real inflationary challenges are over, particularly if the Fed incorporates real time indicators for housing data.

This final week of the year is another big one for economic data. We get money supply data print, which is likely to be flat or outright decline, and this highlights the overly tight Fed. We want the Fed to let this money supply grow 5% a year, not to have it contract. The Case Shiller Housing indexes are also likely to show continued declines, highlighting the continued discrepancy between real world inflation and the official statistics.

The market clearly wants to see a Fed pivot to recognize how much inflation has come down.

I believe the earnings outlook for next year can remain robust than feared—even if there is a mild recession. I think productivity trends will improve after a dreadful year—and that can support more robust corporate profit margins.

My bottom-line year-ahead outlook: I think we should have a very good year for equities, with U.S. markets up 15-20%, which would be surprising. Most think these gains have to wait for the second half of the year, but I can see this happening in the first half. I expect interest rates to be down with the Federal Funds rate to be between 2-3% by year end and the 10-year interest rate to be 50-100 basis points below where it is today.

These are very much outlier views, as most take the Fed at face value for plans to remain at elevated rates for longer. There was a notable interview with hedge fund manager David Tepper, whose bearishness stemmed from taking central banks at their word that they are going to keep at this inflation fight and keep policy extremely tight. I do not take the Fed economists at their words—as they have not predicted this economy or inflation dynamics or their own reactions well at all.

Tepper granted that housing data is much weaker than official inflation statistics, but he hangs an elevated inflation thesis on a structural shift down in labor supply keeping wage pressures elevated.

I want to emphasize: there is nothing the Fed can do about this structural shift in labor supply leading to a rise in real wages. The Fed would have to overly suppress goods into deep negative territory to prevent a rise in real wages and that is not something they should be doing. You cannot improve an economy by forcing wages down—you have to pay workers their marginal productivity. Let us hope the Fed recognizes this in 2023.

The other bearish slant from Tepper stemmed from comments on valuations for the market and he pointed to the lows after the financial crisis when the market traded at 12 times price-to-earnings. That period was clearly an enormous value for stocks and led to extremely strong returns and one of best expansions and bull markets in history.

I believe a long-run fair market multiple is around 20x earnings—and not trough earnings in a recession but long-term trend earnings. If you go back 150 years, the average multiple was 16x earnings. There are many factors that I think support a higher multiple: lower real interest rates by historical standards and the declining transactions costs to get diversified exposure to the market are two of them.

When talking about the increased competition for stocks, we cannot compare a 3.7% nominal 10-year bond yield when stocks have, over the long run, returned 6.7% real after inflation according to my work in *Stocks for the Long Run*. One must compare stocks to real bond yields, and those are currently only 1.4% and I think going to go lower in 2023.

This will be our final commentary of 2022. We wish everyone a happy holidays and new year and speak again in 2023!

Glossary

Basis point: 1/100th of 1 percent.

Bearish: Characterized by or associated with falling share prices.

Bond yield: Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

Bull market: A market in which share prices are rising, encouraging buying.

Case-Shiller Home Prices indexes: The Standard & Poor's CoreLogic Case–Shiller Home Price Indices are repeat-sales house price indices for the United States. There are multiple Case–Shiller home price indices: A national home price index, a 20-city composite index, a 10-city composite index, and twenty individual metro area indices.

Fed funds rate: The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

Federal Reserve (Fed): The Federal Reserve System is the central banking system of the United States.

Inflation: Characterized by rising price levels.

Personal Consumption Expenditure (PCE) Price Index: A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The core PCE Price Index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

Price to Earnings Ratio (P/E): Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Recession: Two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

University of Michigan Consumer Sentiment Index: A consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in December 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample. Fifty core questions are asked.

Yield: The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.