

New Fed Policies are Bullish for Stocks
Monday, 3/18/2020



Jeremy Schwartz, Executive Vice President, Global Head of Research for WisdomTree, hosts a weekly discussion with Professor Siegel, typically on the Wharton Business Radio podcast. The notes below summarize their conversation along with further commentary and context.

Last week was a busy week for the markets, but let us put the Federal Reserve (Fed) inflation targeting policy front and centre.

In agreement with what Professor Siegel has been saying for many months now, Jerome Powell formalized what the Fed would do. The Fed will keep interest rates near zero, while letting inflation run ‘hotter’ than their 2% target for a number of years. The Fed described a new average inflation targeting regime that suggests if we fall short of inflation targets (and we have averaged 1.6% per year over the last decade), we have to run above that 2% target for some time.

Powell refused to put a specific mathematical relationship on how the Fed will determine this ‘average’ method and they’ll evaluate this average target qualitatively. However, Professor Siegel’s calculations show an approximately 4% cumulative deficit that the Fed could make up, but it’s likely to let inflation run higher for longer.

The Fed also acknowledged the Phillips curve relationship that suggests the Fed should pre-emptively hike rates when unemployment rates are below their natural rate, has failed. The Fed will no longer undertake pre-emptive interest rate hikes when the unemployment rate is low—they must see inflation materialize before they take action unless they believe “full employment” has been achieved.

These policies are very bullish for stocks. An important negative for the stock market is when the Fed gets into ‘restrictive’ tightening mode and that risk is now lower under this new regime.

On the political front, the betting markets suggest a tightening election following the Republican convention. Professor Siegel sees the violence in the streets as an important “hidden” issue influencing independent voters and thinks it was a mistake for Biden and the Democrats not to address this ‘law and order’ issue at their convention. The Republicans emphasized it repeatedly.

President Trump believes we will have a vaccine in 2020 and Professor Siegel has also been saying we’ll likely have a vaccine for higher risk people by year end—this should also be a positive for the re-opening of the economy.

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There were 3 new stocks added to the price-weighted Dow Jones Industrial Average—which is the world's oldest continuously computed stock index. For the first time since Professor Siegel could remember, they added Salesforce.com, a company unknown to most Americans. Professor Siegel emphasized how non-sensical the price weighting scheme is—this methodology keeps them from including Google and Amazon due to their high prices.

We have been giving readers the opportunity to ask Professor Siegel questions—email AskSiegel@wisdomtree.com to have your questions answered.

Combining a few questions into one this week, a number asked about market valuations—if it was too late to get into US equity markets due to their rise and what are the structural factors that are impacting valuations in the markets.

Professor Siegel believes the current valuations, while high, are nothing like the 1999-2000 'bubble' valuations when the US total market was selling at 30x forward earnings and the technology stocks in the S&P 500 were at 90 times. And most importantly, US Treasuries were over 6% while today the 10-year bond is only 70 basis points. The Treasury Inflation-Protected Securities (TIPs) rate was over 4% back in 2000 and was actually bigger than the earnings yield on the stock market, an extremely rare instance of inversion. Today the TIPS yields are negative, while stocks have an earnings yield of 4-5%—so the equity premium is still large.

The liquidity provided by the government and the Fed—and these historical low rates—are supporting valuation premiums. Professor Siegel does not see the trend towards indexing as impacting valuations—indexing is just an efficient way to own the market and lowers the cost to own the market. That people can hold the market at a lower cost can support higher valuations, but indexing itself does not boost valuations.

Tesla is an example of how a remarkably strong stock that is not in the S&P 500 can still have a strong upward move although it is not in any major index. Professor Siegel also thinks international stocks offer good valuations compared to the US and are investments to consider for people worried about extended US valuations.

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