QUARTERLY Q&A WITH PROFESSOR JEREMY SIEGEL – PART 2

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Every quarter, we hold a quarterly review and outlook conference call with our Senior Investment Strategy Advisor, Wharton Professor Jeremy Siegel, where listeners can submit questions ahead of time and help drive the content of the call. In this series of blog posts, we review the most pressing economic and market issues that were discussed during this quarter's call. In this part we discuss the fiscal cliff resolution, the upcoming debt ceiling and future growth expectations for the market. **Question:** We had a very happy start to the New Year with the fiscal cliff resolution. Were you happy with that deal? And how do you think that the next fiscal cliff—the debt ceiling—will play out? Do you think there'll be a last-minute showdown at the wire again? **Professor Siegel's Answer:** This is important. In October's quarterly conference call I said the cliff would be avoided. I was giving 2-to-1 odds that we were not going to fall off, although we did go to the very edge. One thing I have said for over a year was that the dividend tax rate would not rise up to ordinary income rates, and in fact, it was maintained at 20% for highest-income earners. This is the same 20% rate as the capital gains tax. We do have that 3.8% Medicare tax on top of this rate for higher-income individuals. I regret that; 23.8 is a big jump from 15. But 23.8% is much lower than the rates on ordinary income, which are effectively over 40%. And of course, for anyone below the highest income thresholds, the 15% and even 10% dividend and capital gains tax rates are extended. Money funds have zero income[1]. Long bonds have the tremendous risk of depreciation as interest rates rise[2]. Everyone is searching for income. The fact that you can get tax-preferred income on the dividends is extremely important. As far as the second cliff, that is what we're coming to, but I do not believe it is going to be a tremendous hurdle. I cannot picture the Republicans forcing to close down governmental functions. And both sides say that interest will be paid on the debt. Obama has too much choice about how he wants to spin the debt ceiling to the American public: what he is going to spend the money on and what he won't. Since the Republicans do not have the bully pulpit, they can't really counter Obama effectively. The fear, I think, is that the government will raise the debt limit without any spending cuts. And that will lead to a further downgrade of U.S. government debt. When Standard and Poor's downgraded the government debt in August 2011, it did scare the stock market and we had over a 5% drop[3]. There was fear that the Chinese were going to dump U.S. Treasuries. Yet the downgrade of the debt had absolutely zero effect on the demand for U.S. treasury bonds. None. In fact, demand for treasuries spiked higher. Stock investors worried, but when they saw the demand holding, the markets reversed and moved up. I believe the same thing will happen if there's another downgrade. The fact is that the Federal Reserve is always ready to lend unlimited amounts to the Treasury if necessary. There cannot be a default[4] on the debt. The only de facto "default" is inflation. If that exists, it's down the road a long, long way and not anything that I fear now. So to me, the debt ceiling deadline will not prove to be a significant event. If we get through this without a downgrading of our debt, I think we could see a big surge in the stock markets, just as we did when the fiscal cliff was resolved at the end of December. **Question:** You mentioned inflation is a potential outcome of money printing. Many are very worried about the dollar now and inflationary consequences of the Fed extending its balance sheet. Can you talk about why we may not have seen inflation as a result of all the Fed's done? **Professor Siegel's Answer:** There's no question the Fed's balance sheet has expanded. The reason we have not seen inflation—and this is very important—is because the increase in Fed credit has resulted in excess reserves. They are not being lent out. The money supply needs to go up to create inflation—in particular the M2 money supply (checking and savings accounts). We have had some strong growth in the M2 money supply over the last few weeks, and we often do early in January, as a result of seasonal movements of funds[5]. But nothing that is inflationary so far. If the money supply measures start running up too fast, then there could be inflation pressures. But again, you're going to see it in the money supply data released weekly. You'll see it in the commodity prices, you'll see it in gold, you'll see it in oil. You'll see it in sensitive commodities well before you'll see it in the Consumer Price Index (CPI) data. The unemployment rate is still too high to have much wage inflation. We've had no wage inflation. I'm not concerned about inflation now. **Question:** You talked earlier about views that the economy and markets should pick up this year. How does that manifest into earnings hitting new highs, potentially? **Professor Siegel's Answer:** Most analysts are looking at a 5%–6% increase. And a lot of people ask how we get new all-time highs in the markets out of that type of increase—first earnings are at an all-time high . But the source of the strong market in 2013 is going to be price-to earnings (P/E) ratio expansion. I do not see a large earnings increase. The stronger the earnings increase, the stronger the gains can be, but with the P/E ratio at 14, stocks are inexpensive. And if people start fearing bonds and start saying, "I want to be into stocks," we have got a long way to go on multiple expansions before it begins to look like an overvalued market on a historical basis. **Question:** It is always to get your optimistic view there. Do you have any reason to believe that the market's historical returns of seven percent plus inflation may not continue? Are there any negatives that would lower your expectations? **Professor Siegel's Answer:** We're hearing so much about the "new pessimism," on the heels of Bill Gross' "New Normal." Now my colleague Robert Gordon at Northwestern University wrote a piece about slowing productivity growth that has gotten much attention. He believes that productivity might slow to 1% or less. I am a strong doubter of that. My own research showed that technological progress and productivity growth are spurred by an increase in communications. And what has happened more than almost any other phenomenon in the last decade is the explosion of the Internet, which has increased communications between researchers all over the world. This is what spurs new technologies. I am not at all pessimistic that we're going to get to a sub-1% growth rate. In fact, there are actually objective reasons to believe that productivity growth over the long run—which has averaged 2% to 2.25%—may even exceed that level in the future. So, no, I am not a believer in slowing technology and not worried about the long-term prospects in the equity market. [1]Zero income: Refers to the fact that money market funds have extremely low interest rates at the present time. [2]While no one can know when or if interest rates will rise, bonds with longer maturities tend to have greater sensitivity and risk of falling price levels, should interest rates rise. [3]Source: Bloomberg. The S&P 500 Index saw its price level drop more than 5% on 8/8/2011, the first day of trading after the official downgrade of U.S. debt from Standard & Poor's. [4]Default: In this case, a failure of the U.S. government to pay regularly scheduled interest or principal payments on the debt that it has outstanding. [5]Source: U.S. Federal Reserve H.6 Release, published weekly. January of 2013 releases show week-over-week growth in M2.

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DEFINITIONS

Fiscal cliff : is a term used to describe the fiscal situation the federal government faces when a series of large tax increases and spending cuts are due to take effect at the end of 2012 and in early 2013.

Ordinary income rates : Tax rates faced by American citizens on their salary and wage income.

Higher-income individuals : Single tax filers reporting $400,000 or more in income after any applicable deductions, and household tax filers reporting $450,000 or more in income after any applicable deductions.

Tax-preferred income : Refers to the fact that dividend tax rates tend to be lower than ordinary income tax rates.

Downgrade of U.S. government debt : Refers to a ratings agency, such as Moody's or Standard & Poor's, lowering their rating of U.S. government debt.

Excess reserves : bank reserves in excess of a reserve requirement determined by local central bank. They represent reserves of cash more than the minimum required amount.

M2 money supply : Contains all funds deposited in checking accounts as well as funds deposited in savings accounts and certificates of deposit. There are various ways to measure the money supply of an economy. This one is meant to broadly account for the majority of savings and checking accounts held by individuals and businesses across the economic landscape.

Productivity growth : The efficiency with which resources are used to generate economic output. Increasing levels indicate an ability to produce more with less.