QUARTERLY Q&A WITH PROFESSOR JEREMY SIEGEL PART 1

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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. **Question to Professor Siegel:** Given your academic training was in monetary policy, let's start with the U.S. Federal Reserve's interest rate policy. Do you think the Fed interest rates will remain at these historically low levels until the middle of 2015, as is currently projected? **Professor Siegel's Answer:** The Fed's pledge is to keep its policy rate target at 0 to 25 basis points until the middle of 2015. The trigger mechanism was specified to be dependent on the unemployment rate and inflation, but Bernanke was very careful to say that according to the projections of the Federal Open Market Committee (FOMC) members on unemployment inflation, that did coincide with the middle of 2015. I keep close track of the Fed funds futures market. I have noticed that December Fed funds futures have jumped to over 30 basis points—up three-and-a-half basis points. That's a rather big move for Fed funds futures. This means a number of participants expect a stronger economy than the Fed anticipates, which would force them to tighten credit before the mid-2015 date. Now this is preliminary, and we have to admit we have had false starts before, where we saw strength early in the economy only to watch it peter out in the middle of the year. But I think that this year's economy will be stronger than expected, with gross domestic product (GDP) growth of 3% or higher rather than the 2% of consensus estimates. I think the stock market senses that—it has matched and exceeded its September 2012 highs that it reached before the fiscal cliff concerns. So yes, I do think that interest rates will rise sooner than 2015. **Question:** A lot of people are starting to worry that if interest rates rise, this could put an end to the bull market we've been experiencing. Is that something you're concerned about? **Professor Siegel's Answer:** At the end of a Fed tightening, there should be concern, but never at the beginning of a Fed tightening. One has to remember that the only reason the Fed would be tightening would be because it sees a stronger economy. And that is good for earnings. Stock prices are dependent on two major variables: future earnings[1] and the rate that you discount those earnings[2]. If we see the interest rate rising, it will be only because we see a stronger economy, which will boost earnings. And one should also note that if we see a stronger economy, that will tend to lower the risk premium that investors demand of stocks and provide further support to prices. When I look back at history, I believe it really takes anywhere from nine months to two years after the beginning of a tightening before stocks can run into problems. I don't think we should be worrying about the end of a bull market now. It's way, way too early. And don't forget—we have been at the rock bottom of interest rates. Raising rates to 2% and 3% would just be a normal level from which the Fed would operate. So I'm not concerned about the Fed's initial tightening being a problem for this market. That said, there's likely to be a short-term reaction if the Fed says they are considering tightening. On that day you will see the market flutter. But remember, this will happen only if the Fed sees a stronger economy, and that can only be a very positive feature for corporate earnings. **Question:** Speaking of ripple effects from monetary policy—the Fed isn't the only place in the world where there's a lot of interest in monetary policies. If you think about the global central bankers today, perhaps there's no country more interesting than Japan and the new prime minister who was elected there, who is calling for the Bank of Japan to increase its inflation target to help weaken the yen. Is this policy going to be effective? **Professor Siegel's Answer:** What's going on in Japan is extraordinarily interesting. Japan was actually the first country, well before the financial crisis, to try quantitative easing. They did so around 2002. It was a half-hearted attempt, and they eventually abandoned it. My own research indicated that it had a marginally positive effect. The Japanese are fearful of quantitative easing, because many in Japan are old enough to remember the terrible inflation that occurred after World War II—which was caused by printing money. So there's a very frightened contingent in Japan about any sort of quantitative easing that might take place. But five to ten years since that first quantitative easing, the economy is weak and there is deflation. So opinion is turning. Shinzo Abe, the new prime minister, has very definitely called for an end to deflation. Deflation's falling prices cause Japanese consumers to put off purchases. Consumers are saying: Why should I buy now? Everything always goes down in price. You have to break that psychology. I think what they are attempting is very, very positive. That said, the relatively weak performance of Japan over the last 20 years, since the bubble burst, is not only due to deflation. There are a lot of structural problems in Japan. But certainly the deflationary policy has been a component. I don't think the monetary policy prescriptions will solve all their problems, but I support Abe's move toward a more aggressive policy—perhaps even to 3% inflation in Japan. I'm sure they're not going to let inflation get out of hand. I do think this could be a game changer and a short-run positive stimulant to the Japanese economy and markets. [1]Since future earnings cannot be known in advance, this actually refers to the market's consensus opinion on the potential behavior of future earnings. [2]Any time an asset has cash flows that extend into the future, discounting refers to the process by which one takes those future, projected values of cash flows and estimates their worth in the present day.

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DEFINITIONS

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Fed Interest Rates : Refers to the Federal Funds Rate, which is 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.

Basis point : 1/100th of 1 percent.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Consensus estimates : Refers to the estimates of a broadly representative group of different economists, part of whose expertise involves forecasting potential rates of GDP growth.

Fed tightening : Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

Risk premium : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Deflation : The opposite of inflation, characterized by falling price levels.