Jeremy Siegel on the Fed, Commodities and Global Markets

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As CBS News put it, "When the Fed Chairman Speaks, Everyone Freaks." What that hyperbolic headline refers to is the sell-off in stocks and rise in bond yields this week after Ben Bernanke, the Federal Reserve chairman, reportedly told a CNBC reporter that markets had misread his testimony before Congress last week during which he had seemed to hint that the Fed might pause in raising interest rates. Stocks and bonds rallied in response. But, after suggesting at a Washington correspondents' dinner over the weekend that the markets had "misunderstood" him, the sell-off began. What, exactly, is the Fed likely to do on May 10? And what will that mean for investors? Jeremy Siegel, a professor of finance at Wharton and author of the book, *The Future for Investors*, spoke with Knowledge@Wharton's Mukul Pandya and Robbie Shell about interest rates, oil prices, the commodities markets, Bernanke's learning curve and President Bush's approval ratings, among other topics.

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Knowledge@Wharton: Before we get into the discussion about interest rates and their impact on the market, what do you think about this whole weekend episode with CNBC? When Alan Greenspan was the Fed chairman, he had a reputation for being very reticent. What lessons does Bernanke need to learn about making off-the-cuff remarks to journalists?

Siegel: I was pretty appalled when I had learned what had happened. It was a rookie mistake. Ben is an excellent man for chairman, but he definitely made a mistake. Interestingly enough, in the first few months of Greenspan's tenure, he also made some comments in response to a reporter's question, and the markets reacted. He never again gave a live TV or radio interview in the next 18 years. He learned his lesson.

Bernanke should have never spoken about the markets and the economy to any media, unless it's specifically off the record. Greenspan became a master at doing this and reporters could have dinner with him and they could ask him as many questions as they wanted. He would be as polite as possible and smile and you would never get an answer from him. Bernanke is going to have to learn that. Now, what does this all mean?

Basically, Ben wants the Fed to be open but he got it a little too open. The truth of the matter is that the Fed does not know two meetings in advance what it is going to do. It's pretty sure that in the meeting that

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is coming up on May 10th it's going to raise rates to 5%. There's virtually no question about that. But when the next meeting comes June 28th and 29th, Bernanke is going to have to look at the data in the next six to seven weeks to make a decision.

He has suggested that the Fed will pause. I think that is the right decision, with an asterisk, and that is that we still have a bubbling, boiling commodities market. Housing has turned down but the rest of the economy is still booming. So Bernanke has to keep his eye on all of these factors. But I still think the odds are, unless we have runaway inflation, that he will raise to 5% in May and will pause, for the first time in two years.

Knowledge@Wharton: Given that scenario, what would be the appropriate response for investors?

Siegel: The earnings are coming in extremely well and that's supporting the stock market. We finally are getting a rise in capital spending, which is also supporting the economy. Oil and interest rates are still the big question mark. But so far economists are bullish about the U.S. economy and world economy. For the first time in nearly 20 years, we have the world economy expanding. We have the European economy beginning to move up; Japan is finally stirring, and the United States is certainly strong. Those are the three major engines of the developed world. The developing world has been on fire for two or three years.

My good friend Steven Roach at Morgan Stanley, [a long-time bear on the economy] has said, 'You know what? Things are looking better right now," although none of the imbalances that he had talked about so extensively over the last two or three years have really been addressed. He just sees all of the engines of the world economy firing together. That's going to support stock prices. Bond interest rates are still creeping higher in response to the fact that we have a strong economy.

Knowledge@Wharton: You referred to the oil crisis, along with interest rates. Clearly oil is a problem area that shows no signs of going down. I just saw that they are at $74 a barrel and, with the tension over Iran and its defiance of the UN sanctions, there is a lot of uncertainty there. Moreover, the commodities markets are also in a quandary because of Bolivia's nationalization of its natural gas fields. How do you think that the signs of weakness compare to the signs of strength in the economy and what will that mean over the coming months?

Siegel: There is no question that we are in a commodity boom. It's fueled by a number of factors. One is, of course, a strong world economy. We all know about India and China buying these raw materials. I'll speak to that again in a moment.

We also have tremendous speculation. Commodity hedge funds, commodity funds of all sorts, are forming. They are buying these commodities on the open market. There is, in many cases, limited supply. Investors think that this is the automatic road to riches. I really see a bubble developing in this area and it could be very treacherous as far as investors are concerned.

But there are two important things to keep in mind. Oil has gone -- I'm speaking about gasoline -- from $2.20 a gallon a year ago to just over $3 a gallon today -- almost a $1 increase. Back in the 1970s, gasoline went from 35¢ to $1. That's a tripling of prices. We have had a $1 increase, to be sure, but gas is only up 33%. This is one of the reasons why the consumer has still been able to spend, despite the high gas prices.

But one should not say, "Hey, there's no problem". The 4th quarter GDP, at 1.6% growth, was a very low level which I'm convinced was caused by the spike in gasoline and oil prices that Katrina produced. When oil prices retreated, we bounced back to a very strong 5% growth in the first quarter. But I am feeling that we are not going to have an overly strong economy in the next three quarters. I particularly think consumer spending will be down. I think what is going to support the economy is that we are finally going to see a rise in capital spending. Indeed, Cap Ex [capital expenditures] for the first time in three to

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fours years has begun to pick up. In 2000, after the burst in spending for Y2K, firms revamped their computers and technology and tech spending then plummeted. Further, since China and India were expanding so rapidly, firms did not have to increase spending on capacity. But now we are beginning to see an increase in capital expenditures as the effects are wearing off.

So what I think is going to happen is that there will be an increase in capital spending in the second half of this year, and a decrease in consumer spending. Both will counterbalance to produce about a 3 to 3.5% increase in GDP. Also, it's still true that although oil has gone from $30-$40 a barrel up to $70-$75 a barrel, still a lot of it is feeding through the Chinese production process, which is a $1 an hour labor cost. So even though oil seems high in the production process, it's going through a very low labor cost and then being exported to the U.S. That is a major reason why inflation is being held down. A lot of the oil prices are offset by the low costs of the goods that are produced in China and India that will keep the U.S. economy from turning into a 1970s inflation runaway.

Knowledge@Wharton: Just to change topic a little bit, what do the low ratings for Bush and the Republicans mean in terms of what you are talking about?

Siegel: Well, it has a lot of meaning. Right now, when we take a look at what the odds makers say, they give it almost 50/50 odds that the House [of Representatives] will turn Democratic in the November midterm elections. Still, the odds are strong that the Senate will remain Republican. The odds are about 4 to 1 at this point, because there are many more Democratic senators up for re-election in November than there are Republicans.

What is the consequence of this? The consequence of this is that Bush market-friendly legislation, i.e., stock market-friendly legislation is going to be much harder to push through.

That is why the Senate has finally now hammered out a position of extending the dividend and capital gains tax cut another two years until 2010. Bush wants to get that extension through. By the way, he had to give a lot up on the AMT [alternative minimum tax] to get this. There was the log rolling: The Democrats wanted relief on the AMT; Republicans wanted relief on the capital gains and dividend tax extension. They made a trade that I think will go through. That trade would have been a slam dunk had it been before Bush's ratings had fallen so dramatically.

Bush's fall in popularity might mean a divided congress. But the American public has said that they don't mind that. It's a check and balance on the system. We had that for the last four to six years of the Clinton administration and we continued our economic boom. I have a feeling the House might go Democratic because there's an accumulation of frustration: The ratings for Congress are lower than the ratings for the President. They are in the low 30s for the President and in the 20s for Congress. People are saying, "I want a change!"

My feeling is that if you had me bet now, I would bet on the Democrats actually taking the House this November. It's going to be a shock for the Republicans. There's going to be a lot of "Oh, what can we do?" Hopefully, both sides will begin to see the light and try to steer the U.S. in a better direction, because clearly the number of people who say the U.S. is going in the wrong direction is at a very, very high level.

Knowledge@Wharton: I'd like to follow up on that. I think that President Bush is also starting to lose a lot of approval ratings even within the Republican Party. Is that significant?

Siegel: Oh yes, absolutely. There is talk among Republicans that they don't want President Bush to be on the stump with them in the November elections. He is definitely not viewed as an asset. He definitely looks like a weak president. His failures in being able to resolve Iraq are clear.

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Now if things go very well in Iraq, that will increase some of the shine to the President. But there's no question that Republicans are moving away from Bush, and yet they haven't been able to establish their own agenda. But they are obviously very concerned.

Knowledge@Wharton: Getting back to the global economy, if you were to look out for the next six months, what would be your most optimistic scenario for the world economy? And on the flip side, what would be your most pessimistic scenario? And what approach would you recommend to investors under either of those circumstances?

Siegel: Since I published my book over a year ago, I have been a big fan of international diversification. Over 50% of the world's equity capital is outside of the U.S. I actually stuck out my neck in *Future for* Investors saying that investors should have 40% of their equities headquartered outside of the U.S. This recommendation was unprecedented. Most advisors were trying to get their clients to 20%, and most people are 10% or less international. But international diversification is very important. I am optimistic on world stock returns. We have growth in all major regions of the world, both the developed world and the developing world.

Now this growth is putting pressure on interest rates. We talked about that in our last podcast. We have a worldwide increase in interest rates, not just the U.S., so it is not just caused by the Fed. Investors around the world are saying, "Hey, you know what? Growth is back."

When growth is back, then the demand for loans is back. Firms start spending again; they start borrowing again. This puts pressure on the bond market. This raises interest rates and that keeps stocks and other assets from getting too high. But I think stocks are in line, although the emerging markets are still very bubbly.

People are asking me about two sectors of the market: emerging stocks and small stocks. I say that I'm concerned about those two sectors, not that they are way out of line, but they don't look cheap to me the way big international stocks look. I think it's very promising for investors in equities going forward. Again, don't overweight the emerging markets because I think that their rise is partly fueled by the commodities boom and partly fueled by tremendous capital inflows. So be very cautious about overweighting there. But in terms of the world equity markets, I think the outlook looks very good.

What could happen on the down side? There is always something to worry about. There's always Iran to worry about; there's oil going to $100 a barrel or who knows, even higher. My feeling is that the bubble is going to burst before we're going to get that high. I think that we're going to suddenly see some very down days in commodities and that's going to be ultimately encouraging. Once commodities settle down and people realize, "Wow, housing is under control, commodities are finally under control," they will become very bullish on equities. That is a very good scenario for the large cap stocks worldwide.

Knowledge@Wharton: One follow-up question to that. We mentioned that Bolivia's president, Evo Morales, has nationalized the natural gas fields, and apparently he's planning to do the same with other natural resources in that country. Can he pull this off? Or is this going to lead to incredible upheaval throughout Latin America?

Siegel: We do see a very left wing populist trend in Latin America with Chavez in Venezuela and now with what we are seeing in Bolivia. Well, you know what? The Arabs nationalized the oil companies back in the 1960s. They said these are our resources and basically they took them over. If you have both expropriation and a loss of foreign capital, that can be very negative to growth.

Countries need foreign investment for growth. Look at China, at how much foreign direct investment is moving in there at the present time. That's combining with all of the domestic saving and investment to

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produce explosive growth. So if you are investment unfriendly, clearly that is going to hurt you long run. But I'm not particularly surprised at Bolivia's actions.

Remember the Russians nationalized Yukos Oil, basically expropriating these private oil and gas companies. So I think that we just have to get used to that -- that the governments are going to basically say that these are ours. If Morales scares away foreign capital, which it looks like he is doing, obviously Bolivia will suffer long run. Every country needs a world capital market if they want development. Most countries are not rich enough to pull it off by themselves. So clearly in the long run, one could say that scaring foreign capital won't be good for the Bolivians.

Knowledge@Wharton: _Finally, are there any issues that you think are important to discuss that we haven't asked you about yet?

Siegel: I think we've talked about most of the issues. What the Federal Reserve is going to do on May 10 is going to be important. We saw a rookie mistake by Bernanke, but he is a quick study and a quick learner. He won't make that mistake again. Everyone at 2:15 on May 10th is going to be looking at the market saying, 'Is that statement going to say that we can afford to pause without an absolute commitment that we're going to do so?

By the way, and I think that this is really important to note that the pause does not mean we are done at 5%. The Fed is going to say, 'I'm going to wait a little longer to see whether the slow down in housing is going to significantly impact the economy. And if I see the economy isn't slowing and I see prices bubbling again,' you can be sure that Bernanke is going continue to raise the rates. At this point though, I think his inclination is to pause after May 10th.

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