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# ECONOMIC AND MARKET COMMENTARY

BY **PROFESSOR JEREMY SIEGEL**

The fourth quarter of last year witnessed the greatest credit shock since the 1930s. It is not surprising that the real economy suffered significantly from the massive disruption in the credit markets that followed the Lehman bankruptcy. Although first-quarter 2009 GDP will decline almost as much as last year's fourth quarter, the composition of that decline, namely a sharp inventory reduction and a small increase in consumption, points to a much better second quarter. This suggests a solid recovery in the second half of this year.

## HOUSING TO STABILIZE

I am particularly encouraged by the sharp drop in mortgage rates. As I write this commentary, 30-year fixed-rate conformable mortgages (less than about $420,000) can be obtained for 4¾%, the lowest rate in 50 years. The reduction in rates was engineered by the Federal Reserve's aggressive buying of conventional mortgage-backed securities that began in March. Although Treasury bond rates hit their lows at the end of 2008, other long-term interest rates fell only moderately, as a high level of risk aversion pervaded non-treasury markets.

The Fed's action to bring these mortgage rates down will help the economy in two ways. First, the ability of homeowners to refinance at lower rates will increase disposable income. Second, these lower rates will stabilize the housing market itself. I believe that housing prices in most areas of the country will fall another 10% at most, and may actually be at the bottom in those locations where owners are not holding out for the best price. I believe that homes selling in foreclosure are now at the bottom price.

The "Affordability Index," which measures the ratio of the median family income to the level of income needed to qualify for a mortgage on the median-priced home, jumped to 173.5 in February, the highest in at least 20 years. And the February data is computed with 30-year fixed mortgage rates at 5.12%. In March the Affordability Index should jump further, as mortgage rates dropped once again. Low rates will stabilize the very housing market that started the credit crisis two years ago and go a long way toward boosting the entire economy.

## CORPORATE EARNINGS

Corporate earnings have been hit hard by the recession, but not as much as indicated by the Standard & Poor's earnings calculations. As I have pointed out in articles in the *Wall Street Journal* and on *Yahoo Finance*, Standard & Poor's calculates aggregate earnings on its index by simply adding the losses of each firm in the Index to the earnings of other firms, without taking into account the market value of each firm. In 2008 we experienced huge losses from the financial firms, many of which have very small market values. For example, S&P claims that for an index investor, AIG's losses of almost $62 billion in the fourth quarter of 2008 more than offset the entire year's profits of Exxon-Mobil. They assert this even though the oil giant has more than 20 times the market value of AIG and a price-to-earnings ratio well below 10.

The way that Standard & Poor's calculates earnings far understates the true earnings capability of an indexed portfolio. By simply adding profits and losses, S&P reported that the S&P 500 Index had aggregate reported earnings of less than $15 per share last year, less than one-fifth the level of 18 months earlier. At current prices, they give the S&P 500 a P/E ratio over 50, which is very expensive on a historical basis.

However, if earnings are weighted by market values, which reflects the portfolio of an indexed investor, a much different picture emerges. The S&P 500 firms earned $71.50 in 2008, giving the market a P/E ratio of just over 11, a very inexpensive valuation from a long-term perspective. Forward-looking P/E ratios are also low and will look even more tempting as profits improve in the second half of the year.

## LONG-TERM RETURNS ON STOCKS FOLLOWING BEAR MARKETS

In a *Barron's* article "Case Closed: Stocks Work," published on March 9, 2009, Gene Epstein profiled research on stocks from my book *Stocks for the Long Run*. Epstein showed that historical returns following periods of below-average returns tended to perform better than average looking forward.

The historical 10-year after-inflation return on stocks ending 2008 was the fourth-worst trailing 10-year return since 1871, and the historical 5-year return was the 15th worst.

**Trailing After-Inflation Returns,** 1871–2008

| | 5-year | 10-year | 20-year | 30-year |
|---|---|---|---|---|
| Best Return | 26.69% | 16.85% | 12.63% | 10.57% |
| Top Quarter | 11.84% | 10.31% | 8.55% | 7.68% |
| Median | 6.97% | 6.84% | 6.85% | 6.23% |
| Bottom Quarter | 2.31% | 3.54% | 4.32% | 4.99% |
| Worst Return | -10.74% | -4.11% | 1.04% | 2.58% |
| 2008 Trailing Returns | -4.25% | -3.15% | 5.17% | 6.60% |

Source: Jeremy Siegel, Stock Index Series

The source data on the return series for the major asset classes can be found in Professor Siegel's book *Stocks for the Long Run*, 4th edition. Professor Siegel compiled his own proprietary indexes on each asset class and updates each data series from the book to reflect most recent periods.
Stocks: The total returns after inflation on the broadest index of stocks available at the time. (Stocks-real-total return index: 1802–2008)

The forward-looking returns after the trailing 5- and 10-year returns were in the bottom quartile of past returns was more attractive than the typical 5- or 10-year period.

The median performance for 10-year forward returns following bottom-quartile 10-year returns was 8.17% per year; this was 133 basis points per year better than median for all 10-year intervals.

The median performance for 5-year forward returns after historical 5-year returns that were in the bottom quartile was 250 basis points per year better than the median of all 5-year periods.

## FORWARD RETURNS ONCE BELOW TREND

The equity market ended 2008 39.4% below its long-term trend line, the fifth-largest gap below the trend since 1865.

The record gap below the long-term trend occurred in 1932, when the market was 43.1% below the long-term trend. The following year, 1933, stocks rallied 58%.

On average, for the seven largest gaps over the past 145 years, the market has rallied 24% in the following year, 21.4% per year over the following three years, and 18.4.% per year over the next five years.

## SUMMARY

I believe that the lows of the equity market have been hit and that the economy will recover in the third quarter. The Fed's massive liquidity injections and the administration's stimulus plan ensure that this economic downturn does not develop into anything worse than the recessions we experienced from 1950 through 1985. Although this recession will be deeper than the mild downturns of 1990–91 and 2001, I believe those who venture into the equity markets now will be richly rewarded in the months ahead.

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Price/Earnings ratio, or "P/E ratio," is a stock's price divided by its historical earnings per share. P/E ratio is a fundamental metric measuring a composite ratio at the index level. It is not intended to demonstrate the potential for growth, income or future earnings.

Basis point "bps" is a unit that is equal to 1/100th of 1%.



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