

Jeremy Siegel, Ph.D. The Future for Investors



Why Stocks Are Dirt Cheap

by Jeremy Siegel, Ph.D.

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No one can guarantee the future of the stock market. But I believe that stock prices are now so extraordinarily cheap that I would be very surprised that if an investor who bought a diversified portfolio today did not make at least 20% or more on his investment in the next twelve months.

Valuations Low Worldwide

The case for equities at these levels is compelling. The last time we have seen prices this low was more than 30 years ago, when the US economy was in far worse shape than today.

The table below lists the price-to-earnings ratios of the world's major stock markets as of October 29. It is taken directly from the Bloomberg World P-E Ratio (WPE) screen. These P-E ratios are calculated based on 2008 earnings, of which the first two quarters have already been reported and the 3rd and 4th quarters' earnings are estimated. Keep in mind that the average historical P-E ratio of the US stock market has been 15 and that when P-E ratios are ten or lower, investors have reaped generous rewards from investing in stocks.

COUNTRY/INDEX	P-E RATIO
North America	
Dow Jones Industrials	10.7
S&P 500 Index	11.7
Nasdaq	16.6
Canada	9.3
Mexico	9.7
Europe	
Euro Stoxx 50	7.9
UK	7.3
France	7.8
Germany	9.5
Spain	7.7
Italy	7.2
Netherlands	5.7
Switzerland	17.3
ASIA	
Nikkei (Japan)	11.4
Hong Kong	8.8
Shanghai	12.3
Australia	8.9
Singapore	8.2

Except for the tech-laden Nasdaq, the US markets are selling at 10 to 11 times 2008 estimated earnings while European markets, save Switzerland, are selling between 7 and 9 times earnings. Asian stocks are also very cheap, as the Japanese Nikkei Index is selling at 11.4 times earnings, not much different than stocks in Hong Kong, Australia, and Singapore. The Chinese market, which had been selling at over 50 times earnings last year is now selling at a far more modest 15 times earnings.

Bears will claim that these P-E ratios are too low, since earnings will sharply deteriorate over the next twelve months. Indeed, the last 12 months of reported earnings on the S&P 500 Index have fallen to \$51.37 from \$84.92 a year earlier. On those numbers, the US market is selling at about an 18 multiple.

But this gives a very distorted picture of the market. Aggregate earnings over

the past year are greatly depressed by huge write-offs not only in the financial sector but in other firms. For example, Ford, GM, and Sprint, whose aggregate market value is less than 0.2% of the S&P 500 Index, lowered the S&P's reported earnings by about \$12.00, more than 20% of the current aggregate earnings.

Even if these firms all go bankrupt and their stock prices go to zero, it would have a negligible impact on the market value of a well-diversified stock portfolio. The same is true of the financial sector as S&P adds the huge losses in banks that now have almost no value today to the earnings of profitable firms. This means that the P-E ratio of firms that are still profitable is far lower than the ratio calculated for the whole index.

Furthermore, it is a major mistake to use earnings in a recession when calculating the right valuation of the market going forward. That is because stock values are dependent on earnings far in the future, not just those estimated over the next 12 month.

Since stocks have historically sold at 15 times annual earnings, the earnings of the next twelve months contribute only 1/15 of the value of the firm, or less than 7%. The other 93% of the value of stock is realized beyond the next twelve months. Right now the "normal" level of earnings, based on trend analysis of past 15 years of earnings on the S&P 500 Index is \$92 a share.

If the average 15 price-earnings ratio applied to these \$92 per share normalized earnings, the S&P 500 Index would be selling at 1380, which is almost 50% above its current level. Even if it takes two, or even three years for earnings to return to the trend line, the normalized valuation of the market is far above what it is today.

Worse Economy in the 1970s

The last time the market was at ten times earnings or less was in the late 1970s and early 1980s. Although the financial stocks are more stressed today, the economy was in much worse shape then. Inflation hit 14.8% in the early 1980s and interest rates on perfectly safe, long-term government securities soared to 15.9%. It is little wonder that nobody wanted stocks when you could pocket nearly 16% per year by just investing in treasury bonds. Short term interest rates soared even higher and some money funds were offering yields near 20%.

To get inflation down from these wrenching levels required an extreme tightening by the Fed, which set the Fed funds target at 20% in both 1980 and 1981. These high rates caused a severe recession and the unemployment rate soared to 10.8%, more than 4 1/2 percentage points higher than the current level. As soon as inflation abated and interest rates eased, the stock market soared. From 1982 onward began the biggest bull market in the history of stocks.

Final Word

Markets go to extremes in both directions. The prices of tech and internet stocks were unjustified in 1999 and 2000, as the Nasdaq soared beyond 5000. But the Nasdaq fell too low in 2002 when it sank to 1100. Similarly, the irrational exuberance in the housing market in 2005 has turned to unjustified despondency for all world stock markets in the fall of 2008. Chew on this fact: The total losses in the world stock markets have been over \$30 trillion dollars over the past year. That is about ten times the entire size of subprime mortgages issued over the past five years, the purported cause of the current crisis. I believe a year from now we will be looking back on this October, kicking ourselves for not having the courage to buy stocks.

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Overall:

20% huh? Jeremy, why not stick to your prediction from last year when you said normal returns would happen. From where we were then, we should be seeing a 50% return from here - and by year-end!

thart2us - Wednesday, November 5, 2008, 8:38AM ET [Report Abuse](#)

Overall:

Great commentary and good use of facts. Important that he plows under the surface of conventional wisdom predictions on where the market is heading. Well written, better than 90% of the stuff yahoo puts out.

pthlsstrvld - Wednesday, November 5, 2008, 7:34AM ET [Report Abuse](#)

Overall:

I basically agree with the last few comments with a little more hope for the future beyond 6 years. My retirement is over 15 years away and I will continue to buy stocks for that. However the short term looks rough.

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Overall:

P/E's may be low by historical standards but the market does not look at history. The market looks ahead to future earnings. And these earnings look bleak, particularly with a democrat administration which is willing to "tax excess windfall corporate profits" (Obama referring to "excess" earnings of U.S. oil companies). In light of the global financial crisis and the impending recession, stocks are, in fact, very expensive.

ishopp - Wednesday, November 5, 2008, 5:36AM ET [Report Abuse](#)

Overall:

I go to Siegel's page mainly to read the comments, which are far more interesting and useful. Siegel touts the stock market on a single dimension, P/E ratio, when the macro environment is having much greater impact on stock prices. The debate on whether the US economy is facing inflation or deflation is more important than the old talk about P/E, and currently the global liquidity situation is

dominating the market direction. Thank you other commentators.

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